Volga Gas plc
**Annual Report and Accounts**
For the year ended 31 December 2010

2010

Contents



# Review of 2010

Volga Gas plc is an independent oil and gas exploration and production company focused on the Volga Region of Russia. It has offices in London, Moscow and Saratov and has 100% interests in four oil and gas exploration and production licences in the Saratov and Volgograd regions.

Steady production from the supra-salt Uzenskoye oil field in the Karpenskiy Licence Area

Sub salt exploration drilling at Grafovskaya #1 completed but not commercially successful

Successful extended production testing on the Vostochny Makarovskoye gas/condensate field

Combined Russian classification C1/C2 recoverable reserves of 67.3 million barrels of oil equivalent on Uzenskoye and Vostochny Makarovskoye

Revenues of US$13.1 million in 2010, positive EBITDA and positive operating cash flow maintained

Year end cash and deposits of US$26.6 million and no debt

Front cover image: Jacques Descloitres, MODIS Land Rapid Response Team

# Corporate Directory

**Registered Office**
Ground Floor, 17-19 Rochester Row
London SW1P 1QT
United Kingdom

**Company Secretary**
Tony Alves
of the registered office

**Nominated Adviser and Joint Broker**
Oriel Securities Ltd
125 Wood Street
London EC2V 7AN
United Kingdom

**Auditors**
PricewaterhouseCoopers LLP,
Chartered Accountants and Statutory Auditors
32 Albyn Place, Aberdeen AB10 1YL
United Kingdom

**Lawyers and Solicitors to the Company as to English and Russian Law**
As to English law:
Akin Gump Strauss Hauer & Feld
8th Floor, Ten Bishops Square
London E1 6EG
United Kingdom

**As to Russian law:**
Akin Gump Strauss Hauer & Feld LLP
Ducat Place II, 7 Gasheka Street
123056 Moscow
Russia

**Registrar**
Capita Registrars
The Registry
34 Beckenham Road, Beckenham
Kent BR3 4TU
United Kingdom

**Corporate Communications/PR**
Financial Dynamics
26 Southampton Buildings
London WC2A 1PB
United Kingdom

**Joint Broker**
Renaissance Securities (Cyprus) Limited
4 Archbishop Makarios III Avenue
Capital Center, 9th Floor
Nicosia 1505
Cyprus



Designed and produced by [illegible] Design Consultants Ltd
Telephone +44 [illegible]

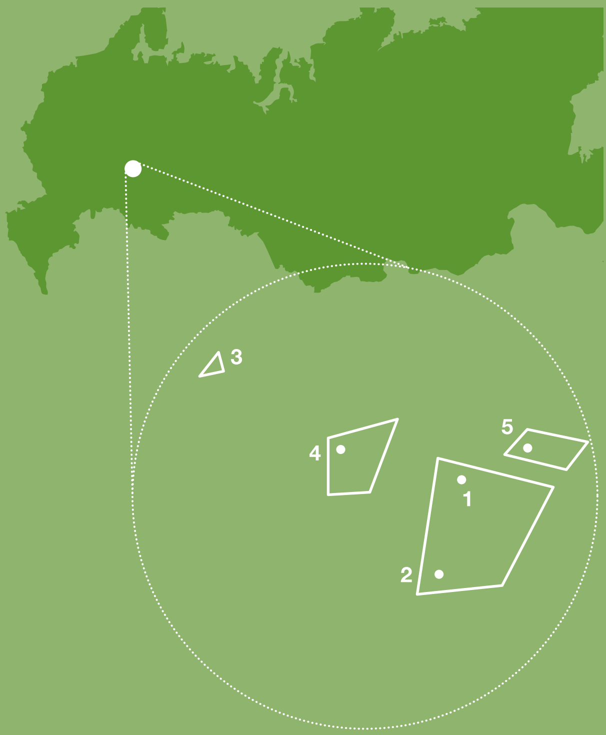
Volga Gas plc
Ground Floor
17–19 Rochester Row
London
SW1P 1QT

**www.volgagas.com**

# Volga at a Glance

**Our assets are located in an established oil and gas province. The area benefits from the existing rail, road and pipeline infrastructure and proximity to Russia's main energy markets.**

Continued steady production from the Uzenskoye field enabled the Company to maintain positive operating cash flow and EBITDA in 2010. With eventual completion of the Vostochny Makarovskoye project and further potential developments, the Company targets further growth in production in the short and medium term.




| 2010 progress | 2011 objectives |
|---|---|
| **1. Karpenskiy ( Sub-Salt)**<br>– Grafovskaya #1 reached total depth of 5,379 metres in April 2010.<br>– Five flow tests conducted on potential hydrocarbon bearing zones but no commercial flow rates were established. | – Data from Grafovskaya #1 to be used for evaluation of further possible sub-salt exploration. |
| **2. Karpenksiy (Supra-Salt)**<br>– Second year of production, averaging 1,116 barrels of oil per day (2009: 1,267 bopd).<br>– Russian C1/C2 reserves of 13.5 mmbbl with 32% upgrade of C1 reserves to 9.7 mmbbl. | – Maintain/enhance production profile and maximise extraction of oil.<br>– Drill new production well. |
| **3. Vostochny Makarovskoye**<br>– First two development wells successfully placed on extended test production.<br>– Negotiations with Trans Nafta on gas processing unit. | – Complete acquisition of gas processing unit.<br>– Install sulphur treatment unit.<br>– Continue test production and prepare for full scale field production from Vostochny Makarovskoye. |
| **4. Pre-Caspian Licence Area**<br>– Geological studies and interpretation of 3-D seismic data. | – Selection of a suitable exploration target to meet exploration drilling commitment by end of 2011. |
| **5. Urozhainoye-2 Licence Area**<br>– Preparation for drilling of a commitment well. | – Drill an exploration well close to an existing oil discovery well. |

# Chairman's Statement

## We believe that Volga Gas has a strong asset base and the financial and operational capability to develop and extend these to provide long term value growth for our shareholders.

**2010 has been a year of transition for Volga Gas. The production side of the business performed well and enabled the Group to continue generating positive net operating cash flow and to maintain a strong financial position with US$26.6 million of net cash. In addition, the Group has significant proven reserves in its two principal fields, which form the basis of a rising profile of future production. Our fields are advantageously located and our costs are sufficiently low for us to achieve good returns at oil and gas prices significantly lower than those we currently enjoy. Most importantly, we have fulfilled our licence commitments on the Karpenskiy and Vostochny Makarovskoye licences and have sufficient funds to meet the commitments due in other licence areas.**

During 2010 drilling of the Group's first deep sub-salt exploration well was completed and the well was subjected to a series of flow tests. Unfortunately, although there were five zones in the well with indications of hydrocarbons, no commercial flow rates were achieved.

Whilst this result is clearly a disappointment, it had no impact on our existing reserves or on our other exploration targets. The Group has identified material exploration targets within existing acreage that can be tested at low cost. These will form the short-term focus of activity. In addition, the deeper sub-salt potential of the area remains untested in other parts of the licence areas, on which, based on the knowledge gained from our first well we may consider further sub-salt drilling in the future.

On the Vostochny Makarovskoye ("VM") field, we continued to deal with the legal and commercial matters that have so far delayed the development. Much of the physical infrastructure for VM is in place and the initial wells are ready for production. In fact, the wells have been placed successfully on long-term test production.

As stated in previous Annual Reports, Volga Gas had planned to acquire a 75% interest in a gas processing unit ("GPU") built by Trans Nafta 5km from the VM licence area. After a lengthy but successful legal process over the last two years, we now appear to be reaching a conclusion which will result in Volga Gas acquiring the gas processing unit and other assets from Trans Nafta. We hope for a timely resolution of this matter and to move on to start production from the VM field.

### Outlook and strategy

During 2011, the strategic priority of the Group will be to make significant progress towards full commercial operation of the VM field. The Board is also evaluating opportunities to extend the Group's activities into new areas, where we have identified the potential to add significant value and incremental production volumes.

The Board believes that Volga Gas has a strong asset base and the financial and operational capability to develop and extend these to provide long term value growth for our shareholders.

**Alexey Kalinin**
Chairman

**Storage tanks at the Uzenskoye field**

# Chief Executive's Report

## We look forward to delivering a successful new stream of production and to pursuing the other growth opportunities that we see for the business.

**During 2010, Volga Gas benefited from the successful development of the Yuzhny Uzenskoye field which has provided and continues to provide valuable and profitable oil production, enabling the Group to report increased revenues and gross profits. We also made good advances on the development of the Vostochny Makarovskoye ("VM") gas-condensate field, with a successful extended production test on the two initial wells. In the course of the year, we also identified a new material and relatively low cost exploration target within the Karpenskiy Licence Area which could materially add to the Group's oil and gas reserves.**

The major event of 2010 was, however, the testing of the Grafovskaya #1 sub-salt exploration well. As I explain in the Operational Report below, this was, regrettably, unsuccessful. Our disappointment is partly offset by the fact that the operations were conducted without incident and within budgeted cost and provided useful geological data which we can use across our other sub-salt licence areas. Nevertheless, this well was the culmination of significant investment over the past three years and, based on the results of the well, we feel it is prudent to recognise substantially all of this investment as impaired. As detailed in the Financial Report below, this has led to an exploration expense of US$23.9 million in the 2010 Income Statement.

Following this result, we have decided for the time being to focus the Group's efforts and investment on the development of our proven reserves and on exploration activity in shallow horizons where we have already had some success.

One of our key objectives now is to bring the VM field into production. Much of the development work has been accomplished. We completed two production wells and installed intra-field pipelines in 2009, and during the second half of 2010 we successfully conducted extended production tests on these two wells.

Following the conclusion of the legal processes and subject to the settlement under negotiation as mentioned above in the Chairman's Statement, we anticipate being able to move in a timely manner towards first production from the VM field. In 2007 and early 2008 construction was commenced of a suitably scaled processing facility for the VM field but was put on hold in November 2008. Certain parts (including an $H_2S$ processing unit) of this facility will need to be relocated to the Dobrinskoye gas processing unit ("GPU") site and further upgrades undertaken to the GPU to enable production to commence from the VM field. Our aim is to achieve this before the end of 2011.

### Current trading

Since the beginning of 2011, oil production from the Uzenskoye field has been steady at approximately 1,300 bopd. We have so far not experienced any significant weather-related disruptions which impacted our oil production early in 2010. With oil sale prices having increased further since the start of the year and costs remaining relatively low, Volga Gas continues to enjoy positive net operating cash flow.

### Outlook

Key activities for 2011 will include ongoing management and development of existing production. The Group's priority is to bring the VM field into production as soon as possible after the commercial and legal matters with Trans Nafta have been resolved. Drilling activity in 2011 comprises an exploration well on the Urozhainoy-2 Licence Area, and a development well on the Uzenskoye oil field. The budgeted cost of these two wells is US$5.5 million.

Certain fiscal changes have been included in draft legislation in Russia. These include proposals that would substantially reduce the tax burden on small oil fields. Based on current draft legislation, we anticipate the Uzenskoye field may benefit from these anticipated changes.

We look forward to delivering a successful new stream of production and to pursuing the other growth opportunities that we see for the business.

**Mikhail Ivanov**
Chief Executive Officer

# Operational Review

## The main features of 2010 were the completion of the Grafovskaya #1 sub-salt exploration well, steady oil production from Uzenskoye and of extended test production on the Vostochny Makarovskoye field.

### Operations overview

The Group's principal activities in 2010 were: completion of the drilling of the Grafovskaya #1 sub-salt exploration well and subsequent testing operations and the commencement of extended test production on the Vostochny Makarovskoye gas-condensate field. On the Uzenskoye supra-salt oil field the Group continued to manage production from the wells drilled in 2008 and 2009 leading to steady production that provides the Group with a valuable source of cash generation which has enabled Volga Gas to remain cash flow positive.

The Group's Russian category C1 and C2 recoverable oil, gas and condensate reserves, as approved by the State Committee for Reserves, total 67.3 million barrels of oil equivalent (2009: 67.7 mmboe) taking into account production of 0.4 mmbbl during 2010. The reserves are presented in detail in the table below. The changes from the previous year reflect volumes of oil produced and a reclassification of certain C2 category reserves into C1 category.

### Karpenskiy Licence Area

Early in 2008 we amended the terms of the Karpenskiy Licence Area ("KLA"), thereby resolving certain licence breaches the Group inherited when it acquired the licence from a LUKOIL subsidiary. The amended licence agreement required the Group to finalise the acquisition of 400km$^2$ of 3-D seismic and drill a further ten exploration or production wells over the following two years. The drilling of the Grafovskaya #1 sub-salt well completed the exploration commitments on the KLA.

### Sub-salt exploration

In April 2010 the Grafovskaya #1 sub-salt exploration well reached a total depth of 5,379 metres and a full string of casing was set. The drilling rig was demobilised and a lower cost workover rig mobilised to the well site, to undertake a series of tests on the well. The testing programme involved perforation, acid treatment and flow testing in a sequence of five horizons starting from the deepest and working up to the shallowest. While strong shows of hydrocarbons were found in three of the tested intervals and some flow to surface was recorded, the rates were deemed to be sub-commercial.

The test results were clearly a disappointment. However, we were pleased with the operational management of the well which was drilled and tested safely, on time and within budgeted cost.

The data gathered from the well will be used to help refine our understanding of the sub-salt potential of other areas of our licences. While we continue to believe in the potential for significant oil and gas reserves in the sub-salt horizons of our licences, for the time being, our exploration activity will concentrate on lower cost shallow targets with which we have had some success already.

### Supra-salt exploration

In April 2010 we disclosed that following analysis of 3-D seismic data, C3 prospective resources had been calculated on a supra-salt and intra-salt structure on the Yuzhny Mokrousovskoye area in the northern portion of the KLA. The C3 resources associated with this total 153 million barrels of oil equivalent representing a potentially material increment to Volga Gas' reserves should a discovery of this size be made.

### Supra-salt production

Having completed the first phase of development drilling in 2009, during 2010, the main focus was on managing production from the five active wells on the Yuzhny Uzenskoye oil field.

During the months of March and April 2010, heavy snow falls followed by the subsequent thaw led to significant disruptions to transportation by the purchasers of our oil which is collected directly from the field site. Consequently, there were periods during which the wells were temporarily shut-in. When the wells were re-opened, it was discovered that the reservoir pressure had significantly increased. This indicates that there is an active water drive in the Yuzhny Uzenskoye field and that for the time being, water injection into the field will not be required.

The Yuzhny Uzenskoye field, whilst of modest scale, is very profitable to the Group. It was developed at a cost of US$1.91 per barrel of C1 reserves and benefits from very low production costs, averaging US$1.07 per barrel (2009: US$0.71 per barrel). In addition as the oil is sold directly at the field facilities, the field bears no oil transportation costs. Details of the financial performance are in the Financial Review below.

Average production for the full year 2010 was 1,115 bopd with production during the second half of the year averaging 1,289 bopd. Since the start of 2011, production has remained steady at a rate of approximately 1,300 bopd. Development plans for 2011 includes an additional well intended to access an undeveloped pocket of the reservoir and upgrades to the in-field roads.

**Flow line during Vostochny Makarovskoye test production**

**Gas flare during test production on the Vostochny Makarovskoye field**

## Vostochny Makarovskoye Licence Area

The Group completed its first phase three well drilling programme on the VM field early in 2009. As previously reported, there are two completed and tested wells on the field with intra field pipelines laid between the well locations to the boundary of the Dobrinskoye gas facility in preparation for production.

During 2010, the Group conducted an extended pilot production programme on the VM#1 and VM#2 wells. The wells were individually flowed through a test separator installed at the field site. Condensate was gathered in storage tanks on location for sale while gas produced from the wells was flared. Although this activity was primarily a technical test programme, it provided a small profit contribution. All costs, including installation of test equipment, were expensed in 2010.

While the test programme has yet to be completed, the data gathered so far has enabled the Group to develop a production plan for the field. Initial production from the field will be managed to enable higher recovery of condensate from the reservoir in the early years while in the later years, an increasing proportion of gas is planned to be produced from the wells.

Commencement of full time production has been delayed pending completion of the previously planned acquisition by the Group of a 75% interest in the gas processing unit ("GPU") located approximately 5km from the VM licence area. With the anticipated settlement of the legal and commercial disputes with Trans Nafta moving to a conclusion, we hope shortly to commence the final work required to bring the VM field into production. Included in the required work is an upgrade to the GPU so it can become fully operational, including transfer of a sulphur treatment unit from the VM licence area to the GPU.

**Mikhail Ivanov**
Chief Executive Officer

**Oil, gas and condensate reserves**

| | Recoverable reserves category | | |
|---|---|---|---|
| | C1 | C2 | C1+C2 |
| **Vostochny-Makarovskoye** | | | |
| Natural Gas (bcf) | 164.5 | 87.5 | 252.1 |
| Condensate (mmbbl) | 8.3 | 3.9 | 12.2 |
| **Total (mmboe)** | **35.8** | **18.5** | **54.2** |
| **Yuzhny Uzenskoye (Karpenskiy Licence supra-salt)** | | | |
| Crude Oil (mmbbl) | 9.3 | 3.8 | 13.1 |

| Group total | C1 | C2 | C1+C2 |
|---|---|---|---|
| Gas (bcf) | 164.5 | 87.5 | 252.1 |
| Condensate (mmbbl) | 8.3 | 3.9 | 12.2 |
| Crude oil (mmbbl) | 9.3 | 3.8 | 13.1 |
| **Total (mmboe)** | **45.0** | **22.3** | **67.3** |

# Financial Review

## During 2010 our operations were primarily in an exploration and development phase although we also benefited from sustained production from the shallow oil reserves in the KLA.

