Volga Gas plc Annual Report and Accounts 2008

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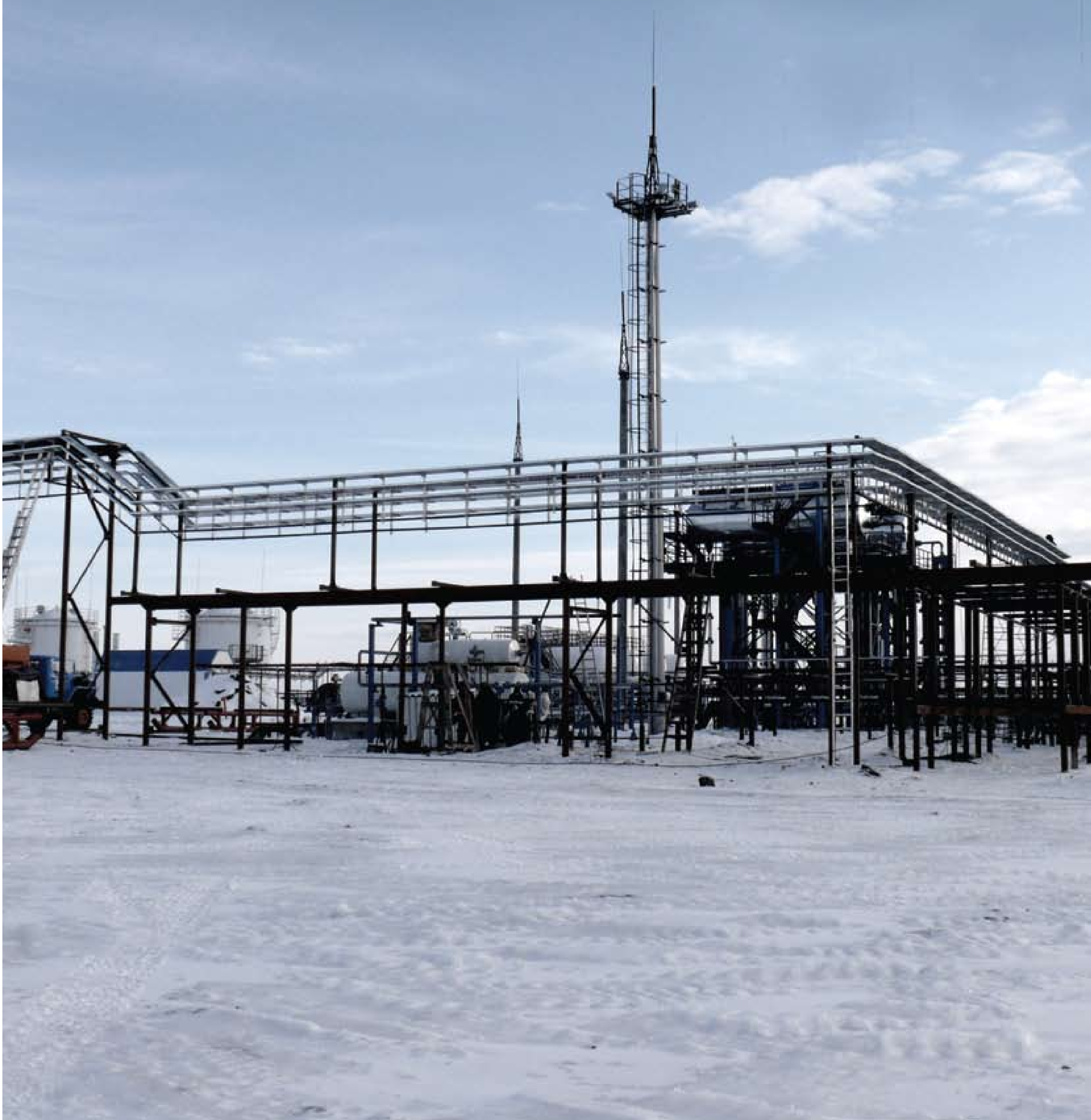
Annual Report and Accounts

2008



Meeting the challenge. Delivering value.

Volga Gas plc is an independent oil and gas exploration and production company with four exploration and production licences in the Volga region of Russia. Since IPO we have focused successfully on executing our plans and delivering on our objectives.

Highlights of 2008

- Full time production commenced from the supra-salt oil field in the Karpenskiy Licence Area ('KLA')
- Three new producing oil wells successfully completed and in production
- First phase of development drilling on the Vostochny-Makarovskoye ('V-M') gas/condensate field completed. Two out of three wells tested at commercial rates
- Resolution of threatened legal action on V-M
- Combined Russian classification C1/C2 reserves of **7.2 bcm (230 bcf)** of gas and **26.2 million** barrels of liquids on Uzenskaya and V-M
- Completed interpretation of 3-D seismic on the Yuzhny-Ershovskoye ('Y-E') and Yuzhny-Mokrousovskoye ('Y-M') sub-salt prospects in KLA
- Rig on location available to commence drilling the first sub-salt well during 2009
- Cash balance of **US$23 million** at year end and no debt

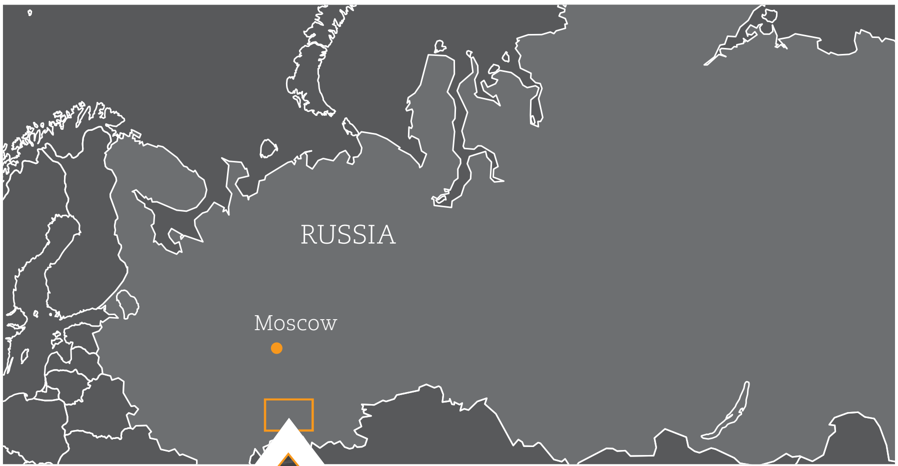
Production
from the shallow oil reservoirs

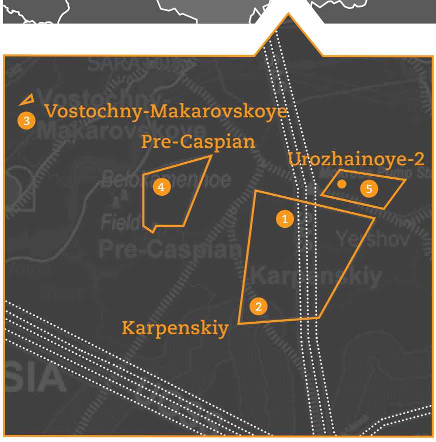
Development
first phase of drilling completed on V-M

Exploration
seismic evaluation of sub-salt prospects completed

A Year of Progress

Our assets are located in a proven area with large oil and gas fields. The area benefits from the existing rail, road and pipeline infrastructure and proximity to Russia's main energy markets.





Successful exploration and development drilling on Uzenskaya and completion of the first phase of drilling on V-M enable the Company to aspire to produce sufficient oil and gas to generate positive cash flows towards the end of 2009. Meanwhile we move closer towards testing the high impact exploration prospects that lie in the sub-salt layers in the Karpenskiy Licence Area and the Pre-Caspian Licence Area.

Licence overview

1. Karpenskiy Licence Area: sub-salt

Covering 4,180 km^2 in the Saratov region of European Russia, the northern part of the Karpenskiy Licence Area has two identified sub-salt structures, Yuzhny-Ershovskoye and Yuzhny-Mokrousovskoye, which have been the subject of both seismic and drilling studies.

2. Karpenskiy Licence Area: supra-salt

The southern end of the Karpenskiy Licence Area contains a number of identified supra-salt structures, including the previously-discovered Starshinovskoye field. The Uzenskaya field was discovered by the Company in 2007.

3. V-M Licence Area

The V-M Licence Area, which covers 18 km^2, is located in the Volgograd region of European Russia. The V-M field is currently in development.

4. Pre-Caspian Licence Area

The licence was awarded at a government auction in October 2006. The Pre-Caspian Licence covers 1,437 km^2 and is approximately 50 km from the Karpenskiy Licence Area.

5. Urozhainoye-2 Licence Area

The licence was awarded at a government auction in September 2007. The licence covers 354 km^2 and is located approximately 15 km north of the Company's Karpenskiy Licence Area. There is one well on the field, currently suspended, which flowed at 1,200 bbls/day of oil on test production. The Company has acquired 350 km of 2-D seismic.

Volga has 100% interest in two Russian companies: Pre-Caspian Gas Company ('PGK') and Gaznefteservis ('GNS') which hold four licences to explore for and produce oil and gas in the Volga region.

	2008 progress	2009 objectives
	Completed processing of 3-D seismic data on the Yuzhny-Ershovskoye and Yuzhny-Mokrousovskoye prospects. Well location selected: Grafovskaya on Yuzhny-Ershovskoye. Rig contract secured, rig mobilised onto location.	C3 resources of 56 bcm of gas and 8 million tonnes of condensate (390 mmBOE) assigned to Yuzhny-Ershovskoye by well passport. Spud first deep exploration well on Yuzhny-Ershovskoye.
	Drilled three successful production Wells on the Uzenskaya field in 2008. Constructed oil preparation facilities. Commenced full time production late in 2008. Russian C1/C2 reserves approved.	Drill at least two more development wells in the Uzenskaya field. Drill three exploration wells on identified structures. Further upgrade of facilities as required.
	First phase development drilling completed. Surface infrastructure construction well advanced. Agreement with Trans Nafta to form a gas processing joint venture. The Russian C1/C2 reserves approved.	Commence production from an initial two wells. Conduct dynamic modelling based on well performance to determine ultimate recovery potential from the field.
	Completed acquisition of 1,000 km of 2-D seismic data. Processing and interpretation commenced. Large sub-salt exploration structure identified.	Acquisition, processing and interpretation of 3-D seismic data over the initial exploration prospect. Preparation for exploration drilling in 2010.
	Completed acquisition, processing and interpretation of 340 km of 2-D seismic.	Acquire well #11 and re-start limited production.

Chairman's Statement

Volga Gas is distinctive for operating entirely in European Russia, close to domestic markets and with pipeline and logistical infrastructure nearby. Our four licence blocks encompass proven oil, gas and condensate in shallow and medium depth horizons and major gas and condensate exploration targets in deep sub-salt horizons. At the start of 2008 it was our intention to advance our exploration and development projects with a view to achieving near term production and to move towards the drilling of our deep high impact exploration targets.

Throughout 2008 we made good progress towards meeting these key objectives. But we have also had to meet some serious challenges in the course of the year. Firstly, we faced a potential law suit seeking to unwind our purchase of the V-M field. However, as announced on 12th November 2008, the court case was withdrawn and we reached a resolution agreement with Trans Nafta which is more extensively described in the Operating Review. Secondly, and more seriously in the short term, the global economic downturn and the associated sharp falls in commodity prices have made for a difficult environment for all oil and gas companies and also for the Russian economy.

The sharp decline in the Ruble exchange rate against the US dollar has set back the progress of achieving netback parity in regulated domestic gas prices. To the best of our knowledge the policy of 25% per annum increases in Ruble denominated gas prices remains in place. In the short term, the economic downturn in Russia will have impacted both the demand and prices paid in the unregulated gas market. Similarly, domestic economic conditions have also impacted the demand and pricing of crude oil in Russia.

