PetroNeft Resources plc

Annual Report and Accounts 2008

Годовой Отчет 2008

4 oil fields 70mmbo 2P reserves

26 prospects and 4 leads
529mmbo 3P reserves

Production
due to commence **2010**

Successful
equity placing
raising **US$17.2m**

US$25.5m
capital expenditure

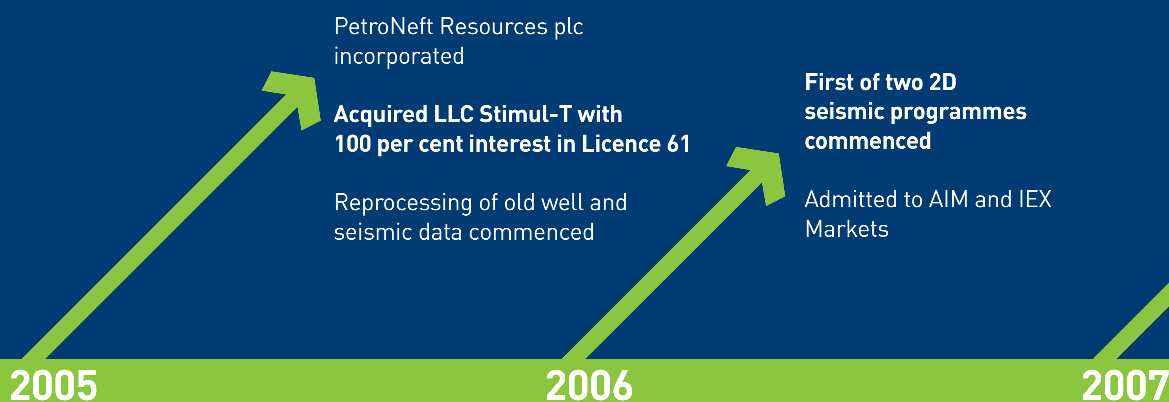
Active exploration and development
of **oil resources** in Western Siberia

At a glance

PetroNeft Resources plc is a public company registered in Ireland.

The Group was established in 2005 to develop oil and gas assets in Russia and the FSU and was admitted to the London AIM and Dublin IEX Markets in 2006. The main asset of the Company is a 100% interest in a 4,991 km^2 oil and gas licence in the Tomsk Oblast in Russia.

1. Drilling rig at West Lineynoye oil field.
2. Site preparation at proposed Lineynoye production pad A.
3. Crew change helicopter.



2005

PetroNeft Resources plc incorporated

Acquired LLC Stimul-T with 100 per cent interest in Licence 61

Reprocessing of old well and seismic data commenced

2006

First of two 2D seismic programmes commenced

Admitted to AIM and IEX Markets

2007

Four years of achievement

Financial highlights

US$17.2m

July 2008 equity placing (2007: US$15.4m)

US$25.5m

Capital Expenditure (2007: US$18.0m)

- Discussions with International Banks on financing options ongoing.
- Appointment of Canaccord Adams as joint broker with Davy.
- Expanding Institutional shareholder base.

Operational highlights

6

6 wells drilled from March 2007 to September 2008

109%

Increase in 2P reserves since IPO

- Further increase in 2P reserves in 2008.
- Board sanction of development in June 2008.
- Production due to commence second half 2010.

First exploration well spudded

New field discovery at West Lineynoye

Pipeline tie-in and sharing agreed with Bashneft

First pilot production from Lineynoye and West Lineynoye oil fields

New field discovery at Kondrashevskoye

Development of Lineynoye and West Lineynoye fields sanctioned

Exploration work programme completed for full 25 year Licence term

2008

01 Introduction

01 Highlights
02 About PetroNeft
04 PetroNeft Reserves
06 Questions & Answers

02 Review of the year

08 Chairman's Statement
10 Chief Executive Officer's Report
14 Health, Safety and Environmental Report
16 Financial Review

03 Governance/ Accounts

20 Board of Directors
22 Directors' Report
26 Independent Auditors' Report
28 Consolidated Income Statement
29 Consolidated Balance Sheet
30 Consolidated Statement of Changes in Equity
31 Consolidated Cash Flow Statement
32 Company Balance Sheet
33 Company Statement of Changes in Equity
34 Company Cash Flow Statement
35 Notes to the Financial Statements
56 Notice of Annual General Meeting
60 Glossary
IBC Group Information

About PetroNeft

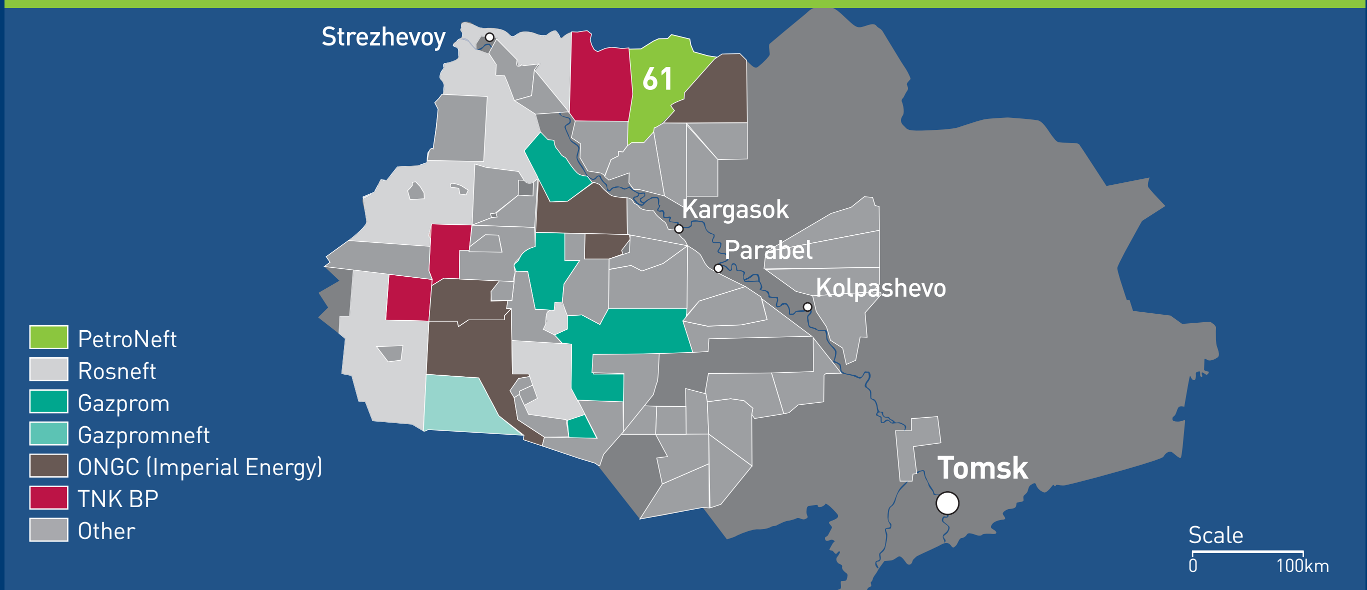
Where we operate

The Tomsk Oblast lies in the south-eastern West Siberian plain. The West Siberian oil and gas basin is the largest oil and gas basin in the world in terms of area and second largest to the Middle East in terms of reserves. The Tomsk Oblast has large reserves of natural resources and raw materials. With production of approximately 210,000 bopd, oil accounts for 62.1% of exports from the region. Oil production is carried out mainly in the north-west and in the north of the Oblast. There have been recent discoveries to the east of the Ob River including those by PetroNeft.

According to the most recent data from the Federal State Statistic Services, there are 1,036,500 residents in the Oblast. About 50% of the population lives in the capital city of Tomsk.

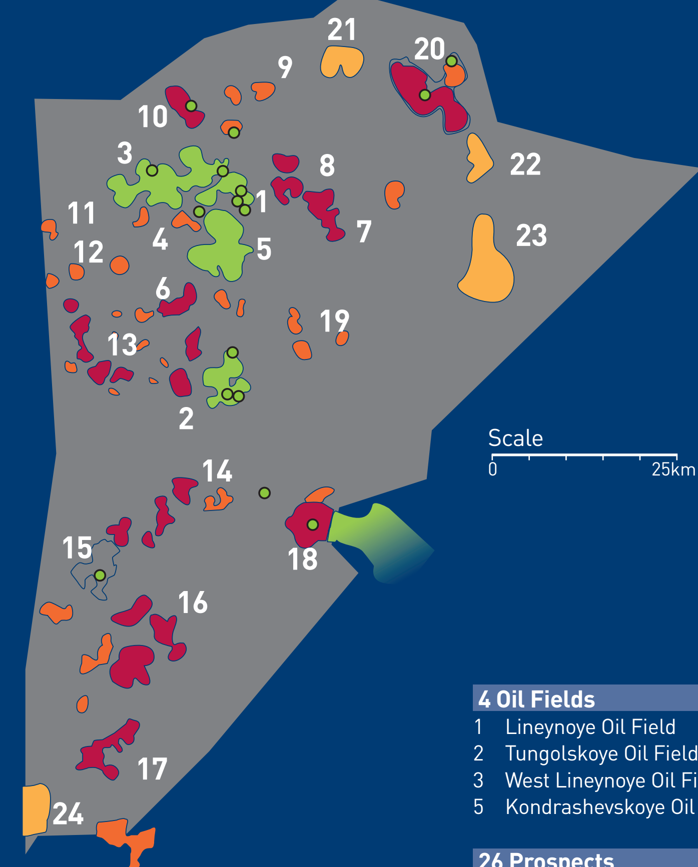
Russia

Tomsk Oblast



1. Coat of Arms of Tomsk Oblast.
2. Drilling Engineer, Dmitry Shelkovnikov, at Lineynoye No. 8 well site.

Licence 61



- Oil field
- Prospect ready for drilling
- Prospect identified
- Potential prospects
- Wells

4 Oil Fields

1 Lineynoye Oil Field
2 Tungolskoye Oil Field
3 West Lineynoye Oil Field
5 Kondrashevskoye Oil Field

26 Prospects

2 Tungolskoye West Lobe and North (2)
4 Lineynoye Lower
6 West Korchegskaya (Lower Jurassic)
7 Varyakhskaya
8 Varyakhskaya North & Upper (2)
9 Emtorskaya East
10 Emtorskaya Crown
11 Sigayevskaya
12 Sigayevskaya East
13 Kulikovskaya Group (2)
14 Kusinskiy Group (2)
15 Tuganskaya Group (3)
16 Kirillovskaya (4)
17 North Balkinskaya
18 Traverskaya
19 Tungolskoye East
20 Sibkrayevskaya

4 Potential Prospects

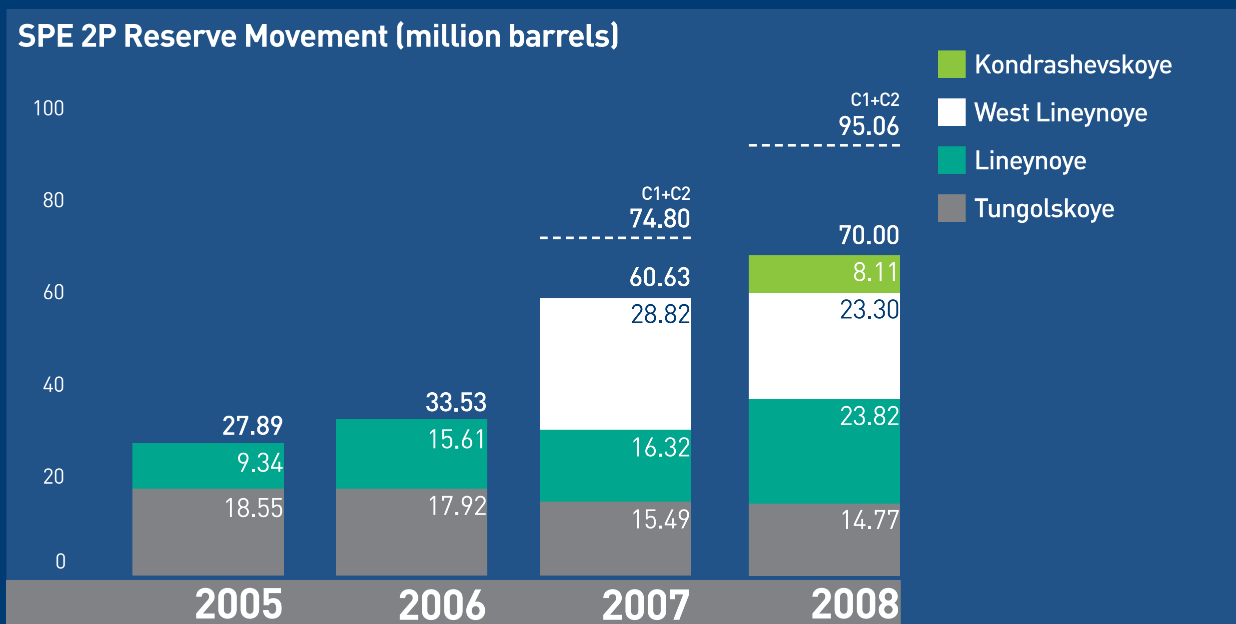
21 Emtorskaya North
22 Sibkrayevskaya East
23 Sobachya
24 West Balkinskaya

Top Five Prospects and Trends

- **Sibkrayevskaya Prospect**
  Upper Jurassic potential – 44 mmbo
- **Varyakhskaya Prospects**
  Upper Jurassic potential – 31 mmbo
- **Tuganskaya Prospects**
  Cretaceous and Jurassic potential – 103 mmbo
- **Traverskaya**
  Cretaceous and Jurassic potential – 24 mmbo
- **Kirillovskaya Prospects**
  Cretaceous and Jurassic potential – 118 mmbo

PetroNeft Reserves

Since acquiring Licence 61 in 2005, proved and probable reserves have grown by 151% to 70 million barrels. This has been achieved through a systematic programme of reprocessing and interpreting old seismic data and well logs, acquiring new 2D seismic and drilling six exploration/delineation wells. This detailed process led to the discovery of two new oil fields, the sanctioning of the development of the Lineynoye and West Lineynoye oil fields and the identification of 26 further prospects for exploration.