### Results for the year

In 2010, the Group generated US$13.1 million in turnover (2009: US$11.6 million) from the sale of 407,050 barrels of crude oil and condensate (2009: 458,900 barrels). Oil and condensate sales were made into the domestic market during the period. The average price realised was the equivalent of US$32.06 per barrel (2009: US$25.76 per barrel). With sales made exclusively into the regional market in the Volga Region at the wellhead, our sales prices closely reflect international prices, adjusted for export taxes and transportation costs. The oil production activities generated a gross profit of US$6.2 million in 2010 (2009: profit of US$5.8 million).

As indicated in the Operational Review, the average cost of production from the Uzenskoye oil field was US$1.07 per barrel (2009: US$0.71 per barrel). Production based taxes increased to US$12.91 per barrel (2009: US$9.65), reflecting the increase in the Urals oil price which determines the rate of Mineral Extraction Tax. Gross profit per barrel of oil sold in 2010 was US$15.26 per barrel (2009: US$13.27 per barrel).

Operating and administrative expenses in 2010 were US$4.7 million (2009: US$3.7 million) as a result of higher legal expenses.

During 2H 2010, the Group undertook extended production testing on the Vostochny Makarovskoye gas-condensate field. The full costs incurred, including installation of test equipment and operating costs, were expensed during the year. These costs, offset by condensate sales from test production, were included in exploration and evaluation expenses.

The Group experienced positive EBITDA (defined as operating profit before non-cash charges, exploration expense, depletion and depreciation) of US$2.6 million (2009: US$3.0 million).

After recording an exploration and evaluation expense of US$23.9 million (2009: US$1.5 million), comprising primarily an impairment charge relating to the unsuccessful Grafovskaya #1 well in the KLA, the Group recorded an operating loss for the year of US$22.5 million (2009: operating profit of US$0.6 million).

The Group recognised a loss before tax of US$22.2 million (2009: profit before tax of US$0.9 million) and reported net loss after tax and minorities interests of US$16.9 million (2009: profit of US$0.2 million). These numbers include current and deferred income tax credits of US$5.3 million (2009: charges of US$0.7 million).

No dividends have been paid or proposed for the year (2009: none).

### Cash flow

Group net cash flow from operating activities was US$7.3 million (2009: US$4.0 million), before expensed exploration costs. The net cash flow of the Group was enhanced by a net US$4.5 million (2009: US$2.5 million) from positive working capital movements and from the recovery of VAT on past capital expenditures. Having accrued net prepayments in earlier years, the cash outflow from investing in exploration and development assets in 2010 was US$14.0 million (2009: US$20.2 million), slightly less than the capital expenditure for the year.

### Capital Expenditure

During 2010 a total of US$14.1 million was invested in capital expenditure on the Group's licence areas (2009: US$23.7 million) as detailed below:

| | **2010 (US$ million)** | 2009 (US$ million) |
|---|---|---|
| Oil & gas exploration assets | **12.5** | 9.8 |
| Development & producing assets | **1.3** | 13.7 |
| Real Estate assets | **0.3** | 0.2 |
| **Total** | **14.1** | **23.7** |

The most significant individual components of the capital expenditure were US$12.5 million on Oil & Gas Exploration assets, predominantly the Grafovskaya #1 exploration well. Expenditure on development and producing assets primarily relates to the VM field.

### Balance Sheet and Financing

As at 31 December 2010, the Group held cash and bank deposits of US$26.6 million (2009: US$33.6 million) and remains debt free.

As at 31 December 2010, the Group's intangible assets were reduced to US$29.0 million (2009: US$40.1 million) following the impairment charge related to the Grafovskaya#1 well. The prepayment of RUR 600 million, made to Trans Nafta in November 2008 continued to be recorded as a security deposit on acquisition of fixed assets, pending final resolution on planned acquisition of the gas plant assets.

**Cattle herding in the Karpenskiy licence area**

The Group intends to fund its development and exploration expenditures using a combination of cash flow from operations and cash-on-hand. The Group will consider raising additional financing, both of equity and debt as appropriate, to explore and develop its asset base.

The Group's financial statements are presented on a going concern basis.

## Issue of share capital

There were no issues of shares during the year to 31 December 2010. During the year to 31 December 2009, the Company issued a total of 27,000,000 shares in a non-preemptive placement generating net proceeds of US$26.6 million.

**Tony Alves**
Chief Financial Officer

## Financial and operational summary

| Sales volumes | 1H10 | 2H10 | 2010 | 2009 |
|---|---|---|---|---|
| Oil & condensate (barrels) | 171,733 | 235,318 | 407,050 | 462,455 |
| Oil & condensate (bopd) | 941 | 1,289 | 1,115 | 1,267 |

| Operating Results (US$ 000) | 1H10 | 2H10 | 2010 | 2009 |
|---|---|---|---|---|
| **Revenue** | **5,156** | **7,896** | **13,052** | **11,580** |
| Production costs | (267) | (169) | (436) | (327) |
| Production based taxes | (2,105) | (3,149) | (5,254) | (4,465) |
| Depletion, depreciation and other | (458) | (692) | (1,150) | (983) |
| **Cost of sales** | **(2,830)** | **(4,010)** | **(6,840)** | **(5,775)** |
| Gross profit | 2,326 | 3,886 | 6,212 | 5,805 |
| Exploration expense | (184) | (23,753) | (23,937) | (1,466) |
| Operating & administrative expenses | (2,485) | (2,248) | (4,733) | (3,728) |
| **Operating profit/(loss)** | **(343)** | **(22,115)** | **(22,458)** | **611** |

| Operating data (US$/bbl) | 1H10 | 2H10 | 2010 | 2009 |
|---|---|---|---|---|
| Net realisation | 30.02 | 33.55 | 32.06 | 25.76 |
| Production costs | 1.55 | 0.72 | 1.07 | 0.71 |
| Production based taxes | 12.26 | 13.38 | 12.91 | 9.65 |
| Depletion, depreciation and other | 2.67 | 2.94 | 2.83 | 2.13 |

| EBITDA calculation (US$ 000) | 1H10 | 2H10 | 2010 | 2009 |
|---|---|---|---|---|
| Operating profit/(loss) | (343) | (22,115) | (22,458) | 611 |
| Exploration expense | 184 | 23,753 | 23,937 | 1,466 |
| DD&A | 458 | 692 | 1,150 | 881 |
| **EBITDA** | **299** | **2,330** | **2,629** | **2,958** |

# Risk Factors

## The Group is subject to various risks relating to political, economic, legal, social, industry, business and financial conditions.

The following risk factors, which are not exhaustive, are particularly relevant to the Group's business activities:

### Volatility of prices for oil and gas

The supply, demand and prices for oil and gas are volatile and are influenced by factors beyond the Group's control. These factors include global demand and supply, exchange rates, interest and inflation rates and political events. A significant prolonged decline in oil and gas prices could impact the viability of some of the Group's exploration activities. Additionally, the Group's production is predominantly sold in the domestic Russian markets which are influenced by domestic supply and demand factors, the level of Russian export taxes and regional transportation costs.

Substantially all of the Group's revenues and cash flows come from the sale of oil and gas. If oil and gas prices should fall below and remain below the Group's cost of production for any sustained period, the Group may experience losses and may be forced to curtail or suspend some or all of the Group's production, at the time such conditions exist. In addition, the Group would also have to assess the economic impact of low oil and gas prices on it's ability to recover any losses the Group may incur during that period and on the Group's ability to maintain adequate reserves.

The Group does not currently hedge its crude oil production to reduce its exposure to oil price volatility.

### Oil and gas production taxes

The Group's sales generated from oil and gas production are subject to Mineral Extraction Taxes, which form a material proportion of the total costs of sales. The rates of these taxes may be subject to increases by the Russian government.

### Exploration and reserve risks

Whilst the Group will seek to apply the latest technology to assess exploration licences, the exploration for, and development of, hydrocarbons is speculative and involves a high degree of risk. These risks include the uncertainty that the Group will discover sufficient commercially exploitable oil or gas resources. Unsuccessful exploration efforts may result in impairment to the balance sheet value of exploration assets.

The Group has disclosed Russian category C1 and C2 reserves for its oil and gas fields, as recorded by the Russian State Committee for Reserves. If the actual results of producing these fields are significantly different to expectations, there may be changes in the future estimates of reserves. These may impact the balance sheet values of the Group's Development Intangible Assets and the Group's Property, Plant and Equipment.

### Environmental risk

The oil and gas industry is subject to environmental hazards, such as oil spills, gas leaks, ruptures and discharges of petroleum products and hazardous substances. These environmental hazards could expose the Group to material liabilities for property damages, personal injuries, or other environmental harm, including costs of investigating and remediating contaminated properties.

The Group is subject to stringent environmental laws in Russia with regards to its oil and gas operations. Failure to comply with such laws and regulations could subject the Group to material administrative, civil, or criminal penalties or other liabilities. Additionally, compliance with these laws may, from time to time, result in increased costs to the Group's operations, impact production, or increase the costs of potential acquisitions.

In particular, the Group's exploration activities in the northern end of the Karpenskiy Licence Area are conducted close to a protected nature area and the natural habitat of the Otis Tarda (Great Bustard), a rare and endangered bird species protected by Russian environmental law. The Group liaises closely with the Federal Service of Environmental, Technological and Nuclear Resources of the Saratov Oblast and conducts environmental studies both as required by, and in addition to, its licence obligations to mitigate any specific risk.

The Group did not incur any material costs relating to the compliance with environmental laws during the period.

### Risk of operating oil and gas properties

The oil and gas business involves certain operating hazards, such as well blowouts, cratering, explosions, uncontrollable flows of oil, gas or well fluids, fires, pollution and releases of toxic substances. Any of these operating hazards could cause serious injuries, fatalities, or property damage, which could expose the Group to liabilities. The settlement of these liabilities could materially impact the funds available for the exploration and development of the Group's oil and gas properties. The Group maintains insurance against many potential losses and liabilities arising from its operations in accordance with customary industry practices, but the Group's insurance coverage cannot protect it against all operational risks.

**Part of the gas processing unit**

### Foreign currency risk
The Group's capital expenditures are predominantly in Russian rubles ("RUR") and its operating costs in both US dollars and RUR. Turnover is in RUR and funding has been raised in US dollars. Any changes in the relative exchange rates among US dollar and RUR could positively or negatively affect the Group's results.

**Business in Russia**
Amongst the risks that face the Group in conducting business and operations in Russia are:

- Economic instability, including in other countries or the global economy that could lead to consequences such as hyperinflation, currency fluctuations and a decline in per capita income in the Russian economy.
- Governmental and political instability that could disrupt, delay or curtail economic and regulatory reform, increase centralised authority or result in nationalisations.
- Social instability from any ethnic, religious, historical or other divisions that could lead to a rise in nationalism, social disturbances or conflict, including terrorist attacks such as the bombing at Moscow Domodedovo airport in January 2011.
- Uncertainties in the developing legal and regulatory environment, including, but not limited to, conflicting laws, decrees and regulations applicable to the oil and gas industry and foreign investment.
- Unlawful or arbitrary action against the Group and its interests by the regulatory authorities, including the suspension or revocation of their oil or gas contracts, licences or permits or preferential treatment of their competitors.
- Lack of independence and experience of the judiciary, difficulty in enforcing court or arbitration decisions and governmental discretion in enforcing claims.
- Expected changes to the federal and local tax systems.
- Laws restricting foreign investment in the oil and gas industry.

### Legal systems
Russia, and other countries in which the Group may transact business in the future, have or may have legal systems that are less well developed than those in the United Kingdom. This could result in risks such as:
- Potential difficulties in obtaining effective legal redress in the court of such jurisdictions, whether in respect of a breach of contract, law or regulation, including an ownership dispute.
- A higher degree of discretion on the part of governmental authorities.
- The lack of judicial or administrative guidance on interpreting applicable rules and regulations.
- Inconsistencies or conflicts between and within various laws, regulations, decrees, orders and resolutions.
- Relative inexperience of the judiciary and courts in such matters.

In certain jurisdictions, the commitment of local business people, government officials and agencies and the judicial system to abide by legal requirements and negotiated agreements may be more uncertain, creating particular concerns with respect to licences and agreements for business. These may be susceptible to revision or cancellation and legal redress may be uncertain or delayed. There can be no assurance that joint ventures, licences, licence applications or other legal arrangements will not be adversely affected by the jurisdictions in which the Group operates.

### Liquidity risk
At 31 December 2010 the Group had US$26.6 million of cash and cash equivalents available to fund its ongoing operations and associated exploration and development activities. At 31 December 2010 the Group has committed and planned capital expenditure of US$5.5 million relating to licence obligations on the Urozhainoye-2 licence area and further development drilling on the Uzenskoye field.

Through its ordinary course activities, the Group is exposed to legal, operational and development risk that could delay cash generation from operations or may require additional capital investment that could place increased burden on the Group's available cash resources.

The Group's discretionary exploration drilling activities on the sub-salt structures on the Karpenskiy and Pre-Caspian Licence Areas may require additional funding. Furthermore, should these activities lead to one or more discoveries, the Group will require significant further funds to appraise and develop these licence areas.

**Tony Alves**
Chief Financial Officer

# Board of Directors




**Alexey Kalinin**
**Non-Executive Chairman**
Appointed to the Board: 14 March 2007
Committee membership: Remuneration

Mr Kalinin is a Senior Partner of Baring Vostok Capital Partners. He joined Baring Vostok in 1999 from Alfa Capital, where he served for six years as the Director of the Department for Direct Investments. Alexei represents the interests of Baring Vostok's funds on the Board of Directors of a wide range of portfolio companies. He has a doctorate from the Moscow Power Engineering Institute, where he conducted scientific research, lectured for 12 years and served as the Director of the Youth Center for Scientific and Technical Creativity. Mr Kalinin is 51 years old.

**Mikhail Ivanov**
**Chief Executive Officer, Executive Director**
Appointed to the Board: 14 March 2007
Committee membership: n/a

Mr Ivanov was Director of Oil and Gas Investments at Baring Vostok. Mr Ivanov has over 18 years experience in the oil and gas industry which includes 10 years working for the Schlumberger Group, beginning his career with Schlumberger Limited as a Field Engineer in Siberian Russia. During his time with Schlumberger he assumed various management and technical positions in Russia, the USA and the United Kingdom. He was responsible for Schlumberger's operations in Iran, Georgia and Azerbaijan. He is the co-founder of a number of successful venture companies. During 2009 he was appointed non-executive director of Zhaikmunai Group Limited. Mr Ivanov holds an M.S. degree in Geophysics from Novosibirsk State University and an M.B.A. from the Kellogg School of Management of Northwestern University. He is an elected member of SPE. Mr Ivanov is 41 years old.

**Antonio Alves**
**Chief Financial Officer, Executive Director**
Appointed to the Board: 12 January 2009
Committee membership: n/a

Mr Alves has had experience with the independent oil and gas industry for over 20 years as one of the leading equity analysts covering the sector. Prior to joining Volga Gas, he was head of oil and gas research for KBC Peel Hunt and was closely involved with the Company's 2007 IPO. He previously held positions with Investec Securities, The Bell Group International and Schroders. He is a Member of the Securities Institute and of the Petroleum Exploration Society of Great Britain. He read mathematics at Cambridge University between 1977 and 1983 both as an undergraduate and a post-graduate research student. Mr Alves is 51 years old. He was appointed as Chief Financial Officer and Company Secretary and joined the Board on 12 January 2009.

**Ronald Freeman**
**Non-Executive Director**
Appointed to the Board: 14 March 2007
Committee membership: Audit, Nomination, Remuneration

Mr Freeman is a non-executive board director of Troika Dialog, (Moscow); Severstal (Cherepovets); Polish Telecom (Warsaw). He is also a member of the Executive Committee of the Atlantic Council (Washington DC), the International Advisory Committee of Columbia Law School (New York); co-chairman of the finance committee of the UK-US Fulbright Commission (London). From 1973 to 1991 and from 1997 until his retirement from Citigroup as co-head of European Investment Banking in 2000, he was an investment banker specialising in financing and mergers and acquisition for companies in the oil and gas industry with Salomon Brothers, now a unit of Citigroup. From 1991 to 1997, he was head of the Banking Department of the European Bank for Reconstruction and Development (London). Prior to that, he practiced law with Baker & McKenzie (Paris) and served as a management consultant in the Paris office of McKinsey & Company. Mr Freeman was born in New York and has dual US and UK citizenship. He has a B.A from Lehigh University and an LL.B. from Columbia Law School (1964). He was admitted to the Bar of the State of New York. He is 71 years old.



