



Belon Group

2006

Performance Results

In 2006, Belon Group continued consistent implementation of the strategic development plans designed in 2003.

Coal Production

In 2006, our enterprises produced 3,381,000 tons of coal, including:

- 1,657,000 tons of steam coal;
- 1,502,000 tons of metallurgical coal;
- 222,000 tons of slime to be processed at the coal preparation plant.

In 2006, Aggregate production of run-of-mine coal increased insignificantly as compared to 2005 - 3,381,000 against 3,225,000. However, the 2006 production of metallurgical coal increased as compared to 2005 - 1,502,000 against 1,049,000 or by 43%.

Metallurgical coal production increase was due to the following factors:

- An increase in the production at the first section of the Novobachatsky open-pit mine amounted to 307,000 tons in 2006 against 97,000 tons in 2005.
- Production at the Novaya-2 mine incorporated into the group in March 2006, constituted to 352,000 tons.

At the same time, a certain decrease in the production at the Chertinskaya-Koksovaya mine took place - 900,000 tons in 2006 against 1,046,000 tons in 2005. A lowered production volume was caused by complicated mining and geological factors of face working, which led to periodical company shut-offs due to safety considerations to carry out blowout prevention and degassing works.

The 2007 volume of entire Group's metallurgical coal production amounted to 545,000 tons. First of all, one should note a considerable increase in the rate of production at the Chertinskaya-Koksovaya mine - 337,000 tons due to the elimination of restraining factors (+18% to the same period of 2005).

The Novobachatsky open-pit mine also showed a considerable increase in production - 126,000 tons, which virtually corresponds to the full estimated capacity of the open-pit mine. The works in the frameworks of the exploration license at the second section of the open-pit mine are being continued at full speed. The stripping volume planned for 2007 should amount to 7,450,000 cubic meters. This will allow beginning of preproduction mining at this section as early as in 2008.

In compliance with the modernization plan for the Novaya-2 mine approved by the Technical Council, coal mining at this mine will be suspended in June 2007 due to its preparation for new equipment installation. Coal mining will resume in November-December 2007, after a new mechanized complex consisting of a DBT plough machine and a GLINIK lining comes into operation. Application of a lining technology for thin layer mining should ensure the monthly coal output of no less than 65,000 tons with a considerably decreased ash level of produced coal.

Decreased production at the Listvyazhnaya mine in 2006 was caused by periodical production shut-offs due to the concluding stage of mine modernization. At the beginning of 2007, a new mechanized production complex consisting of a JOY MACHINERY machine (Great Britain) and a Zhengzhou Machinery lining (China) with Tiffenbach GmbH power hydraulics (Germany) started to work at the Listvyazhnaya mine. The results of production at the Listvyazhnaya mine in the 1st quarter of 2007, which amounted to 550,000 tons, reinforce our confidence that the production plan for 2007 (2,700,000 tons) is quite feasible for this enterprise.

Coal Preparation

Metallurgical coal. The volume of run-of-mine coal preparation in 2006 amounted to 4,389,000 tons against 6,665,000 tons in 2005. The decrease was caused by two factors: a scheduled shut-off of operations at the Chertinskaya coal preparation plant that had reached the end of its operating age and whose liquidation started in April 2006 (-674,000 tons of coal), and decreased deliveries of coal by third-party suppliers to the Belovo coal preparation plant—a total of 1,600,000 tons of coal. A decrease in delivery was caused by the Group's refusal to perform

preparation according to tolling schemes under unfavorable market conditions not to decrease the product quality and by the considerable loss of profitability of these operations.

Following the results of 2006, tolling coal preparation amounted to only 877,000 tons compared to the actual value of 3,933,000 tons in 2005. At the same time, the volume of preparation of own coal increased from 1,266,000 tons in 2005 to 1,735,000 tons in 2006 (an increase of 37%). The volume of purchased coal increased from 1,456,000 tons in 2005 to 1,776,000 tons in 2006 (an increase of 22%).

The overall change in the plant's workload led to a decrease in the output of finished product from 5,141,000 tons to 3,018,000 tons. Besides, the change in the structure of delivered coal towards hard-cleaning grades of coal of the Belovo basin resulted in a certain decrease of the concentrate output in 2006 as compared to 2005. However, the change in the structure of delivered coal towards own and purchased raw materials resulted in a non-significant decrease in the sales volume of concentrate. While in 2005 the sold volume of the Group's concentrate amounted to 2,764,000 tons, in 2006 this indicator went down to 2,520,000 tons (i.e. a 9% decrease).

The operating indicators took a positive change in the first quarter of 2007 due to both the improved market conditions and the increase in the production of the Group's enterprises. The volume of preparation at the Belovo coal preparation plant amounted to 1,179,000 tons, which meets the projected forecast value of 4,800,000 tons for the annual program. In addition, a certain increase in the "output" of concentrate took place, which led to the production of concentrate in the amount of 863,000 tons (the estimate for the entire 2007 is 3,300,000 tons).

Steam coal. In 2006, the quality of produced coal at the Listvyazhnaya mine decreased as compared to 2005 due to unfavorable mining and geological conditions. The ash level of the produced run-of-mine coal varied between 18% and 25%. Deterioration of quality influenced the Group's pricing policy, which prevented an increase in the price of the product in spite of favorable market conditions. This fact confirmed once again the appropriateness of the decision passed to expedite construction of Listvyazhnaya coal preparation plant.