1. Well head at Lineynoye No. 6.

- 2P reserves are as estimated by Ryder Scott, Petroleum Consultants, each year and conform to the definitions approved by the Society of Petroleum Engineers (SPE) and the World Petroleum Congress.
- Oil water contact not defined at Kondrashevskoye – reserves could approach 20 million bbls if oil water contact is at spill point of structure, which is common for fields in the region.
- Russian C1 + C2 Reserves equal 95.06 million bbls as approved by the Russian State Reserves Committee in January 2009.

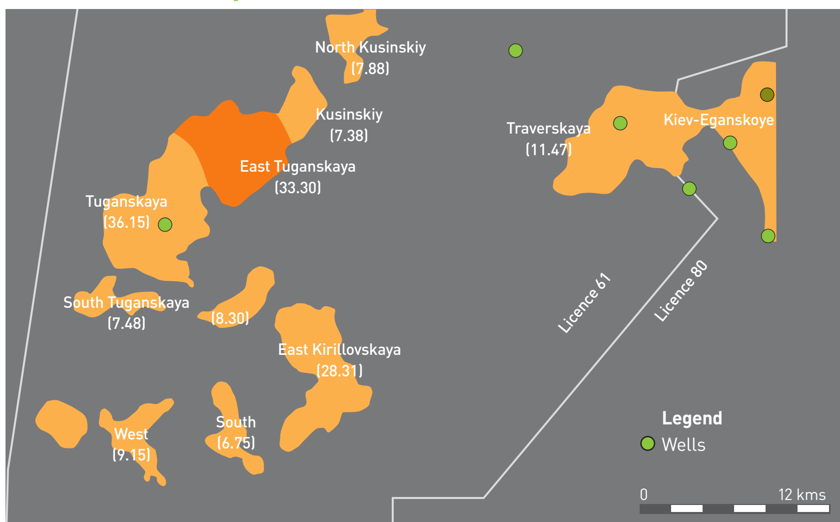
16%

Increase in 2P reserves in 2008 (2007: 81%)

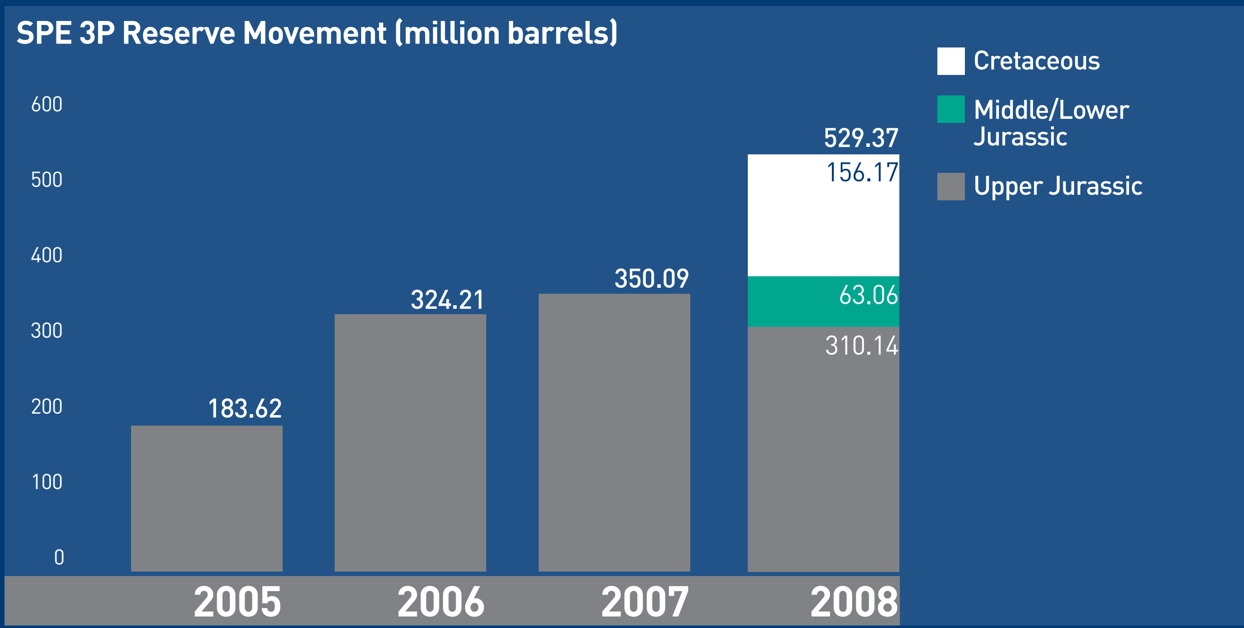
51%

Increase in 3P reserves in 2008 (2007: 8%)

Cretaceous Prospects



Cretaceous prospects identified in the southern half of the Licence area in 2008 following Cretaceous discovery at neighbouring Licence 80 and reinterpretation of old wells at Traverskaya and Tuganskaya. Numbers denote the possible (P50) Cretaceous prospect reserves in million barrels.



- 3P reserves are as estimated by Ryder Scott, Petroleum Consultants, each year and conform to the definitions approved by the Society of Petroleum Engineers (SPE) and the World Petroleum Congress.
- Possible reserves have been added for Lower to Middle Jurassic and Cretaceous structures in southern part of Licence 61 as a result of new petrophysical study by Tomsk Geophysical Company which identified potential by-passed pay in Tuganskaya and Traverskaya wells.
- The study was undertaken following Cretaceous discovery in adjacent Block 80 by Imperial Energy.
- The West Korchegskaya No. 1 well identified potential pay in Lower Jurassic J6 interval.

Questions & Answers

Dennis Francis, Chief Executive Officer, and Paul Dowling, Chief Financial Officer, address some key questions about our business:

Dennis Francis (left)
Paul Dowling (right)

Q. STRATEGY:

In addition to operations on Licence 61, PetroNeft continues to evaluate new projects for acquisition, with the objective of acquiring new 'Core Exploration and Production Areas'. How is this strategy progressing?

A. This strategy was slowed last autumn as a result of the financial crisis and falling oil prices. However most recently asset valuations are more in line with the overall financial situation and the deal flow is increasing. While PetroNeft's share price had declined since late 2008, our acreage, management, governance structure and access to capital markets are an attractive currency for other acreage holders and potential partners. We are actively investigating a number of potential opportunities and alliances which would allow PetroNeft to broaden its business and progress its development and production plans. Any transaction will be undertaken following extensive due diligence and with the objective of enhancing the long term potential of the business for any new and all existing shareholders.

Q. POLITICAL CLIMATE:

Are there particular challenges faced by PetroNeft as a result of the political climate in Russia?

A. PetroNeft strives to be considered as a 'well intentioned', fully compliant organisation by authorities in the areas where we operate and a good corporate citizen by stakeholders generally. This means that in addition to obeying laws, meeting our licence obligations and paying our taxes we respect our employees, the environment and the community around us. Our experience has been that both Regional and Federal authorities have welcomed and supported our activities. The most difficult challenge we face in Russia is in meeting the approval, reporting and permitting process of a large and occasionally bureaucratic government. Our Tomsk team is very experienced in this process, but it remains a high priority area for PetroNeft.

Q. INVESTMENT CASE FOR RUSSIA:

In light of the previous question can you summarise why an investor would want to invest in the Russian oil and gas industry and more particularly in PetroNeft?

A. Russia has the largest oil and gas reserve base in the world after the Middle East. The political regime is stable and the fiscal policy which has evolved through years of legislation is stable and provides comparatively attractive returns for investors. The local workforce is knowledgeable and low cost by western standards. The Russian government appreciates the importance of the oil and gas industry and recent tax changes have been beneficial to producers. PetroNeft has a core area in Licence 61 with significant reserves, future production and exploration upside which serves as a basis for future expansion. PetroNeft's focus is building a business based on small oil and gas fields which are not strategic to Russia and below the radar screen of the major Russian and foreign companies. In fact Russian majors are divesting of these sorts of assets as they allocate their human resources to their larger assets. PetroNeft could be a significant consolidator in this sphere over the next few years.

Q. TAX INCENTIVES:

You mention that the Russian government has been responsive to the financial crisis by providing some tax relief to mitigate the low oil prices. Are there any additional areas where the government can improve the situation for PetroNeft?

A. PetroNeft, in conjunction and co-operation with many other smaller oil companies, has been actively lobbying for additional tax relief in the area of the Mineral Resources Tax (MRT). This is an extraction tax that has a significant impact on project economics and the availability of finance. The government currently provides a seven year MRT tax holiday for projects in remote locations such as East Siberia and Timan Pechora, primarily as an incentive to compensate for new infrastructure. The situation in Western Siberia, particularly on the less developed eastern side of the Ob River where our Licence is located, is not that different as we need to build significant new infrastructure for the project. A two or three year MRT tax holiday would significantly improve the financibility of

1. Korchegskaya No.1 well.
2. Storage tanks at Lineynoye oil field.

The Company plans growth for shareholders through:

- **Active exploration and development of oil resources on Licence 61.**
- **Selective acquisition of new projects to develop an integrated portfolio.**
- **Active asset management to give best returns to shareholders.**

PetroNeft's project at low oil prices, and enhance the opportunity set for smaller companies generally throughout Russia.

Q. FINANCIAL CRISIS:

What has been the effect of the financial downturn on PetroNeft and what have you been doing to mitigate its effect on the Group?

A. Financial, operational and strategic flexibility are vital to small companies such as PetroNeft. When conditions in the financial markets began to deteriorate during 2008 PetroNeft was quick to adapt and the Board took the decision to delay Phase 1 of the development of the Lineynoye and West Lineynoye oil fields. This was not an easy decision at the time but it was the correct decision in the context of the Group's long term strategy and ambitions. Since then we have implemented pay cuts throughout the Group and focused our work activities on further cost reductions and project optimisation of the Phase 1 development plan. We delayed our decision on winter production until late December when we were sure that oil prices had stabilised and we could make a profit on the production. These decisions have ensured that PetroNeft remains debt-free and has minimal commitments, thereby enabling the Group to look at a wide range of alternative development and value optimisation opportunities for its acreage and its business.

Q. FUNDING:

How does a lower oil price environment affect the Group and its ability to raise funds?

A. When the Board took the decision in October 2008 to delay the development of the Lineynoye and West Lineynoye oil fields it was against a backdrop of the financial crisis, rapidly falling oil prices combined with development costs still at the level reached when oil prices peaked in July 2008. Since then development costs have also started to fall.