**Stephen Ogden**
**Non-Executive Director**
Appointed to the Board: 14 March 2007
Committee membership: Audit, Nomination, Remuneration

Mr Ogden is the Founder & Managing Partner of the First Montenegro Stone Property Fund, and the Co-Founder & Managing Partner of the Istanbul-based Prospera Property Fund. Mr Ogden is the Chairman of the Board of MDM-Print (Russia). Mr Ogden is the former Chairman of the Board of Lenta, Russia's largest privately owned food retailer, and was previously a non-executive director of United Confectioneries (Russia), Heineken Russia and Metropolis Media (former Yugoslavia). He was Chief Financial Officer of the Bochkarev Brewery in St. Petersburg from 1997 to 2002. Prior to becoming Chief Financial Officer of Bochkarev, Mr Ogden was an auditor with KPMG and PricewaterhouseCoopers, and Financial Controller of CS First Boston (Moscow). Mr Ogden has a joint honours degree in economics & politics from Durham University, England, and is a qualified British chartered accountant ("FCA"). Mr Ogden is active in British politics. He is a former Conservative Councillor of Altrincham, Cheshire and his name is on the approved list of Conservative Parliamentary candidates. Mr Ogden is 43 years old.

**Michael Calvey**
**Non-Executive Director**
Appointed to the Board: 14 March 2007
Committee membership: Audit, Nomination

Mr Calvey is a Founder and Senior Partner of Baring Vostok Capital Partners in Moscow, and a Director of Baring Private Equity International, a global private equity firm headquartered in London. Since 1994 Mr Calvey has co-led the investment team managing and has acted as the Chairman of the Investment Committee for all of Baring Vostok's funds. Mr Calvey is currently on the Boards of several of Baring Vostok's portfolio companies. Prior to joining Baring Vostok, Mr Calvey worked at the European Bank for Reconstruction and Development where he was responsible for several of the bank's investments in the oil and gas sector in Russia. Prior to his work with the bank, Mr Calvey was a member of the oil and gas team at Salomon Brothers Inc in New York on a variety of corporate finance and mergers and acquisitions assignments. Mr Calvey has a M.Sc. in accounting and finance from the London School of Economics. Mr Calvey is 43 years old.

**Vladimir Koshcheev**
**Non-Executive Director**
Appointed to the Board: 14 March 2007
Committee membership: n/a
Mr Koshcheev currently acts as President of Joint Stock Company "NPO POG". Until 2009 he was President of Pervaya Investizionno-Stroitelnaya Company LLC, Spinaker LLC. He has been Chairman of CJSC AKSM since 2002. Mr Koshcheev was President of Privolzhskaya Neftyanaya Company LLC between 2003 and 2005 and was previously a shareholder in and acted as President of Vesla. Mr Koshcheev received a specialist diploma from Moscow State Technical University in 1978 and he is a member of the Russian Academy of Natural Sciences. Mr Koshcheev is 53 years old.

# Corporate Governance Statement

## Introduction
The Board's overriding objective is to ensure that the Group delivers long-term capital appreciation for its shareholders.

## Compliance
Volga Gas plc seeks to comply with the Combined Code on Corporate Governance albeit as an AIM-listed company it is not required to. The Board of Directors is committed to developing and applying high standards of corporate governance appropriate to the Company's size and its future prospects.

This statement sets out measures taken by the Board to apply the principles of the Code to the year ended 31 December 2009 and to the date of the Directors' Report.

## Board of directors
### Role of the Board
The Board's role is to provide entrepreneurial leadership to the Group within a framework of prudent and effective controls which enables risk to be assessed and managed. The Board sets the Group's strategic aims and ensures that the necessary financial and human resources are in place for the Group to meet its objectives, and reviews management's performance in meeting these objectives. The Board sets and monitors the Group's values and standards and ensures that the Group's obligations to shareholders and other stakeholders are understood and met.

The Board has a formal schedule of matters reserved for its approval, including:
- Strategic and policy considerations
- Annual budget, including capital expenditure
- Interim and final financial statements
- Management structure and appointments
- Mergers, acquisitions, disposals
- Capital raising
- Significant changes in accounting policies
- Appointment or removal of Directors or the Company Secretary

### Board composition
The Board currently comprises two executive directors and five non-executive directors, of whom three are deemed to be independent and two non-independent:
- Alexey Kalinin – Non-Executive Chairman
- Mikhail Ivanov – Executive Director and CEO
- Tony Alves – Executive Director, CFO and Company Secretary
- Ronald Freeman – Independent Non-executive
- Stephen Ogden – Independent Non-executive
- Vladimir Koshcheev – Independent Non-executive
- Michael Calvey – Non-executive

There is a clear division of responsibilities between the executive and non-executive directors.

### Board balance and independence
The Board recognises that Messrs Kalinin and Calvey are not independent by virtue of their direct management responsibilities for the limited partnerships comprising Baring Vostok Private Equity Funds III and IV, the Company's controlling shareholder ('Controlling Shareholder'). However, in light of the value, experience and contacts which they afford to the Company at this stage of its development and by virtue of the Relationship Agreement, which, inter alia, ensures that the Controlling Shareholder does not exercise undue influence over the Company or prevent it from acting independently of the Controlling Shareholder, the Board believes that the continued presence of Messrs Kalinin and Calvey on the board is beneficial for the Company. Mr Kalinin also serves as Chairman of the Board and was not considered to be independent on his appointment.

Notwithstanding under the provisions of the Combined Code as a Smaller Company the Company meets the requirements to have at least two independent non-executives on the Board.

All directors are permitted access to independent professional advice in the course of execution of their duties, at the Company's expense.

The Board has established the following committees:

## Audit Committee
The Audit Committee was appointed in March 2007 and comprises three directors:
Mr Ogden – Chairman
Mr Freeman
Mr Calvey

The Audit Committee is responsible for selecting the Group's independent auditors, pre-approving all audit and non-audit related services, reviewing with management and the independent auditors the Group's financial statements, significant accounting and financial policies and practices, audit scope and adequacy of internal audit and control systems.

The audit committee meets at least twice each year.

## Remuneration Committee
The Remuneration Committee was also appointed in March 2007 and comprises three directors:
Mr Freeman – Chairman
Mr Ogden
Mr Kalinin

The Remuneration Committee is responsible for determining compensation of the Company's key employees, including the Chief Executive Officer, Chief Financial Officer, and other key personnel as may be determined from time to time by the Remuneration Committee.

The directors' remuneration report is set out on pages 17 to 18.

## Nomination Committee
The Nomination Committee was appointed in March 2007 and comprises three directors:
Mr Freeman – Chairman
Mr Ogden
Mr Calvey

The Nomination Committee is responsible for reviewing the structure, size and composition of the Board, making recommendations to the Board concerning plans for succession for both Executive and Non-Executive Directors including the Chief Executive and other senior management, preparing a description of the role and capabilities required for a particular appointment and identifying and nominating candidates to fill Board positions as and when they arise.

## Board meetings
The Board met eight times during the year ended 31 December 2010 with the following attendance:

| | **2010** | 2009 |
|---|---|---|
| Alexey Kalinin | **7** | 8 |
| Mikhail Ivanov | **7** | 8 |
| Tony Alves | **8** | 9 |
| Ronald Freeman | **8** | 6 |
| Stephen Ogden | **7** | 7 |
| Vladimir Koshcheev | **5** | 5 |
| Michael Calvey | **7** | 7 |

## Indemnification of directors
In accordance with the Company's Articles of Association and to the extent permitted by the law of England and Wales, directors are granted an indemnity from the Company in respect of liabilities incurred as a result of their office. In respect of those matters for which the directors may not be indemnified, the Company maintained a directors' and officers' liability insurance policy throughout the financial year. This policy has been renewed for the next financial year.

## Re-election of directors
The Company requires that all directors stand for re-election at intervals of no more than three years. Accordingly Messrs Kalinin, Koshcheev and Freeman will retire at the forthcoming AGM and will seek re-election by shareholders.

## Internal controls
The Directors acknowledge their responsibility for the system of internal controls for the Group and for reviewing its effectiveness. Any system of internal control can only provide reasonable, and not absolute, assurance that material financial irregularities will be detected or that the risk of failure to achieve business objectives is eliminated.

The Group's risk and controls framework covers all material risks and controls including those of an operational, financial, and compliance nature. Internal control procedures consist, inter alia, of formal delegations of expenditure authority by the Board to executive management, and controls relating to key stages of transactions including supplier approval, contract signature, and payment release.

The Directors consider that the frequency of Board meetings and level of detail presented to the Board for its consideration in relation to the operations of the Group provide an appropriate process to identify, evaluate and manage significant risks relevant to its operations on a continuous basis, and this process is considered to be in accordance with the revised guidance on internal control published in October 2005 ('Turnbull Guidance').

## Investor relations
The Company places considerable importance on communication with shareholders and engages them on a wide range of issues.

The Group has an ongoing programme of dialogue and meetings between the executive directors and institutional investors, fund managers and analysts. At these meetings a wide range of relevant issues including strategy, performance, management and governance are discussed within the constraints of the information already made public.

The Company is equally interested in the views and concerns of private shareholders and to this end ensures that the executive directors present the Company at forums where private investors are present.

Shareholders have the opportunity to meet and question the Board at the AGM which will be held on 13 June 2011, at which the Chairman, the Chairman of the Audit Committee and all Executive Directors will be available.

By order of the Board

**Tony Alves**
Company Secretary
28 March 2011

# Report of the Directors

The directors present their report together with the Group's audited consolidated financial statements for the period from 1 January 2010 to 31 December 2010.

## Results and dividend

The Group's results are set out on pages 20 to 25 and show net loss of US$16.9 million for the year to 31 December 2010. The directors do not propose to pay a dividend.

## Subsequent events

Trans Nafta case: In February 2011 the Moscow Court of cassation upheld the initial verdict in the case with Trans Nafta ordering Trans Nafta to pay RUR 640 million (approximately $22 million) representing the advance previously made to Trans Nafta in respect of the acquisition of a 75% interest in a gas processing unit.

## Principal activities, business review and future developments

Volga Gas is a public limited company registered in England and Wales with registered number 5886534, was incorporated in the United Kingdom on 25 July 2006 and listed on AIM on 25 April 2007. Volga Gas operates primarily through subsidiary companies as set out in Note 2.2 to the accounts. The principal activity of the Group is the exploration, development and production of its gas, condensate and oil fields in the Volga Region of European Russia. The Group owns 100% of four licence areas in the Saratov and Volgograd regions: Karpenskiy, Vostochny-Makarovskoye, Pre-Caspian and Urozhainoye-2.

The Group's business strategy is to bring the proven-undeveloped Vostochny-Makarovskoye field into production and to grow production on the supra-salt Uzenskoye field in the Karpenskiy Licence Area ("KLA") whilst at the same time exploring the potentially prospective structures on the Group's licence areas. The Group is also evaluating certain acquisition opportunities.

Highlights of the Group's activities for the period ended 31 December 2010 are:

- Continued and steady production from the Yuzhny Uzenskoye oil field on the KLA
- Completion of drilling and testing of the Grafovskaya #1 sub-salt exploration well on the Yuzhny-Ershovskoye structure on the KLA
- Successful extended production testing of the wells on the Vostochny Makarovskoye gas-condensate field.
- Ongoing negotiations over a gas processing facility to enable production from the Vostochny-Makarovskoye licence area.

The Group's activities are described in greater detail in the Chief Executive's Review on page 3 and in the Operational Review on pages 4 to 5. The principal risks associated with the Group's activities are set out in the Financial Review on pages 6 to 7.

## Key performance indicators

Given the nature of the business and that the Group is in a start-up phase of operations, the directors are of the opinion that further analysis using KPI's is not appropriate for an understanding of the development, performance or position of our business at this time. The directors are of the opinion that the Operational Review on pages 4 to 5 provides the relevant information.

## Directors

The directors who served during the year were:
Alexey Kalinin, non-executive Chairman
Mikhail Ivanov, Chief Executive Officer
Michael Calvey, non-executive
Tony Alves, Chief Financial Officer
Ronald Freeman, non-executive
Vladimir Koshcheev, non-executive
Stephen Ogden, non-executive

Messrs Kalinin, Koshcheev and Freeman will retire by rotation and offer themselves for re-election in accordance with the Company's Articles of Association.

## Directors' interests

The directors serving during the year had the following beneficial interests in the shares of the Company:

| | **31 December 2010** | Ordinary Shares of 0.01p each 31 December 2009 |
|---|---|---|
| Alexey Kalinin[1] | **–** | – |
| Mikhail Ivanov | **1,000,000** | 1,000,000 |
| Tony Alves | **25,000** | 25,000 |
| Ronald Freeman | **55,000** | 55,000 |
| Stephen Ogden | **115,000** | 115,000 |
| Vladimir Koshcheev | **650,000** | 650,000 |
| Michael Calvey[1] | **–** | – |

1 Mr Calvey and Mr Kalinin are Co-Managing Partners of Baring Vostok Capital Partners Limited, a related party to Cavendish Nominees Limited and Dehus Dolmen Nominees Limited. As such Mr Calvey and Mr Kalinin have an indirect beneficial interest in the Company.

## Substantial shareholders

On 22 March 2011 the following parties had notifiable interests of 3% or greater in the nominal value of the Company's issued 0.01p ordinary shares:

| | Number of shares | Percentage |
|---|---|---|
| Cavendish Nominees Ltd[1] | 39,620,000 | 48.90 |
| Dehus Dolmen Nominees Ltd[2] | 7,906,889 | 9.76 |
| HQ Fonder Sverige AB | 4,499,633 | 5.55 |

1 Cavendish Nominees Ltd is a nominee vehicle which holds the interests of the limited partnerships which comprise Baring Vostok Private Equity Fund III.
2 Dehus Dolmen Nominees Ltd is a nominee vehicle which holds the interests of the limited partnerships which comprise Baring Vostok Private Equity Fund IV.

### Options granted
An Executive Share Option Plan was adopted by the Company in July 2008 following which options over a total of 1,706,196 shares were granted to Mikhail Ivanov and to Tony Alves. During 2010 options over 450,247 shares (2009: 71,092 shares) were eligible for vesting. The details of these option grants are disclosed in the Remuneration Report below.

### Interests in contracts
There were no contracts or arrangements during the period in which a director of the Company was materially interested and which were significant in relation to the business of the Company.

### Creditors payment policy and practice
The Group aims to pay all its creditors promptly. For trade creditors it is the Group's policy to:
(i) agree the terms of the payment at the start of the business with that supplier;
(ii) ensure that suppliers are aware of the terms of the payment; and
(iii) pay in accordance with contractual and other obligations.

### Political and charitable contributions
No political or charitable contributions were made in the year.

### Employment policies
The Group is committed to pursuing an equal opportunities employment policy, covering recruitment and selection, training, development, appraisal and promotion. The Group recognises the diversity of its employees, its customers, and the community at large and seeks to use employees' talents to the fullest. This approach extends to the fair treatment of people with disabilities, in relation to their recruitment, training and development. Full consideration is given to staff who become disabled during employment.

### Employee communication
The Group is committed to effective communications, which it maintains through regular information releases and staff briefings. Formal communications with employees take place through these channels. With respect to the Group's operations in Russia and the recruitment of Russian employees, announcements, contracts, interviews and advertisements are conducted in the English and Russian languages, as applicable.

### Health, safety and the environment
The Group's policy and practice is to comply with health, safety and environmental regulations and requirements of the countries in which it operates, to protect its employees, contractors, assets and the environment.

The Company closely monitors its environmental obligations under the terms of its licence agreements. In particular, portions of the Karpenskiy Licence Area are located in the Saratovskiy Federal Nature Reserve and Tulipannaya Steppe Natural Sanctuary, which are protected by Russian environmental law. In accordance with Russian environmental law, all economic activity within the protected area is approved by the Russian government. The Otis Tarda, also known as the great bustard, a rare and endangered bird, occupies portions of the Karpenskiy Licence Area; the Company has ensured that all its activities minimise the impact on the birds' habitat.

### Share capital
The Company has authorised ordinary share capital of 330,720,100 shares of 1p each. Under a special resolution by the shareholders of the Company on 14 June 2010 the directors have authority to allot shares up to an aggregate nominal value of £1,000,000 of which £150,000 could be issued non-preemptively, in accordance with sections 570 and 573 of the Companies Act 2006. This authority will expire the earlier of (i) fifteen months from the passing of the Resolution, or (ii) the conclusion of the Annual General Meeting of the Company to be held in 2011.

### Statement of disclosure of information to auditors
As at the date of this report the serving directors confirm that;
- so far as the directors are aware, there is no relevant audit information of which the Company's auditors are unaware; and
- they have taken all steps that they ought to have taken as directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

### Auditors
The Company's auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office and a resolution concerning their reappointment will be proposed at the next Annual General Meeting.

### Statement of directors' responsibilities
Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the group and parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and the company and of the profit or loss of the group for that period.

# Report of the Directors continued

In preparing those financial statements, the directors are required to:

– select suitable accounting policies and then apply them consistently;
– make judgements and estimates that are reasonable and prudent;
– prepare the financial statements on the going concern basis unless it is inappropriate to presume the Group will continue in business; and
– state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and the group and enable them to ensure that the financial statements and the directors' remuneration report comply with the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the company and the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

### Electronic communications

The maintenance and integrity of the Volga Gas plc website (www.volgagas.com) is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

The Company's website is maintained in compliance with AIM Rule 26.

Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

On behalf of the Board

**Alexey Kalinin**
Chairman of the Board
28 March 2011

# Directors' Remuneration Report

In common with the Board's commitment to compliance with the Combined Code, the Company has adopted the Principles of Good Governance relating to directors' remuneration. The Company discloses certain information relating to directors' remuneration in this report, which is not audited.