Volga Gas, however, is well placed to withstand these challenges. Our fields are advantageously located and our costs are sufficiently low for us to achieve acceptable returns even at very low oil and gas prices. We will be able to complete the development of our production projects to benefit immediately from an eventual recovery in oil and gas prices. Most importantly, we have the necessary capital to fulfil our current licence commitments.

Key achievements for the Company in 2008 include 100% success with our development drilling of the supra-salt wells on the Uzenskaya oil field in the Karpenskiy Licence Area ('KLA') and two successful wells on the V-M gas-condensate field. We have commenced full-time production from Uzenskaya and hope to follow suit at V-M during 2009. These fields should enable the Company to achieve the important milestone of financial self-sustainability before the end of 2009.

Volga Gas was originally created to explore the sub-salt structures on the KLA. Not only are we excited by the potential of the two structures, Yuzhny-Ershovskoye ('Y-E') and Yuzhny-Mokrousovskoye ('Y-M'), but our initial evaluation of the sub-salt potential in the nearby Pre-Caspian Licence Area is showing equally compelling prospectivity.

Of course, we need to turn our potential into results. During 2008 we have laid the foundations for the drilling of our first sub-salt well. Interpretation of the 3-D seismic data over the two main prospects in the Karpenskiy Licence Area was completed and we have identified a location (Grafovskaya) on which we plan to drill an exploration well on the Y-E prospect. Furthermore, we have secured a suitable rig for this well and have received the necessary official consents for the well ('Passport'). On the Pre-Caspian Licence, we have acquired and interpreted 2-D seismic and are seeing some highly interesting results.

We started 2009 with a cash balance of US$23.1 million and so are well positioned to fund our development work programme. However, if we were to accelerate the drilling of our sub-salt exploration well, the Company would require additional funding.

Finally, we pay tribute to the hard work and dedication of the small team of employees who have worked tirelessly throughout the year to deliver the impressive results which we are now able to report. I would like to thank them for their hard work. The end of 2008 saw the departure of our Chief Financial Officer, Alistair Stobie. We thank him for his hard work and welcome his successor, Tony Alves to the Company. Tony has been closely involved with Volga Gas from an early stage and has the experience to carry on Alistair's good work.

Alexey V. Kalinin
Chairman

The Russian gas market

Supply and demand
Gazprom's major producing fields have either reached peak production or are already suffering from declining production. At the same time, demand for Russian gas, both domestically and from Western Europe, already exceeds supply. Aggregate domestic and international demand for Russian gas in 2007 was approximately 707 bcm, which exceeded Gazprom's production of approximately 548 bcm and exceeded total Russian production of approximately 640 bcm, as a result of which Gazprom had to purchase and transit gas from Central Asia in order to meet its supply commitments.

This gas supply deficit is unlikely to abate, and could widen, in the medium term. The next major fields being developed by Gazprom, such as the Barents Sea Shtockman field, are technologically challenging. Gazprom may not be able to bring them into production, as previously scheduled in 2011 and current expectations are for 2014 at the earliest. Meanwhile, aggregate domestic and international demand for Russian gas, notwithstanding current economic uncertainties, is expected to remain robust and growing in the long term.

Prices
The gas supply deficit has led to a significant premium in unregulated domestic prices for Russian gas, with independent producers achieving prices 20% above regulated tariffs. In 2008 regulated prices increased by 25% and are set to rise by 16% in 2009. We expect further increases in the regulated price for natural gas as part of the Russian government's efforts to liberalise the price of natural gas on the Russian domestic market. The Federal Tariff Service will continue to approve the effective increase on an annual basis although it reserves the right, based on market conditions and other factors, to modify the percentages published as well as potentially prolong the timetable toward market price liberalisation, which when formulated in 2006 was envisaged in 2011.

Chief Executive's Review

The focus for Volga Gas in 2008 was on advancing our key exploration and production projects; firstly, to ensure that production, and hence cash flow, begins from the V-M field and from the supra-salt Uzenskaya field in the Karpenskiy Licence Area ('KLA'); secondly, to complete the geological studies on the two deep sub-salt structures on the KLA, and to prepare for the drilling of our first sub-salt exploration well there.

We have also had to deal with a serious legal challenge, a resolution of which has been agreed, and a sudden and sharp deterioration of the external business environment. We are confident that we can withstand these challenges and have made good progress in creating a profitable and self-sustaining business, while in parallel pursuing the high impact exploration ventures which were the original motivation for the foundation of the Company.

During 2008, the majority of the activity and investment was concentrated on developing our production assets.

Drilling on Uzenskaya delivered better than anticipated results, confirming a high quality light oil resource. As a result of this drilling activity, as recently announced, we were able to record Russian classification C1 and C2 recoverable reserves on Uzenskaya of 1.9 million tonnes (approximately 13.9 million barrels). During 2008 we completed three production wells on this field and each of these flowed at rates of between 2,220 and over 4,000 barrels of oil per day on open hole tests, demonstrating very good reservoir characteristics. We intend to manage the production from this reservoir very carefully to ensure maximum recovery of the oil in place.

On V-M, our initial results were extremely encouraging. As reported in the 2007 Annual Report, we found a gross gas-condensate column of close to 200 m in the V-M #1 well. This well tested at commercial flow rates and led to a Russian reserve C1/C2 classification of 7.141 bcm plus 1.528 million tonnes (12.2 million barrels) of condensate which was approved by the State Committee for Mineral Resources in November 2008. We also commenced the construction of the required gas processing facility for the first stage of production with the aim of starting production before the end of 2008.

During the year, however, there was a legal challenge raised by a shareholder of Trans Nafta, the company from which we purchased the V-M licence, seeking to have our purchase unwound. This threatened legal action was later withdrawn and we entered into a resolution agreement with Trans Nafta involving the creation of a gas processing joint venture in which Volga Gas will have a 75% interest. The establishment of this joint venture will require a balancing payment by Volga Gas substantially covered by a prepayment of 600 million Rubles (approximately US$20.4 million) made by Volga Gas in November 2008. Final details of the structure of the joint venture and legal completion of the asset transfer are still being negotiated.

The threatened legal action obviously set back our plans for first production from V-M. First production from the field is awaiting completion of construction and commissioning of the Dobrinskoye gas plant, which is the main asset in the gas processing joint venture and through which our gas and condensate production will flow. We are now hoping to achieve first production early in the second half of 2009.

Meanwhile we drilled two further wells on V-M with mixed results as we detailed in recent announcements. We will cover this more extensively in the Operational Review below, but in summary we recognise that there is some risk that reserve estimates for the field may be subject to future revision. We intend to re-examine the technical data on the field and incorporate new data from an extended period of production from the existing wells in order to provide a new estimate of recoverable gas and condensate reserves by the end of 2009.

Our deep sub-salt exploration projects, both in the KLA and in the Pre-Caspian Licence Area are as exciting as ever. During 2008 we completed processing of the new 3-D seismic data that we acquired in 2007 over the two main exploration prospects identified in the KLA. This has refined our picture of the potential targets and, we believe, has reduced the geological risk associated with the prospects. Based on this data we have selected a location to drill our first well. We have also secured and mobilised a suitable rig to drill a 5,000 m sub-salt well, although as yet we have not made a firm commitment to start drilling.

In the Pre-Caspian Licence Area, analysis of the 1,000 km of 2-D seismic data, which we acquired during 2008, has confirmed a large exploration target in the sub-salt play. We now propose to shoot 3-D seismic over this structure with the aim of facilitating an exploration well within the next twelve months.

As a result of this activity we now have a total of six productive wells on our two fields and expect to add further production wells in the course of 2009. Based on current plans and assuming no exploration success, Volga Gas should by the end of 2009 achieve daily production of 300,000 m^3 (approximately 12 million cubic feet per day) of gas and 2,000 barrels per day of oil and condensate.

Naturally, the revenue and cash flow deriving from this production will largely depend on the price we realise for our oil, condensate and gas sales. In common with the rest of the industry, domestic oil prices in Russia are currently depressed. In the Russian gas market the increases in regulated gas prices continue but the sharp devaluation of the Ruble against the US dollar has led us to expect lower US dollar realisations for our short-term gas production. Nevertheless, we are endeavouring to keep our costs low in order to achieve profitability and to be able to benefit from a future recovery in prices. Meanwhile, lower levels of activity in the oil industry and the weak Ruble have some beneficial impacts on the costs of our ongoing exploration and development activities.

We now have Russian C1 Recoverable reserves of 43.2 mmBOE and a further 25.0 million barrels equivalent of C2 Recoverable reserves contained in just two fields. Our C3 Prospective Resources, based on just one of the three sizeable sub-salt prospects we have mapped within our licence blocks, are 394 mmBOE. This solid base of reserves and resources gives us confidence that we can continue to build Volga Gas into a successful and profitable independent exploration and production company and to create sustainable value for our shareholders.

Volga Gas has a culture of delivering on commitments with a small team of professionals working smartly. This culture will help us meet the challenges ahead. The coming year promises to be a challenging but exciting one for the team. I am confident that they will continue to deliver results on schedule and on budget.

Mikhail Ivanov
Chief Executive Officer

Executing our strategy

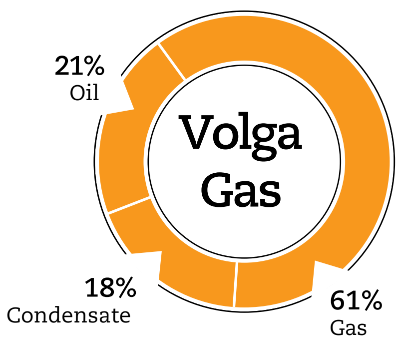
1. Developing our production assets
With greater than anticipated success on Uzenskaya, to which we hope to add new wells on Vostochny Uzenskaya and first production from V-M, Volga Gas looks forward to developing a growing and sustainable production business from its existing licence areas.

2. Exploration of the deep sub-salt structures
We have completed the required sub-surface work ahead of drilling our first sub-salt well Grafovskaya #1, in the KLA, and have already secured and mobilised a suitable rig for the purpose. We intend to commence drilling once we are confident of our financial position. We are similarly progressing with our exploration project in the Pre-Caspian Licence Area.

3. Financing
Our existing funds are sufficient to meet our current commitments. We recognise that timely execution of our exploration strategy may require additional funds or the creation of joint ventures with other parties.

4. Acquisitions
Our acquisition strategy has enabled the Company to be secure an asset base of four licences with low entry cost. We continue to seek further similar opportunities where we can rapidly add value and, where possible, incremental production volumes.

C1/C2 reserves



Operational Review

The Company's two principal areas of focus in 2008 were: exploration activities on two major sub-salt prospects in the Karpenskiy Licence Area ('KLA'), development of the Uzenskaya supra-salt oil field, also in the KLA, and development of the V-M gas-condensate field.

Operations overview

- We have now completed processing of the 3-D seismic over the KLA and have secured a rig to start drilling our first sub-salt exploration well in 2009.
- At Uzenskaya we already have four productive wells and expect to add further producing wells in the course of 2009.
- On the V-M field, two successful development wells have been drilled and construction of the gas processing plant is near completion.

In addition, we have acquired and interpreted 2-D seismic over the Pre-Caspian Licence Area where we also see exciting sub-salt prospects.

KLA

Early in 2008 we amended the terms of the Karpenskiy Licence Agreement, thereby curing certain licence breaches the Company inherited when it acquired the licence from a LUKoil subsidiary. The amended licence agreement requires the Company to finalise the acquisition of 400 km^2 of 3-D seismic and drill a further ten exploration or production wells over the next two years. We have already fulfilled our seismic obligations. The ongoing supra-salt drilling programme, which will also add to our current production, is expected to fulfil the remaining drilling commitments before the end of 2009.