Today we are seeing a drop in rouble prices for drilling and key services of approximately 20% from peak prices. The rouble has also depreciated almost 30% to the US dollar from July 2008. Our efforts are also focused on optimising the development of the Phase 1 project in order to further reduce or defer costs. This combination reduces our project financing requirements from US$65 million to US$40 million. This lower borrowing requirement in itself means that bank funding should be easier to obtain.

It is also clear that, given the importance of the oil and gas industry to the Russian economy, there is a close relationship between the oil price and the US dollar/rouble exchange rate whereby the rouble will typically weaken on lower oil prices and strengthen on higher oil prices.

Russia is one of the few countries in the world where the oil services industry is developed to such an extent that most of the costs are incurred in the local currency as opposed to US dollars. All our development and Russian operating costs are based on rouble denominated contracts.

Q. CULTURE:

How would you describe the culture of PetroNeft and what are your core values?

A. While PetroNeft is a relatively new Group, its culture and core values are based on the past experiences and common beliefs of the western and Russian management team. Our core values are based in honesty, hard work, professionalism, respect for others and teamwork throughout the Group.

Chairman's Statement

"The Group has a solid asset base. It is well positioned, having met all of its licence obligations, is debt free and has sufficient cash reserves for 2009."

David Golder
Chairman

Since the formation of PetroNeft in 2005, our primary strategy for building a long term profitable company has been to focus on rapid exploration and early production of oil from Licence 61 in the Tomsk Oblast in Western Siberia.
A secondary strategy, as resources allow, is to acquire new assets, both exploration and producing, that will help the Company to grow beyond Licence 61.
The worldwide recession and turmoil in the financial and commodities markets in 2008 have slowed, but not stopped, our progress on these strategies.
We have built a strong foundation from which to grow as economic conditions improve, based upon sound technical data, a successful and systematic exploration programme, compliance with government requirements, detailed planning for production development and good working relationships with the financial and equity markets.

Exploration success and further reserve upgrade

Our successful exploration drilling programme on Licence 61 continued in 2008 with the Korchegskaya No.1 discovery at the Kondrashevskoye oil field, the Lineynoye No. 8 delineation well and the discovery of a new but as yet untested Lower Jurassic oil zone in the West Korchegskaya No.1 well. These wells, together with an exciting programme to re-examine and re-interpret the data from the pre-existing exploration wells on Licence 61 to look for by-passed or previously unidentified oil bearing zones have resulted in yet another significant upgrade to PetroNeft's reserves. Our proved and probable (2P) reserves have increased by 16% to 70 million barrels of oil and proved, probable and possible (3P) reserves are now estimated at 529 million barrels of oil, 51% greater than before. The 2008 drilling programme also completely fulfilled our exploration obligations for the full 25 year term of Licence 61, although we will continue to explore in the Licence area for years to come.

Oil field development

The successful Lineynoye No. 8 delineation well allowed the Board to sanction the development of the Lineynoye and West Lineynoye fields in June 2008. This would permit the development of 2P reserves of more than 47 million barrels of oil (as estimated by Ryder Scott; the Russian State Reserves Committee estimates about 60 million barrels of oil of comparable C1 + C2 reserves in these fields).

Preparations were nearing completion to mobilise pipeline, drilling and production equipment to begin the development as soon as project financing became available. The funding of the project was delayed in October 2008 by the collapse of the financial markets. The Board is confident that funding will become available later in 2009, however the delay means production will not now commence until 2010 instead of 2009 as previously planned.

We are taking advantage of this delay to seek ways to reduce the cost of the development, both by redesign and by securing some of the lower priced goods and services now available due to a slowing of competing projects and to substantially more favourable rouble/dollar exchange rates. With the cost reductions the project economics should be robust enough to allow development to proceed in the current lower oil price environment, once debt financing becomes available again.

To obtain more reservoir and well performance data from our fields to aid in optimising the project design, we have once again conducted a winter pilot production programme, trucking the oil over winter roads to two small refineries in the Tomsk Oblast. In addition to the Lineynoye No. 6 and No. 7 wells that were produced in early 2008, we have added the original discovery well, Lineynoye No. 1, which was successfully re-entered in 2008 and equipped for production. Lineynoye No. 1 flowed at a stabilised rate of 271 bopd without artificial lift or reservoir stimulation, confirming the original test results from 1972. In addition to gaining valuable well and reservoir performance data, the winter pilot production in early 2009 has paid for all of our operational costs plus a modest profit, while providing additional operating experience for our personnel.

Exploration and delineation wells drilled in 2008

Natural flow rate at Lineynoye No. 1 well which was re-entered in 2008

1. MI 8 helicopter used for crew change and supplies transport.

Successful equity financing

PetroNeft successfully raised US$17.2 million of financing for our development project through a placing in July 2008, prior to most of the market turmoil. The money was raised primarily to satisfy the terms of the mandate with Standard Bank and to enable the purchase of pipe for the pipeline, works associated with field development and general corporate overhead.

Board changes

In April 2008 Paul Dowling, Chief Financial Officer, joined the Board. Paul joined PetroNeft in October 2007 and has already made a significant contribution to the development of the Group. Paul is a Fellow of the Association of Chartered Certified Accountants and a member of the Irish Taxation Institute and has many years experience in corporate finance and financial reporting.

In March 2009 Executive Director Des Burke retired from the Board. Des was a founding Director of PetroNeft and established many of the key relationships with advisers and early investors in the Company as well as being closely involved in the Company's IPO and listing on the AIM and IEX markets in 2006. I would like to note both the Board's and my own personal appreciation of the contribution to PetroNeft made by Des over the past number of years.

Planning for the future

While the main objective of the Group remains the development of the northern oil fields on Licence 61, we have not lost sight of our other main objective of securing assets outside of Licence 61 to provide growth for the future. The financial downturn has provided numerous opportunities for new asset acquisitions, both exploration and producing, and we have been actively evaluating and prioritising opportunities to pursue at the appropriate time. In addition we have continuously sought ways to manage our current assets and programmes as cost effectively as possible, to provide the strongest possible base from which to eventually secure and manage a broader portfolio of assets.

The Group has a solid asset base. It is well positioned, having met all of its licence obligations, is debt free and has sufficient cash reserves for 2009. It is also working to increase and diversify its asset base, through a variety of opportunities that are arising, related to the business downturn. The oil and gas industry, just like the financial markets, is cyclical in nature and it is expected that pricing will improve from current levels. PetroNeft has a highly experienced management team and the size of the organisation allows us to be flexible and responsive to changing times in order to take advantage of the opportunities that current circumstances bring. Details of the current activities to secure the future funding of PetroNeft are included in the Financial Review.

I am confident that the Group's staff and management will meet the array of challenges we are facing and move forward in 2009 and beyond on both of our strategic focus areas, developing Licence 61 and providing growth for the Group.

Finally, I know that I speak for all the management and staff of the Company in giving sincere thanks to our shareholders, both old and new, for your confidence and continued support through the past year.

David Golder
Non-Executive Chairman

Chief Executive Officer's Report

"The foundations of the Group are set in high quality technical data, systematic exploration, compliance with government requirements and detailed planning towards production."

Dennis Francis
Chief Executive Officer

General

The primary strategy of PetroNeft is to bring its existing oil fields to production thereby generating sufficient cash flows to enable the exploration of the many remaining prospects on Licence 61. The foundations of the Group are set in high quality technical data, systematic exploration, compliance with government requirements and detailed planning towards production. The Group has developed a good working relationship with the financial markets in order to fund these developments and has established clear Health, Safety and Environmental (HSE) policies. A secondary strategy has been the acquisition of new assets, both exploration and producing, that will bring about more rapid expansion of the Group. Both strategies slowed in 2008 because of the worldwide financial crisis.

The 2008 drilling successes at the Korchegskaya No. 1 exploration well (Kondrashevskoye oil field) and particularly at the Lineynoye No. 8 delineation well enabled the Board to sanction the development of Licence 61 commencing with the northerly fields of Lineynoye and West Lineynoye. The project was then delayed in October due to volatility in the financial and crude oil markets.

Oil field development

Despite the schedule delay the Group has continued to advance the established oil fields toward full year-round pipeline production. Pilot production was achieved in early 2008 from the Lineynoye and West Lineynoye fields by way of long term flow tests from wells drilled in 2007. These efforts were continued in 2009 with the addition of the Lineynoye No. 1 well which was re-entered and re-completed in 2008. Lineynoye No. 1 flowed at a stabilised rate of 271 bopd without the aid of artificial lift or reservoir stimulation which confirmed the test results achieved in 1972. This long term test production was trucked via winter roads to two small refineries located at Parabel in the Tomsk Region. In addition to generating a modest profit over the period this production data will help in planning the optimal development for the fields.

A major milestone early in the year was the agreement with Bashneft, a producer in the Khanty Mansiysk Oblast, immediately to the north of Licence 61, to receive and process as required oil from the Group's oil fields and transport to the TransNeft export pipeline system, at favourable tariff rates. This focuses the initial production development on the northern oil fields of the Licence area, Lineynoye and West Lineynoye, where the main 2P reserves have been established. The new field at Kondrashevskoye, Tungolskoye and any other new discoveries will be developed later on an incremental basis. The delay has not changed this basic development philosophy, but studies are now underway to cut costs and further optimise the development project.

As stated above, the initial focus of development to oil production (Phase 1) will be on the Lineynoye and West Lineynoye oil fields. The 2P reserve base of these fields is 47.12 million barrels of oil, as reported by Ryder Scott, with 8.40 million barrels in the P1 category. The Russian State Reserves Balance for these two fields was updated during the year with registered C1+C2 reserves of 59.91 million bbls including 13.41 million barrels in the C1 category. The Plan of Development, as designed in conjunction with the Tomsk branch of the Siberian Scientific Institute of Geology, Geophysics and Mineral Resources (SNIIGGMS), demonstrates that the economics of Phase 1 are sufficiently robust to support the export pipeline and common field processing facilities. These economics are based on an export oil price of US$65.00 per barrel and domestic sales at US$36.44 per barrel beginning in July 2010. These economics are subject to continuing review based on lower oil prices, decreasing capital costs and changes in the Russian taxation system for oil producers. Additions of production from other oil fields and possible future discoveries, developed on an incremental basis, will also enhance these economics.

107

Total number of production wells expected to be drilled at Lineynoye and West Lineynoye oil fields

4,000bopd

Expected production by end 2010

1. MI 26 helicopter transporting workover equipment to Lineynoye No.1 site.

SNIIGGMS also obtained approval of Russian classified reserves by the Russian State Reserve Committee and approval of the Development Plan from the Russian Central Development Committee. The Institute has a great deal of experience in preparing such plans and in getting the necessary approvals to proceed with the development.

Even though the financing has been delayed the basic Development Plan for Phase 1 remains intact, with ongoing efforts to cut costs and further optimise the design. A general outline for Phase 1 of the Development Plan will be as follows:

(a) Pipeline development to Bashneft terminal

The design engineering, soil sampling survey and environmental studies for the pipeline and pipeline route have been completed and approvals are underway. The design of the custody transfer point has been completed but is under further review for possible optimisation. The Company purchased 65 km of 273 mm diameter pipe in July 2008 which was transported by rail and then river barge to a staging area on the Vakh River 24 km north of the Lukpaiskaya custody transfer point. The pipe is currently stored at this location until the project recommences.

(b) Processing facilities for the oil

Field oil processing facilities are simple and of standard design for the region. The initial requirements are minimal and efforts are underway to design and time the construction to carefully align with the development needs and defer expenditures that are not needed early on.

(c) Infrastructure development at oil field site

These include the development of production crew accommodation and facilities, the installation of roads, power generation capacity, oil gathering facilities and water injection lines, etc. Again the development of these will be delayed to avail of capital reductions.

(d) Drilling of production wells

This will commence in 2010 using one platform drilling rig in the first year and two drilling rigs thereafter. Approximately nine deviated production wells will be drilled each year by each rig from a drilling pad. At peak production there will be over 100 production and water injection wells. The drilling programme has been designed around the Russian BU 3000 EUK production rig which is cost efficient and technically proven in the area. All producing wells are likely to utilise hydraulic fracturing and electrical submersible pumps in order to maximise production.

(e) Production

Initial production from the Lineynoye and West Lineynoye oil fields is planned at approximately 4,000 bopd in year one of production, peaking at 12,000 bopd three years later.