### Remuneration Committee
The Company established a Remuneration Committee in April 2007, as set out in Corporate Governance on pages 12 to 13.

The Remuneration Committee advises the Board on Group compensation policy as it relates to executive directors and other key members of management, and may obtain advice from independent remuneration consultants appointed by the Company. The Remuneration Committee comprises Ronald Freeman (Chairman), Stephen Ogden and Alexey Kalinin, who are all deemed to be non-executive directors. Executive directors may be invited to attend meetings of the Remuneration Committee but do not vote on their own remuneration or incentives. The Remuneration Committee meets as required.

### Remuneration Policy
The Company's policy is to maintain levels of compensation for the Group that are comparable and competitive with peer group companies, so as to attract and retain individuals of the highest calibre, by rewarding them as appropriate for their contribution to the Group's performance.

### Executive Directors' Employment Agreement and Terms of Appointment
The terms of each executive director's appointment are set out in their service agreements. Each executive director agreement is based on similar terms, with no fixed duration. Each service agreement sets out details of basic salary and share options as applicable.

All executive director employment agreements can be terminated either by the director concerned or by the Company on giving six months notice during the first 24 months of service and thereafter by giving three months notice.

The executive directors do not participate in any Group pension scheme and their remuneration is not pensionable. However, one of the executive directors has elected to receive part of his remuneration by way of contributions to a personal pension plan. The executive directors are eligible for payment of cash bonuses and participation in any share-based incentive plan the Board implements.

### Basic salaries
The basic salary of each executive director is established by reference to their responsibilities and individual performance.

### Non-Executive Directors' Terms, Conditions and Fees
The non-executive directors have been engaged under the terms of their letters of appointment. These engagements are for two years and can be terminated upon one month's notice by either party. Re-appointment is subject to the Company's Articles of Association which provide that one third of the directors shall be required to retire each year.

### Fees
The fees paid to non-executive directors are determined by the Board and reviewed periodically to reflect current rates and practice commensurate with the size of the Company and their roles.

The remuneration of the non-executive directors is a matter for the Chairman of the Board and the Chief Executive Officer. In the event of the appointment of an independent non-executive Chairman his remuneration would be a matter for the Chairman of the Remuneration Committee and the Chief Executive Officer.

**Audited Information – Directors Detailed Emoluments**

| | Salary US$ 000 | Pension Contribution US$ 000 | Share Based Compensation US$ 000 | Fees US$ 000 | **Aggregate Remuneration for the Year 31 December 2010 US$ 000** | Aggregate Remuneration for the Year 31 December 2009 US$ 000 |
|---|---|---|---|---|---|---|
| **Executive Directors** | | | | | | |
| M. Ivanov | 404 | – | 15 | – | **419** | 437 |
| A. Alves | 273 | 31 | 108 | – | **412** | 320 |
| **Non-Executive** | | | | | | |
| A. Kalinin | – | – | – | – | **–** | – |
| R. Freeman | – | – | – | 50 | **50** | 50 |
| S. Ogden | – | – | – | 50 | **50** | 50 |
| V. Koshcheev | – | – | – | – | **–** | – |
| M. Calvey | – | – | – | – | **–** | – |

# Directors' Remuneration Report continued

## Directors' Interests in the Share Capital of the Company

The Directors' interests in the share capital of the Company are disclosed in the Report of the Directors on pages 14 to 16. There has been no change in the interest of any director between 1 January 2010 and the date of this report.

## Directors' Share Options

The Company adopted an Executive Share Option Plan ("ESOP") on 14 July 2008, which was subsequently amended on 17 December 2008. Under the terms of this Plan, a maximum of 2,843,661 shares (equivalent to approximately 5% of the then issued share capital) may be allocated and subject to performance criteria and vesting periods as specified by the Remuneration Committee.

During 2008, the Company granted options to acquire 1,137,464 Ordinary Shares to Mikhail Ivanov under the terms ESOP. The options may be exercised at a price of 405p per share and vest in equal portions on May 2010, 2011 and 2012 and will remain outstanding until May 2017. On 17 December 2008, Tony Alves was granted options to acquire 568,732 Ordinary Shares in the Company at an exercise price of 100p per share. The options will vest over a period of up to four years subject to the satisfaction of performance conditions which are related to the market price of the Company's shares. The vested options become exercisable on a straight line, cumulative basis at a rate of 12.5% of the total option grant every six months (starting from the date of grant) and will remain exercisable until eight years from the date of grant. During 2010, options over 450,247 shares became eligible for vesting (2009: 71,092 shares).

By order of the Board

**Tony Alves**
Company Secretary
28 March 2011

# Independent Auditors' Report to the Members of Volga Gas plc

We have audited the group and parent company financial statements (the ''financial statements'') of Volga Gas plc for the year ended 31 December 2010 which comprise the Group Income Statement, the Group Statement of Comprehensive Income, the Group Balance Sheet, the Group Cash Flow Statement, the Company Balance Sheet, the Company Cash Flow Statement, the Group Statement of Changes in Shareholders' Equity, the Company Statement of Changes in Shareholders' Equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

## Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

## Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's and parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

## Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and the parent company's affairs as at 31 December 2010 and of the group's loss and group's and parent company's cash flows for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

## Opinion on other matter prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

## Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

**Kevin Reynard (Senior Statutory Auditor)**
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Aberdeen
29 March 2011

# Group Income Statement (presented in US$ 000)

| Year ended 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **Continuing operations** | | | |
| Revenue | | **13,052** | 11,580 |
| Cost of sales | 5 | **(6,840)** | (5,775) |
| **Gross profit** | | **6,212** | 5,805 |
| Exploration and evaluation expense | 5(a) | **(23,937)** | (1,466) |
| Operating and administrative expenses | 5 | **(4,733)** | (3,728) |
| **Operating (loss)/profit** | | **(22,458)** | 611 |
| Finance income | 6 | **144** | 87 |
| Other gains and losses – net | 7 | **97** | 183 |
| **(Loss)/profit for the period before tax** | | **(22,217)** | 881 |
| Current income tax | 8 | **1,518** | (21) |
| Deferred income tax | 8 | **3,808** | (716) |
| **(Loss)/profit for the period before non-controlling interests** | | **(16,891)** | 144 |
| Attributable to: | | | |
| Non-controlling interests | | **(22)** | (88) |
| **The owners of the parent company** | | **(16,869)** | 232 |
| Basic and diluted (loss)/profit per share (in US dollars) | 9 | **(0.21)** | 0.004 |
| *Weighted average number of shares outstanding* | | ***81,017,800*** | *66,915,354* |

*The Company has elected to take the exemption under section 408 of the Companies Act 2006 to not present the parent company profit and loss account. The loss for the parent company for the year was US$1,158,000 (2009: US$1,086,000).*

# Group Statement of Comprehensive Income (presented in US$ 000)

| Year ended 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **(Loss)/profit for the period** | | **(16,891)** | 144 |
| Other comprehensive expense: | | | |
| Currency translation differences | | **(1,007)** | (2,037) |
| **Total comprehensive expense for the period** | | **(17,898)** | (1,893) |
| Attributable to: | | | |
| Non-controlling interests | | **(22)** | (88) |
| **The owners of the parent company** | | **(17,876)** | (1,805) |

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Group Balance Sheet (presented in US$ 000)

| At 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **Assets** | | | |
| **Non-current assets** | | | |
| Intangible assets | 10 | **28,965** | 40,093 |
| Property, plant and equipment | 11 | **37,493** | 37,628 |
| Other non-current assets | 12(a) | **3,578** | 6,229 |
| Security deposit on acquisition of fixed assets | 12(b) | **19,687** | 19,839 |
| Deferred tax assets | 8 | **5,105** | 1,211 |
| **Total non-current assets** | | **94,828** | 105,000 |
| **Current assets** | | | |
| Cash and cash equivalents | 13 | **26,599** | 32,643 |
| Term bank deposit | 13 | **–** | 1,000 |
| Inventories | 14 | **1,630** | 3,614 |
| Other receivables | 15 | **2,125** | 2,952 |
| **Total current assets** | | **30,354** | 40,209 |
| **Total assets** | | **125,182** | 145,209 |
| **Equity and Liabilities** | | | |
| **Equity** | | | |
| Share capital | 16 | **1,485** | 1,485 |
| Share premium (net of issue costs) | 16 | **165,873** | 165,873 |
| Other reserves | 17 | **(13,874)** | (12,990) |
| Accumulated loss | | **(30,870)** | (13,911) |
| **Equity attributable to the shareholders of the parent** | | **122,704** | 140,457 |
| Non-controlling interest | | **(114)** | (92) |
| **Total equity** | | **122,590** | 140,365 |
| **Non-current liabilities** | | | |
| Asset retirement obligation | | **162** | 164 |
| **Total non-current liabilities** | | **162** | 164 |
| **Current liabilities** | | | |
| Trade and other payables | 18 | **2,430** | 3,162 |
| Current income tax liability | | **–** | 1,518 |
| **Total current liabilities** | | **2,430** | 4,680 |
| **Total equity and liabilities** | | **125,182** | 145,209 |

Approved by the Board of Directors on 28 March 2011 and signed on its behalf by

**Mikhail Ivanov**
Chief Executive Officer

**Tony Alves**
Chief Financial Officer

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Group Cash Flow Statement (presented in US$ 000)

| Year ended 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **(Loss)/profit before tax and non-controlling interests** | | **(22,217)** | 881 |
| **Adjustments to loss before tax:** | | | |
| Share grant expense | | **123** | 72 |
| Depreciation | | **1,114** | 890 |
| Exploration & evaluation expense | | **23,737** | – |
| Increase in accruals | | **130** | 220 |
| Foreign exchange differences | | **–** | (220) |
| Decrease/(increase) in long-term assets | | **2,612** | 770 |
| **Operating cash flow prior to working capital** | | **5,499** | 2,613 |
| **Working capital changes** | | | |
| Decrease/(increase) in trade and other receivables | | **730** | 3,794 |
| Increase/(decrease) in payables | | **(770)** | 6 |
| Increase in inventory | | **1,963** | (2,067) |
| **Cash flow from operations** | | **7,422** | 4,346 |
| Income tax paid | | **(92)** | (389) |
| **Net cash flow from operating activities** | | **7,330** | 3,957 |
| **Cash flows from investing activities** | | | |
| Expenditure on exploration and evaluation | 10 | **(12,513)** | (7,048) |
| Purchase of intangible assets | 10 | **(26)** | (299) |
| Purchase of property, plant and equipment | 11 | **(1,446)** | (12,847) |
| Maturity of term bank deposit | 13 | **1,000** | (1,000) |
| **Net cash used in investing activities** | | **(12,985)** | (21,194) |
| **Cash flows from financing activities** | | | |
| Proceeds from the issue of shares (net of issue costs) | | **–** | 26,632 |
| Loans received | | **373** | 56 |
| Loans repaid | | **(296)** | – |
| **Net cash provided by financing activities** | | **77** | 26,688 |
| Effect of exchange rate changes on cash and cash equivalents | | **(355)** | 99 |
| **Net increase/(decrease) in cash and cash equivalents** | | **6,044** | 9,550 |
| Cash and cash equivalents at beginning of the year | 13 | **32,643** | 23,093 |
| **Cash and cash equivalents at end of the year** | 13 | **26,599** | 32,643 |

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Company Balance Sheet (presented in US$ 000)

Company registration number: 05886534

| At 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **Assets** | | | |
| **Non-current assets** | | | |
| Investments in subsidiaries | 19 | **151,034** | 144,734 |
| Intercompany Recievables | | **15,950** | 15,876 |
| **Total non-current assets** | | **166,984** | 160,610 |
| **Current assets** | | | |
| Cash and cash equivalents | 13 | **5,292** | 11,999 |
| Term bank deposit | 13 | **–** | 1,000 |
| Other receivables | | **38** | 20 |
| **Total current assets** | | **5,330** | 13,019 |
| **Total assets** | | **172,314** | 173,629 |
| **Equity and Liabilities** | | | |
| **Equity** | | | |
| Share capital | 16 | **1,485** | 1,485 |
| Share premium (net of issue costs) | 16 | **165,873** | 165,873 |
| Other reserves | 17 | **5,196** | 5,073 |
| Accumulated loss | 20 | **(1,840)** | (682) |
| **Total equity** | | **170,714** | 171,749 |
| **Current liabilities** | | | |
| Trade and other payables | | **1,600** | 1,666 |
| Current income tax liability | | **–** | 214 |
| **Total current liabilities** | | **1,600** | 1,880 |
| **Total equity and liabilities** | | **172,314** | 173,629 |

Approved by the Board of Directors on 28 March 2011 and signed on its behalf by

**Mikhail Ivanov**
Chief Executive Officer

**Tony Alves**
Chief Financial Officer

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Company Cash Flow Statement (presented in US$ 000)

| Year ended 31 December | Notes | 2010 | 2009 |
|---|---|---|---|
| **Loss before tax** | | **(1,372)** | (1,410) |
| **Adjustments to loss before tax:** | | | |
| Share grant expense | | **123** | 72 |
| Increase in accruals | | **130** | 220 |
| **Operating cash flow prior to working capital** | | **(1,119)** | (1,118) |
| **Working capital changes** | | | |
| (Increase)/decrease in trade and other receivables | | **(92)** | 38 |
| Decrease in payables | | **(196)** | (6,231) |
| **Cash flow from operations** | | **(1,407)** | (7,311) |
| Income tax paid | | **–** | (389) |
| **Net cash flow from operating activities** | | **(1,407)** | (7,700) |
| **Cash flows from investing activities** | | | |
| Maturity/(placement of) term bank deposit | 13 | **1,000** | (1,000) |
| Investments in subsidiaries | 19 | **(6,300)** | (24,429) |
| **Net cash used in investing activities** | | **(5,300)** | (25,429) |
| **Cash flows from financing activities** | | | |
| Proceeds from the issue of shares (net of issue costs) | | **–** | 26,632 |
| **Net cash provided by financing activities** | | **–** | 26,632 |
| **Net increase/(decrease) in cash and cash equivalents** | | **(6,707)** | (6,497) |
| Cash and cash equivalents at beginning of the year | 13 | **11,999** | 18,496 |
| **Cash and cash equivalents at end of the year** | 13 | **5,292** | 11,999 |

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Group Statement of Changes in Shareholders' Equity (presented in US$ 000)

| | Notes | Attributable to the equity shareholders of the Company | | | | | |
|---|---|---|---|---|---|---|---|
| | | Share Capital | Share Premium | Other Reserves | Accumulated Loss | Non-controlling Interests | Total Equity |
| **Opening equity at 1 January 2009** | | **1,045** | **39,681** | **(11,025)** | **(14,143)** | **–** | **115,558** |
| Profit for the year | | – | – | – | 232 | (92) | 140 |
| **Transactions with owners** | | | | | | | |
| Share capital issued | 16 | 440 | 26,560 | – | – | – | 27,000 |
| Share issue costs | | – | (368) | – | – | – | (368) |
| Share-based payments | | – | – | 72 | – | – | 72 |
| Total transactions with owners | | 440 | 26,192 | 72 | – | – | 26,704 |
| Other comprehensive income | | | | | | | |
| Currency translation differences | | – | – | (2,037) | – | – | (2,037) |
| Total other comprehensive income | | – | – | (2,037) | – | – | (2,037) |
| **Closing equity at 31 December 2009** | | **1,485** | **165,873** | **(12,990)** | **(13,911)** | **(92)** | **140,365** |
| **Opening equity at 1 January 2010** | | **1,485** | **165,873** | **(12,990)** | **(13,911)** | **(92)** | **140,365** |
| Loss for the year | | – | – | – | (16,869) | (22) | (16,890) |
| **Transactions with owners** | | | | | | | |
| Share-based payments | | – | – | 123 | – | – | 123 |
| Total transactions with owners | | – | – | 123 | – | – | 123 |
| Comprehensive income | | | | | | | |
| Currency translation differences | | – | – | (1,007) | – | – | (1,007) |
| Total comprehensive income | | – | – | (1,007) | – | – | (1,007) |
| **Closing equity at 31 December 2010** | | **1,485** | **165,873** | **(13,874)** | **(30,780)** | **(114)** | **122,590** |

# Company Statement of Changes in Shareholders' Equity (presented in US$ 000)

| | Notes | Share Capital | Share Premium | Other Reserves | Accumulated Profit/(loss) | Total Equity |
|---|---|---|---|---|---|---|
| **Opening equity as at 1 January 2009** | | **1,045** | **139,681** | **5,001** | **324** | **146,051** |
| Loss for the year | | – | – | – | (1,006) | (1,006) |
| Share capital issued | | 440 | 26,560 | – | – | 27,000 |
| Share Issue costs | | – | (368) | – | – | (368) |
| Share-based payments | 16 | – | – | 72 | – | 72 |
| **Closing equity at 31 December 2009** | | **1,485** | **165,873** | **5,073** | **(682)** | **171,749** |
| **Opening equity as at 1 January 2010** | | **1,485** | **165,873** | **5,073** | **(682)** | **171,749** |
| Loss for the year | | – | – | – | (1,372) | (1,372) |
| Share capital issued | | – | – | – | – | – |
| Share Issue costs | | – | – | – | – | – |
| Share-based payments | 16 | – | – | 123 | – | 123 |
| **Closing equity at 31 December 2010** | | **1,485** | **165,873** | **5,196** | **(2,054)** | **170,500** |

The accompanying notes on pages 26 to 43 are an integral part of these financial statements.