Sub-salt

The Company acquired 107 km² and 160 km² of 3-D seismic respectively over the Yuzhny-Ershovskoye ('Y-E') and Yuzhny-Mokrousovskoye ('Y-M') structures during 2007. We completed processing and interpretation of this data during 2008. Based on this information, the location for the first well (Grafovskaya #1) has been identified and the drilling passport issued. Russian category C3 reserves of 42 bcm of gas (247 mmBOE) and 48 million barrels of condensate and 14 bcm of gas (81.2 mmBOE) and 15.6 million barrels of condensate have been identified in two separate structures within the Y-E prospect.

The Evrasia rig has been constructed on the site of Grafovskaya #1. In order to accelerate drilling of this well, the Company will need to raise additional funding.

Supra-salt

Following on from the successful exploration well on Uzenskaya #1, the Company continued drilling on the adjacent South Uzenskaya structure, completing two successful wells in 2008 and drilling a third well which was completed after the year end. Each of these wells flowed light (45° API) oil from a high quality cretaceous sandstone reservoir. The flow rates recorded from open hole testing on each ranged from 2,220 to 4,600 barrels per day.

We have constructed surface infrastructure, including a separator unit, storage tanks and gas fired generator utilising associated gas. Full time production has commenced with each of the wells producing on average between 350 and 400 barrels of oil per day per well, with a 6 mm choke. Given the reservoir characteristics and the strong apparent natural water drive, these production rates are expected to be maintained for several years.

Russian category C1 and C2 recoverable reserves on the Yuzhny Uzenskaya field have recently been approved by the State Committee for Reserves of 13.9 mmbbl.

The Uzenskaya field has as yet no SPE standard reserves associated with it. The estimation of reserves under SPE standards will be undertaken after completion of the current drilling programme.

We have concluded operations on Uzenskaya #6. As announced on 30 March, the main target reservoir was not present in the well. The well has been suspended.

Ongoing drilling activity in the area includes an exploration well, Uzenskaya #7, currently being drilled on the Vostochny Uzenskaya prospect, approximately 7 km east of the existing field facility. Should this be successful, we plan to drill Uzenskaya #9, 10 and 11 on the Vostochny Uzenskaya structure after completing Uzenskaya #8 which will be a development well on the Yuzhny Uzenskaya field.

V-M Licence Area

The Company undertook its first phase drilling programme on the V-M field during 2008 and commenced construction of a gas processing facility for the field.

The V-M #1 well was completed early in 2008. As we reported in the 2007 Annual Report, this well encountered a significantly larger gas column than previously expected, exceeding 200 m in total. A series of open hole tests carried out over a 160 m interval resulted in a cumulative flow rate of 267 mcm/d (approximately 9.4 mmcf/d) of gas plus 215 tonnes per day (approximately 1,763 b/d) of condensate.

Focused on production

V-M and Uzenskaya

Cash flow

Growing production from Uzenskaya and the start of V-M will lead to meaningful cash flow which will support the Group's activities on its other licence areas.

Drilling programme

First phase drilling on V-M is completed. Current drilling is focused principally on our 2009 programme of seven supra-salt wells that may add materially to reserves in addition to driving production growth.

Uzenskaya well flow rates

Well	Announced	Flow rates m³/d	bbl/d	
Uzenskaya #3	*September 2008*	353	2,220	*open hole test*
Uzenskaya #4	*December 2008*	95	600	*cased hole, 6 mm choke*
Uzenskaya #5	*February 2009*	731	4,608	*open hole test*

Operational Review continued

The Company subsequently drilled two further wells on the field, V-M #2 and V-M #4. We decided to change the order of drilling, and well V-M #3 will be drilled later. The V-M #2 well also tested gas in the Evlano-Livenskiy layer. When cased and perforated the well initially produced formation water. The well was subsequently repaired. On a further initial test, the well flowed at a rate of 190 mcm/d of gas plus 320 b/d of condensate from a 30 m perforated interval with a 12 mm choke.

The V-M #4 well was spudded in November 2008 and completed early in February 2009. The result of this well was unexpectedly disappointing. It was drilled on the southern portion of the field close to the edge of the probable reserve limits. V-M #4 found gas and condensate on an open hole test at a depth of 2,746–2,755 m in the Evlano-Livenskiy formation. Net pay measured in the well was substantially less than anticipated. Although it is capable of production, the Company has decided to suspend the well with the option in the future, pending an evaluation of the data, of sidetracking the well to a potentially more favourable bottom hole location.

Any impact of this well result on gas and condensate reserves in the V-M field has yet to be estimated.

In November 2008, Russian category C1 and C2 recoverable reserves were calculated following the results of well V-M #1 and approved by State Committee for Reserves.

The current plan for the field is to commence production from the first two wells which will enable a dynamic modelling of the field's productive capacity and ultimate potential recovery. In the interim, the Company plans not to make any changes to reserve estimates. Production is expected to commence shortly after commissioning of the gas processing plant, which is anticipated before the end of H1 2009.

Court proceedings and gas processing joint venture

As we announced in August 2008, a claim was filed in July 2008 against our 100% owned subsidiary, Woodhurst Holdings ('Woodhurst'), and Trans Nafta. The claim, which was filed by Alexander Alexandrovich Kulyaev, a minority shareholder in Trans Nafta, in the Moscow Arbitration Court, sought to invalidate the agreement ('the Sale Agreement') pursuant to which Gaznefteservis ('GNS'), the holder of the V-M licence, was sold by Trans Nafta to Woodhurst in September 2006 ('the Moscow Proceedings').

The basis of the claim was that Trans Nafta had not obtained the necessary corporate approvals to sell GNS to Woodhurst. Woodhurst responded by commencing proceedings in the High Court in London seeking an injunction to restrain the Moscow Proceedings. Woodhurst also commenced an arbitration in London seeking a declaration as to the validity of the Sale Agreement and seeking damages against Trans Nafta for breach of warranty in the event that the Sale Agreement were declared invalid by the Moscow Arbitration Court (together, 'the UK Proceedings'). The parties subsequently arrived at a resolution pursuant to which, inter alia, the Moscow Proceedings and the UK Proceedings were withdrawn in November 2008.

As part of the resolution between the parties, Volga Gas and Trans Nafta agreed

Group oil and gas reserves and resources

	Recoverable reserves C1	C2	C1/C2	Resources C3
V-M				
Natural gas (bcm)	4.661	2.480	7.141	
Condensate (mmT)	1.043	0.485	1.528	
Total (mmBOE)	**35.844**	**18.512**	**54.356**	
Yuzhny-Uzenskaya (Karpenskiy Licence, supra-salt)				
Crude oil (mmT)	0.983	0.886	1.869	
Total (mmBOE)	**7.373**	**6.510**	**13.883**	
Yuzhny-Ershovskoye prospect (Karpenskiy Licence, sub-salt)				
Natural gas (bcm)				56.0
Condensate (mmT)				8.0
Total (mmBOE)				**394.0**

All licences	Recoverable reserves C1	C2	C1/C2	Resources C3
Gas (bcm)	4.7	2.5	7.1	56.0
Condensate (mmT)	1.0	0.5	1.5	8.0
Crude oil (mmT)	1.0	0.9	1.9	0.0
Total (mmBOE)	**43.2**	**25.0**	**68.4**	**394.0**

Conversion factors used: 1 bcm natural gas = 5.9 mmBOE, I tonne condensate = 8.0 BOE; 1 tonne crude oil = 7.5 BOE
A B C1 C2 and C3 are official Russian classifications as approved by the State Committee for Reserves

to combine their Gas Processing Units ('GPUs') and form a Russian Company owned through a 75:25 split. Trans Nafta's GPU is already connected to the Gazprom pipeline network. Volga Gas will be able to begin selling its gas and condensate as soon as its existing wells are tied in to the GPU.

The combined facility will have sufficient capacity to process quantities of gas and condensate previously contemplated by Phase 1 and Phase 2 of V-M's development. Initially the GPU will be dedicated to processing gas and condensate produced from the V-M field and from Trans Nafta's Dobrisnkoye gas field.

In accordance with this agreement, the Company made a prepayment to Trans Nafta of RUR 600 million (approximately US$20 million) in November 2008. This prepayment substantially covers the estimated balancing payment that would fall due to 75% of the cost of constructing the GPU. The final operational framework for the joint venture and the legal transfer of the GPU assets to the joint venture have yet to be concluded. Legal closure is conditional, inter alia, on the plant being formally commissioned by 30th September 2009. Should this not be achieved within that timeframe, the Company has the right to unwind the joint venture and to seek recovery of its RUR 600 million pre-payment with accrued interest.

Pre-Caspian Licence Area

The Pre-Caspian Licence Area has no reserves associated with it. To date a total of 1,000 km of 2-D seismic has been acquired. Processing and interpretation is under way. Initial results have revealed a very large sub-salt structure in a geological setting similar to the sub-salt prospects in the KLA.

The licence terms require a further 500 km to be acquired. We may propose to the licensing authorities an exchange of our remaining 2-D seismic commitment for 78 km^2 of 3-D seismic data over the identified prospect. The cost of forward seismic programme is expected to be similar in either case.

The results of this seismic will be processed and interpreted during 2009 and will provide a basis for eventual exploration drilling.

Urozhainoye-2

On 7 September 2007 the Company acquired Urozhainoye-2 at a government mandated auction for approximately US$1.7 million. The licence area covers 354 km^2 and is located approximately 15 km to the north of the Company's KLA and is in close proximity with up to 30 oil, gas and condensate fields.

The licence area is principally an exploration asset. Notwithstanding this, the licence area has had one well drilled on it in 1990 which discovered the Sobolevskoye field which has Russian C1 recoverable reserves of 800,000 barrels of oil. The well produced at 1,200 barrels per day of oil and 1.9 mmcf/d of gas with an 8 mm choke on test production.

During 2008 we acquired 350 km of 2-D seismic, fulfilling our seismic commitment on the licence. Processing and interpretation is ongoing.

Mikhail Ivanov
Chief Executive Officer

Experienced Russian and Western management

Meeting the challenge and delivering value

Volga Gas has an experienced management team which has the diverse and complementary skills and local market knowledge required to manage and develop an oil and gas exploration and production company in Russia.

Volga Gas has a culture of delivering on commitments with a small team of professionals working smartly. This culture will help us meet the challenges ahead. The coming year promises to be a challenging but exciting one for the team.

Financial Review

During 2008 our operations were primarily in an exploration and development phase. The Group recorded a loss of US$10.3 million for the year ended 31 December 2008 (2007: loss US$2.6 million). No dividends have been paid or proposed for the year (2007: none).

Results for the year

The Group generated US$0.6 million in turnover from the sale of 24,545 barrels of crude oil. An additional 1,770 barrels of crude oil were held in inventory as of the balance sheet date. Crude oil sales were made into the domestic market during the period.

The operating loss for the year was US$12.8 million (2007: US$8.4 million) which includes exploration expenses of US$5.6 million (2007: nil) and administrative expenses of US$7.8 million (2007: US$8.4 million). Included in the latter were expenses of US$2.3 million relating to the legal issues on V-M and in charges relating to share-based payments of US$1.1 million (2007: US$3.9 million).

The Group recognised a loss before tax of US$10.1 million (2007: loss US$2.8 million) and after tax loss of US$10.3 million (2007: loss US$2.6 million). This includes net gains on foreign exchange contracts of US$1.3 million (2007: US$3.5 million).

Cash flow

Group net cash outflow from operating activities was US$15.9 million (2007: US$5.1 million), including US$5.6 million of exploration expenses and US$6 million of prepayments for equipment and services relating to the Group's exploration and development activities. The remainder of cash outflow consisted principally of general and administrative expenses incurred to run the Group's operations as well as expenditure relating to the resolution of the V-M legal issues.

Financial summary

	Year ended 31 December 2008	*Year ended 31 December 2007*
Turnover	**0.6**	0.0
Loss for the period	**(10.3)**	(2.6)
Net cash outflow from operating activities	**(15.9)**	(5.1)
Net cash used in investing activities	**(55.7)**	(12.9)
Net cash at the end of the period	**23.1**	97.5

Capital expenditure

During 2008 a total of US$48.5 million was invested in capital expenditure on the Group's licence areas including acquisitions (2007: US$12.9 million) as detailed below.