Exploration and reserve expansion

Drilling

Since the IPO in September 2006 the Company has discovered two new fields and increased its 2P reserve base from 33.53 million barrels to 70.00 million barrels. The Russian Registered reserves in the C1+C2 category now stand at 95.06 million barrels. These reserves are not calculated on exactly the same criteria as the SPE reserves, but there should be general alignment between the C1+C2 and 2P numbers.

Five of the six wells drilled by the Group to date have intersected oil reservoirs at the predicted horizons. West Lineynoye was a significant discovery and we expect further delineation will show the Kondrashevskoye field also to be a significant discovery. The discovery well at Kondrashevskoye was drilled on the crest of the structure and the main reservoir was oil saturated throughout. In order to define the location of the oil water contact and the ultimate size of the field, a further delineation well will be required. Ryder Scott currently estimate Kondrashevskoye 2P reserves at 8.11 million barrels, but the ultimate figure could be significantly greater.

Chief Executive Officer's Report (continued)

"PetroNeft has now drilled the required six wells and has met all of its exploration drilling and seismic requirements for the 25 year term of the Licence."

41° API

Typical gravity of oil from wells drilled to date

2,750 metres

Typical total depth of exploration well

The last exploration well of the 2008 season, West Korchegskaya No. 1, was disappointing in that the main Upper Jurassic reservoir interval was not present in the well. However, a 25 metre thick sandstone interval, with hydrocarbon potential, was identified in the secondary Lower Jurassic objective. This reservoir is tight and will require hydraulic fracturing for proper testing. The well has been cased and will be tested in the future when proper equipment for the testing is available in the field.

PetroNeft has now drilled the required six wells and has met all of its exploration drilling and seismic requirements for the 25 year term of the Licence.

Geological and geophysical studies

In 2006 and 2007 the Group acquired 1,055 km of high resolution 2D seismic data, thereby completing its 1,000 km seismic obligation. As a result several prospects and potential prospects have moved into the 'ready to drill' category, further enhancing the potential of Licence 61. A significant amount of reserve has also been moved from the P4 exploration resource category, to the P3 possible category.

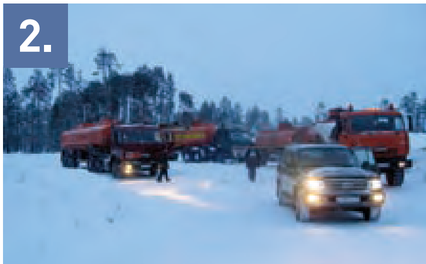
In 2008 a well in the Kiev-Eganskoye field in adjacent Block 80 to the east of Licence 61 successfully tested Lower Cretaceous oil pay that had been by-passed by previous exploration.

The KE 361 well tested over 1,500 bopd without stimulation or pumping from a 7 metre thick Lower Cretaceous sandstone. Following this successful test PetroNeft commissioned Tomsk Geophysical Company (TGK) to re-interpret the geological and geophysical data from select exploration wells in Licence 61. TGK is the same contractor that identified the by-passed pay in old wells at Kiev-Eganskoye and they interpret potential by-passed pay in both the Cretaceous and Lower to Middle Jurassic sections in the Tuganskaya No. 1 and Traverskaya No. 1 wells. These structures are located in the southern portion of the Licence and are believed to have a similar geological history to the Kiev-Eganskoye structure. In fact the Traverskaya structure is the western extension of the Kiev-Eganskoye structure and was already believed to have by-passed Upper Jurassic pay in tight reservoir above the field-wide oil water contact for the Kiev-Eganskoye field. The TGK study also confirmed this potential Upper Jurassic pay in Traverskaya No. 1 as well as 8.4 metres of potential Upper Jurassic by-passed pay in Sibkrayevskaya No. 1 located in the northeast part of the Licence. This is a very large structure and could potentially represent a very significant oil field.

Ryder Scott used the results of the TGK study and calculated possible reserves for the Lower to Middle Jurassic and Cretaceous prospects in the Licence area. These two new potentially productive intervals significantly add to the overall prospectivity of the Licence area. As a result P3 possible reserves have increased from 289.46 to 459.37 million barrels. Total 3P (P1+P2+P3) reserves for the Licence have increased from 350.09 to 529.37 million barrels.

Summary of reserves of Licence 61 as per Ryder Scott report dated 31 December 2008:

	Proved 1P mmbo	Proved and probable 2P mmbo	Proved, probable and possible 3P mmbo
Lineynoye field	5.69	23.82	28.65
West Lineynoye field	2.71	23.30	29.19
Kondrashevskoye field	.39	8.11	26.10
Tungolskoye field	1.42	14.77	18.91
Total	10.21	70.00	102.85
Upper Jurassic – 24 prospects			207.29
Cretaceous – 10 prospects			156.17
Lower to Middle Jurassic – 11 prospects			63.06
Total	**10.21**	**70.00**	**529.37**



1. Loading of crude oil transport trucks at Lineynoye oil field.
2. Convoy of crude oil trucks en route to market.

Winter Oil Production

PetroNeft commenced winter oil production in February 2008 from the L-6 and L-7 wells.

In January 2009, having negotiated favourable crude oil sales agreements with two small refineries at Parabel in the Tomsk Region, another season of production was commenced. Oil was produced from the L-1, L-6 and L-7 wells up until the end of March 2009 while winter roads were in place to truck the oil. Valuable production data was obtained during both test periods which will further help in the optimisation of the field development plan. Generally the crude is of high quality, 40°API gravity, and no reservoir pressure decline or water production was observed during the test period. The Group made a modest profit on the 2009 production.

Business Development

With the initial phase of exploration on Licence 61 completed and the development plan for Phase 1 in place in mid 2008, the Group began to focus more on the expansion of its asset portfolio to expand both its exploration and production capacity. A number of opportunities have been examined and some of them met the Group's strict technical and commercial criteria for acquisition. The Group was in the process of agreeing terms for the acquisition of some assets when the financial markets collapsed. The Group is still pursuing these assets and reviewing others and it is clear that sellers' expectations are beginning to reflect the new financial environment.

Also, in August 2008 the Group entered into a strategic alliance to jointly pursue opportunities outside of License 61 in Western Siberia with Arawak Energy. Under the terms of the agreement PetroNeft would have the first right of refusal to operate any projects.

While the Group's focus remains the development of the already discovered fields in the northern portion of the Licence area as soon as practicable, it will continue to look for ways to accelerate the evaluation of the numerous remaining prospects on Licence 61 through a farm-out and to consider acquisitions or other opportunities which could enhance the value of the Company.

Health, Safety and Environmental

The Group is fully committed to high standards of Health, Safety and Environmental (HSE) management and to act responsibly within the communities where we operate. More details of our HSE activities are included in our Health, Safety and Environmental report on pages 14 and 15.

Conclusion

2008 was a year of both progress and setbacks. Proved and probable reserves have been increased and moved towards ready for production status. A Plan of Development for the Lineynoye and West Lineynoye fields is now in place. Potential by-passed oil pay has been identified in several old exploration wells and as a result possible reserves have increased significantly. Firm foundations have been laid upon which to build the Group. The Group has a solid asset base in terms of both reserves and people and will be well positioned to move forward once liquidity returns to the financial markets.

Dennis Francis
Chief Executive Officer

Health, Safety and Environmental Report

"There are inherent risks in the oil and gas industry and these are managed through policies and practices which stress the need for individual and collective responsibility within our staff structure and with contractors that operate for the Group."

The Group is fully committed to high standards of Health, Safety and Environmental (HSE) management and social responsibilities within the communities we work in. There are inherent risks in the oil and gas industry and these are managed through policies and practices which stress the need for individual and collective responsibility within our staff structure and with contractors that operate for the Group.

Alexey Balyasnikov, the General Director of LLC Stimul-T, has primary responsibility for all aspects of Health, Safety and Environmental management. As well as reporting directly to Group CEO Dennis Francis he attends all Board meetings to report to the full Board on HSE issues.

There were no lost time incidents in the year and no events which breached the stringent environmental regulations that exist in Russia.

Health and Safety Management

2008 was a year of major advances for the Group in the area of Health and Safety. Having previously outsourced the monitoring and implementation of Health and Safety guidelines in our operations, in September 2008 Elena Morgunova joined LLC Stimul-T in a full time position as Labour Safety and Industrial Security Engineer.

The role of the Labour Safety and Industrial Security Department is to minimise the risks to employees and contractors from the day to day operation of our business, to train all staff in safety awareness, and to prepare contingency plans to minimise the potential impact of any unplanned incidents or events. For that purpose we:

- Control compliance of all employee operations with labour safety requirements and ensure that employees are adequately trained in the use of relevant equipment
- Monitor all contracts the Group enters into in order to ensure that contractors are informed of the labour safety policies of the Group
- Make Group employees and employees of contractors aware of labour safety policies of the Group
- Carry out regular site inspections to ensure full compliance
- Developed and delivered labour safety and industrial security training to Group employees
- Developed Emergency Response Plan for explosion and fire hazard facilities of the Group
- Developed and approved with state authorities:
  - Regulation for control of industrial safety compliance at hazardous facilities
  - Regulation for order of accidents investigation at hazardous industrial facilities of the Group
- Implemented a vaccination and insurance programme for tick-borne encephalitis, a disease common in the West Siberian environment

The Russian Federal Service for Ecological, Technical and Atomic Supervision, Rostechnadzor, carried out inspections at some of our operations during 2008 and no significant breaches were identified.

Environmental Impact Management

The Board recognises that the Group's activities can have a significant impact on the environment. As part of its responsibilities under Russian law an environmental assessment of the Licence area was carried out before any drilling work commenced in 2007. This was to establish the state of the environment within the Licence area in advance of any major works.

Since early 2007 there has been a dedicated full time Environmental Engineer, Elena Nepriyateleva, on staff in our Tomsk office. Her responsibilities include:

- Monitoring of exploration and production activities
- Monitoring activities of sub-contractors
- Maintaining compliance with various environmental laws and regulations

1. Typical landscape of Western Siberia.
2. Elena Morgunova, Labour Safety and Industrial Security Engineer, appointed in September 2008.
3. Safety signage at Lineynoye oil field.

In 2008 the main activities from an environmental perspective were the monitoring of:

- Drilling of Korchegskaya No. 1 well
- Drilling of West-Korchegskaya No. 1 well
- Drilling of Lineynoye No. 8 well
- Re-entry and workover of Lineynoye No.1 well
- Construction of bridge over Kiev-Egan River including borrow pit and access ways to construct the bridge
- Pilot production activities from January to March 2008

This included the use of an independent company to supervise the work of both our own staff and staff of contractors working at our sites.

Significant progress has also been made in the permitting and approvals process associated with the plan to develop the Lineynoye and West Lineynoye fields. Environmental approvals are required in the following areas associated with the development of the fields and the construction of the pipeline:

- Forestry and tree cutting permits
- Land management approvals for pipeline route
- Environmental aspect of engineering survey
- Project design and expert opinions from State expert assessment department

During 2008 a new Oil Spill Recovery plan was also implemented and a contract entered into with a local company that provides emergency support in the event of a major oil spill.

Community

One of PetroNeft's key philosophies is to operate as a compliant well intentioned Group within the communities where we work. This entails ensuring compliance with laws and regulations and returning and paying our taxes on time.

During 2008 we also made contributions to orphanages in the Tomsk Oblast and contributed to social programs run in the Alexandrovskoye region of Tomsk where our Licence area is located.

The completion of our new bridge over the Kiev-Egan River has also helped local communities as it opens up an area for hunting, fishing and mushroom gathering that had previously been inaccessible in summer time.

Financial Review

"During 2008, PetroNeft made significant advances towards its core strategy of bringing existing reserves to commercial development."

Paul Dowling
Chief Financial Officer

During 2008, PetroNeft made significant advances towards its core strategy of bringing existing reserves to commercial development. A US$17.2 million equity fund raising in July enabled the Group to purchase the 65 km of pipe required for construction of the pipeline from Lineynoye to Lukpaiskaya. In July PetroNeft entered into a mandate with Standard Bank in respect of the debt required to complete the development of the Lineynoye and West Lineynoye oil fields. In October, against the backdrop of the turmoil in the world financial markets, the Board took the decision to postpone the development of Lineynoye and West Lineynoye.

The mandate with Standard Bank remains in place and PetroNeft is continuing to work with Standard Bank and a number of other banks in order to finance the project.