# Notes to the IFRS Consolidated Financial Statements For the year ended 31 December 2010

## 1. General information

Volga Gas plc (the "Company" or "Volga") is a public limited company registered in England and Wales with registered number 5886534. The company was incorporated on 25 July 2006. The principal activities of the Company and its subsidiaries (the "Group") are the acquisition, exploration and development of hydrocarbon assets and production of hydrocarbons in the Volga Region of the Russian Federation. Its registered office is at Ground floor, 17–19 Rochester Row, London, SW1P 1QT.

The Company is listed on the Alternative Investment Market of the London Stock Exchange.

These Group consolidated financial statements were authorised for issue by the Board of Directors on 28 March 2011.

## 2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

### 2.1 Basis of preparation

The consolidated financial statements of Volga have been prepared in accordance with International Financial Reporting Standards, as adopted by the European Union (IFRSs as adopted by the EU), IFRIC interpretations, and the Companies Act 2006 applicable to companies reporting under IFRS. The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Group's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 4.

No income statement is presented for Volga Gas plc as permitted by Section 408 of the Companies Act 2006.

The consolidated financial statements have been prepared on the going concern basis as the directors have concluded that the Group will continue to have access to sufficient funds in order to meet its obligations as they fall due for at least the foreseeable future.

**Disclosure of Impact of New and Future Accounting Standards**

The following new standards and amendments to standards are mandatory for the first time for the financial year beginning 1 January 2010:

– **IFRS 3 (revised)**, 'Business combinations', and consequential amendments to IAS 27, 'Consolidated and separate financial statements', IAS 28, 'Investments in associates', and IAS 31, 'Interests in joint ventures', are effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009.

  The revised standard continues to apply the acquisition method to business combinations but with some significant changes compared with IFRS 3. For example, all payments to purchase a business are recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the income statement. There is a choice on an acquisition-by-acquisition basis to measure the non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's net assets. All acquisition-related costs are expensed. The adoption of IFRS 3 (revised) had no impact on the Group's financial statements as no business combinations have been undertaken in the period.

  As the Group has adopted IFRS 3 (revised), it is required to adopt IAS 27 (revised), 'consolidated and separate financial statements', at the same time. IAS 27 (revised) requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control and these transactions will no longer result in goodwill or gains and losses. The standard also specifies the accounting when control is lost. Any remaining interest in the entity is re-measured to fair value, and a gain or loss is recognised in profit or loss. There has been no impact of IAS 27 (revised) on the current period, as none of the non-controlling interests have a deficit balance. There have been no transactions whereby an interest in an entity is retained after the loss of control of that entity; there have been no transactions with non-controlling interests.

The following new standards, amendments to standards and interpretations are mandatory for the first time for the financial year beginning 1 January 2010, but are not currently relevant for the Group:

– IFRIC 17, 'Distributions of non-cash assets to owners', effective for annual periods beginning on or after 1 July 2009. This is not currently applicable to the Group, as it has not made any non-cash distributions.
– IFRIC 18, 'Transfers of assets from customers', effective for transfer of assets received on or after 1 July 2009. This is not relevant to the Group, as it has not received any item of PPE or cash that must be used only to acquire or construct the item of PPE in order to connect to a customer's network or to provide a customer with ongoing access to a supply of goods or services (or both).
– 'Additional exemptions for first-time adopters' (Amendment to IFRS 1) was issued in July 2009. The amendments are required to be applied for annual periods beginning on or after 1 January 2010. This is not relevant to the Group, as it is an existing IFRS preparer.
– Improvements to International Financial Reporting Standards 2009 were issued in April 2009. The effective dates vary standard by standard but most are effective 1 January 2010.
– Group Cash-settled Share-based Payment Transactions – Amendments to IFRS 2, Share-based Payment (effective for annual periods beginning on or after 1 January 2010). The

amendments provide a clear basis to determine the classification of share-based payment awards in both consolidated and separate financial statements. The amendments incorporate into the standard the guidance in IFRIC 8 and IFRIC 11, which are withdrawn. The amendments expand on the guidance given in IFRIC 11 to address plans that were previously not considered in the interpretation. The amendments also clarify the defined terms in the Appendix to the standard.

The following new standards, amendments to standards and interpretations have been issued, but are not effective for the financial year beginning 1 January 2010 and have not been early adopted:

- IFRS 9, 'Financial instruments', issued in November 2009 and updated in October 2010. This addresses the classification and measurement of financial assets and is likely to affect the Group's accounting for its financial assets. The standard is not applicable until 1 January 2013 but is available for early adoption. This standard has not yet been endorsed by the EU. The Group is yet to assess IFRS 9's full impact. However, management's initial assessment is that IFRS 9 is unlikely to have any impact on the Group's financial statements. The Group has not yet decided when to adopt IFRS 9.
- Revised IAS 24, 'Related party disclosures', issued in November 2009. It supersedes IAS 24, 'Related party disclosures', issued in 2003. The revised IAS 24 is required to be applied from 1 January 2011. Earlier application, in whole or in part, is permitted.
- 'Classification of rights issues' (Amendment to IAS 32), issued in October 2009. For rights issues offered for a fixed amount of foreign currency, current practice appears to require such issues to be accounted for as derivative liabilities. The amendment states that if such rights are issued pro rata to all the entity's existing shareholders in the same class for a fixed amount of currency, they should be classified as equity regardless of the currency in which the exercise price is denominated. The amendment should be applied for annual periods beginning on or after 1 February 2010. Earlier application is permitted.
- 'Prepayments of a minimum funding requirement' (Amendments to IFRIC 14), issued in November 2009. The amendments correct an unintended consequence of IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction'. Without the amendments, entities are not permitted to recognise as an asset some voluntary prepayments for minimum funding contributions. This was not intended when IFRIC 14 was issued, and the amendments correct the problem. The amendments are effective for annual periods beginning 1 January 2011. Earlier application is permitted. The amendments should be applied retrospectively to the earliest comparative period presented.
- IFRIC 19, 'Extinguishing financial liabilities with equity instruments'. This clarifies the requirements of IFRSs when an entity renegotiates the terms of a financial liability with its creditor and the creditor agrees to accept the entity's shares or other equity instruments to settle the financial liability fully or partially. The interpretation is effective for annual periods beginning on or after 1 July 2010. Earlier application is permitted.
- Disclosures—Transfers of Financial Assets – Amendments to IFRS 7 (issued in October 2010 and effective for annual periods beginning on or after 1 July 2011). The amendment requires additional disclosures in respect of risk exposures arising from transferred financial assets. The amendment includes a requirement to disclose by class of asset the nature, carrying amount and a description of the risks and rewards of financial assets that have been transferred to another party yet remain on the entity's balance sheet. Disclosures are also required to enable a user to understand the amount of any associated liabilities, and the relationship between the financial assets and associated liabilities. Where financial assets have been derecognised but the entity is still exposed to certain risks and rewards associated with the transferred asset, additional disclosure is required to enable the effects of those risks to be understood. This standard has not yet been adopted by the EU.
- Improvements to International Financial Reporting Standards 2010 were issued in May 2010. The effective dates vary standard by standard but most are effective 1 January 2010.

Management expects that these new pronouncements will have no impact on the financial statements of the Group.

### 2.2 Consolidation

**(a) Subsidiaries**

The consolidated financial statements include the financial statements of the Company and its subsidiaries. Subsidiaries are all entities in which the Group directly or indirectly owns more than 50 percent of the voting stock or otherwise has the power to govern the financial and/or operating policies. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

The group uses the acquisition method of accounting to account for business combinations. The consideration transferred for the acquisition of a subsidiary is the fair values of the assets transferred, the liabilities incurred and the equity interests issued by the group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition-related costs are expensed as incurred. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. On an acquisition-by-acquisition basis, the group recognises any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's net assets.

Investments in subsidiaries are accounted for at cost less impairment. Cost is adjusted to reflect changes in consideration arising from contingent consideration amendments.

Cost also includes direct attributable costs of investment.

The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree over the fair value of the group's share of the identifiable net assets

# Notes to the IFRS Consolidated Financial Statements continued

2.2 Consolidation continued

acquired is recorded as goodwill. If this is less than the fair value of the net assets of the subsidiary acquired in the case of a bargain purchase, the difference is recognised directly in the statement of comprehensive income.

Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated; unrealised losses are also eliminated unless the cost cannot be recovered.

The Company and its subsidiaries outside the Russian Federation maintain their financial statements in accordance with IFRS as adopted by the EU. The Russian subsidiaries of the Group maintain their statutory accounting records in accordance with the Regulations on Accounting and Reporting of the Russian Federation. The consolidated financial statements are based on these statutory accounting records, appropriately adjusted and reclassified for fair presentation in accordance with International Financial Reporting Standards as adopted by the EU.

A list of the Company's subsidiaries is provided in Note 19.

2.3 Segment reporting

Segmental reporting follows the Group's internal reporting structure.

Operating segments are defined as components of the Group where separate financial information is available and reported regularly to the chief operating decision maker ("CODM"), which is determined to be the Board of Directors of the Company. The Board of Directors which decide how to allocate resources and assesses operational and financial performance using the information provided.

The CODM receives monthly IFRS based financial information for the Group and its development and production entities. There were two development and production entities during both 2009 and 2010. Management has determined that the operations of these production and development entities are sufficiently homogenous (both are concerned with upstream oil and gas development and production activities) for these to be aggregated for the purpose of IFRS 8, "Operating Segments". The Group has other entities that engage as either head office or in a corporate capacity or as holding companies. Management has concluded that due to application of the aggregation criteria that separate financial information for segments is not required.

No geographic segmental information is presented as all of the companies operating activities are based in the Russian Federation.

Management has determined therefore that the operations of the Group comprise one class of business, being oil and gas exploration, development and production and the Group operates in only one geographic area – the Russian Federation.

There is no concentration of sales with any major customer that is required to be separately disclosed.

2.4 Foreign currency translation

**(a) Functional and presentation currency**

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in US dollars, which is the Company's functional and the Group's presentation currency.

The functional currency of the Group's subsidiaries that are incorporated in the Russian Federation is the Russian ruble ("RUR"). It is the Management's view that the RUR best reflects the financial results of its Cyprus subsidiaries because they are dependant on entities based in Russia that operate in an RUR environment in order to recover their investments. As a result, the functional currency of the subsidiaries continues to be the RUR.

**(b) Transactions and balances**

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement. Translation differences on non-monetary financial assets and liabilities are reported as part of the fair value gain or loss.

Foreign exchange gains and losses that relate to cash and cash equivalents, borrowings and other foreign exchange gains and losses are presented in the income statement within "Other gains and losses".

**(c) Group companies**

The results and financial position of all the Group entities (none of which has the currency of a hyper-inflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
(ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the rate on the dates of the transactions); and
(iii) all resulting exchange differences are recognised in other comprehensive income.

The major exchange rates used for the revaluation of the closing balance sheet at 31 December 2010 were:

– GBP1: US$1.5523 (2009: GBP1: US$1.5653)
– US$1: RUR.30.4769 (2009: US$1: RUR.30.2442)

2.5 Oil and gas exploration assets

The Company applies the successful efforts method of accounting for Exploration and Evaluation ("E&E") costs, in accordance with IFRS 6 "Exploration for and Evaluation of Mineral Resources". Costs are accumulated on a field-by-field basis. Costs directly associated with an exploration well, including certain geological and geophysical costs, and exploration and property leasehold acquisition costs, are capitalised until the determination of reserves is evaluated. If it is determined that a commercial discovery has not been achieved, these costs are charged to expense after the conclusion of appraisal activities. Exploration costs such as geological and geophysical that are not directly related to an exploration well are expensed as incurred.

Capital expenditure is recognised as property, plant and equipment or intangible assets in the financial statements according to the nature of the expenditure and the stage of development of the associated field, i.e. exploration, development, production.

Once commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to development tangible and intangible assets. No depreciation or amortisation is charged during the exploration and evaluation phase.

**(a) Development tangible and intangible assets**
Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells into commercially proven reserves, is capitalised within property, plant and equipment and intangible assets depending on the nature of the expenditure. When development is completed on a specific field, it is transferred to producing assets as part of property and equipment or intangible assets. No depreciation or amortisation is charged during the development phase.

**(b) Oil and gas production assets**
Development and production assets are accumulated generally on a field by field basis and represent the cost of developing the commercial reserves discovered and bringing them into production together with E&E expenditures incurred in finding commercial reserves and transferred from the intangible E&E assets as described above.

The cost of development and production assets also includes the cost of acquisitions and purchases of such assets, directly attributable overheads, finance costs capitalised and the cost of recognising provisions for future restoration and decommissioning.

Where major and identifiable parts of the production assets have different useful lives, they are accounted for as separate items of property, plant and equipment. Costs of minor repairs and maintenance are expensed as incurred.

**(c) Depreciation/amortisation**
Oil and gas properties intangible assets are depreciated or amortised using the unit-of-production method. Unit-of-production rates are based on proved and probable reserves, which are oil, gas and other mineral reserves estimated to be recovered from existing facilities using current operating methods. Oil and gas volumes are considered produced once they have been measured through meters at custody transfer or sales transaction points at the outlet valve on the field storage tank.

**(d) Impairment – exploration and evaluation assets**
Exploration and evaluation assets are tested for impairment prior to reclassification to development tangible or intangible assets, or whenever facts and circumstances indicate that an impairment condition may exist. An impairment loss is recognised for the amount by which the exploration and evaluation assets' carrying amount exceeds their recoverable amount. The recoverable amount is the higher of the exploration and evaluation assets' fair value less costs to sell and their value in use. For the purposes of assessing impairment, the exploration and evaluation assets subject to testing are grouped with existing cash-generating units of production fields that are located in the same geographical region.

**(e) Impairment – proved oil and gas production properties and intangible assets**
Proven oil and gas properties and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. The cash generating unit applied for impairment test purposes is generally the field, except that a number of field interests may be grouped together where the cash flows of each field are interdependent, for instance where surface infrastructure is used by one or more field in order to process production for sale.

**(f) Decommissioning**
Provision is made for the cost of decommissioning assets at the time when the obligation to decommission arises. Such provision represents the estimated discounted liability (the discount rate used currently being at 10% per annum) for costs which are expected to be incurred in removing production facilities and site restoration at the end of the producing life of each field. A corresponding item of property, plant and equipment is also created at an amount equal to the provision. This is subsequently depreciated as part of the capital costs of the production facilities. Any change in the present value of the estimated expenditure attributable to changes in the estimates of the cash flow or the current estimate of the discount rate used are reflected as an adjustment to the provision and the property, plant and equipment. The unwinding of the discount is recognised as a finance cost.

### 2.6 Other business and corporate assets
Property, plant and equipment not associated with exploration and production activities are carried at cost less accumulated depreciation. These assets are also evaluated for impairment when circumstances dictate.

Land is not depreciated. Depreciation of other assets is calculated on a straight line basis as follows:

| | |
|---|---|
| Machinery and equipment | 6–10 years |
| Office equipment in excess of US$5,000 | 3–4 years |
| Vehicles and other | 2–7 years |

# Notes to the IFRS Consolidated Financial Statements continued

## 2.7 Financial assets

The Group classifies its financial assets in the following categories:

**(a) Financial assets at fair value through profit or loss**

Financial assets at fair value through profit or loss are financial assets held for trading. This category comprises derivatives unless they are effective hedging instruments. The Group had no financial assets in this class as at 31 December 2009 or 31 December 2010.

**(b) Loans and receivables**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. This category comprises trade and other receivables and cash and cash equivalents in balance sheet.

## 2.8 Derivative financial instruments

Derivative financial assets and financial liabilities are financial instruments whose value changes in response to an underlying variable, require little or no initial investment and are settled in the future. The Company has used derivatives such as foreign exchange forward contracts to manage risks of changes in foreign exchange rates. The Group has not applied hedge accounting in respect of forward foreign exchange contracts. Consequently, movements in the fair value of derivative instruments are immediately recognised in profit and loss.

## 2.9 Acquisitions, asset purchases and disposals

Acquisitions of oil and gas properties are accounted for under the purchase method where the business meets the definition of a business combination.

Transactions involving the purchases of an individual field interest, or a group of field interests, that do not qualify as a business combination are treated as asset purchases, irrespective of whether the specific transactions involved the transfer of the field interests directly or the transfer of an incorporated entity. Accordingly, no goodwill or deferred tax gross up arises. The purchase consideration is allocated to the assets and liabilities purchased on an appropriate basis.

Proceeds on disposal are applied to the carrying amount of the specific intangible asset or development and production assets disposed of and any surplus is recorded as a gain on disposal in the income statement.

## 2.10 Inventories

Crude oil inventories are stated at the lower of cost and net realisable value. Materials and supplies inventories are recorded at average cost and are carried at amounts which do not exceed the expected recoverable amount from use in the normal course of business. Cost comprises direct materials and, where applicable, direct labour plus attributable overheads based on a normal level of activity and other costs associated in bringing inventories to their present location and condition.

## 2.11 Trade and other receivables

Trade and other receivables are recorded initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate.

## 2.12 Cash and cash equivalents

Cash and cash equivalents include cash in hand, and deposits held at call with banks.