The most significant individual components of the capital expenditure were US$16.1 million on the V-M field, including drilling and plant construction. In addition, US$6.4 million was expended on development drilling and field facilities for the Uzenskaya oil field.

Security deposit on acquisition of fixed assets comprises the US$20.4 million of prepayment to Trans Nafta relating to the gas processing joint venture.

Balance sheet and financing

As at 31 December 2008, the Group held cash balances of US$23.1 million (2007: US$97.5 million) and remains debt free.

The Group intends to fund its operating expenditures using a combination of cash flow from operations and cash-on-hand. The Group will also consider raising additional capital to more fully explore and develop its asset base.

The Group is currently capable of producing approximately 1,200 barrels of oil per day from three producing wells in the Uzenskaya field. The Group's production is being sold on the domestic crude oil markets.

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

Issue of share capital

During the year to 31 December 2008, the Company issued a total of 393,852 shares at par value in accordance with Restricted Share Agreements with Mikhail Ivanov, Chief Executive Officer of the Company and Alistair Stobie, at that time the Chief Financial Officer of the Company.

During the year to 31 December 2007, the Company issued 22.9 million shares, generating US$125.1 million in net proceeds.

Tony Alves
Chief Financial Officer

Capital expenditure summary

	2008 (US$ million)	*2007 (US$ million)*
Oil and gas exploration assets	**0.3**	3.1
Oil and gas exploration assets (work in progress)	**2.1**	3.4
Development and producing assets	**25.5**	5.8
Real estate assets	**0.2**	0.5
Other	**0.0**	0.1
Security deposit on acquisition of fixed assets	**20.4**	0.0
Total	**48.5**	12.9

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, production from geographically isolated countries may be sold at a discount to current market prices.

Substantially all of the Group's revenues and cash flows will 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 the Group'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.

Exploration risk

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 oil or gas resources to exploit the discovered resource.

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.

Foreign currency risk

The Group's capital expenditures are predominantly in Rubles and its operating costs in both US dollars and Rubles. Turnover is in Rubles and funding has been raised in US dollars.

Any changes in the relative exchange rates among US dollars and Rubles could positively or negatively affect the Group's results. The Group has sought to mitigate exchange risk by a) entering in to a number of non-deliverable forward contracts with the Royal Bank of Scotland which allow the Group to match its cash holdings with expected capital expenditures whilst maintaining its cash balances with highly-rated institutions and b) holding significant Ruble cash balances.

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.
- 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 issuer may transact business in the future, have or may have legal systems that are less well developed than that 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 2008 the Group has US$23.1 million of cash and cash equivalents available to fund its ongoing operations and associated exploration and development activities. At 31 December 2008 the Group has committed capital expenditure of US$12.0 million relating to licence obligations on the Karpinskiy, Pre-Caspian Licence Areas and completion of the V-M field development.

Through its ordinary course activities however, the Group is exposed to 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 has evaluated the current exploration and development plan for the Karpinskiy, Pre-Caspian and V-M Licence Areas and has identified a number of measures that can be taken to preserve cash and secure additional funding if necessary. These measures include, where practicable, deferral of discretionary capital expenditures until such time as sufficient cash flow from operations has been generated in order to fund these expenditures and the potential farmout of interests in one or more of its exploration licences by way of a joint venture type arrangement.

Based on management's projections the Directors believe the Group has sufficient cash to fund its remaining licence commitments related to exploration activity on the Karpenskiy and Pre-Caspian Licence Areas, to complete the development of the V-M Licence Area and to satisfy all expenditure related to administrative and operating expenses through calendar year 2009.

If the Group does not generate sufficient liquidity to fund its expenditures, the Group's ability to execute its long-term growth strategy could be significantly affected. In addition, adjustments to the Group income statement may be required to record additional liabilities and to write down assets to their recoverable amounts.

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

Alexey Kalinin is a Co-Managing 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 twelve years and served as the Director of the Youth Center for Scientific and Technical Creativity. Mr Kalinin is 49 years old.

Mikhail Ivanov

Chief Executive Officer, Executive Director

Mikhail Ivanov was Director of Oil and Gas Investments at Baring Vostok. Mr Ivanov has over 15 years' experience in the oil and gas industry which includes ten 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. Mr Ivanov holds an MS degree in Geophysics from Novosibirsk State University and an MBA from the Kellogg School of Management of Northwestern University. He is an elected member of SPE. Mr Ivanov is 39 years old.

Tony Alves

Chief Financial Officer, Executive Director (appointed 12th January 2009)

Tony 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 49 years old.
He was appointed as Chief Financial Officer and Company Secretary effective 12 January 2009.

Ronald Freeman

Non-executive Director

Ronald 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 BA from Lehigh University and an LLB from Columbia Law School (1964). He was admitted to the Bar of the State of New York. He is 69 years old.

Stephen Ogden

Non-executive Director

Stephen Ogden is the Founder and Managing Partner of the First Montenegro Stone Property Fund, and the Co-Founder and Managing Partner of the Istanbul-based Pera Property Fund. Mr Ogden is Chairman of the Board of Lenta, Russia's largest privately owned food retailer, and was previously a non-executive Director of MDM-Print (Russia), 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 and 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 41 years old.

Michael Calvey

Non-executive Director

Michael Calvey is a Founder and Co-Managing 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 Gallery Media Group, Caspian Bank, Europlan, Etalon and Volga Gas. 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 MSc in accounting and finance from the London School of Economics. Mr Calvey is 41 years old.

Vladimir Koshcheev

Non-executive Director

Vladimir Koshcheev currently acts as 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 51 years old.

Alistair Stobie

Chief Financial Officer, Executive Director (resigned 31 December 2008)

Alistair Stobie acted as the Managing Director of Chiron Capital, a merchant banking corporate finance boutique from 2004 to 2006. Prior to joining Chiron Capital, Mr Stobie acted as the Managing Partner of Mint Capital, a venture capital company interested in the Russian telecommunications, media and technology sectors, which he founded in 2000. Mr Stobie was a Founding Partner of Baring Vostok Capital Partners and acted as a member of the investment management team of First NIS Regional Fund since inception in 1994 to 1998. Mr Stobie was responsible for identifying, negotiating and monitoring private equity investments for Baring Vostok Capital Partners, including the fund's investment in Burren Energy PLC, where he was a Director from 1995 to 1998. He graduated from Keele University with a BA in International Relations. Mr Stobie resigned from the Board effective 31 December 2008.

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 2008 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; and
- 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
- Alistair Stobie – Executive Director, CFO and Company Secretary (resigned 31 December 2008)
- Tony Alves – Executive Director, CFO and Company Secretary (appointed 29 January 2009)
- 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 Fund III, 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 24 and 25.

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 seven times during the year ended 31 December 2008 with the following attendance:

	2008	2007
Alexey Kalinin	**7**	7
Mikhail Ivanov	**7**	7
Alistair Stobie	**7**	7
Ronald Freeman	**7**	6
Stephen Ogden	**6**	7
Vladimir Koshcheev	**6**	7
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 and Koshcheev will retire at the forthcoming Annual General Meeting 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.

Corporate Governance Statement continued

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 Annual General Meeting which will be held on 18 June 2009, 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
31 March 2009

Report of the Directors

The Directors present their report together with the Group's audited financial statements for the period from 1 January 2008 to 31 December 2008.

Results and dividend

The Group's results are set out on pages 27 to 33 and show a net loss of US$10.3 million for the year to 31 December 2008. The Directors do not propose to pay a dividend.

Subsequent events

In December 2008 the Company announced the terms of a share option granted in relation to the appointment of Tony Alves as Chief Financial Officer effective 12 January 2009. In February 2009 the Company announced disappointing drilling results from the V-M #4 well on the V-M field, as described in the Operational Review on pages 8 to 11.

Principal activities, business review and future developments

Volga Gas 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, V-M, Pre-Caspian and Urozhainoye-2.

The Group's business strategy is to bring the proven-undeveloped V-M field into production and to grow production on the supra-salt Uzenskaya field in the Karpenskiy Licence Area ('KLA'). whilst at the same time exploring the potentially highly prospective sub-salt structures on the KLA and Pre-Caspian licence areas. The Group is also conducting an exploration programme on a number of identified supra-salt structures on the KLA and Pre-Caspian Licence area.

Highlights of the Group's activities for the period ended 31 December 2008 are:

- Completed the first phase of development drilling on the V-M field.
- Commenced construction of a gas processing facility on the V-M licence area.
- Commenced full time production from the Yuzhny Uzenskaya ('Y-U') field on the KLA.
- Completed processing and interpretation of 260 km^2 of 3-D seismic over the Yuzhny-Ershovskoye ('Y-E') and Yuzhny-Mokrousovskoye ('Y-M') sub-salt structures on the KLA.
- Completed the acquisition of 1,000 km of 2-D seismic on the Pre-Caspian Licence Area.
- Court action threatened by purported shareholder of Trans Nafta was withdrawn.
- Agreed a gas processing joint venture in the V-M Licence Area in which the Company has a 75% interest.

The Group's activities are described in greater detail in the Chief Executive's Review on pages 6 and 7 and in the Operational Review on pages 8 to 11. The principal risks associated with the Group's activities are set out in Risk Factors on pages 14 and 15.

Key performance indicators ('KPIs')

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 analysis using KPIs 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 8 to 11 provide the relevant information.

Directors

The Directors who served during the year were:

Alexey Kalinin, non-executive Chairman	
Mikhail Ivanov, Chief Executive Officer	
Alistair Stobie, Chief Financial Officer	resigned 31 December 2008
Ronald Freeman, non-executive	
Stephen Ogden, non-executive	
Vladimir Koshcheev, non-executive	
Michael Calvey, non-executive	

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

Report of the Directors continued

Directors' interests

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

	Ordinary Shares of 0.01p each	
	31 December 2008	31 December 2007
Alexey Kalinin[1]	**–**	–
Mikhail Ivanov[2]	**525,100**	262,549
Alistair Stobie[3]	**274,350**	131,299
Ronald Freeman	**5,000**	5,000
Stephen Ogden	**15,000**	15,000
Vladimir Koshcheev	**866,550**	866,550
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. As such Mr Calvey and Mr Kalinin have an indirect beneficial interest in the Company.
2 Under the terms of a Restricted Share Agreement Mr Ivanov was issued 262,551 shares during 2008.
3 Under the terms of a Restricted Share Agreement Mr Stobie was issued 131,301 during 2008.

Substantial shareholders

On 31 December 2008 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]	29,620,000	54.83
HQ Fonder Sverige AB	2,999,735	5.55
Capital Group International, Inc.	2,125,000	3.93
Kairos Investment Management Limited	2,011,244	3.72

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

Options granted

As of 31 December 2007 the Company had granted no options. During 2008, under the terms of the Executive Share Option Plan adopted by the Company in July 2008, options over a total of 1,706,196 shares were granted to the Executive Directors. 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.

Impact of the credit crunch

The Group is not directly impacted by the credit crunch as it has no outstanding borrowings at balance sheet date. Furthermore, many of its suppliers and contractors do not themselves have access to borrowing facilities. The Group's Russian subsidiaries operate in a cash-based economy. The Company does not envisage seeking any borrowings in the foreseeable future. Liquidity risks are discussed in Risk Factors on pages 14 and 15 and in Note 3 to the Accounts.

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 KLA 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, a rare and endangered bird, occupies portions of the KLA; 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 300 million shares of 1p each. Under a special resolution by the shareholders of the Company on 17 June 2008 the Directors have authority to allot shares up to an aggregate nominal value of £520,000 of which £150,000 could be issued non-preemptively, in accordance with sections 80(1) and 89 of the Companies Act 1985. This authority will expire the earlier of (i) 15 months from the passing of the Resolution, or (ii) the conclusion of the Annual General Meeting of the Company to be held in 2009.