Key Financial Metrics

	2008 US$	2007 US$
Overheads	**2,871,339**	2,467,459
Share-based payment expense	**727,164**	958,468
Foreign exchange loss/(gain) on intra group loans	**3,010,932**	(386,239)
Other foreign exchange loss/(gain)	**1,225,010**	(439,127)
Administrative expenses	**7,834,445**	2,600,561
Exceptional item – write off of survey costs for previous pipeline route	**–**	815,827
Loss for the year attributable to equity holders of the parent	**7,911,968**	3,203,262
Capital expenditure in the year	**25,475,299**	18,043,960
Net proceeds of equity share issues	**17,516,291**	14,686,870
Bank and cash balance at year-end	**2,168,197**	8,304,295

Net Loss

The net loss for the year increased to US$7,911,968 from US$3,203,262 in 2007. The main reason for the increase in losses relates to a foreign exchange loss of US$3,010,932 on US Dollar denominated loans from PetroNeft to its wholly owned subsidiary, LLC Stimul-T whose functional currency is the Russian Rouble. This loss arises due to the weakening of the Russian Rouble against the US Dollar in the last six months of the year. Once LLC Stimul-T is earning income from oil sales some of this income will be in US dollars and LLC Stimul-T will therefore be capable of repaying its US Dollar denominated debt out of US Dollar income.

Overheads increased by 16% to US$2,871,339 which primarily reflects some additional staff costs as we move towards development of oil fields.

Finance Revenue

Finance revenue of US$128,487 arises from bank interest received on bank deposits. A combination of less funds on deposit and lower interest rates was the reason for the reduction in the year.

Taxation

The current tax charge arises on finance revenue earned from bank deposits. The deferred tax charge arises on finance revenue earned by PetroNeft on loans to its wholly owned subsidiary LLC Stimul-T.

1. Pipe in storage near Lukpaiskaya.
2. Pipe at rail yard near Nizhnevartovsk prior to being loaded onto barges for onward transport.

16%

Increase in overheads in 2008

104%

Increase in staff numbers in 2008 (From 28 to 57 employees)

Capital Investment

Three wells were drilled during 2008 at a cost of approximately US$10 million. This work programme enabled the sanctioning of the development of the Lineynoye and West Lineynoye oil fields by virtue of the successful Lineynoye No. 8 development well. It also added 8.1 mmbo to our 2P reserves with the discovery of the Kondrashevskoye oil field which is likely to have reserves of up to 20 million barrels once a delineation well can prove the oil water contact of the field. The Russian State Reserves Committee have approved C1+C2 reserves of 19 mmbo in respect of Kondrashevskoye.

The third well drilled at West Korchegskaya was initially disappointing as the primary objective in the Upper Jurassic horizon was absent but a potentially oil productive 25 metre sand was intersected at the Lower Jurassic horizon which will require further testing to confirm.

In 2008 we also completed a bridge over the Kiev-Egan River within our Licence area at a cost of US$789,843. This bridge significantly extends the all weather roads further within our Licence area which will lead to cost savings, particularly on the use of helicopter transport.

Oil and gas properties

Once the Board sanctioned the development of the Lineynoye and West Lineynoye oil fields, expenditure incurred to date relating to these oil fields was transferred from exploration and evaluation assets to oil and gas properties in accordance with IFRS 6, *Exploration for and Evaluation of Mineral Resources*. Total expenditure amounted to US$11,202,901 and it was necessary to carry out an impairment review in accordance with IAS 36, *Impairment of Assets*. This review did not result in any impairment to the carrying value of these assets. Expenditure during 2008 in respect of oil and gas properties totalled US$16,767,510 including US$9,542,923 in respect of 65 km of pipe.

Russian VAT

Prior to 2008 PetroNeft's Russian subsidiaries had not received any refunds of Russian VAT incurred on the work carried out to date. The amount due as at 31 December 2007 was US$3,311,690 and it had been accounted for at that date as part of exploration and evaluation costs in non-current assets as the Group was uncertain whether this amount would be recoverable. This matter was resolved during the year and refunds were received for all periods up to 30 June 2008 before the year-end. In March 2009 the refund for the quarter ending 30 September 2008 was received and we now expect to receive future refunds on a timely basis. The Board would like to acknowledge the efforts of our in house finance and legal team in Tomsk for their diligence and perseverance in this matter.

Cost cutting in 2009

In January 2009, as part of a review of costs, the current Executive Directors, Dennis Francis, Paul Dowling and David Sanders, as well as all staff in the Group agreed to a voluntary 10% pay cut effective immediately. The Executive Directors also elected to receive some of their remuneration for 2008 by way of shares. These shares will be issued once the close period for the 2008 accounts has passed at the higher of the market price at date of issue or the IPO price of the shares of £0.198. The Board has also agreed to allow Directors elect to have their Directors fees paid in shares. Where this option is exercised by a Director it is binding for a minimum of 12 months. The Group is also working to reduce all other overhead costs.

Future funding of PetroNeft

In order to achieve first production in 2010 the pipeline must be laid in the first quarter of 2010 and drilling of production wells commenced in the first half of 2010. This requires finance to be in place so that contracts can be completed, advance payments made and materials purchased in time for the key winter months when the materials required for the 2010 drilling programme can be moved into place in the most efficient manner.

The Group have prepared budgets and forecasts until 31 December 2010 and, based on this, the current development funding requirement is US$40 million (including estimated fees and interest costs of US$5 million). This is significantly lower than the previous requirement

Financial Review (continued)

"The reduction in the funding requirement is due to the weakening of the rouble as compared to the dollar and a softening of rouble prices for oilfield services and equipment across the Tomsk region."

Investor relations meetings held in 2008 (2007: 61)

of approximately US$65 million which existed at peak oil prices in mid 2008. The reduction in the funding requirement is due to the weakening of the rouble as compared to the dollar and a softening of rouble prices for oilfield services and equipment across the Tomsk region. Work is also ongoing to optimise the development so as to:

- reduce or modify field facilities where possible;
- delay expenditures where possible;
- reduce costs by utilising existing facilities at the pipeline tie-in point.

Once this optimisation work is complete it is hoped that the final funding requirement will be lower than US$40 million.

Based on the above the Board have approved a development plan and discussions are ongoing with selected banks, including Standard Bank in relation to funding. Considering progress to date the Board is confident that it can fund the project wholly or substantially with debt finance. However, should sufficient funding not be available by the fourth quarter of 2009 it is likely that the project would have to be delayed by at least 12 months as the winter season is the only time when the pipeline can be laid.

If this was the case then PetroNeft would require US$3 million to fund its base operations through to 31 December 2010 without any further cost cutting measures. The Board and its advisers believe that this funding could be raised through either the placement of new ordinary shares and/or the sale of some of the stock of pipe that is currently in storage.

In addition to the measures discussed above, the Group is in discussions with potential strategic investors to invest in Licence 61. Such an investment would provide funding for the development project as part of any agreement to invest. The Group is also examining a number of acquisition opportunities for producing assets that would bring both immediate and ongoing positive operational cash flows.

Financial Risk Management

The Board sets the treasury policies and objectives of the Group, which include controls over the procedures used to manage financial risk. The Group's activities expose the Group to a variety of financial risks including foreign currency, commodity price, credit, liquidity and interest rate risks. These financial risks are managed by the Group under policies approved by the Board. Details of the Group's financial risk management policies are set out in detail in Note 22 to the consolidated financial statements.

Investor Relations

During 2008, the CEO and CFO held regular meetings with analysts and institutional investors and the fund raising in July 2008 widened the base of institutional investors in the Company. In February 2008, PetroNeft hosted analysts and bankers in Tomsk, which included a trip to the field and presentations from our various technical partners in Tomsk.

The target for 2009 is to continue our programme of meetings and specifically to get more analyst coverage in order to further increase our visibility within the investment community.

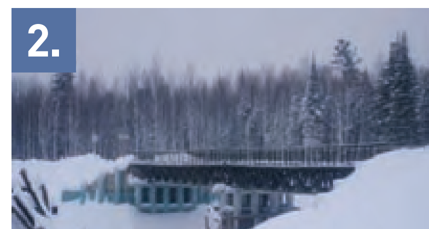
In May 2009 PetroNeft appointed Canaccord Adams as our London based joint-broker in addition to our Nomad Davy.

Paul Dowling
Chief Financial Officer

Significant Shareholders

So far as the Directors are aware, the names of the persons other than the Directors who, directly or indirectly, are interested in 3% or more of the Issued Share Capital at 2 June 2009 are as follows:

Name of Shareholder	Shares	Percentage
RAB Octane Fund Limited	37,868,791	16.52%
Ali Sobraliev	23,014,273	10.04%
Davycrest Nominees Limited	31,694,191	13.83%
JP Morgan Asset Mgt (UK) Limited	11,149,400	4.86%
Arawak Energy	10,101,010	4.41%
Lynchwood Nominees Limited	9,432,900	4.12%



1. Kiev-Egan bridge under construction.
2. Completed bridge.

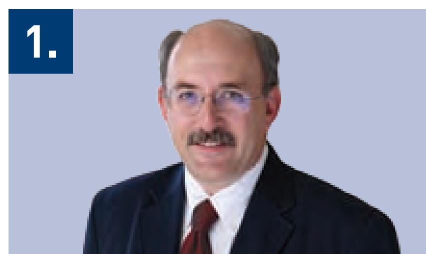
Principal Risks and Uncertainties

The principal risks and uncertainties affecting the Group are:

Risk Category	Issue	Mitigation
Country Risks	Political – federal risks	Fields/acquisitions below 500 million boe not considered strategic.
		State is encouraging small operators.
	Political – local risks	Oblast administration very supportive of development.
		Local management well respected in region.
	Ownership of assets	Licence received at government auction – work programme is complete.
		25 year Licence term can be extended based on approved production plan.
	Changes in tax structure	Fiscal system is stable and recent changes benefit oil & gas companies.
		Proactive lobbying effort in area of tax legislation.
Technical Risks	Exploration risk	Proven oil and gas basin with multiple plays.
		Good quality 2D seismic.
		Knowledgeable exploration team with proven track record in region.
	Drilling risk	Relatively shallow wells with proven technology.
		Good rig availability.
		Experienced operations team.
	Production/Completion risk	Routine completion practices including fracture stimulation.
		Reserves high graded, extensive reservoir simulation and reservoir management will be undertaken.
		Performance of similar fields in region.
	Reserve risk	SPE and Russian reserves updated and in alignment.
Financial Risks	Availability of finance	Bank mandate entered into in July 2008. Numerous other financing options continue to be explored. Regular Investor Relations meetings held.
	Oil price	Robust project sanction economics – conservative base case assumptions.
		Board will consider use of appropriate hedging instruments once year-round production commences.
	Industry cost inflation	Rigorous contracting procedures with competitive tendering. Also the relationship of the dollar/rouble exchange rate to the dollar provides a natural hedge on costs as compared to income.
	Uninsured events	Comprehensive insurance programme in place.
Other Risks	HSE incidents	HSE standards set and monitored regularly across the Group.
	Export quota	Conservative assumption in economics – domestic net back price now largely in alignment with export net back.
	Third party pipeline access	Transportation agreement in place.
	Transneft pipeline access	Available capacity and access confirmed.
		East Siberia-Pacific Ocean (ESPO) pipeline will allow export of West Siberian Light to Pacific market.

Board of Directors

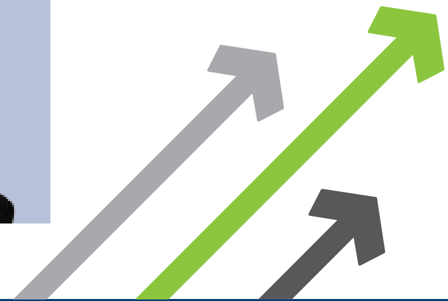
The Group's strategy is to develop an oil exploration, development and production business in Russia, using the combined skills, experience and resources of the Group's Directors and employees.



1. David Golder
Non-Executive Chairman (Age 61)
Mr. Golder has been Non-Executive Chairman of the Company since 2005. He is also Chairman of the Remuneration Committee and a member of the Audit Committee. He has over 38 years experience in the petroleum industry and was formerly Senior Vice President of Marathon Oil Company ("Marathon"), retiring in 2003. From June 1996 to 1999, Mr. Golder was seconded from Marathon to Sakhalin Energy Investment Company where he was Executive Vice President – Upstream. Located in Moscow, he managed all upstream activities which focused on the oil development and company infrastructure aspects of the Sakhalin II Project onshore and offshore Sakhalin Island. Mr. Golder is a member of the Society of Petroleum Engineers. He has a BSc degree in Petroleum & Natural Gas Engineering from Pennsylvania State University and has completed the Program for Management Development at Harvard University.