## 2.13 Share capital

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

## 2.14 Trade payables

Trade payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

## 2.15 Current and deferred income tax

The tax expense for the period comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised in other comprehensive income or directly in equity. In this case the tax is also recognised in other comprehensive income or directly in equity, respectively.

The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the countries where the Company's subsidiaries and associates operate and generate taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred income tax is recognised, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the end of the reporting period and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

### 2.16 Employee benefits

**(a) Share-based compensation**

The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non-market vesting conditions (for example, profitability and sales growth targets). Non-market vesting conditions are included in assumptions about the number of options that are expected to vest. The option plan currently in place for certain of the Directors is an equity settled share option plan.

The Company measures the equity instruments granted to employees at the fair value at grant date. The fair value of fully-vested shares is expensed immediately. The fair value of shares with vesting requirements is estimated using Black-Scholes option pricing model. This value is recognised as an expense over the vesting period on a straight-line basis. The estimate is revised, as necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

**(b) Social obligations**

Wages, salaries, contributions to the Russian Federation state pension and social insurance funds, paid annual leave, sick leave and bonuses are accrued in the year in which the associated services are rendered by the employees of the Group.

### 2.17 Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of oil and gas in the ordinary course of the Group's activities. Revenue is shown net of value added tax, returns, rebates and discounts and after eliminating sales within the Group.

**(a) Sales of oil and gas**

Revenue from the sale of oil or gas is recognised when the oil/gas is delivered to customers and title has transferred. Revenue is stated net of value-added tax. For oil sales, this is at the physical point of delivery, i.e. the loading of a customer's truck. For gas sales, this is typically the point of entry to the gas distribution system. In 2009 and 2010 all of the Group's revenue related to oil sales collected directly by customers.

**(b) Interest income**

Interest income is recognised on a time-proportion basis using the effective interest method.

### 2.18 Prepayments

Prepayments are carried at cost less provision for impairment. A prepayment is classified as non-current when the goods or services relating to the prepayment are expected to be obtained after one year, or when the prepayment relates to an asset which will itself be classified as non-current upon initial recognition. Prepayments to acquire assets are transferred to the carrying amount of the asset once the Group has obtained control of the asset and it is probable that future economic benefits associated with the asset will flow to the Group. Other prepayments are written off to profit or loss when the goods or services relating to the prepayments are received. If there is an indication that the assets, goods or services relating to a prepayment will not be received, the carrying value of the prepayment is written down accordingly and a corresponding impairment loss is recognised in profit or loss for the year.

### 2.19 Provisions

Provisions for environmental restoration, restructuring costs and legal claims are recognised when: the group has a present legal or constructive obligation as a result of past events; it is probable that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. Restructuring provisions comprise lease termination penalties and employee termination payments. Provisions are not recognised for future operating losses.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognised as interest expense.

## 3. Financial risk management

### 3.1 Financial risk factors

The Group's activities expose it to a variety of financial risks: market risk (including currency risk, price risk, and cash flow interest rate risk), credit risk, and liquidity risk. The Group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Group's financial performance.

**(a) Market Risk**

(i) Foreign exchange risk

The Group is exposed to foreign exchange risk arising from currency exposures, primarily with respect to the Russian ruble. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities.

At 31 December 2010, if the US dollar had weakened/strengthened by 5% against the RUR with all other variables held constant, post-tax profit for the year would have been US$751,000

# Notes to the IFRS Consolidated Financial Statements continued

### 3.1 Financial risk factors continued

(2009: US$812,000) higher/lower, mainly as a result of foreign exchange gains/losses on translation of RUR denominated trade payables and financial assets. At 31 December 2010, if the US dollar had weakened/strengthened by 5% against the Pound Sterling ("GBP") with all other variables held constant, post-tax profit for the year would have been US$16,000 (2009: US$14,000) higher/lower, mainly as a result of foreign exchange gains/losses on translation of GBP denominated trade payables and financial assets.

The following table shows the currency structure of financial assets and liabilities:

| **At 31 December 2010** | **Rubles US$ 000** | **US Dollars US$ 000** | **Sterling US$ 000** | **Total US$ 000** |
|---|---|---|---|---|
| **Financial assets** | | | | |
| Cash and cash equivalents | **6,008** | **20,100** | **491** | **26,599** |
| Term bank deposit | **–** | **–** | **–** | **–** |
| **Total financial assets** | **6,008** | **20,100** | **491** | **26,599** |
| Financial liabilities (before provision for UK taxes) | **2,174** | **244** | **12** | **2,430** |

| At 31 December 2009 | Rubles US$ 000 | US Dollars US$ 000 | Sterling US$ 000 | Total US$ 000 |
|---|---|---|---|---|
| **Financial assets** | | | | |
| Cash and cash equivalents | 4,032 | 28,219 | 392 | 32,643 |
| Term bank deposit | – | 1,000 | – | 1,000 |
| **Total financial assets** | 4,032 | 29,219 | 392 | 33,643 |
| Financial liabilities (before provision for UK taxes) | 3,060 | 56 | 46 | 3,162 |

No foreign exchange forward contracts were used in 2010 or 2009.

### (ii) Price risk

The Group is not exposed to price risk as it does not hold financial instruments of which the fair values or future cash flows will be affected by changes in market prices.

### (iii) Cash flow and fair value interest rate risk

As the Group has no significant interest-bearing assets and liabilities, the Group's income and operating cash flows are substantially independent of changes in market interest rates.

**(b) Credit risk**

The Group's maximum credit risk exposure is the fair value of each class of assets, presented in note 3.1(a)(i) of US$26,599,000 and US$33,643,000 at 31 December 2010 and 2009 respectively.

The Group's principal financial asset is cash and credit risk arises from cash and cash equivalents and deposits with banks and financial institutions. It is the Group's policy to monitor the financial standing of these assets on an on-going basis. Bank balances are held with reputable and established financial institutions.

The Group's oil sales are undertaken on a prepaid basis and accordingly the Group has no trade receivables and consequently no credit risk associated with trade receivables.

| Rating of financial institution (Fitch) | **31 December 2010** | 31 December 2009 |
|---|---|---|
| AA+ | **–** | – |
| AA- | **13,908** | 13,552 |
| A- | **–** | – |
| BBB+ | **7,691** | 19,752 |
| Other | **–** | 339 |
| **Total bank balance** | **26,599** | 33,643 |

**(c) Liquidity risk**

Cash flow forecasting is performed by Group finance. Group finance monitors rolling forecasts of the Group's liquidity requirements to ensure it has sufficient cash to meet operational needs. The Group believes it has at least sufficient liquidity headroom to fund its currently planned exploration and development activities.

The Group expects to fund its exploration and development programme, as well as its administrative and operating expenses, through 2011 using a combination of existing working capital and expected proceeds from the sale of oil and gas production. If the Group is unsuccessful in generating enough liquidity to fund its expenditures, the Group's ability to execute its long-term growth strategy could be significantly affected. The Group may need to raise additional equity or debt finance as appropriate to fund investments beyond its current commitments.

### 3.2 Capital risk management

The Group's objectives when managing the balance of equity and debt capital are (a) to safeguard the Group's ability to continue as a going concern, (b) provide returns for shareholders and benefits for other stakeholders and (c) to maintain an optimal capital structure to reduce the cost of capital.

In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares or sell assets to reduce debt. To date the Group has been funded entirely by equity capital.

### 3.3 Fair value estimation

Effective 1 January 2009, the Group adopted the amendment to IFRS 7 for financial instruments that are measured in the balance sheet at fair value, this requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1).
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2).
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3).

The Group has no financial assets and liabilities that are required to be measured at fair value.

## 4. Critical accounting estimates and judgments

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

### (a) Carrying value of fixed assets/impairment

Fixed assets are assessed for impairment when events and circumstances indicate that an impairment condition may exist. The carrying value of fixed assets is evaluated by reference to their value in use and primarily looks to the present value of management's best estimate of the cash flows expected to be generated from the asset. In identifying cash flows management firstly determine the cash-generating unit or group of assets that give rise to the cash flows. The cash-generating unit is the lowest level of asset at which independent cash flows can be generated.

The estimation of forecast cash flows involves the application of a number of significant judgements and estimates to a number of variables including production volumes, commodity prices, operating costs, capital investment, hydrocarbon reserves estimates, inflation and discount rates. In addition, judgement is applied in determining the cash-generating unit to be assessed for impairment.

### (b) Estimation of oil and gas reserves

Estimates of oil and gas reserves are inherently subjective and subject to periodic revision. In addition, the results of drilling and other exploration or development activity will often provide additional information regarding the Group's reserve base that may result in increases or decreases to reserve volumes. Such revisions to reserves can be significant and are not predictable with any degree of certainty. Management considers the estimation of reserves to represent a significant judgement in the context of the financial statements as reserve volumes are used as the basis for assessing the useful life of oil and gas assets, applying depreciation to oil and gas assets and in assessing the carrying value of oil and gas assets. Decreases in reserve estimates can lead to significant impairment of oil and gas assets where revisions (positive or negative) can have a significant effect on depreciation rates from period to period.

### (c) Income taxes

Significant judgement is frequently required in estimating provisions for deferred taxes. This process involves an assessment of temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the balance sheet.

### (d) Classification and carrying value of the advance to Trans Nafta (security deposit on acquisition of fixed assets)

In 2008, the Group advanced RUR 600 million to Trans Nafta (TN) in accordance with a sale and purchase agreement for the acquisition of a 75% interest in a gas processing unit being constructed by TN. This amount was classified as a security deposit (prepayment for fixed assets). In 2009, 2010 and 2011 to date negotiations regarding the acquisition have continued with TN. In May 2010, GNS initiated court action because it considered that TN had not complied with the requirements of the original purchase agreement with regard to the completion and registration of the sale of the GPU interest. In August 2010, the Group obtained court rulings in its favour related to the repayment of the advance (plus interest) by TN to the Group. The rulings were upheld by the Court of Cassation in Moscow in February 2011. Notwithstanding the court rulings obtained, management's intention remains to acquire the interest in the GPU and accordingly has continued to present the advance made as a prepayment. Management considers the outcome of negotiations with TN to represent a significant judgement in the context of the financial statement as the outcome of the negotiations may affect the carrying value of the asset recorded or result in settlement other than by way of asset purchase.

# Notes to the IFRS Consolidated Financial Statements continued

### 5. Cost of sales and administrative expenses – Group

Cost of sales and administrative expenses are as follows:

| Year ended 31 December | 2010 US$000 | 2009 US$000 |
|---|---|---|
| Cost of sales | **6,840** | 5,775 |
| Exploration & evaluation expenses | **23,937** | 1,466 |
| Operating and administrative expenses | **4,733** | 3,728 |
| **Total operating and administrative expenses** | **35,510** | 10,969 |

Total operating and administrative expenses are analysed as follows:

| Year ended 31 December | | 2010 US$000 | 2009 US$000 |
|---|---|---|---|
| Exploration & evaluation | (a) | **23,937** | 1,466 |
| Mineral extraction tax | | **5,254** | 4,465 |
| Field operating expenses | | **436** | 327 |
| Depreciation & amortisation | (f) | **1,037** | 881 |
| Salaries & staff benefits | (b) | **1,171** | 938 |
| Directors' emoluments and other benefits | (c) | **942** | 857 |
| Audit fees | (d) | **295** | 285 |
| Taxes other than payroll and mineral extraction | | **245** | 112 |
| Legal & consulting services | (e) | **1,181** | 410 |
| Other | | **1,012** | 1,228 |
| **Total** | | **35,510** | 10,969 |

#### (a) Exploration and evaluation

The principal component of the 2010 exploration and evaluation expense is the impairment charge on the carrying value of intangible assets relating to the Grafovskaya #1 well. This includes the cost of seismic studies as well as costs of drilling and testing operations on the well. In 2009 expenditure on seismic studies certain drilling expenditures relating to supra-salt exploration on the Karpenskiy Licence were expensed as management considered that the expenditure was not related closely enough to specific oil and gas reserves to allow its capitalisation in accordance with IFRS 6 'Exploration for and evaluation of mineral resources'.

#### (b) Staff and salaries

The average monthly number of employees (including Executive Directors) employed by the Group was:

| Year ended 31 December | 2010 | 2009 |
|---|---|---|
| Exploration and production | **28** | 29 |
| Administration and support | **16** | 15 |
| **Total** | **44** | 44 |

Their aggregate remuneration (excluding Executive Directors) comprised:

| Year ended 31 December | 2010 US$000 | 2009 US$000 |
|---|---|---|
| Wages and salaries | **909** | 716 |
| Payroll taxes & social contribution | **210** | 136 |
| Staff benefits | **52** | 56 |
| **Total** | **1,171** | 908 |

The average monthly number of employees employed by the Company was:

| Year ended 31 December | 2010 | 2009 |
|---|---|---|
| Administration and support | **2** | 2 |

Only directors are employed by the Company.

(c) Directors' emoluments and other benefits

Details of Directors emoluments and other benefits for the years ended 31 December 2010 and 31 December 2009 are provided in the Directors' Remuneration Report. Included in Directors' emoluments were share grant expenses of US$123,000 (2009: US$72,000).

(d) Audit Fees – Group and Company

Disclosure of the fees paid to the Company's auditors and its associates is given in Note 21.

(e) Legal expense

An amount of US$1,181,000 is included in legal and consultancy expenses in 2010. The major proportion of this in this was in respect of the court proceedings brought by the Group against the Trans Nafta group. The costs include legal and other consultation services related to preparation for the court proceedings.

(f) Depreciation

Substantially all depreciation relates to oil and gas assets and is included within cost of sales.

## 6. Finance income – Group

Finance income comprises interest earned during the period on cash balances with different financial institutions (Note 13).

## 7. Other gains and losses – Group

| Year ended 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Foreign exchange gain | **81** | 163 |
| Other gains | **16** | 20 |
| **Total other gains and losses** | **97** | 183 |

## 8. Current and deferred income tax – Group

| Year ended 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Current tax: | | |
| Current income tax | **–** | (584) |
| Adjustments to tax charge in respect of prior periods | **1,518** | 563 |
| **Total current tax** | **1,518** | (21) |
| Deferred tax: | | |
| Origination and reversal of timing differences | **3,808** | (716) |
| **Total deferred tax** | **3,808** | (716) |
| **Total tax credit/(charge)** | **5,326** | (737) |

The tax charge in the Group income statement differs from the theoretical amount that would arise using the weighted average tax rate applicable to profits of the consolidated entities as follows:

| Year ended 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Profit/(loss) before income tax and minority interest | **(22,217)** | 881 |
| Tax calculated at domestic tax rates applicable to (profits)/losses in the respective countries | **4,367** | (163) |
| Tax effect of items which are not deductible or assessable for tax purposes: | | |
| Additional deemed taxable income | **–** | (469) |
| Non-deductible expenses | **(124)** | (218) |
| Current tax – adjustments in respect of prior years | **1,518** | 563 |
| Tax losses for which no deferred tax asset was recognised | **(433)** | (400) |
| Other tax adjustments | **–** | (50) |
| **Income tax credit/(charge)** | **5,326** | (737) |

The weighted average applicable tax rate was 19.6% (2009: 18.5%).

# Notes to the IFRS Consolidated Financial Statements continued

## 8. Current and deferred income tax – Group continued

Deferred taxation is attributable to the temporary differences that exist between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. The tax effects of temporary differences that give rise to deferred taxation are presented below:

| | **31 December 2010** | Differences recognition and reversal | 31 December 2009 | Differences recognition and reversal | 31 December 2008 |
|---|---|---|---|---|---|
| Tax effects of taxable temporary differences: | | | | | |
| Exploration assets | **(698)** | 682 | (1,380) | (1,160) | (220) |
| Inventories | **(13)** | (8) | (5) | (12) | 7 |
| **Total** | **(711)** | 674 | (1,385) | (1,172) | (213) |
| Tax effect of deductible temporary differences: | | | | | |
| Tax losses carry forward | **5,271** | 3,154 | 2,117 | 261 | 1,856 |
| Trade and other receivables | **342** | 2 | 340 | (18) | 358 |
| Property, plant and equipment | **196** | 64 | 132 | 130 | 2 |
| Share grant expenses | **7** | – | 7 | 7 | – |
| **Total** | **5,816** | 3,220 | 2,596 | 380 | 2,216 |
| **Net tax effect of temporary differences** | **5,105** | 3,894 | 1,211 | (792) | 2,003 |

Deferred income tax assets are recognised for tax loss carry forwards to the extent that the realisation of the related tax benefit through the future taxable profits is probable. Tax losses in respect of Cyprus and the UK do not expire. The group has not recognised a deferred tax asset of US$750K in respect of tax losses and other short term timing differences in the UK (2009: US$428K).