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 (or period) which give a true and fair view of the state of affairs of the Group and of the Company and of the profit and loss of the Group for that year.

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 accounting standards have been followed, subject to any material departures and explained in the financial statements.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure the financial statements comply with the Companies Act of 1985.

They are also responsible for safeguarding the assets of the Group and hence for taking 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.

By order of the Board

Alexey V. Kalinin
Chairman of the Board
31 March 2009

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 18 to 20.

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. The Remuneration Committee met once in 2008.

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's 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.

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. Reappointment 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.

In 2007 fees paid to non-executive Directors were satisfied partially in cash and partially through the issuance of restricted shares.

Details of the Directors' compensation are set out below:

	Salary US$000	Bonus US$000	Loss of office US$000	Fees US$000	Share-based compensation US$000	**Aggregate remuneration for the year 31 December 2008 US$000**	Aggregate remuneration for the year 31 December 2007 US$000
Executive Directors							
Mikhail Ivanov	387	125	–	–	753	**1,262**	2,823
Alistair Stobie	292	50	75	–	377	**793**	1,500
Non-executive							
Alexey Kalinin	–	–	–	–	–	**–**	–
Ronald Freeman[1]	–	–	–	50	–	**50**	72
Stephen Ogden[1]	–	–	–	50	–	**50**	72
Vladimir Koshcheev	–	–	–	–	–	**–**	–
Michael Calvey	–	–	–	–	–	**–**	–

1 In 2007 US$30,000 was settled through the issuance of 5,000 shares.

Directors' interests in the share capital of the Company

	Ordinary Shares of 0.01p each 31 December 2007	31 December 2006
Alexey Kalinin[1]	–	–
Mikhail Ivanov[2]	525,100	262,549
Alistair Stobie[3]	274,350	131,299
Ronald Freeman	5,000	5,000
Stephen Ogden	15,000	15,000
Vladimir Koshcheev	866,550	866,550
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. As such Mr Calvey and Mr Kalinin have an indirect beneficial interest in the Company.
2 Under the terms of a Restricted Share Agreement Mr Ivanov was issued 262,551 shares during 2008.
3 Under the terms of a Restricted Share Agreement Mr Stobie was issued 131,301 during 2008.

There has been no change in the interest of any Director between 1 January 2008 and the date of this report.

Directors' share options

The Company adopted an Executive Share Option Plan 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 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 and 568,732 Ordinary Shares to Alistair Stobie under the terms of an Executive Share Option Plan adopted by the Company on 14 July 2008. 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 his resignation effective 31 December 2008, Alistair Stobie surrendered his rights under the Executive Share Option Plan. 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 new options will vest over a period of up to four years subject to the satisfaction of certain performance conditions. 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. The option arrangements for Mikhail Ivanov, Chief Executive Officer, remain unchanged.

By order of the Board

Tony Alves
Company Secretary
31 March 2009

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 2008 which comprise the Group Income Statement, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statements, the Group and Parent Company Statements of Changes in Shareholders' Equity and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, 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.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the unaudited part of the Directors' Remuneration Report, the Chairman's Statement, the Operational Review, the Financial Review, the Corporate Governance Statement and all of the other information listed on the contents page. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

The maintenance and integrity of the Volga Gas plc website 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.

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

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its loss and cash flows for the year then ended;
- the Parent Company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Parent Company's affairs as at 31 December 2008 and cash flows for the year then ended; and
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Aberdeen
31 March 2009

Group Balance Sheet
(presented in US$000)

At 31 December	Notes	2008	2007
ASSETS			
Non-current assets			
Intangible assets	5	**30,596**	34,114
Property, plant and equipment	6	**26,550**	5,940
Other non-current assets	7	**7,245**	2,612
Security deposit on acquisition of fixed assets	7	**20,422**	–
Deferred tax assets	18	**2,003**	645
Total non-current assets		**86,816**	43,311
Current assets			
Cash and cash equivalents	8	**23,093**	97,539
Derivative financial instruments	9	**–**	2,756
Inventories	10	**1,485**	145
Other receivables	11	**8,449**	2,661
Total current assets		**33,027**	103,101
Total assets		**119,843**	146,412
EQUITY AND LIABILITIES			
Equity			
Share capital		**1,045**	1,037
Share premium (net of issue costs)	12	**144,682**	143,552
Other reserves	13	**(16,027)**	4,061
Accumulated loss		**(14,142)**	(3,844)
Total equity		**115,558**	144,806
Current liabilities			
Trade and other payables	14	**2,416**	1,336
Current income tax liability		**1,869**	270
Total current liabilities		**4,285**	1,606
Total equity and liabilities		**119,843**	146,412

Approved by the Board of Directors on 31 March 2009 and signed on its behalf by:

Mikhail Ivanov
Chief Executive Officer

Tony Alves
Chief Financial Officer

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

Company Balance Sheet
(presented in US$000)

At 31 December	Notes	2008	2007
ASSETS			
Non-current assets			
Investments	21	**120,305**	46,751
Inter-company loan	22	**–**	55,682
Inter-company receivables		**15,862**	14,897
Total non-current assets		**136,167**	117,330
Current assets			
Cash and cash equivalents	26	**18,496**	26,838
Derivative financial instruments	9	**–**	2,756
Other receivables		**72**	105
Total current assets		**18,568**	29,699
Total assets		**154,735**	147,029
EQUITY AND LIABILITIES			
Equity			
Share capital	12	**1,045**	1,037
Share premium (net of issue costs)	12	**144,682**	143,552
Accumulated profit	23	**324**	1,408
Total equity		**146,051**	145,997
Non-current liabilities			
Deferred tax liabilities		**–**	271
Current liabilities			
Trade and other payables	24	**2,311**	491
Intercompany payables	25	**6,067**	–
Current income tax liability		**306**	270
Total current liabilities		**8,684**	761
Total equity and liabilities		**154,735**	147,029

Approved by the Board of Directors on 31 March 2009 and signed on its behalf by:

Mikhail Ivanov
Chief Executive Officer

Tony Alves
Chief Financial Officer

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

Group Income Statement
(presented in US$000)

Year ended 31 December	Notes	2008	2007
CONTINUING OPERATIONS			
Revenue		**617**	19
Cost of sales	15	**(607)**	(29)
Gross profit/(loss)		**10**	(10)
Operating and administrative expenses	15	**(12,784)**	(8,392)
Operating loss		**(12,774)**	(8,402)
Interest income	16	**1,461**	2,474
Interest expense		**–**	(373)
Other gains and losses – net	17	**1,256**	3,470
Loss for the period before tax		**(10,057)**	(2,831)
Current income tax	18	**(1,600)**	(270)
Deferred income tax	18	**1,358**	528
Loss for the period attributable to equity holders		**(10,299)**	(2,573)
– Basic and diluted loss per Ordinary Share (in US dollars)		**0.19**	0.06
Weighted average number of shares outstanding	19	**54,008,474**	46,376,181

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

Group Cash Flow Statement
(presented in US$000)

Year ended 31 December	Notes	2008	2007
Net cash outflow from operating activities	20	**(15,860)**	(5,137)
Cash flows from investing activities			
Purchase of intangible assets	5	**(8,628)**	(6,987)
Purchase of property, plant and equipment	6	**(24,903)**	(5,928)
Security deposit on acquisition of fixed assets	7	**(22,204)**	–
Net cash used in investing activities		**(55,736)**	(12,915)
Cash flows from financing activities			
Proceeds from issue of shares (net of issue costs)		**–**	125,118
Repayment and receipt of long-term borrowings		**–**	(14,387)
Net cash provided by financing activities		**–**	110,731
Effect of exchange rate changes on cash and cash equivalents		**(2,850)**	1,532
Net (decrease)/increase in cash and cash equivalents		**(74,446)**	94,211
Cash and cash equivalents at beginning of the year	8	**97,539**	3,328
Cash and cash equivalents at end of the year	8	**23,093**	97,539

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

Company Cash Flow Statement
(presented in US$000)

Year ended 31 December	Notes	2008	2007
Net cash from/used in operating activities	27	**7,658**	(67,260)
Cash flows from investing activities			
Investments in capital	21	**(16,000)**	(34,051)
Net cash used in investing activities		**(16,000)**	(34,051)
Cash flows from financing activities			
Proceeds from issue of shares (net of issue costs)		**–**	125,118
Net cash provided by financing activities		**–**	125,118
Net (decrease)/increase in cash and cash equivalents		**(8,342)**	23,807
Cash and cash equivalents at beginning of the year	26	**26,838**	3,031
Cash and cash equivalents at end of the year	26	**18,496**	26,838

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

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

	Notes	Share capital	Share premium	Other reserves	Currency translation reserve	Accumulated loss	Total equity
Opening equity at 1 January 2007		**579**	**15,251**	**588**	**460**	**(1,271)**	**15,607**
Loss for the year		–	–	–	–	(2,573)	(2,573)
Share capital issued	12	450	134,550	–	–	–	135,000
Share issue costs	12	–	(10,120)	–	–	–	(10,120)
Discount on long-term debt		–	–	(588)	–	–	(588)
Share-based payments	12	8	3,871	–	–	–	3,879
Adjustments on translation of non-dollar subsidiaries		–	–	–	3,601	–	3,601
Closing at 31 December 2007		**1,037**	**143,552**	**–**	**4,061**	**(3,844)**	**144,806**
Opening equity at 1 January 2008		**1,037**	**143,552**	**–**	**4,061**	**(3,844)**	**144,806**
Loss for the year		–	–	–	–	(10,299)	(10,299)
Share-based payments	12	8	1,130	–	–	–	1,138
Adjustments on translation of non-dollar subsidiaries		–	–	–	(20,087)	–	(20,087)
Closing equity at 31 December 2008		**1,045**	**144,682**	**–**	**(16,026)**	**(14,143)**	**115,558**

All equity and reserves are attributable to the Company's equity holders.

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

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

	Notes	Share capital	Share premium	Accumulated profit/(loss)	Total equity
Opening equity at 1 January 2007		**579**	**15,251**	**(40)**	**15,790**
Profit for the year		–	–	1,448	1,448
Share capital issued	12	450	134,550	–	135,000
Share issue costs	12	–	(10,120)	–	(10,120)
Share based payments	12	8	3,871	–	3,879
Closing equity at 31 December 2007		**1,037**	**143,552**	**1,408**	**145,997**
Opening equity as at 1 January 2008		**1,037**	**143,552**	**1,408**	**145,997**
Loss for the year		–	–	(1,084)	(1,084)
Share based payments	12	8	1,130	–	1,138
Closing equity at 31 December 2008		**1,045**	**144,682**	**324**	**146,051**

All equity and reserves are attributable to the Company's equity holders.

The accompanying notes on pages 34 to 53 are an integral part of these financial statements.

Notes to the IFRS Consolidated Financial Statements
for the year ended 31 December 2008 (presented in US$000)

1. General information
Volga Gas plc ('the Company' or 'Volga') is a public liability company registered in England and Wales with registered number 5886534. 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 has its primary listing 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 30 March 2009.

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 Gas plc 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 1985/2006 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 judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement 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 230 of the Companies Act 1985.

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

At 31 December 2008, the Group has US$23.1 million of cash and cash equivalents available to fund its ongoing operations and associated exploration and development activities. During the year to 31 December 2008 the Group had cash outflow from operations of US$19.7 million. In addition, at 31 December 2008 the Group has committed capital expenditure of US$12.0 million as explained in Note 29 to the financial statements. The committed capital expenditure primarily relates to licence obligations on the Karpenskiy, Pre-Caspian and V-M Licence Areas. The Group has no specific plans or commitments at this time for drilling expenditures in respect of Karpinskiy deep. Additional funding will be required prior to drilling Karpinskiy deep.