2. Dennis Francis
Chief Executive Officer and Executive Director (Age 60)
Mr. Francis has been Chief Executive Officer and an Executive Director of the Company since its formation in 2005. He has over 37 years experience in the petroleum industry and was with Marathon for 30 years. From 1990, Mr. Francis was USSR/FSU task force manager responsible for developing new opportunities for Marathon in Russia. Marathon and its partners ultimately won the first Russian competitive tender which was to develop the Sakhalin II Project offshore Sakhalin Island. Mr. Francis was instrumental in the formation of Sakhalin Energy Investment Company and was a Director in that Company. He is a member of the American Association of Petroleum Geologists and Society of Exploration Geophysicists. He has a BSc degree in geophysical engineering and an MSc degree in geology, both from the Colorado School of Mines. He has also completed the Program for Management Development at Harvard University.

3. Dr. David Sanders
General Legal Counsel, Executive Director and Company Secretary (Age 60)
Dr. Sanders has been General Legal Counsel, Executive Director and Company Secretary of the Company since its formation in 2005. He is an attorney of law and has over 32 years experience in the petroleum industry, including 14 years of doing business in Russia and three years in the oil and gas litigation division of the law firm of Fulbright & Jaworski LLP. In 1988, Dr. Sanders joined Marathon where he analysed and reviewed joint venture agreements for worldwide production until his assignment in 1991 to the negotiating team for the Sakhalin II Project in Russia. Dr. Sanders has a degree in electronics from Pennsylvania Institute of Technology, a liberal arts degree from the University of Houston and a doctorate of jurisprudence from South Texas College of Law. He is a member of the State Bar of Texas and of the American Bar Association.



4. Paul Dowling
Chief Financial Officer and Executive Director (Age 37)
Mr. Dowling joined the Company on 1 October 2007 and was appointed to the Board of Directors on 29 April 2008. He has 17 years experience in the areas of accounting, auditing, taxation, financial reporting, AIM/IPO reporting, corporate restructuring, corporate finance and acquisitions/disposals. Most recently he was a Partner in the accounting firm, LHM Casey McGrath, located in Dublin. Mr. Dowling is a fellow of the Association of Chartered Certified Accountants (ACCA) and a member of the Irish Taxation Institute. He currently represents the ACCA with the Consultative Committee of Accountancy Bodies – Ireland (CCAB-I).

5. Thomas Hickey
Independent Non-Executive Director (Age 40)
Mr. Hickey has been a Non-Executive Director of the Company since 2005. He is Chairman of the Audit Committee and a member of the Remuneration Committee. He was Chief Financial Officer and a Director of Tullow Oil plc from 2000 to 2008. During this time Tullow grew via a number of significant acquisitions. Prior to joining Tullow Oil plc he was an Associate Director of ABN AMRO Corporate Finance (Ireland) Limited. In this role, he advised public and private companies in a wide range of industry sectors in the areas of fund raising, stock exchange requirements, mergers and acquisitions, flotations and related transactions. Mr. Hickey is a Commerce graduate of University College Dublin and a Fellow of the Irish Institute of Chartered Accountants.

6. Vakha A. Sobraliev
Non-Executive Director (Age 54)
Mr. Sobraliev has been a Non-Executive Director of the Company since 2005. He is a member of both the Audit and Remuneration Committees. He has over 30 years experience operating and managing energy service companies and state operating units exploring for and exploiting oil resources in the Western Siberian oil basin. Mr. Sobraliev is currently a shareholder and General Director of Tomskburneftegaz LLC, an oil and gas well drilling and services company operating in Western Siberia. From 1975 to 2000, Mr. Sobraliev worked for Tomskneft and Strezhevoy drilling boards in various drilling and economic capacities including chief engineer and chief accountant. He has degrees in mining engineering and economics from Tomsk Polytechnic Institute and the Tomsk State University respectively. Mr. Sobraliev is a resident of Tomsk, Russia.

Senior Management

1. Alexey Balyasnikov
General Director
LLC Stimul-T

2. Alexander Frenovsky
Executive Director
LLC Stimul-T

3. Nikolay Karapuzov
Chief Geologist
LLC Stimul-T

For biographies of senior management see www.petroneft.com

Directors' Report

For the year ended 31 December 2008

The Directors present herewith their Annual Report and the audited financial statements of PetroNeft Resources plc (the 'Company') and its subsidiaries (collectively, the 'Group') for the year ended 31 December 2008.

Principal Activity

The principal activities of the Group are that of oil and gas exploration, development and production. The Group was established to acquire and develop, directly or indirectly, oil and gas exploration, development and production interests in Russia and other countries of the former Soviet Union. A detailed business review is included in the Chief Executive Officer's Report and in the Financial Review.

Results and Dividends

The loss for the year before tax amounted to US$7,705,958 (2007: US$2,950,993). After a tax charge of US$206,010 (2007: US$252,269) the loss for the year amounted to US$7,911,968 (2007: US$3,203,262). The Directors do not recommend payment of a dividend. Accordingly, an amount of US$7,911,968 has been debited to reserves.

Review of the Development and Performance of the Business

In compliance with the requirements of the Companies Acts, 1963 to 2006, a fair review of the performance and development of the Group's business during the year, its position at the year-end and its future prospects is contained in the Chief Executive Officer's Report on pages 10 to 13 and the Financial Review on pages 16 to 19. The key performance indicators used by management are set out in the Financial Review on page 16.

Corporate Governance

The Company is not subject to the Combined Code on Corporate Governance applicable to companies with full listings on the Dublin and London Stock Exchange. The Company does, however, intend, in so far as is practicable and desirable, given the size and nature of the business and the constitution of the Board, to comply with the Corporate Governance Guidelines for AIM Companies (the 'QCA Guidelines') as published by the Quoted Companies Alliance (the 'QCA').

The QCA Guidelines were devised, in consultation with a number of significant institutional small company investors, as an alternative corporate governance code applicable to AIM companies. An alternative code was proposed because the QCA considered the Combined Code on Corporate Governance to be inappropriate to many AIM companies.

The QCA Guidelines state that 'the purpose of good corporate governance is to ensure that the Company is managed in an efficient, effective and entrepreneurial manner for the benefit of all shareholders over the longer term.' The guidelines set out a code of best practice for AIM companies. Those guidelines require, among other things, that:

a) certain matters be specifically reserved for the Board's decision;
b) the Board should be supplied in a timely manner with information (including regular management financial information) in a form and of a quality appropriate to enable it to discharge its duties;
c) the Board should, at least annually, conduct a review of the effectiveness of the Company's system of internal controls and should report to shareholders that they have done so;
d) the roles of Chairman and Chief Executive should not be exercised by the same individual or there should be a clear explanation of how other Board procedures provide protection against the risks of concentration of power within the Company;
e) a Company should have at least two independent Non-Executive Directors on the Board and should not be dominated by one person or group of people;
f) all Directors should be submitted for re-election at regular intervals subject to continued satisfactory performance;
g) the Board should establish audit, remuneration and nomination committees; and
h) there should be a dialogue with shareholders based on a mutual understanding of objectives.

Major corporate decisions of the Group are subject to Board approval. The Board is supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. These matters include approval of the Group's general commercial strategy, financial statements, Board membership, significant acquisitions and disposals, major capital expenditures and risk management and treasury policies. The Company holds regular Board meetings throughout the year.

In accordance with the QCA Guidelines, the Board has established audit and remuneration committees, as described below, and utilises other committees as necessary in order to ensure effective governance.

Audit Committee

The members of the Audit Committee are Thomas Hickey, David Golder and Vakha Sobraliev. It is chaired by Thomas Hickey. The Audit Committee's responsibilities include, among other things, reviewing interim and year end financial statements, accounting principles, policies and practices, internal controls, and overseeing the relationship with the external auditor, including the planned scope and results of their audit.

Remuneration Committee

The members of the Remuneration Committee are David Golder, Thomas Hickey and Vakha Sobraliev. It is chaired by David Golder. The Remuneration Committee's responsibilities include, among other things, determining the policy on remuneration provided, however, that no Director shall be directly involved in any decisions as to their own remuneration.

Nomination Committee

Given the current size of the Group, a Nominations Committee is not considered necessary. The Board reserves to itself the process by which a new director is appointed.

The recent retirement of Des Burke as an Executive Director of the Board means that the percentage of Non-Executive Directors on the Board is now equal to the recommended 50%. The Group has adopted a model code for Directors' dealings that is appropriate for an AIM company. The Group complies with Rule 21 of the AIM Rules relating to Directors' dealings and will take all reasonable steps to ensure compliance by the Directors and the Group's applicable employees and their relative associates.

Shareholder Communication

Shareholder communication is given high priority by the Group and there are regular meetings between senior executives, institutional shareholders, analysts and brokers. These meetings, which are governed by procedures designed to ensure that price sensitive information is not divulged, are designed to facilitate a two way dialogue based upon the mutual understanding of objectives. The Annual General Meeting ('AGM') affords individual shareholders the opportunity to question the Chairman and the Board, and their participation is welcomed.

The Chairmen of the Audit Committee and Remuneration Committee are available at the AGM to answer questions. In addition, major shareholders can meet with the Chairman or Executive and Non-Executive Directors on request.

The Board is kept appraised of the views of shareholders, and the market in general, through feedback from the meetings programme. Analysts' reports on the Company are also circulated to the Board on a regular basis. The Group's website, www.petroneft.com, is also a key communication tool with all shareholders. News releases are made available on the website immediately after release to the Stock Exchange.

Internal Control

The Directors have overall responsibility for the Group's system of internal control and have delegated responsibility for the implementation of this system to executive management. This system is reviewed annually and includes financial controls that enable the Board to meet its responsibilities for the integrity and accuracy of the Group's accounting records.

The Group's system of internal financial control provides reasonable, though not absolute, assurance that assets are safeguarded, transactions authorised and recorded properly and that material errors or irregularities are either prevented or detected within a timely period.

Directors

The present Directors are listed on pages 20 and 21. On 29 April 2008 Paul Dowling was appointed to the Board. His appointment was ratified at the Annual General Meeting on 14 August 2008 in accordance with the Articles of Association. On 31 March 2009 Desmond Burke retired from the Board.

In accordance with the Articles of Association, Thomas Hickey and Vakha Sobraliev retire by rotation and being eligible offer themselves for re-election.

Directors, Company Secretary and their Interests

The Directors and Secretary who held office during the year had no interest, other than those shown below, in the shares of the Company. All interests shown below are beneficial interests.

	Ordinary shares As at 2-Jun-09	Ordinary shares As at 31-Dec-08	Ordinary shares As at 1-Jan-08
David Golder	3,165,458	3,165,458	3,165,458
Dennis Francis	22,409,045	22,409,045	20,388,843
Paul Dowling*	48,000	48,000	–
David Sanders#	2,102,802	4,205,605	4,205,605
Vakha Sobraliev†	–	23,014,273	23,014,273
Thomas Hickey	1,535,057	1,535,057	896,226
Desmond Burke‡	n/a	5,623,396	5,304,204

* Paul Dowling was appointed to the Board on 29 April 2008. He held 48,000 ordinary shares on the date of his appointment.

\# In April 2009, pursuant to a court order, David Sanders transferred 2,102,803 ordinary shares or 50 per cent of his shareholding to his former-wife.

† On 12 February 2009 Vakha Sobraliev transferred his entire holding of 23,014,273 to his adult son Ali. Ali Sobraliev has advised the Company that he intends to remain a long term holder of the shares.

‡ Desmond Burke retired from the Board on 31 March 2009.

Directors' Report (continued)

For the year ended 31 December 2008

In addition to the above the Directors hold the following share options:

Director	Options held as at 1 January 2008	Granted in Year	Exercised in Year	Options held as at 31 December 2008	Exercise price
David Golder	440,000	55,000	–	495,000	€0.295-£0.36
Dennis Francis	880,000	330,000	–	1,210,000	€0.295-£0.36
Paul Dowling	400,000	175,000	–	575,000	€0.420-£0.36
David Sanders	880,000	280,000	–	1,160,000	€0.295-£0.36
Vakha Sobraliev	440,000	35,000	–	475,000	€0.295-£0.36
Thomas Hickey	308,000	45,000	–	353,000	€0.295-£0.36
Desmond Burke*	660,000	175,000	–	835,000	€0.295-£0.36

* Desmond Burke retired from the board on 31 March 2009.