## 9. Basic and diluted (loss)/profit per share – Group

Profit per share is calculated by dividing the profit attributable to equity holders of the Company by the weighted average number of ordinary and diluted shares in issue during the year excluding Ordinary Shares purchased by the Company and held as treasury shares.

| Year ended 31 December | **2010** | 2009 |
|---|---|---|
| Net (loss)/profit attributable to equity shareholders (per share) | **(0.21)** | 0.004 |
| Net (loss)/profit attributable to equity shareholders | **(16,869)** | 232 |
| Basic weighted number of shares | **81,017,800** | 66,915,354 |

## 10. Intangible assets – Group

Intangible assets represent exploration and evaluation assets such as licenses, studies and exploratory drilling, which are stated at historical cost.

| | Work in progress: exploration and evaluation | Exploration and evaluation | Development assets | Producing assets | Total |
|---|---|---|---|---|---|
| At 1 January 2009 | 5,072 | 7,244 | 18,280 | – | 30,596 |
| Additions | 9,147 | 679 | 290 | 9 | 10,125 |
| Disposals | (197) | – | – | – | (197) |
| Transfers | – | (1,576) | – | 1,576 | – |
| At 31 December 2009 | 14,022 | 6,347 | 18,570 | 1,585 | 40,524 |
| **Accumulated amortisation** | | | | | |
| At 1 January 2009 | – | – | – | – | – |
| Depreciation | – | – | – | (55) | (55) |
| At 31 December 2009 | – | – | – | (55) | (55) |
| Exchange differences | 306 | (252) | (507) | 77 | (376) |
| **At 31 December 2009** | **14,328** | **6,095** | **18,063** | **1,607** | **40,093** |

| | Work in progress: exploration and evaluation | Exploration and evaluation | Development assets | Producing assets | Total |
|---|---|---|---|---|---|
| At 1 January 2010 | 14,328 | 6,095 | 18,063 | 1,664 | 40,150 |
| Additions | 12,496 | 26 | 26 | – | 12,548 |
| Transfers | – | – | – | – | – |
| At 31 December 2010 | 26,824 | 6,121 | 18,089 | 1,664 | 52,698 |
| **Accumulated amortisation and impairment** | | | | | |
| At 1 January 2010 | – | – | – | (57) | (57) |
| Impairment charge | (23,305) | – | – | – | (23,305) |
| Depreciation | | | | (98) | (98) |
| At 31 December 2010 | (23,305) | – | – | (155) | (23,460) |
| Exchange differences | (75) | (48) | (138) | (12) | (273) |
| **At 31 December 2010** | **3,444** | **6,073** | **17,951** | **1,497** | **28,965** |

The impairment in 2010 relates to the write off of the Grafovskaya exploration well on the Karpenskiy licence and associated costs. The Grafovskaya well was the first exploration well on the Yuzhny Ershovskoye prospect. It did not encounter commercial quantities of hydrocarbons and, as a result, the well and associated costs have been written off. Approximately US$1,995,000 of seismic costs related to the unexplored portion of the Karpenskiy licence continue to be included within exploration and evaluation assets.

## 11. Property, plant and equipment – Group

Movements in property, plant and equipment, for the years ended 31 December 2010 and 2009 are as follows:

| **Cost** | Development assets | Land & Buildings | Producing assets | Other | Total |
|---|---|---|---|---|---|
| At 1 January 2009 | 20,442 | 616 | 5,054 | 546 | 26,658 |
| Additions | 13,298 | 157 | 81 | 28 | 13,564 |
| Disposals | (1,445) | – | (8) | – | (1,453) |
| Transfers | (6,177) | – | 6,177 | – | – |
| **At 31 December 2009** | 26,118 | 773 | 11,304 | 574 | 38,769 |
| **Accumulated depreciation** | | | | | |
| At 1 January 2009 | – | – | (80) | (28) | (108) |
| Depreciation | – | – | (822) | (13) | (835) |
| At 31 December 2009 | – | – | (902) | (41) | (943) |
| Exchange adjustments | (297) | (10) | 125 | (16) | (198) |
| **At 31 December 2009** | **25,821** | **763** | **10,527** | **517** | **37,628** |

| **Cost** | | | | | Total |
|---|---|---|---|---|---|
| At 1 January 2010 | 25,821 | 764 | 11,474 | 560 | 38,619 |
| Additions | 1,287 | 313 | – | – | 1,600 |
| Disposals | (339) | – | (94) | – | (433) |
| Transfers | (1,012) | – | 982 | 30 | – |
| **At 31 December 2010** | 25,757 | 1,077 | 12,362 | 590 | 39,786 |
| **Accumulated depreciation** | | | | | |
| At 1 January 2010 | – | – | (947) | (43) | (990) |
| Depreciation | – | – | (998) | (18) | (1,016) |
| At 31 December 2009 | – | – | (1,945) | (61) | (2,006) |
| Exchange adjustments | (194) | (7) | (82) | (4) | (287) |
| **At 31 December 2010** | **25,563** | **1,070** | **10,335** | **525** | **37,493** |

# Notes to the IFRS Consolidated Financial Statements continued

## 12. Non-current assets

### (a) Other non-current assets – Group

| As at 31 December | 2010 US$ 000 | 2009 US$ 000 |
|---|---|---|
| VAT recoverable | **3,572** | 6,189 |
| Other non-current assets | **6** | 40 |
| **Total other non-current assets** | **3,578** | **6,229** |

Management believes that it may not be able to recover all VAT specific to license and E&E contractors' payments within the 12 months of the balance sheet date. Therefore this VAT is classified as a non-current asset.

### (b) Security deposit on acquisition of fixed assets – US$19.7 million (2009: US$19.8 million)

The security deposit on acquisition of fixed assets of US$19.7 million (2009: US$19.8 million) relates to an advance of RUR 600 million that was paid by the Group to Trans Nafta in 2008. The payment was for the Group's share of costs associated with the construction of a Gas Processing Unit ("GPU") to be jointly owned by the Group and Trans Nafta.

Since the initial payment to Trans Nafta, this item has been subject to an ongoing legal process. The background is as follows:
- In October 2008, the Group reached a legal settlement with Trans Nafta relating to the original purchase by the Group of GNS. As part of that settlement the Group and Trans Nafta entered into a sale and purchase agreement ("SPA") relating to the GPU and the Group made an advance payment to Trans Nafta in accordance with the SPA.
- During 2009 and 2010, negotiations continued between the Group and Trans Nafta on the purchase and joint operation of the GPU. However, it became clear that the resolution of the key legal, operational and commercial matters was unlikely to be achieved within a reasonable timeframe.
- On 2 May 2010, legal proceedings commenced by the Group's wholly-owned subsidiary GNS, against OOO Gazneftedobycha ("GND"), a subsidiary of Trans Nafta, for the recovery from GND of the security deposit plus interest accrued since November 2008.
- On 24 August 2010, the Moscow Arbitration Court ordered GND to pay RUR 640 million (approximately US$22 million) to Volga Gas, representing the original prepayment plus an uplift for interest. This judgement was then revised in the Court of Appellation on 22 November 2010.
- A subsequent hearing in the Court of Cassation on 28 February 2011 fully upheld the original judgement given in August 2010.

Having a final judgement on the legal status of the security deposit, the Group is currently negotiating a final settlement with Trans Nafta which is expected to include, inter alia, purchase of the Group's share in the GPU. The interest element of the August judgement (RUR 40 million) has not yet been accrued by the Group as it is deemed to be a contingent asset as at 31 December 2010.

## 13. Term deposits, cash and cash equivalents – Group

| At 31 December | 2010 US$ 000 | 2009 US$ 000 |
|---|---|---|
| Cash at bank and on hand | **21,514** | 14,171 |
| Short-term bank deposits | **5,085** | 18,472 |
| **Total cash and cash equivalents** | **26,599** | 32,643 |
| **Term bank deposit** | **–** | 1,000 |

In November 2009, the Company placed US$1.0 million on a six month term deposit with EBS Building Society in the Republic of Ireland. This was repaid in full on maturity.

An analysis of Group deposits, cash and cash equivalents by bank and currency is presented in the table below:

| At 31 December<br>Bank | Currency | 2010<br>US$ 000 | 2009<br>US$ 000 |
|---|---|---|---|
| Cyprus | | | |
| Bank of Cyprus | RUR | **–** | – |
| United Kingdom | | | |
| The Royal Bank of Scotland | USD | **18,417** | 12,160 |
| The Royal Bank of Scotland | GBP | **491** | 392 |
| Russian Federation | | | |
| Unicreditbank | RUR | **261** | 3,697 |
| Other banks and cash on hand | RUR | **5,747** | 339 |
| Unicreditbank | USD | **1,683** | 16,055 |
| **Total cash at bank and short-term deposits** | | **26,599** | 32,643 |
| Republic of Ireland | | | |
| EBS Building Society | USD | **–** | 1,000 |
| **Total term deposit** | | **–** | 1,000 |

## 14. Inventories – Group

| At 31 December | 2010<br>US$ 000 | 2009<br>US$ 000 |
|---|---|---|
| Production & other spares | **1,540** | 3,533 |
| Crude oil inventory | **90** | 81 |
| **Total inventories** | **1,630** | 3,614 |

## 15. Other receivables – Group

| At 31 December | 2010<br>US$ 000 | 2009<br>US$ 000 |
|---|---|---|
| VAT receivable | **336** | 1,355 |
| Prepayments | **1,668** | 1,338 |
| Other accounts receivable | **121** | 259 |
| **Total other receivables** | **2,125** | 2,952 |

Prepayments to contractors relate to initial advances made in respect of drilling, construction and other projects.

## 16. Share capital and share premium – Group

The following table summarises the movement in the share capital and share premium of the Company for the years ended 2009 and 2010.

| | Number of shares | Share capital US$ 000 | Share premium US$ 000 |
|---|---|---|---|
| At 1 January 2009 | 54,017,800 | 1,045 | 139,681 |
| Issue of shares: | | | |
| – public placement | 27,000,000 | 440 | 26,560 |
| – share issue costs | – | – | (368) |
| **At 31 December 2009** | **81,017,800** | **1,485** | **165,873** |
| At 1 January 2010 | 81,017,800 | 1,485 | 165,873 |
| Issues of shares | – | – | – |
| **At 31 December 2010** | **81,017,800** | **1,485** | **165,873** |

The total number of authorised Ordinary Shares is 330,720,100 (2009: 330,720,100) with a par value of £0.01 per share (2009: £0.01 per share).

# Notes to the IFRS Consolidated Financial Statements continued

## 16. Share capital and share premium – Group continued

### Share based compensation

Share options and other share based awards have been granted to certain directors. There were no shares issued to directors under such schemes during 2010.

**2008 Executive Share Option Plan**

On 15 July 2008 the Group announced a new Executive Share Option Plan ("ESOP"). During 2008, the Company granted options to acquire 1,137,464 Ordinary Shares to Mikhail Ivanov under the terms of the ESOP. The options may be exercised at a price of 405p per share and vest in equal portions on May 2010, 2011 and 2012 and will remain outstanding until May 2017. In January 2009, the Company granted 568,732 thousand share options to Tony Alves under the ESOP. The options vest in eight semi-annual tranches over a period of four years providing certain performance conditions related to the Company's share price are met. The options have an exercise price of £1.00. Under the terms of the plan, during 2010 options over 450,247 shares (2009: 71,092 shares) were eligible for vesting. Share grant expenses of US$123,000 (2009: US$72,000) have been made.

The fair value of share options granted and of restricted shares issued is measured by use of the Black-Scholes pricing model with the following assumptions:

| Year ended 31 December | 2009 Executive Share Option Plan |
|---|---|
| Share price | 76.5p |
| Exercise price | 100.0p–200.0p |
| Expected volatility | 107.7% |
| Expected life | 0–4 years |
| Risk free rate | 3.0% |
| Expected dividends | None |

## 17. Other reserves – Group

| At 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Currency translation adjustment | **(19,070)** | (18,063) |
| Share grant expense | **5,196** | 5,073 |
| **Total other reserves** | **(13,874)** | (12,990) |

Currency translation adjustments represent adjustments on translation of the share capital of non-US$ subsidiaries into US$. All related exchange gains and losses are charged directly to equity.

## 18. Trade and other payables – Group

| At 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Trade payables | **860** | 2,688 |
| Taxes other than profit tax | **1,074** | 316 |
| Customer advances | **496** | 158 |
| **Total** | **2,430** | 3,162 |

The maturity period of the Group's financial liabilities, comprising only trade and other payables at 31 December 2010 and 2009 is as follows:

| Maturity period at 31 December 2010 | **0 to 3 months** | **3 to 12 months** | **Over 1 year** | **Total** |
|---|---|---|---|---|
| Trade payables | **620** | **240** | **–** | **860** |

| Maturity period at 31 December 2009 | 0 to 3 months | 3 to 12 months | Over 1 year | Total |
|---|---|---|---|---|
| Trade payables | 1,945 | 549 | 194 | 2,688 |

## 19. Investments – Company

Investments in subsidiaries are accounted for at cost. The Company's subsidiaries are as follows:

| Name | Jurisdiction | Nature of Operations | % Owned | From |
|---|---|---|---|---|
| Woodhurst Holdings Ltd. | Cyprus | Intermediate Holding Company | 100% | October 2005 |
| Pre-Caspian Gas Company | Russia | Oil & gas exploration and development | 100% | May 2006 |
| Gaznefteservice | Russia | Oil & gas exploration and development | 100% | September 2006 |
| Shropak Investments Ltd | Cyprus | Dormant | 100% | June 2007 |
| Volga Gas (Cyprus) Ltd. | Cyprus | Intermediate Holding Company | 100% | August 2007 |
| Gazservice | Russia | Special purpose entity | 99% | October 2008 |
| ZAO Gamma | Russia | Joint operating company | 75% | January 2009 |
| Volga Gas Finance Ltd. | UK | Intermediate Holding Company | 100% | March 2010 |

To avoid certain legal restrictions on land ownership in October 2008 Pre-Caspian Gas Company acquired a 99% shareholding in ZAO Gazservice. Subsequently, Pre-Caspian Gas Company sold an unimproved plot of land to ZAO Gazservice at cost basis.

| Company | 31 December 2009 US$ 000 | Additions US$ 000 | Disposals US$ 000 | 31 December 2010 US$ 000 |
|---|---|---|---|---|
| Investments in Woodhurst Holdings | 143,683 | 6,000 | – | 149,683 |
| Investments in Volga Gas (Cyprus) | 1,051 | 300 | – | 1,351 |
| **Total investments** | **144,734** | **6,300** | **–** | **151,034** |

The Company funds its activities in the Russian Federation via Woodhurst Holdings, the Company's Cyprus registered subsidiary.

## 20. Accumulated (loss)/profit – Company

| At 31 December | **2010 US$ 000** | 2009 US$ 000 |
|---|---|---|
| Retained losses | **(682)** | (1,006) |
| (Loss)/profit for the year | **(1,158)** | 324 |
| **Accumulated loss** | **(1,840)** | (682) |

## 21. Audit fees – Group and Company

During the year the Group (including its overseas subsidiaries) obtained the following services from the Company's auditors and associates:

| Year ended 31 December | **2010 US$ 000** | 2008 US$ 000 |
|---|---|---|
| Fees payable to Company's auditor for the audit of parent company and consolidated financial statements | **242** | 235 |
| Fees payable to the Company's auditor and its associated firms for other services: | | |
| – The audit of company's subsidiaries pursuant to legislation | **39** | 20 |
| – Other services pursuant to legislation | **120** | 50 |
| – Tax services | **22** | 201 |
| – Other, training | **–** | – |
| **Total** | **423** | **506** |

# Notes to the IFRS Consolidated Financial Statements continued

## 22. Related party transactions – Group and Company

The Group is controlled by Baring Vostok Private Equity Funds III and IV, which respectively own 48.9% and 9.76% (in aggregate 58.66%) of the Company's shares. The Baring Vostok Private Equity Funds exercise their control through a number of nominee holding companies. The remaining 41.34% of the shares are widely held.

The following transactions concerning purchases of goods and services were carried out with related parties:

| | | | Year ended 31 December | |
|---|---|---|---|---|
| Related party | Relationship | Nature of transactions | **2010 US$ 000** | 2009 US$ 000 |
| Baring Vostok Cyprus Limited | Affiliated with controlling shareholder | Rent, services | **127** | 133 |
| Vladimir Koshcheev | Director | Services | **–** | 13 |

### (a) Other related parties

The following transactions were carried out with companies nominally held by the Group's employees but not controlled by the Group.

| | | Year ended 31 December | |
|---|---|---|---|
| Related party | Nature of transactions | **2010 US$ 000** | 2009 US$ 000 |
| OOO Geo Eko | Long-term loan (interest rate 1%) | **36** | 24 |
| OOO Geopotential | Long-term loan (interest rate 1%) | **33** | 23 |

### (b) Year-end balances arising from transactions with related parties

| | **31 December 2010 US$ 000** | 31 December 2009 US$ 000 |
|---|---|---|
| **Due to related parties** | | |
| Baring Vostok (Cyprus) Limited | **13** | 12 |

All transactions with related parties were made on commercial basis.

### (b) Key management

Key management is considered to be the Company's executive directors. Information on key management compensation is presented in the Directors' Remuneration Report.

## 23. Contingencies and Commitments

### 23.1 Capital commitments

**(i) Pre-Caspian Licence Area**

In accordance with the license agreement for the Pre-Caspian license area, PGK was required to acquire an additional 500 km of 2D seismic in 2009. At the end of the reporting period PGK had completed its seismic commitments on the Pre-Caspian licence area. In order to maintain its licence interest, PGK will be required to commence drilling a well before 31 December 2011. This expenditure is not at present committed.

**(ii) Urozhainoye-2 Licence Area**

PGK was required to commence drilling a well in the Urozhainoye-2 Licence Area during 2010. As a result of operational delays, this was deferred to early 2011. Management estimates the cost of such a well to be US$3.5 million.