Through its ordinary course activities however, the Group is exposed to 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 has evaluated the current exploration and development plan for the Karpenskiy, Pre-Caspian and V-M Licence Areas and has identified a number of measures that can be taken to preserve cash and ensure the Group operates within its existing amount of available cash. These measures include, where practicable, deferral of discretionary capital expenditures, changes in drilling schedule and other measures until such time as sufficient cash flow from operations has been generated in order to fund these expenditures.

Based on management's projections the Directors believe the Group has sufficient cash to fund its remaining licence commitments related to exploration activity on the Karpenskiy and Pre-Caspian Licence Areas, to complete the development of the V-M Licence Area and to satisfy all expenditure related to administrative and operating expenses for the forseeable future.

If the Group does not generate sufficient liquidity to fund its expenditures, the Group's ability to execute its long-term growth strategy could be significantly affected.

Disclosure of impact of new and future accounting standards
The following standards, amendments and interpretations to published standards were mandatory for the year ended 31 December 2008:
- IFRIC 11 Group and Treasury Share Transactions
  This interpretation addresses how to apply IFRS 2 to share-based payment arrangements involving an entity's own equity instruments or instruments of another entity in the same group. IFRS 2 charges are correctly accounted for in a fellow subsidiary of the Group. There has been no impact to the Group from the introduction of IFRIC 11.

The Group has not yet adopted the following standards, amendments and interpretations which are only effective for periods commencing on or after 1 January 2009:

- IFRS 8 Operating Segments
  This standard replaces IAS 14 'Segment Reporting' and proposes that entities adopt a 'management approach' to reporting financial performance.
- IFRS 3 (Revised) Business Combinations
  This standard includes some significant changes to IFRS 3 in respect of business combinations with all payments made to purchase a business recorded at fair value at acquisition date. The standard also requires the recognition of subsequent changes in the fair value of the contingent consideration in the income statement rather than goodwill. Transaction costs should be recognised immediately in the income statement. This standard is effective from 1 July 2009, but the Group will adopt this on any acquisitions made from 1 January 2009.
- IAS 27 (Revised) Consolidated and Separate Financial Statements
  The revised standard 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. When control is lost, any remaining interest in the entity is remeasured to fair value and a gain or loss is recognised in profit or loss.
- IAS 1 Presentation of Financial Statements
  This standard prescribes the basis for presentation of financial statements and aims to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.
- IFRS 2 Share-Based Payment – Vesting Conditions and Cancellations
  The revised standard clarifies the definition of a vesting condition and prescribes the treatment of an award that is effectively cancelled because a non-vesting condition is not satisfied.
- IAS 23 (Revised) Borrowing Costs
  The revised standard removes the option of immediately recognising an expense on borrowing costs that relate to assets that take a substantial period of time to get ready for use.

Other standards, amendments and interpretations were considered but specifically excluded as they were not expected to have a material impact on the Group or Company's financial statements.

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% 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 deconsolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

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. 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 IFRS.

A list of the Company's subsidiaries is provided in Note 21.

(b) Segment reporting

Segmental reporting follows the Group's internal reporting structure.

In the opinion of the Directors 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.

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008 (presented in US$000)

2. Summary of significant accounting policies continued
2.3. 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 RUR best reflects the financial results of its Cyprus subsidiary Woodhurst Holdings Ltd ('Woodhurst') because Woodhurst is dependant on entities based in Russia that operate in a RUR environment in order to recover its investments. As a result the functional currency of Woodhurst was changed from the US dollar to the RUR prospectively from 1 July 2007. The RUR was also determined to be the functional currency for the Group's Cyprus subsidiaries established in 2007.

The closing rates used as at 31 December 2008 were:
- US$1: RUR29.38 (at 31 December 2007 US$1: RUR24.55);
- US$1: GBP0.69 (at 31 December 2007 US$1: GBP0.50);
- average rate for 2008 US$1: RUR24.87 (average rate for 2007 US$1: RUR25.58).

(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 as a separate component of equity.

2.4. 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 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 and/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 according to nature. When development is completed on a specific field, it is transferred to production or intangible assets. No depreciation or amortisation is charged during the work in progress 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 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.

2.5. Other businesses 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	six to ten years
Office equipment in excess of US$5,000	three to four years
Vehicles and other	two to seven years

2.6. 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. No financial assets are currently designated as hedging instruments.

(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.

2.7. 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 uses derivatives such as foreign exchange forward contracts to minimise risks of changes in foreign exchange rates. The Group does not apply hedge accounting in respect of forward foreign exchange contracts as management believes that existing derivative do not qualify for hedge accounting. Consequently, movements in the fair value of derivative instruments are immediately recognised in the income statement.

2.8. 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.

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008
(presented in US$000)

2. Summary of significant accounting policies continued

2.9. 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.

2.10. Trade and other receivables
Trade and other receivables are presented at recoverable amounts. 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.

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

2.12. 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.

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

2.14. Current and deferred income tax
Current tax is the amount expected to be paid in respect of taxable profits for the current and prior periods. 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 Group's entities operate and generate taxable income.

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 balance sheet date 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.

2.15. 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 Company measures the equity instruments granted to employees at the fair value at grant date. Fair value of fully-vested shares is expensed immediately. 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.

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

2.16. 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 customers truck. For gas sales, this is typically the point of entry to the gas distribution system.

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

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.

The following table shows the currency structure of financial assets and liabilities at 31 December 2008:

	Rubles US$000	US dollars US$000	Sterling US$000	Total US$000
Financial assets				
Total financial assets – cash	844	22,229	20	23,093
Financial liabilities (before provision for UK taxes)	2,245	171	–	2,416

The following table shows the currency structure of financial assets and liabilities at 31 December 2007:

	Rubles US$000	US dollars US$000	Sterling US$000	Total US$000
Financial assets				
Cash	70,688	26,583	268	97,539
Derivatives	–	2,756	–	2,756
Other financial receivables	–	105	–	105
Total financial assets	**70,688**	**29,444**	**268**	**100,400**
Financial liabilities (before provision for UK taxes)	593	506	–	1,099

During 2008 the Group used foreign exchange forward contracts to manage financial risks from fluctuation in FX rates (see Note 9).

At 31 December 2008, 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$234,000 (2007: US$367,000) higher/lower, mainly as a result of foreign exchange gains/losses on translation of RUR denominated trade payables and financial assets at fair value through profit or loss.

(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 3.1a (i) of US$23,093,000 and US$100,400,000 at 31 December 2008 and 2007 respectively.

The Group's principal financial asset is cash and credit risk arises from cash and cash equivalents, derivative financial instruments 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.

Rating of financial institution (Fitch)	**31 December 2008**	31 December 2007
AA+	**–**	26,838
AA–	**19,216**	–
A–	**–**	69,825
BBB+	**3,457**	–
Other	**420**	876
Total bank balance	**23,093**	97,539

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008 (presented in US$000)

3. Financial risk management continued
(c) Liquidity risk
The Group believes it has sufficient capital to fund the exploration of the Karpenskiy Licence Area and development of the V-M Licence Area until such stage as the Group is operating cash flow positive. Should the Group's exploration activities on the sub-salt structures on the Karpenskiy and Pre-Caspian Licence Areas be successful the Group will require significant additional funding to develop these licence areas. The Group does not currently intend to drill the previously planned sub-salt well on the Karpinskiy licence unless additional funding is obtained.

The Group expects to fund its exploration and development programme, as well as its administrative and operating expenses, through 2009 using a combination of existing working capital and expected proceeds from the sale of future 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 maturity period of the Group's financial liabilities, comprising only trade and other payables at 31 December 2008 and 2007 is as follows:

	0 to 3 months	3 to 12 months	Over 1 year	Total
Maturity period at 31 December 2008				
Trade and other payables	2,265	151	–	2,416

	0 to 3 months	3 to 12 months	Over 1 year	Total
Maturity period at 31 December 2007				
Trade and other payables	1,082	254	–	1,336

3.2. Capital risk management
The Group's objectives when managing 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.

3.3. Fair value estimation
The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. The carrying value less impairment provision of trade and other receivables and trade and other payables approximate their fair values.

The fair value of financial instruments that are not traded in an active market is determined by using valuation techniques.

4. Critical accounting estimates and judgements
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) Fair value of derivatives
The fair value of derivative financial instruments is determined by using valuation techniques. The Group uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at each balance sheet date. No derivatives are held at 31 December 2008.

(b) 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.

(c) Useful lives of property, plant and equipment
The Group applies a range of useful lives to assets, which are classified as property, plant and equipment. The useful lives of oil and gas properties are determined by reference to associated reserves estimates. Estimates of oil and gas reserves are inherently subjective. Significant judgement is required in estimating the useful life of such assets.

(d) 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.

5. Intangible assets – Group

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

	Work in progress – exploration and evaluation	Exploration and evaluation	Development	Total
At 1 January 2007	570	24,725	–	25,295
Additions	3,361	3,106	520	6,987
Transfers	–	(21,215)	21,215	–
Exchange adjustments	41	1,791	–	1,832
At 31 December 2007	**3,972**	**8,407**	**21,735**	**34,114**

	Work in progress – exploration and evaluation	Exploration and evaluation	Development	Total
At 1 January 2008	3,972	8,407	21,735	34,114
Additions	2,065	261	139	2,465
Disposals	–	–	4	4
Exchange adjustments	(965)	(1,424)	(3,598)	(5,987)
At 31 December 2008	**5,072**	**7,244**	**18,280**	**30,596**

6. Property, plant and equipment – Group

Movements in property, plant and equipment, for the years ended 31 December 2008 and 2007 are as follows:

	Development assets	Work in progress	Subtotal – assets under construction	Producing assets	Land and buildings	Other	Total
Cost							
At 1 January 2007	–	–	–	–	–	38	38
Additions	5,334	–	5,334	–	528	66	5,928
Transfers	(1,658)	–	(1,658)	1,658	–	–	–
At 31 December 2007	3,676	–	3,676	1,658	528	104	5,966
Accumulated depreciation							
At 1 January 2007	–	–	–		–	–	–
Depreciation	–	–	–	(8)	–	(19)	(27)
At 31 December 2007	–	–	–	(8)	–	(19)	(27)
Exchange adjustments	–	–	–	–	–	1	1
At 31 December 2007	**3,676**	**–**	**3,676**	**1,650**	**528**	**86**	**5,940**

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008
(presented in US$000)

6. Property, plant and equipment – Group continued

	Development assets	Work in progress	Subtotal – assets under construction	Producing assets	Land and buildings	Other	Total
Cost							
At 1 January 2008	3,676	–	3,676	1,658	528	104	5,966
Additions	24,568	539	25,107	296	207	3	25,613
Transfers	(4,039)	–	(4,039)	4,039	–	–	–
At 31 December 2008	24,205	539	24,744	5,993	735	107	31,579
Accumulated depreciation							
At 1 January 2008	–	–	–	(8)	–	(19)	(27)
Depreciation	–	–	–	(86)	–	(14)	(100)
At 31 December 2008	–	–	–	(94)	–	(33)	(127)
Exchange adjustments	(3,763)	(83)	(3,846)	(925)	(119)	(12)	(4,902)
At 31 December 2008	**20,442**	**456**	**20,898**	**4,974**	**616**	**62**	**26,550**

7. Other non-current assets – Group

	31 December 2008	31 December 2007
VAT recoverable	**7,209**	2,612
Other non-current assets	**36**	–
Total other non-current assets	**7,245**	2,612
Security deposit on acquisition of fixed assets	**20,422**	–

Management believes that it will not be able to recover value added tax specific to licence and E&E contractors' payments until these licences are revenue producing. Therefore this value added tax is classified as a non-current asset.

The construction advance of US$20.4 million relates to an advance paid by the Company to Trans Nafta for the Group's share of costs associated with the construction of a Gas Processing Unit ('GPU') to be jointly owned by the Company and Trans Nafta. The payment reflected in the Cash Flow statement differs from the amount shown in the non-current assets due to the forex exchange difference.