Details of the terms and conditions of the option scheme are included in Note 26 to the financial statements.

Principal Risks and Uncertainties

The Group has a risk management structure in place which is designed to identify, manage and mitigate business risks. Risk assessment and evaluation is an essential part of the Group's internal control system.

Details of the principal risks and uncertainties affecting the Group as required to be disclosed in accordance with the Companies Acts, 1963 to 2006, are detailed in the Financial Review.

Remuneration Committee Report

The Group's policy on senior executive remuneration is designed to attract and retain people of the highest calibre who can bring their experience and independent views to the policy, strategic decisions and governance of the Group.

In setting remuneration levels, the Remuneration Committee takes into consideration the remuneration practices of other companies of similar size and scope. A key philosophy is that staff must be properly rewarded and motivated to perform in the best interests of the shareholders. Bonuses for Executive Directors are based on various performance targets such as shareholder return and individual performance.

Directors' remuneration during the year was as follows:

	2008 US$	2007 US$
Remuneration and other emoluments – Executive Directors*	**780,124**	765,009
Remuneration and other emoluments – Non-Executive Directors	**80,177**	77,432
Ex-gratia payment to retiring director	**92,704**	–
Remuneration and other emoluments payable in shares	**45,065**	–
Share-based payment expense	**338,082**	460,125
	1,336,152	1,302,566

* Paul Dowling was appointed to the Board on 29 April 2008 and his remuneration is only included above with effect from that date.

The share option scheme is designed to incentivise performance and loyalty of Directors and key employees. Options vest when certain operational and total shareholder return targets are met. Share option holdings of the Directors are disclosed above. During 2008 the Executive Directors elected to receive a portion of their remuneration in shares instead of cash. These shares will be issued once the close period relating to the 2008 accounts has passed at the higher of the IPO price of 19.8p or the market price at date of issue.

The Board has also agreed to allow Directors elect to have their Directors' fees paid in shares. Under this scheme the number of shares issued will be based on the closing price at each quarter end. Elections under this scheme must be for a minimum of one year.

Statement of Directors' Responsibilities in respect of the Financial Statements

Company law in the Republic of Ireland requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the Group and of the profit or loss of the Group for that period.

In preparing these financial statements of the Group, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable;
- comply with applicable International Financial Reporting Standards as adopted by the European Union; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and Company will continue in business.

The Directors are responsible for keeping proper books of account that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Acts, 1963 to 2006. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Books of account

The measures taken by the Directors to ensure compliance with the requirements of Section 202, Companies Act 1990, regarding proper books of account are the implementation of necessary policies and procedures for recording transactions, the employment of competent accounting personnel with appropriate expertise and the provision of adequate resources to the financial function. The books of account of the Company are maintained at 1 Wainsfort Drive, Terenure, Dublin 6W, Ireland.

Going Concern

In preparing the consolidated financial statements the Directors consider it appropriate to continue to use the going concern assumption on the basis that the Board has approved a plan to raise funds required in order to bring sanctioned fields to commercial production and further develop the business. As described in the Financial Review and Note 2 to these financial statements the Group is in discussions with International Banks, Corporate Finance advisers and potential strategic investors in this regard. The Directors believe that this will enable the Group and the Company to continue in operational existence for the foreseeable future and to continue to meet its obligations as they fall due.

Important Events after the Balance Sheet Date

There were no events affecting the consolidated financial statements after the year-end.

Auditors

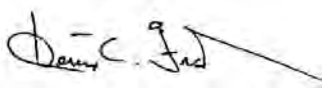
Ernst & Young, Chartered Accountants, have indicated their willingness to continue in office in accordance with the provisions of Section 160(2) of the Companies Act, 1963.

Annual General Meeting

Your attention is drawn to the Notice of Meeting set out on page 56.

Your Directors believe that the Resolutions to be proposed at the Meeting are in the best interests of the Company and its shareholders as a whole and, therefore, recommend you to vote in favour of the Resolutions. Your Directors intend to vote in favour of the Resolutions in respect of their own beneficial holdings of 29,260,362 Ordinary Shares.

Approved by the Board on 3 June 2009.



Dennis Francis
Director

Paul Dowling
Director

Independent Auditors' Report

To the members of PetroNeft Resources plc

We have audited the Group and Parent Company financial statements (the 'financial statements') of PetroNeft Resources plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Parent Company Balance Sheets, the Consolidated and Parent Company Cash Flow Statements, the Consolidated and Parent Company Statement of Changes in Equity, and the related notes 1 to 27. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with section 193 of the Companies Act, 1990. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditors

The Directors are responsible for the preparation of the financial statements in accordance with applicable Irish law and International Financial Reporting Standards (IFRSs) as adopted by the European Union as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Acts, 1963 to 2006. We also report to you our opinion as to: whether proper books of account have been kept by the Company; whether, at the balance sheet date, there exists a financial situation which may require the convening of an extraordinary general meeting of the Company; and whether the information given in the Directors' Report is consistent with the financial statements. In addition, we state whether we have obtained all the information and explanations necessary for the purposes of our audit and whether the Company Balance Sheet is in agreement with the books of account.

We also report to you if, in our opinion, any information specified by law regarding directors' remuneration and other transactions is not disclosed and, where practicable, include such information in our report.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Chairman's Statement, the Chief Executive Officer's Report, the Financial Review and the Directors' Report. 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.

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. 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 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.

Opinion

In our opinion the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of affairs of the Group and of the Company as at 31 December 2008, and of the loss of the Group for the year then ended and have been properly prepared in accordance with the Companies Acts, 1963 to 2006.

We have obtained all the information and explanations we consider necessary for the purposes of our audit. In our opinion proper books of account have been kept by the Company. The Company Balance Sheet is in agreement with the books of account.

In our opinion the information given in the Directors' Report is consistent with the financial statements.

In our opinion, the Company balance sheet does not disclose a financial situation which under section 40(1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the Company.

Emphasis of matter – going concern

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in Note 2 to the financial statements concerning the Group and the Company's ability to continue as a going concern. These conditions indicate the existence of a material uncertainty which may cast significant doubt about the Group and the Company's ability to continue as a going concern.

The financial statements do not include any adjustments to the carrying amount or classification of assets and liabilities that would result if the Group or the Company was unable to continue as a going concern.

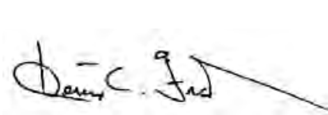
Ernst & Young
Chartered Accountants and Registered Auditors
Dublin
3 June 2009

Consolidated Income Statement

For the year ended 31 December 2008

	Note	2008 US$	2007 US$
Revenue		–	–
Administrative expenses – normal		(4,823,513)	(2,986,800)
Administrative expenses – exceptional	5	–	(815,827)
Exchange (loss)/gain on intra group loans	6	(3,010,932)	386,239
Group operating loss	6	(7,834,445)	(3,416,388)
Finance revenue	7	128,487	465,395
Loss for the year for continuing operations before taxation		(7,705,958)	(2,950,993)
Income tax expense	9	(206,010)	(252,269)
Loss for the year attributable to equity holders of the parent		(7,911,968)	(3,203,262)
Loss per ordinary share attributable to ordinary equity holders of the parent:			
Basic and diluted – US dollar cent	10	(3.81)	(1.74)

Approved by the Board on 3 June 2009.



Dennis Francis
Director

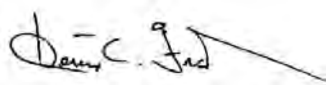
Paul Dowling
Director

Consolidated Balance Sheet

as at 31 December 2008

	Note	2008 US$	2007 US$
Assets			
Non-current Assets			
Oil and gas properties	11	23,769,980	–
Property, plant and equipment	12	1,867,397	1,591,324
Exploration and evaluation assets	13	18,684,771	29,415,286
Leasehold land payments	15	181,009	181,110
		44,503,157	31,192,720
Current Assets			
Trade and other receivables	17	3,067,736	3,542,741
Cash and cash equivalents	18	2,168,197	8,304,295
		5,235,933	11,847,036
Total Assets		49,739,090	43,039,756
Equity and Liabilities			
Capital and Reserves			
Called up share capital	21	2,919,041	2,343,864
Share premium account		57,193,950	40,252,836
Share-based payment reserve		1,904,829	1,177,665
Retained loss		(12,280,851)	(4,368,883)
Currency translation reserve		(5,024,070)	1,466,092
Other reserves		336,000	336,000
Equity attributable to equity holders of the parent		45,048,899	41,207,574
Non-current Liabilities			
Provisions	20	254,646	131,243
Deferred tax liability	9	546,984	372,708
		801,630	503,951
Current Liabilities			
Trade and other payables	19	3,888,561	851,147
Provisions	20	–	477,084
		3,888,561	1,328,231
Total Liabilities		4,690,191	1,832,182
Total Equity and Liabilities		49,739,090	43,039,756

Approved by the Board on 3 June 2009.



Dennis Francis
Director

Paul Dowling
Director

Consolidated Statement of Changes in Equity

For the year ended 31 December 2008

	Share Capital US$	Share Premium US$	Other reserves US$	Translation reserve US$	Retained Losses US$	Total US$
At 1 January 2007	2,132,436	25,777,394	555,197	269,861	(1,165,621)	27,569,267
Loss for the year	–	–	–	–	(3,203,262)	(3,203,262)
Currency translation adjustments	–	–	–	1,196,231	–	1,196,231
Total recognised income and expense	–	–	–	1,196,231	(3,203,262)	(2,007,031)
New share capital subscribed	209,493	15,216,010	–	–	–	15,425,503
Transaction costs on issue of share capital	–	(795,720)	–	–	–	(795,720)
Share options exercised	1,935	55,152	–	–	–	57,087
Share-based payment expense	–	–	958,468	–	–	958,468
At 31 December 2007	2,343,864	40,252,836	1,513,665	1,466,092	(4,368,883)	41,207,574
At 1 January 2008	**2,343,864**	**40,252,836**	**1,513,665**	**1,466,092**	**(4,368,883)**	**41,207,574**
Loss for the year	**–**	**–**	**–**	**–**	**(7,911,968)**	**(7,911,968)**
Currency translation adjustments	**–**	**–**	**–**	**(6,490,162)**	**–**	**(6,490,162)**
Total recognised income and expense	**–**	**–**	**–**	**(6,490,162)**	**(7,911,968)**	**(14,402,130)**
New share capital subscribed	**532,538**	**16,619,782**	**-**	**-**	**-**	**17,152,320**
Transaction costs on issue of share capital	**-**	**(666,044)**	**-**	**-**	**-**	**(666,044)**
Shares issued on exercise of warrant	**41,621**	**958,379**	**-**	**-**	**-**	**1,000,000**
Share options exercised	**1,018**	**28,997**	**-**	**-**	**-**	**30,015**
Share-based payment expense	**-**	**-**	**727,164**	**-**	**-**	**727,164**
At 31 December 2008	**2,919,041**	**57,193,950**	**2,240,829**	**(5,024,070)**	**(12,280,851)**	**45,048,899**

Consolidated Cash Flow Statement

For the year ended 31 December 2008

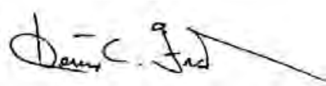
	Note	2008 US$	2007 US$
Loss before taxation		(7,705,958)	(2,950,993)
Adjustment to reconcile loss before tax to net cash flows			
Non-cash			
Depreciation and amortisation		238,013	42,527
Share-based payment expense		727,164	958,468
Unwinding of fair value discount on decommissioning		17,062	–
Deduct finance revenue		(128,487)	(465,395)
Working capital adjustments			
Decrease in trade receivables		475,005	85,912
Increase in trade payables		2,918,821	632,064
Income tax paid		(25,387)	(106,329)
Net cash flows from operating activities		(3,483,767)	(1,803,746)
Investing activities			
Purchase of oil and gas properties		(15,047,118)	-
Purchase of property, plant and equipment		(1,008,545)	(1,223,125)
Exploration and evaluation payments		(6,744,993)	(16,634,725)
VAT refund		3,311,690	-
Acquisition of subsidiary undertaking		-	(186,110)
Finance revenue		128,487	465,395
Net cash used in investing activities		(19,360,479)	(17,578,565)
Financing activities			
Proceeds from exercise of share options		30,015	57,087
Proceeds from exercise of warrant		1,000,000	–
Proceeds from issue of share capital		17,152,320	15,425,503
Transaction costs of issue of shares		(666,044)	(795,720)
Net cash received from financing activities		17,516,291	14,686,870
Net decrease in cash and cash equivalents		(5,327,955)	(4,695,441)
Translation adjustment		(808,143)	127,420
Cash and cash equivalents at the beginning of the year		8,304,295	12,872,316
Cash and cash equivalents at the end of the year	18	2,168,197	8,304,295