Trading in Mill Products

Against the background of the favorable situation with construction growth in Russia in 2006, this business trend demonstrated an increase in all indicators. Sales went up from 266,000 tons in 2005 to 282,000 tons in 2006. In addition, 3 trading facilities were opened in St.Petersburg, Krasnoyarsk and Arkhangelsk in 2006.

Financial Results

Due to changes in the Group's consolidated accounting statements for 2005, which occurred for reasons outlined in the Auditor's Report, comparison of financial indicators is performed using the already adjusted profits and earnings figures.

The Group's earnings in 2006 amounted to 396 million dollars, which is lower than the adjusted earnings of 2005 (481 million dollars) by 21%. The sharpest decline of earnings occurred for metallurgical coal (a 33% decline). Earnings from steam coal fell less significantly (a 14% decline). Earnings from mill products trade increased (a 14% increase).

Apart from the earnings-inhibiting factors discussed above, a sharp decline in the prices for metallurgical coal concentrates in the first half of 2006 was also a significant contributing factor. According to the FGUP VUKHIN, the average metallurgical coal concentrate price decline in Russia amounted to 14% in a six-month period. However, for the Group the decline was more substantial and amounted to over 20% for certain delivery destinations. In the second half of 2006, the drop in prices stopped, stabilization took place and an up-trend took shape. This anticipated up-trend was confirmed in the first quarter of 2007. The contract prices for delivered concentrate went up by approximately 12%.

At the end of 2006 and beginning of 2007, a long-term 5-year contract was signed with the OAO Novolipetskiy Steel Mill for metallurgical coal supplies, as well as one-year contracts with other key customers. Long-term contracts with the OAO Magnitogorskiy Steel Mill and OOO Uralskaya Stal (Orsko-Khalilovski Steel Mill) are currently being negotiated.

All the above circumstances resulted in a sales decline for the entire Group from 117 million dollars down to 83 million dollars, or by 30%. Apart from the decline in earnings, another

considerable factor that had contributed to diminished business profitability was an inflationary growth of uncontrolled expenditures. In particular, the growth of commercial costs was brought about by the rising railroad tariffs.

	2005	2006
Commercial costs	27	35
Administrative costs	23	23
Other operating costs	7	11

Despite a certain share of success in the implementation of the long-term costs-mitigating program that was launched in early 2006, the growth of raw materials and feed prices could not be leveled at the expense of lowering costs per unit.

The growth of costs was indirectly caused by the considerable amount of efforts directed by the Group's management at ensuring mining work safety. The Group allocated the total of 12.5 million dollars for these purposes. This work is to be continued in 2007, and the total amount of funds allocated for safety purposes will reach 20 million dollars.

The Group's Investment Program

In 2006, the Group made massive investments into the projects that would be crucial for the future growth of coal production:

- The Listvyazhnaya mine—37 million dollars;
 - The Novobachatsky open-pit mine—24 million dollars;
 - The Novaya-2 mine—25 million dollars;
 - The Kostromovskaya mine—26.5 million dollars;
 - The Chertinskaya mine—14 million dollars .
- Total production investment - 126.5 million dollars

The construction of the Listvyazhnaya coal preparation plant was also extensively financed. The volume of investment in 2006 amounted to 32.7 million dollars. 4 million dollars was invested into the scheduled equipment upgrade at the Belovo coal preparation plant.

The total volume of disbursed investments following the results of 2006 came up to 152 million dollars. The sources of investment were: the Group's internal funds in the amount of 71million dollars and borrowed funds in the amount of 81 million dollars. This led to a certain increase in the amount of the Group's net debt that went up by 104 million dollars to reach 227 million dollars. As a result, the costs of paying interest rates also increased—from 1 million dollars (2005) to 7 million dollars in 2006.

Personnel

Due to an increase in production and business expansion, the size of the Group's human resources also increased. Whereas in 2005 the staff size was 6,767 people, in 2006 it went up to 7,665, or increased by 13%.

The wage fund grew from 36 million dollars in 2005 to 45 million dollars in 2006, or by 25%. The average monthly wages went up from 443 USD in 2005 to 489 USD in 2006, or by 12.4%. The growth of the average wages is conditioned by a certain increase in labor productivity and by the implementation of sectoral agreements with the trade unions concerning the inflation indexing.

Changes in the Accounting Policy

In 2006, the Company's management made changes in the Group's accounting policy related to interest on borrowings. According to the amendments made, interest on borrowings

aimed at purchasing and creation of assets is included into the cost of such assets (it is capitalized). The management believes that such a change will allow for a more accurate reflection of the cost of such assets. The decision on changes in the accounting policy was taken based on the experience of the global mining companies and on the recommendations made by the consulting auditors.

Starting from 2003, the Group began to implement the program for increased coal production. In 2006 the work associated with preparation of mine workings that were to provide for the main field of operations in the subsequent years, was conducted most actively. Because the coal production process is divided in time into two sub-processes—tunneling and mining itself, deferred expenses emerge in accounting during advance tunneling over the existing mining. These expenses are reflected in current assets as "deferred tunneling of mine workings".

In 2006, the Group also introduced changes in the classification of fixed assets putting coal reserves in a separate group in accounting, which led to a change in the costs of fixed assets. For the same reason, section "Depreciation" features the increased costs of coal reserves depreciation.