In October 2008, the Group reached a resolution in relation to a legal claim regarding its 2006 purchase of Gaznefteservice from Trans Nafta. As part of the resolution between the parties, the Group and Trans Nafta entered into a preliminary sale and purchase agreement under which the parties agreed to combine their GPUs, both of which were under construction at the time of the legal action. The combined GPU will be owned and operated on a 75/25 basis by the Group and Trans Nafta.

In accordance with this preliminary agreement, the Group made an advance to Trans Nafta of RUR600 million (approximately US$20.4 million). Management considers this advance will substantially cover the Group's 75% share of the cost of constructing the GPU. On completion of the GPU, Trans Nafta will register the asset with the authorities. When the completed GPU is registered, a final sale and purchase agreement will be entered into and title to the 75% of the completed GPU will pass to the Group.

The final legal form of ownership of the GPU assets has not been determined.

8. Cash and cash equivalents – Group

	31 December 2008	31 December 2007
Cash at bank and on hand	**22,753**	91,507
Short-term bank deposits	**340**	6,032
Total cash and cash equivalents	**23,093**	97,539

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

Bank	Currency	**31 December 2008 US$000**	31 December 2007 US$000
Cyprus			
Bank of Cyprus	RUR	**3**	55,100
	US$	**8**	1
United Kingdom			
The Royal Bank of Scotland	US$	**19,196**	26,570
	GBP	**20**	268
Russian Federation			
Unicreditbank	RUR	**432**	14,712
Other banks	RUR	**409**	876
Unicreditbank	US$	**3,025**	12
Total cash and cash equivalents		**23,093**	97,539

9. Derivative financial instruments – Group

At 31 December 2008 the Company has no derivative financial instruments. At 31 December 2007 the Company had two open forward currency contracts to sell US dollars for RUR with the Royal Bank of Scotland. The fair value of the financial instruments at 31 December 2007 were:

Terms of contract	Settlement date	Unrealised gain/(loss)
Forward sale of US$50 million for RUR	4 February 2008	2,767
Forward sale of US$10 million for RUR	17 March 2008	(11)
Total derivative financial instruments		**2,756**

These two forward contracts were settled on the due dates for US$2,828,000 and US$488,000 respectively, US$2,756,000 of this gain was recognised in 2007.

10. Inventories – Group

	31 December 2008	31 December 2007
Production and other spares	**1,462**	114
Crude oil inventory	**23**	31
Total inventories	**1,485**	145

11. Other receivables – Group

	31 December 2008	31 December 2007
Prepayments, including construction advances made to suppliers	**8,314**	2,480
Other accounts receivable	**135**	181
Total other receivables	**8,449**	2,661

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008 (presented in US$000)

12. Share capital and premium – Group

The following table summarises the movement in the share capital and share premium of the Company for the years ended 2007 and 2008.

	Number of shares	Share capital US$000	Share premium US$000
At 1 January 2007	307,201	579	15,251
Number of shares before subdivision	307,201	–	–
Subdivision of shares	30,720,100	–	–
Issue of shares:			
– public placement	22,500,000	450	134,550
– share issue costs	–	–	(10,120)
– shares issued to Directors (a)	403,848	8	3,871
At 31 December 2007	**53,623,948**	**1,037**	**143,552**

	Number of shares	Share capital US$000	Share premium US$000
At 1 January 2008	53,623,948	1,037	143,552
Issue of shares:			
– shares issued to Directors (a)	393,852	8	1,130
At 31 December 2008	**54,017,800**	**1,045**	**144,682**

The total number of authorised Ordinary Shares is 330,720,100 (2007: 330,720,100) with a par value of £0.01 per share (2007: £0.01 per share).

(a) Share-based compensation

Share options and other share-based awards granted to certain Directors. The Group had two share based payment schemes in 2008, details of which are given in the Directors' Remuneration Report.

2007 Restricted share awards

The following table summarises information on the shares issued to the Directors of the Company in exchange for services provided under the 2007 Restricted Share Awards:

Directors	Number of shares allotted at 1 January 2008	Number of shares allotted for the period	Number of shares allotted at 31 December 2008
Executive Directors:			
Mikhail Ivanov	262,549	262,551	525,100
Alistair Stobie	131,299	131,301	262,600
Non-executive Directors:			
Ronald Freeman	5,000	–	5,000
Stephen Ogden	5,000	–	5,000
	403,848	393,852	797,700

Shares issued to non-executive Directors in 2007 had no vesting conditions, they were valued at the placing price of US$6 each and were fully-expensed during the period to 31 December 2007.

The fair value of restricted shares issued to Mikhail Ivanov and Alistair Stobie is measured by use of the Black-Scholes pricing model with the following assumptions:

Share price	US$6.29
Exercise price (equal to nominal value of share)	US$0.02
Expected volatility	8.48%
Expected life	0–3 years
Risk free rate	5.71%–6.15%
Expected dividends	None

Accordingly US$1,130,000 (2007: US$3,871,000) of the total fair value determined was charged to the income statement for the period (Note 15).

According to the Restricted Share Agreement, Mikhail Ivanov ('CEO') and Alistair Stobie ('CFO') received 787,700 shares in six semi-annual instalments. As of 31 December 2008 there are no outstanding restricted share agreements under this programme.

2008 Executive Share Option Plan

On 15 July 2008 the Group announced a new Executive Share Option Plan that certain of the Executive Directors (Mikhail Ivanov and Alistair Stobie) are entitled to participate in. No deeds of grant under the scheme have been formally approved by the Board at 31 December 2008 and accordingly no options have been issued to the Directors under the plan. No charge is recognised in the 2008 financial statements in respect of the Executive Share Option Plan.

13. Other reserves – Group

Other reserves represent adjustment of translation on share capital of non-US dollar subsidiaries into US dollar. All related exchange gains and losses are charged directly to equity.

	31 December 2008	31 December 2007
Adjustment of translation of non-US dollar subsidiaries	**(16,027)**	4,061

14. Trade and other payables – Group

	31 December 2008	31 December 2007
Trade and other payables	**2,416**	1,099
Value added tax provision	**–**	237
Total	**2,416**	1,336

15. Cost of sales, operating and administrative expenses – Group

	Year ended 31 December 2008	Year ended 31 December 2007
Cost of sales	**607**	29
Operating and administrative expenses	**12,784**	8,392
Total costs and expenses	**13,391**	8,421

Total costs and expenses are analysed as follows:

	Year ended 31 December 2008	Year ended 31 December 2007
Exploration and evaluation (a)	**5,598**	1,893
Legal expenses (b)	**2,536**	156
Directors' emoluments and other benefits (c)	**2,162**	4,417
Salaries (d)	**858**	368
Consulting service	**428**	577
Taxes other than payroll	**390**	72
Audit fees	**285**	318
Financing costs	**234**	–
Travel and transport	**232**	88
Rent and communications	**178**	125
Depreciation	**100**	27
Insurance	**22**	112
Other	**368**	268
Total costs and expenses	**13,391**	8,421

(a) Exploration and evaluation

During 2008 expenditure on seismic studies on the Pre-Caspian Licence Area and the supra-salt study of the Karpenskiy licence was expensed as management believes that the expenditure is 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'.

	Year ended 31 December 2008	Year ended 31 December 2007
Seismic studies	**5,553**	1,777
Ecological monitoring	**45**	116
	5,598	1,893

Notes to the IFRS Consolidated Financial Statements continued for the year ended 31 December 2008 (presented in US$000)

15. Cost of sales, operating and administrative expenses – Group continued

(b) Legal expense

An amount of US$2,366,000 is included in legal expenses in 2008 in respect of the 2008 court proceedings brought by Alexander Kulyaev to purchase of Gaznefteservice from Trans Nafta in 2006. The costs include legal and other consultation services related to preparation for the court proceedings. The court proceedings were withdrawn in November 2008 following resolution of the matter.

(c) Directors' emoluments and other benefits

Analysis of Directors emoluments and other benefits for the years ended 31 December 2008 and 31 December 2007 is as follows:

Year ended 31 December 2007	Salary	Share-based compensation[1]	Other[2/3]	Total
Executive Directors:				
Mikhail Ivanov	282	2,541	–	2,823
Alistair Stobie	180	1,270	50	1,500
Non-executive Directors:				
Ronald Freeman	42	30	–	72
Stephen Ogden	42	30	–	72
	546	3,871	50	4,467

Year ended 31 December 2008	Salary	Share-based compensation[1]	Other[2/3]	Total
Executive Directors:				
Mikhail Ivanov	387	753	125	1,265
Alistair Stobie	292	377	125	794
Non-executive Directors:				
Ronald Freeman	50	–	–	50
Stephen Ogden	50	–	–	50
Vladimir Koshcheev		–	3	3
	779	1,130	253	2,162

1 Details of Directors' interests in the share capital of the Company are provided in Note 12 and in the Directors' Remuneration Report.
2 Alistair Stobie received a special bonus in respect of the Company's admission to AIM. This bonus is included within costs associated with the issue of capital.
3 In 2008 Mikhail Ivanov received a performance bonus of US$125,000 in respect of 2007. Alistair Stobie received a performance bonus in 2008 in the amount of US$50,000, the remaining amount represents an additional amount received on his departure from the Group.

(d) Staff and salaries

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

	Year ended 31 December 2008	Year ended 31 December 2007
Exploration and production	**22**	18
Administration and support	**16**	9
	38	27

Their aggregate remuneration comprised[1]		
Wages and salaries	**701**	288
Payroll taxes and social contribution	**157**	80
	858	368

1 Executive Directors' remuneration is not included. For details of Directors' remuneration see separate disclosure in Note 15 (c) and Directors' Remuneration Report.

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

	Year ended 31 December 2008	Year ended 31 December 2007
Administration and support	**2**	2

Only Directors are employed by the Company.

16. Interest income – Group

Interest income comprises interest earned during the period on cash balances with different financial institutions (Note 8).

17. Other gains and losses – Group

	Year ended 31 December 2008	Year ended 31 December 2007
Realised gain on forward currency contract	**4,179**	949
Gain on forward currency contracts	**–**	2,756
Foreign exchange loss	**(3,160)**	(235)
Other gains	**237**	–
Total other gains and losses	**1,256**	3,470

Realised gains on forward currency contracts for the years ended 31 December 2008 includes net gain of US$560,000 from two open forward currency contracts recognised in 2007 on fair value and net gain of US$3,619,000 from new forward currency contracts settled during the reporting period.

18. Current and deferred income tax – Group

	Year ended 31 December 2008	Year ended 31 December 2007
Current income tax	**(1,600)**	(270)
Net deferred income tax	**1,358**	528
	(242)	258

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 2008	Year ended 31 December 2007
Loss before income tax and minority interest	**(10,057)**	(2,831)
Tax calculated at domestic tax rates applicable to profits/(losses) in the respective countries	**2,180**	287
Tax effect of items which are not deductible or assessable for taxation purposes:		
Non-taxable gain	**167**	56
Additional deemed taxable income	**(1,075)**	–
Non-deductible expenses	**(814)**	(85)
UK taxes on overseas income	**(700)**	–
Income tax (charge)/benefit	**(242)**	258

Income tax benefit represents the effect of corporate profit tax provision in the amount of US$900,000 and deferred tax accrual in the amount of US$1,358,000.

The weighted average applicable tax rate was 21.7% (2007: 10.1%). The increase is caused by a change in the profitability of the Group's subsidiaries in the respective countries.