As of the balance sheet date all other licence commitments have been met.

### 23.2 Taxation

Russian tax, currency and customs legislation is subject to varying interpretations and changes which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review, but under certain circumstances, reviews may cover longer periods.

At 31 December 2010, management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency and customs positions will be sustained.

### 23.3 Restoration, rehabilitation, and environmental costs

The Group operates in the upstream oil industry in the Russian Federation and its activities may have an impact on the environment. The enforcement of environmental regulations in the Russian Federation is evolving and the enforcement posture of government authorities is continually being reconsidered. The Group periodically evaluates its obligation related thereto. The outcome of environmental liabilities under proposed or future legislation, or as a result of stricter interpretation and enforcement of existing legislation, cannot reasonably be estimated at present, but could be material.

Under the current levels of enforcement of existing legislation, management believes there are no significant liabilities in addition to amounts which are already accrued and which would have a material adverse effect on the financial position of the Group.

### 23.4 Oilfield licences

The Group is subject to periodic reviews of its activities by governmental authorities with respect to the requirements of its oilfield licences. Management of the Group correspond with governmental authorities to agree on remedial actions, if necessary, to resolve any findings resulting from these reviews. Failure to comply with the terms of a licence could result in fines, penalties, licence limitation, suspension or revocation. The Group's management believes any issues of non-compliance will be resolved through negotiations or corrective actions without any materially adverse effect on the financial position or the operating results of the Group.

In January 2008 the Group was issued with an amendment to its Karpenskiy Licence Agreement. The amendments to the KLA remove the historical licence breaches.

The principal licences of the Group and their expiry dates are:

| Field | Licence Holder | Licence expiry date |
|---|---:|---:|
| Karpenskiy | OOO Pre-Caspian Gas Company | 2021 |
| Pre-Caspian | OOO Pre-Caspian Gas Company | 2031 |
| Urozhainoye-2 | OOO Pre-Caspian Gas Company | 2032 |
| Vostochny-Makarovskoye | OOO Gaznefteservice | 2026 |

Management believes that in practice the relevant authorities rarely suspend or restrict the licences, especially at the exploration stage, and tend to terminate licences only in the event of continuous non-compliance and the failure of the licence holder to remedy breaches. The Group has not received any official warnings or notifications about continuous non-compliance or any risk of suspension, restriction or termination.

## 24. Post-balance sheet events

Trans Nafta case: In February 2011 the Moscow Court of cassation upheld the initial verdict in the case with Trans Nafta ordering Trans Nafta to pay RUR 640 million (approximately US$22 million) representing the advance previously made to Trans Nafta in respect of the acquisition of a 75% interest in a gas processing unit.

# Notice of Meeting

Notice is hereby given that the annual general meeting (the "AGM") of Volga Gas plc (the "Company") will be held at the London office of Akin Gump Strauss Hauer & Feld at Ten Bishops Square, London E1 6EG on 13 June 2011 at 10.00 a.m. for the following purposes:

## Ordinary Business

1. To receive and adopt the Company's accounts for the year ended 31 December 2010 and the directors' report.
2. To reappoint Aleksey Kalinin, who retires by rotation, as a director.
3. To reappoint Vladimir Koshcheev, who retires by rotation, as a director.
4. To reappoint Ronald Freeman, who retires by rotation, as a director.
5. To reappoint PricewaterhouseCoopers LLP as auditors of the Company until the conclusion of the next general meeting at which accounts are laid before the Company.
6. To authorise the directors to determine the remuneration of the auditors of the Company.

## Special Business

To consider and, if thought fit, to pass resolution 7 as an ordinary resolution and resolution 8 as a special resolution.

7. That the directors be and they are hereby generally and unconditionally empowered to exercise all the powers of the Company to allot shares in the Company and/or to grant rights to subscribe for or to convert any security for shares in the Company (together "Relevant Securities") up to a maximum aggregate nominal amount of £1,000,000 to such persons and at such times and on such terms as they think proper, provided that this authority shall expire the earlier of (i) fifteen months from the passing of this resolution, or (ii) the conclusion of the AGM of the Company to be held in 2012 (unless renewed, varied or revoked by the Company prior to or on such date), save that this authority shall allow the Company to make offers or agreements before the expiry of such authority which would or might require Relevant Securities to be allotted after such expiry and the directors shall be entitled to allot Relevant Securities pursuant to any such offer or agreement as if this authority had not expired; and all unexercised authorities previously granted to the directors to allot Relevant Securities be and are hereby revoked.
8. That the directors be and they are hereby empowered pursuant to Sections 570 and 573 of the Companies Act 2006 (the "Act") to allot equity securities (as defined in Section 560 of the Act) for cash; pursuant to the authority conferred by resolution 7 set out in this Notice convening the AGM (the "Notice") as if Section 561 of that Act did not apply to any such allotment, provided that this power shall be limited to:

   (a) the allotment of equity securities in connection with a rights issue, open offer or other offer of securities in favour of the holders of ordinary shares on the register of members at such record date(s) as the directors may determine where the equity securities respectively attributable to the interests of the ordinary shareholders are proportionate (as nearly as may be) to the respective numbers of ordinary shares held by them on any such record date(s), subject to such exclusions or other arrangements as the directors may deem necessary or expedient to deal with fractional entitlements or legal or practical problems arising under the laws of any overseas territory or the requirements of any regulatory body or stock exchange or by virtue of shares being represented by depositary receipts or any other matter; and

   (b) the allotment (otherwise than pursuant to sub-paragraph (a) above) to any person or persons of equity securities up to an aggregate nominal amount of £150,000.

   And the power conferred hereby shall expire upon the expiry of the general authority conferred by resolution 7 set out in this Notice (unless renewed, varied or revoked by the Company prior to or on such date), save that the Company shall be entitled to make offers or agreements before the expiry of such power which would or might require equity securities to be allotted after such expiry and the directors shall be entitled to allot equity securities pursuant to any such offer or agreement as if the power conferred hereby had not expired.

Registered Office:
Ground Floor
17-19 Rochester Row
London
SW1P 1QT

BY ORDER OF THE BOARD
Antonio Maria Alves
Company Secretary
14 April 2011

Notes:

1. Resolutions 1–7 are ordinary resolutions. For these resolutions to be passed, a simple majority of the votes cast at the Company's AGM must be in favour of the resolutions. Resolution 8 is a special resolution. For this resolution to be passed, at least three-quarters of the votes cast at the AGM must be in favour of the resolution.
2. A member entitled to attend, speak and vote at the meeting convened by the notice set out above is entitled to appoint a proxy to attend, speak and, on a poll, to vote in his place. To appoint more than one proxy you may photocopy this form. Please indicate the proxy holder's name and the number of shares in relation to which they are authorised to act as your proxy (which, in aggregate, should not exceed the number of shares held by you). Please also indicate if the proxy instruction is one of multiple instructions being given. All forms must be signed and should be returned together in the same envelope.
3. A form of proxy is enclosed. To be effective, it must be deposited at the office of the Company's registrars (Capita Registrars) so as to be received not later than 48 hours before the time appointed for holding the AGM. Completion of the proxy does not preclude a member from subsequently attending and voting at the meeting in person if he or she so wishes.
4. To change your proxy instructions simply submit a new proxy appointment using the methods set out in Notes 2 and 3 above. Note that the cut-off time (in Note 3 above) for receipt of proxy appointments also apply in relation to amended instructions; any amended proxy appointment received after the relevant cut-off time will be disregarded.
   Where you have appointed a proxy using the hard-copy proxy form and would like to change the instructions using another hard-copy proxy form, please contact the Company's registrars. If you submit more than one valid proxy appointment, the appointment received last before the latest time for the receipt of proxies will take precedence.
5. In order to revoke a proxy instruction you will need to inform the Company using one of the following methods:
   (a) by sending a signed hard copy notice clearly stating your intention to revoke your proxy appointment to the Company's registered office address. In the case of a member which is a company, the revocation notice must be executed under its common seal or signed on its behalf by an officer of the company or an attorney for the company. Any power of attorney or any other authority under which the revocation notice is signed (or duly a certificated copy of such power of authority) must be included with the revocation notice; or
   (b) by sending an email to info@volgagas.com

   In either case, the revocation notice must be received by the Company's registrars no later than the cut-off time set out in Note 3 above.
6. The register of interests of the directors and their families in the share capital of the Company and copies of contracts of service of directors with the Company or with any of its subsidiary undertakings will be available for inspection at the registered office of the Company during normal business hours (Saturdays and public holidays excepted) from the date of this notice until the conclusion of the AGM.
7. To appoint a proxy or to give or amend an instruction to a previously appointed proxy via the CREST system, the CREST message must be received by the issuer's agent RO33 no later than forty eight hours before the meeting date. For this purpose, the time of receipt will be taken to be the time (as determined by the timestamp applied to the message by the CREST Applications Host) from which the issuer's agent is able to retrieve the message. After this time any change of instructions to a proxy appointed through CREST should be communicated to the proxy by other means. CREST Personal Members or other CREST sponsored members, and those CREST Members who have appointed voting service provider(s) should contact their CREST sponsor or voting service provider(s) for assistance with appointing proxies via CREST. For further information on CREST procedures, limitations and system timings please refer to the CREST Manual. We may treat as invalid a proxy appointment sent by CREST in the circumstances set out in Regulation 35(5) (a) of the Uncertificated Securities Regulations 2001. In any case your proxy form must be received by the Company's registrars no later than forty eight hours before the meeting date.
8. Only those members entered on the register of members of the Company at 6.00 p.m. on 11 June 2011 or, in the event that this meeting is adjourned, in the register of members as at 6.00 p.m. on the day two days before the date of any adjourned meeting, shall be entitled to attend and vote at the meeting in respect of the number of ordinary shares registered in their names at that time. Changes to the entries on the register of members after 6.00 p.m. on 11 June 2011 or, in the event that this meeting is adjourned, in the register of members after 6.00 p.m. on the day two days before the date of the adjourned meeting, shall be disregarded in determining the rights of any person to attend or vote at the meeting.
9. Any corporation which is a member can appoint one or more corporate representatives who may exercise on its behalf all of its powers as a member provided they do not do so in relation to the same shares.

# Glossary of Technical Terms

| | |
|---|---|
| **2-D seismic** | geophysical data that depicts the subsurface strata in two dimensions |
| **3-D seismic** | geophysical data that depict the subsurface strata in three dimensions. 3-D seismic typically provides a more detailed and accurate interpretation of the subsurface strata than 2-D seismic |
| **abandonment** | application of a cement plug to close a well and welding of a steel plate to the top of the well; the well is then plugged and abandoned |
| **bbl** | the standard barrel of crude oil or other petroleum product is 42 US gallons (approximately 159 litres) |
| **bcf** | billion cubic feet |
| **bcm** | billion cubic metres |
| **Best estimate** | the term 'best estimate' is used here as a generic expression for the estimate considered to be the closest to the quantity that will actually be recovered from the accumulation between the date of the estimate and the time of abandonment |
| **boe** | barrels of oil equivalent, being for natural gas the energy equivalent on one barrel of oil. The usual ratio is to equate 6,000 cubic feet to one barrel of oil equivalent |
| **condensate** | liquid hydrocarbons associated with the production from a primarily natural gas reservoir |
| **field** | means an area consisting of either a single reservoir or multiple reservoirs, all grouped on or related to the same individual geological structural feature and/or stratigraphic condition |
| **gas** | natural gas |
| **gas processing facilities** | together with the laboratory, gathering pipelines and storage facilities (if any), a plant comprising one or more units such that after conditioning the gas will be of pipeline quality as, specified by Gazprom, such units may include dehydration, sweetening and separation of natural gas liquids |
| **gas-water contact** | bounding surface in a reservoir above which predominantly gas occurs and below which predominantly water occurs |
| **hydrocarbons** | compounds formed from the elements hydrogen (H) and carbon (C) and existing in solid, liquid or gaseous forms |
| **Kungurian Salt** | a layer of salt laid down during the lower Permian age which occurs in the Northern Caspian Petroleum Province |
| **licence area** | the particular subsoil plot specified in the subsoil licence issued by the applicable Russian federal authority, which the licence holder has the right to use for the purpose and on the terms specified in the subsoil licence. A licence area may contain one or more fields or may encompass only a portion of a field |
| **liquidation** | Abandonment |
| **mmbbls** | million barrels |
| **mcm** | thousand cubic metres |
| **mmboe** | million barrels of oil equivalent |
| **natural gas** | hydrocarbons that are gaseous at one atmosphere of pressure at 20°C. It can be divided into lean gas, primarily methane but often containing some ethane and smaller quantities of heavier hydrocarbons (also called sales gas) and wet gas, primarily ethane, propane and butane as well as smaller amounts of heavier hydrocarbons; partially liquid under atmospheric pressure |

| | |
|---|---|
| **petroleum** | naturally occurring liquids and gasses which are predominantly comprised of hydrocarbon compounds |
| **possible reserves** | are those unproven reserves that, on the available evidence and taking into account technical and economic factors, have a 10.0 per cent. chance of being produced |
| **probable reserves** | are those reserves in which hydrocarbons have been located within the geological structure with a lesser degree of certainty because fewer wells have been drilled and/or certain operational tests have not been conducted. Probable reserves are those reserves that, on the available evidence and taking into account technical and economic factors, have a better than 50.0 per cent. chance of being produced |
| **prospective resources** | Are those quantities of hydrocarbons which are estimated, on a given date, to be potentially recoverable from undiscovered accumulations |
| **proved reserves** | include reserves that are confirmed with a high degree of certainty through an analysis of development history and/or volume method analysis of the relevant geological and engineering data. Proved reserves are those that, based on the available evidence and taking into account technical and economic factors, have a better than 90.0 per cent. chance of being produced |
| **proved plus probable reserves** | sum of the proved reserves and the probable reserves calculated in accordance with SPE standards |
| **reserves** | quantities of petroleum which are anticipated to be commercially recoverable from known accumulations from a given date forward |
| **reservoir** | a porous and permeable underground formation containing a natural accumulation of producible natural gas and/or oil that is confined by impermeable rock or water barriers and is separate from other reservoirs |
| **risk factor** | for contingent resources means the estimated chance, or probability, that the volumes will be commercially extracted; for prospective resources means the chance or probability of discovering hydrocarbons in sufficient quantity for them to be tested to the surface, this, then, is the chance or probability of the prospective resource maturing into a contingent resource |
| **SPE standards** | reserves definitions consistent with those approved in March 1997 by the Society of Petroleum Engineers and the World Petroleum Congresses |
| **sub-salt** | below the Kungurian salt layer |
| **supra-salt** | above the Kungurian salt layer |

# Russian Classification of Reserves

The Russian reserves system is based solely on the analysis of geological attributes. Explored reserves are represented by categories A, B, and C1; preliminary estimated reserves are represented by category C2; and potential resources are represented by category C3.

Category A reserves are calculated on the part of a deposit drilled in accordance with an approved development project for the oil or natural gas field. They represent reserves that have been analysed in sufficient detail to define comprehensively the type, shape and size of the deposit; the level of hydrocarbon saturation; the reservoir type; the nature of changes in the reservoir characteristics; the hydrocarbon saturation of the productive strata of the deposit; the content and characteristics of the hydrocarbons; and the major features of the deposit that determine the conditions of its development.

Category B represents the reserves of a deposit (or portion thereof), the oil or natural gas content of which has been determined on the basis of commercial flows of oil or natural gas obtained in wells at various hypsometric depths. Category B reserves are computed for a deposit (or a portion thereof) that has been drilled in accordance with either a trial development project or an approved development scheme.

Category C1 represents the reserves of a deposit (or of a portion thereof) whose oil or natural gas content has been determined on the basis of commercial flows of oil or natural gas obtained in wells and positive results of geological and geophysical exploration of non-tested wells. Category C1 reserves are computed on the basis of results of geological exploration work and production drilling and must have been studied in sufficient detail to yield data from which to draw up either a trial development project or a development scheme.

Category C2 reserves are preliminary estimated reserves of a deposit calculated on the basis of geological and geophysical research of unexplored sections of deposits adjoining sections of a field containing reserves of higher categories and of untested deposits of explored fields. Category C2 reserves are used to determine the development potential of a field and to plan geological, exploration and production activities.

Category C3 resources are prospective reserves prepared for the drilling of (i) traps within the oil-and-gas bearing area, delineated by geological and geophysical exploration methods tested for such area and (ii) the formation of explored fields which have not yet been exposed by drilling. The form, size and stratification conditions of the assumed deposit are estimated from the results of geological and geophysical research. The thickness, reservoir characteristics of the formations, the composition and the characteristics of hydrocarbons are assumed to be analogous to those for explored fields. Category C3 resources are used in the planning of prospecting and exploration work in areas known to contain other reserve bearing fields.

In accordance with the Law on Subsoil mineral reserves in Russia are subject to mandatory state examination, a precondition of the granting of a production license. The state examination of reserves is conducted by subsidiary organisations of the Federal Agency on Subsoil Use, including the State Reserve Commission, Central Reserve Commission and its regional departments. Once a subsoil user is granted an exploration, development or production license, it is required to file annual reports reflecting changes in reserves. Subsoil users' reserve reports are submitted annually for examination and approval by the Central Reserve Commission or, if there has been a substantial change in reserves, by the State Reserve Commission.