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008
(presented in US$000)

18. 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 2008	Differences recognition and reversal	31 December 2007
Tax effects of taxable temporary differences:			
Other receivables	**(487)**	(487)	–
Property, plant and equipment	**(12)**	59	(71)
Derivatives	**–**	785	(785)
Exploration assets	**–**	329	(329)
Total	**(499)**	686	(1,185)
Tax effect of deductible temporary differences:			
Tax losses carry forward	**2,302**	1,223	1,079
Exploration assets	**128**	128	–
Trade and other payables	**71**	(25)	96
Inventories	**1**	(89)	90
Share grant expenses	**–**	(403)	403
Other receivables	**–**	(155)	155
Insurance assets	**–**	(7)	7
Total	**2,502**	672	1,830
Net tax effect of temporary differences	**2,003**	1,358	645
Corporate profit tax provision	**–**	(1,600)	–
Income tax	**–**	(242)	–

19. Earnings per share – Group

Loss 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 2008	Year ended 31 December 2007
Net loss attributable to equity shareholders (per share)	**0.19**	0.06
Basic weighted number of shares	**54,008,474**	46,376,181

20. Cash flows used in operating activities – Group

	Year ended 31 December 2008	Year ended 31 December 2007
Loss for the period before tax	**(10,057)**	(2,831)
Adjustments to loss before tax:		
Share grant expense	**1,138**	3,871
Depreciation	**100**	27
Other non-cash operating gains	**(238)**	–
Charge for provision	**234**	–
Interest accrued	**–**	(94)
Gain on forward contract	**–**	(2,756)
Foreign exchange differences	**(1,841)**	235
Total effect of adjustments	**(607)**	1,283
Increase in long-term assets	**(5,981)**	–
Operating cash outflow prior to working capital	**(16,645)**	(1,548)
Working capital changes		
Increase in trade and other receivables	**(33)**	(4,510)
Decrease in derivative financial instruments	**2,756**	–
Increase in payables	**(327)**	1,066
Increase in inventory	**(1,611)**	(145)
Net cash outflow from operating activities	**(15,860)**	(5,137)

21. 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 and gas exploration and development	100%	May 2006
Gazneftеservice	Russia	Oil and 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

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 2007	Additions	Disposals	**31 December 2008**
Investments in Woodhurst Holdings	46,700	72,554	–	**119,254**
Investments in Volga Gas (Cyprus) Limited	51	1,000	–	**1,051**
Total investments	46,751	73,554	–	**120,305**

Included in additions above is an amount of US$57,554,000 reclassified from intercompany loan to investments in the period as the Directors consider this item to be permanent in nature.

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

22. Inter-company loan – Company

During 2008 management took the view that the loan of US$55,682,000 together with the interest accrued of US$1,872,000 was permanent in nature and accordingly the outstanding balance has been reclassified to 'Investments' (Note 20).

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008 (presented in US$000)

23. Accumulated profit – Company

	31 December 2008	31 December 2007
Retained (losses)/earnings	(1,084)	1,448
At start of year profit/(loss) for the year	1,408	(40)
Accumulated profit at 31 December	**324**	1,408

24. Trade and other payables – Company

	31 December 2008	31 December 2007
Trade creditors	1,611	254
Current tax provision	700	–
Value added tax provision	–	237
Total trade and other payables	**2,311**	491

25. Inter-company payables – Company

Intercompany payables represent an interest-free loan from Woodhurst Holdings.

26. Cash and cash equivalents – Company

	31 December 2008	31 December 2007
Cash at bank and on hand	18,496	21,213
Short-term bank deposits	–	5,625
Total cash and cash equivalents	**18,496**	26,838

27. Cash flows from/used in operating activities – Company

	31 December 2008	31 December 2007
(Loss)/profit for the period before tax	**(619)**	1,989
Adjustments to profit/loss before tax:		
Interest accrued	(1,871)	(777)
Other non-cash operating gains	(238)	–
Gain on forward contract	–	(2,756)
Charge for provision	234	–
Share grant expense	1,138	3,871
Foreign exchange differences	–	–
Operating cash outflow prior to working capital	**(1,356)**	2,327
Decrease in trade and other receivables	(933)	(69,791)
Decrease in derivative financial instruments	2,756	–
Increase in payables	7,191	204
Net cash from/used in operating activities	**7,658**	(67,260)

28. Audit fees – Group and Company

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

	Year ended 31 December 2008	Year ended 31 December 2007
Fees payable to Company's auditor for the audit of Parent Company and consolidated financial statements	235	255
Fees payable to the Company's auditor and its associated firms for other services:		
– The audit of Company's subsidiaries pursuant to legislation	9	–
– Other services pursuant to legislation	50	548
– Tax services	90	–
– Other, training	5	–
Total	**389**	803

Other services pursuant to legislation in 2007 include fees paid by the Group to the previous auditor, Moore Stephens, of US$491,000 relating to the IPO and US$57,000 relating to the interim review.

29. Related party transactions – Group and Company

The Group is controlled by Baring Vostok Private Equity Fund III, which owns 54.83% of the Company's shares. Baring Vostok Private Equity Fund III performs its control through a number of nominee holding companies. The remaining 45.17% of the shares are widely held.

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

Related party	Relationship	Nature of transactions	Year ended 31 December 2007	**Year ended 31 December 2008**
Cavendish Nominees	Controlling shareholder	Interest expense on loans received	–	**373**
Granite Consulting	Affiliated with controlling shareholder	Salaries, rent, services	–	**194**
Baring Vostok (Cyprus) Limited	Affiliated with controlling shareholder	Salaries, rent, services	86	**56**
Vladimir Koshcheev	Director	Services	3	**–**

Outstanded balances with above mentioned related parties as at 31 December 2008 and 31 December 2007 were as follows:

Related party	**31 December 2008**	31 December 2007
Cavendish Nominees	**–**	–
Granite Consulting	**–**	–
Baring Vostok (Cyprus) Limited	**12**	56

All transactions with related parties were made on commercial basis.

(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.

Related party	Kind of transactions	**Year ended 31 December 2008**	Year ended 31 December 2007
OOO Geo Eko	Long-term loan (interest rate 1%)	**13**	4
OOO Geopotential	Long-term loan (interest rate 1%)	**13**	4

(b) Key management compensation

	Year ended 31 December 2008	Year ended 31 December 2007
Salaries and other short-term employee benefits	**1,032**	596
Share-based payments	**1,130**	3,871
	2,162	4,467

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

	31 December 2008	31 December 2007
Due to/(from) related parties		
Baring Vostok (Cyprus) Limited	**12**	56
OOO Geo Eko	**(13)**	(4)
OOO Geopotential	**(13)**	(4)

All transactions with related parties were made on commercial basis.

30. Contingencies and commitments

30.1. Capital commitments

(a) Pre-Caspian Gas Company

(i) Karpenskiy licence area

In accordance with the amended Karpenskiy Licence Agreement ('Amended KLA') PGK is required to acquire 400 km^2 of 3-D seismic studies and to drill 14 wells. At the balance sheet date the Company had acquired 402.7 km^2 of 3-D seismic studies, thereby completing the licence requirements on 3-D acquisition. As at the balance sheet date seven of the committed wells have been drilled. Management currently estimates that expenditure to drill the balance will be approximately US$10 million.

Notes to the IFRS Consolidated Financial Statements continued
for the year ended 31 December 2008
(presented in US$000)

30. Contingencies and commitments continued

(ii) Pre-Caspian licence area

In accordance with the licence agreement for the Pre-Caspian Licence Area, PGK is required to acquire an additional 500 km of 2-D seismic in 2009. At balance sheet date the Company had acquired 1,000 km. The cost of seismic acquisition in 2009 is expected to be US$1,478,000. The Company may apply for exchange of existing 2-D acquisition obligations to 3-D seismic acquisition. The overall cost of seismic acquisition is expected to remain the same.

(iii) Urozhainoye licence area

There are no capital commitments in respect of the Urozhainoye Licence Agreement for 2009.

(b) Gaznefteservice-V-M licence area

In accordance with the V-M Licence Agreement, GNS must drill at least one well by July 2008. As of balance sheet date two wells have been completed. As of balance sheet date approximately US$512,449 remained to be paid under the drilling contract with BK Eurasia.

30.2. 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 2008, management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency and customs positions will be sustained.

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.

30.3. 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 KLA. 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
V-M	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 is attempting to comply with its licence requirements and has not received any official warnings or notifications about continuous non-compliance or any risk of suspension, restriction or termination.

31. Post-balance sheet events

Results of drilling

On 3 February 2009 the Group announced the results of well #4, a development well on the V-M field that had commenced drilling in November 2008. Net gas pay measured in the well was substantially less than anticipated and management has suspended the well pending full evaluation of the results. The impact of the results of the well on estimated gas and condensate reserves in the V-M field is yet to be estimated. The immediate plan for the field is to commence production from the first two wells early in 2H 2009.

In accordance with the successful efforts method of accounting, the costs associated with the well (US$3,425,000) continue to be capitalised as 'development assets'.

Executive Share Option Plan – grant of options

On 14 January 2009, the Company announced its intention to grant 568,732 thousand share options to Tony Alves, CFO, under the 2008 Executive Share Option Plan. The options are due to 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 are intended to have an exercise price of £1.00 representing the quoted market price in Volga Gas plc.

Notice of Meeting

Notice is hereby given that the Annual General Meeting of Volga Gas plc will be held at the London office of Akin Gump Strauss Hauer & Feld at Ten Bishops Square, London E1 6EG on 18 June 2009 at 9.00am for the following purposes:

Ordinary business

1. To receive the Directors' report and accounts for the year ended 31 December 2008.

2. To declare a final dividend of £nil.

3. To elect Antonio Maria Alves as a Director

4. To re-elect Aleksey Kalinin and Vladimir Koshcheev as Directors.

5. To reappoint auditors and to authorise the Directors to agree the remuneration of the auditors.

Special business

To consider and, if thought fit, to pass resolution 6 as an ordinary resolution and resolution 7 as a special resolution.

6. That, the Directors be and they are hereby generally and unconditionally authorised in accordance with Section 80(1) of the Companies Act 1985 ('the Act') to exercise all the powers of the Company to allot relevant securities (as defined in Section 80(2) of the Act) 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) 15 months from the passing of this Resolution, or (ii) the conclusion of the Annual General Meeting of the Company to be held in 2010, 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.

7. That, the Directors be and they are hereby empowered pursuant to Section 95 of the Act to allot equity securities (as defined in Section 94(2) of the Act) for cash; pursuant to the authority conferred by resolution 5 set out in the Notice convening this Annual General Meeting as if Section 89(1) 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 shall expire upon the expiry of the general authority conferred by resolution 6 set out in the Notice convening this Annual General Meeting, 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
March 2008

Notes:

1. 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.

2. A form of proxy is enclosed. To be effective, it must be deposited at the office of the Company's registrars so as to be received not later than 48 hours before the time appointed for holding the Annual General Meeting. 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.

3. 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 Annual General Meeting.

4. 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 48 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 48 hours before the meeting date.

5. In accordance with Regulation 41 of the Uncertificated Securities Regulations 2001, only those members entered on the Company's register of members at 6.00pm on the day which is two days before the day of the meeting or, if the meeting is adjourned, shareholders entered on the Company's register of members at 6.00pm on the day two days before the date of any adjournment shall be entitled to attend and vote at the meeting.

6. In order to facilitate voting by corporate representatives at the Annual General Meeting, arrangements will be put in place at the Annual General Meeting so that (i) if a corporate shareholder has appointed the Chairman of the meeting as its corporate representative to vote on a poll in accordance with the directions of all of the other corporate representatives for that shareholder at the meeting, then on a poll those corporate representatives will give voting directions to the Chairman and the Chairman will vote (or withhold a vote) as corporate representative in accordance with those directions; and (ii) if more than one corporate representative for the same corporate shareholder attends the meeting but the corporate shareholder has not appointed the Chairman of the meeting as its corporate representative, a designated corporate representative will be nominated, from those corporate representatives who attend, who will vote on a poll and the other corporate representatives will give voting directions to that designated corporate representative.

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
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
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	to apply a cement plug to close the well and weld a steel plate to the top of the well; the well is then abandoned
mbbls	thousand 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% 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% 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% 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	reserves definitions consistent with those standards 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 licence. 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 licence, 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.

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