Company Balance Sheet

As at 31 December 2008

	Note	2008 US$	2007 US$
Non-current Assets			
Property, plant and equipment	12	5,700	6,464
Financial assets	14	40,049,269	30,161,546
		40,054,969	30,168,010
Current Assets			
Trade and other receivables	17	16,910,265	8,025,309
Cash and cash equivalents	18	1,659,810	5,077,802
		18,570,075	13,103,111
Total Assets		58,625,044	43,271,121
Equity and Liabilities			
Capital and Reserves			
Called up share capital	21	2,919,041	2,343,864
Share premium account		57,193,950	40,252,836
Share-based payment reserve		1,904,829	1,177,665
Retained loss		(4,654,272)	(1,586,406)
Other reserves		336,000	336,000
Equity attributable to equity holders of the parent		57,699,548	42,523,959
Non-current Liabilities			
Deferred tax liability	9	546,984	372,708
Current Liabilities			
Trade and other payables	19	378,512	374,454
Total Liabilities		925,496	747,162
Total Equity and Liabilities		58,625,044	43,271,121

Approved by the Board on 3 June 2009.



Dennis Francis
Director

Paul Dowling
Director

Company Statement of Changes in Equity

For the year ended 31 December 2008

	Share Capital US$	Share Premium US$	Other reserves US$	Retained Losses US$	Total US$
At 1 January 2007	2,132,436	25,777,394	555,197	(270,381)	28,194,646
Loss for the year	–	–	–	(1,316,025)	(1,316,025)
Total recognised income and expense	–	–	–	(1,316,025)	(1,316,025)
New share capital subscribed	209,493	15,216,010	–	–	15,425,503
Transaction costs on issue of share capital	–	(795,720)	–	–	(795,720)
Share options exercised	1,935	55,152	–	–	57,087
Share-based payment expense	–	–	958,468	–	958,468
At 31 December 2007	2,343,864	40,252,836	1,513,665	(1,586,406)	42,523,959
At 1 January 2008	**2,343,864**	**40,252,836**	**1,513,665**	**(1,586,406)**	**42,523,959**
Loss for the year	**–**	**–**	**–**	**(3,067,866)**	**(3,067,866)**
Total recognised income and expense	**–**	**–**	**–**	**(3,067,866)**	**(3,067,866)**
New share capital subscribed	**532,538**	**16,619,782**	**-**	**-**	**17,152,320**
Transaction costs on issue of share capital	**-**	**(666,044)**	**-**	**-**	**(666,044)**
Shares issued on exercise of warrant	**41,621**	**958,379**	**-**	**-**	**1,000,000**
Share options exercised	**1,018**	**28,997**	**-**	**-**	**30,015**
Share-based payment expense	**-**	**-**	**727,164**	**-**	**727,164**
At 31 December 2008	**2,919,041**	**57,193,950**	**2,240,829**	**(4,654,272)**	**57,699,548**

Company Cash Flow Statement

For the year ended 31 December 2008

	Note	2008 US$	2007 US$
Loss before taxation		(2,861,856)	(1,063,756)
Adjustment to reconcile loss before tax to net cash flows			
Non-cash			
Depreciation of property, plant and equipment		2,009	1,884
Share-based payment expense		407,978	648,686
Deduct finance revenue		(824,040)	(1,048,805)
Working capital adjustments			
Increase in trade receivables		(7,517,797)	(630,436)
(Decrease)/increase in trade payables		(2,289)	229,706
Income tax paid		(25,387)	(106,329)
Net cash flows from operating activities		(10,821,382)	(1,969,050)
Investing activities			
Purchase of property, plant and equipment		(1,245)	(4,822)
Advances to subsidiary undertakings		(9,568,537)	(21,192,488)
Acquisition of subsidiary undertaking		-	(186,110)
Finance revenue		126,936	465,395
Net cash used in investing activities		(9,442,846)	(20,918,025)
Financing activities			
Proceeds from exercise of share options		30,015	57,087
Proceeds from exercise of warrant		1,000,000	-
Proceeds from issue of share capital		17,152,320	15,425,503
Transaction costs of issue of shares		(666,044)	(795,720)
Net cash received from financing activities		17,516,291	14,686,870
Net decrease in cash and cash equivalents		(2,747,937)	(8,200,205)
Translation adjustment		(670,055)	439,127
Cash and cash equivalents at the beginning of the year		5,077,802	12,838,880
Cash and cash equivalents at the end of the year	18	1,659,810	5,077,802

Notes to the Financial Statements

For the year ended 31 December 2008

1. General information on the Company and the Group

PetroNeft Resources plc ('the Company', or together with its subsidiaries, 'the Group') is a Company incorporated in Ireland under the Companies Acts, 1963 to 2006. The Company is listed on the Alternative Investments Market ('AIM') of the London Stock Exchange and the Irish Enterprise Exchange ('IEX') of the Irish Stock Exchange. The address of the registered office is One Earlsfort Centre, Earlsfort Terrace, Dublin 2. The business address in Ireland is 1 Wainsfort Drive, Terenure, Dublin 6W. The Company is domiciled in the Republic of Ireland.

The principal activities of the Group are oil and gas exploration, development and production.

2. Going Concern

As described in more detail in the Financial Review on pages 17 and 18 the Board has approved a plan to raise the funds required in order to bring sanctioned fields to commercial production and further develop the business. The Group have prepared budgets and forecasts until 31 December 2010 and, based on this, the current development funding requirement is US$40 million (including estimated fees and interest costs of US$5 million). The Group is in discussions with selected International Banks, Corporate Finance advisers and potential strategic investors in this regard. Should debt funding or a strategic investment agreement not be available within the required timescale an amount of US$3 million will be required to enable the Group to fund its base operations for a further 12 months. The options to fund this base requirement include the disposal of some of the 65 km of pipe currently held in storage or the raising of funds through a new equity issue. In the event of the sale of the pipe it may not realise its carrying value. The Directors are of the opinion that these alternatives are reasonably practicable should debt funding not be secured.

These circumstances represent a material uncertainty that may cast significant doubt upon the Group and the Company's ability to continue as a going concern. Nevertheless, after making enquiries, and considering the uncertainties described above, the Directors are confident that the Group and the Company will have adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and accounts.

Accordingly, these financial statements do not include any adjustments to the carrying amount or classification of assets and liabilities that would result if the Group or Company was unable to continue as a going concern.

3. Accounting policies

3.1 Basis of Preparation

The consolidated financial statements have been prepared on a historical cost basis, except for derivative financial instruments that have been measured at fair value. The consolidated financial statements are presented in US dollars ('US$').

(a) Statement of Compliance

The consolidated financial statements of PetroNeft Resources plc and its subsidiaries have been prepared in accordance with International Financial Reporting Standards ('IFRS') as adopted by the European Union ('EU'). In addition to complying with its legal obligation to comply with IFRS as adopted for use in the EU, the Group has also complied with IFRS as issued by the International Accounting Standards Board ('IASB').

(b) Basis of Consolidation

The consolidated financial statements comprise the financial statements of PetroNeft Resources plc and its subsidiaries as at 31 December each year.

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Group obtains control, and continue to be consolidated until the date that such control ceases.

The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies.

All intra-group balances, income and expenses and unrealised gains and losses resulting from intra-group transactions are eliminated in full.

3.2 Significant Accounting Judgments, Estimates and Assumptions

The preparation of the Group's consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities and contingent liabilities. However, uncertainty about these assumptions and estimates could result in outcomes that could require a material adjustment to the carrying amount of the asset or liability affected in the future.

Notes to the Financial Statements (continued)

3. Accounting policies (continued)

(a) Judgments

In the process of applying the Group's accounting policies, management has made the following judgments, apart from those involving estimations, which have a significant effect on amounts recognised in the consolidated financial statements.

Exploration and evaluation expenditure

Exploration and evaluation expenditure represents active exploration projects. These amounts will be written off to the Income Statement as exploration costs unless commercial reserves are established, or the determination process is not completed and there has been no impairment. The outcome of ongoing exploration, and therefore whether the carrying value of these assets will ultimately be recovered, is inherently uncertain.

Going Concern

In preparing the consolidated financial statements the Directors consider it appropriate to continue to use the going concern assumption on the basis that the Board have approved a plan to raise funds required in order to bring sanctioned fields to commercial production and further develop the business. As described in the Financial Review and Note 2 to these financial statements the Group are in discussions with International Banks, Corporate Finance advisers and potential strategic investors in this regard. The Directors believe that this will enable the Group and the Company to continue in operational existence for the foreseeable future and to continue to meet its obligations as they fall due.

Impairment of non-financial assets

The Group assesses whether there are any indicators of impairment for all non-financial assets at each reporting date. When value-in-use or fair value less costs to sell calculations are undertaken, management must estimate the future expected cash flows from the asset or cash-generating unit and choose a suitable discount rate in order to calculate the present value of those cash flows.

The Group has capitalised intangible exploration and evaluation assets in accordance with IFRS 6, which are evaluated for indicators of impairment. Any impairment review, where required, involves significant judgment related to matters such as recoverable reserves, production profiles, oil and gas prices, development, operating and offtake costs and other matters. The carrying amount of intangible exploration and evaluation assets at 31 December 2008 is US$18,684,771 (2007: US$29,415,286).

It is reasonably possible that the oil price assumption may change, which may then impact the estimated life of the field and may then require a material adjustment to the carrying value of the assets. The Group continuously monitors internal and external indicators of impairment relating to its tangible and intangible assets.

In June 2008 the Board sanctioned the development of the Lineynoye and West Lineynoye oil fields. In accordance with IFRS 6 amounts included in exploration and evaluation assets in respect of these oil fields were transferred to oil and gas properties following an impairment review. In addition, in accordance with IAS 36, the Group conducted an impairment review at 31 December 2008 on oil and gas properties as they were not in use at year-end.

Information in respect of the impairment review process and the key estimates and judgments used in carrying out the impairment review are described in Note 11.

Investments in subsidiaries are stated at cost and are reviewed for impairment if there are indications that the carrying value may not be recoverable.

Reserves base

Oil and gas properties will be depreciated once in use on a unit-of-production basis at a rate calculated by reference to proved and probable reserves determined in accordance with Society of Petroleum Engineers rules and incorporating the estimated future cost of developing and extracting those reserves. Commercial reserves are determined using estimates of oil in place, recovery factors and future oil prices. Future development costs are estimated using assumptions as to number of wells required to produce the commercial reserves, the cost of such wells and associated production facilities, and other capital costs. The current long-term Urals blend oil price assumption used in the estimation of commercial reserves is US$65.00.

The level of estimated commercial reserves is also a key determinant in assessing whether the carrying value of any of the Group's oil and gas properties are impaired. The carrying amount of oil and gas properties at 31 December 2008 is shown in Note 11.

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(b) Estimates and Assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year, are discussed below:

Financial liabilities at fair value through profit or loss

The Group measures the cost of financial liabilities at fair value. Estimating fair value requires determining the most appropriate valuation model for the financial liability, which is dependent on the terms and conditions of the financial liability. This also requires determining the most appropriate inputs to the valuation model and making assumptions about them.

Share-based payment transactions

The Group measures the cost of equity-settled transactions with employees by reference to the fair value of the equity instruments at the date on which they are granted. Estimating fair value requires determining the most appropriate valuation model for a grant of equity instruments, which is dependent on the terms and conditions of the grant. This also requires determining the most appropriate inputs to the valuation model; including the expected life of the option, volatility and dividend yield, and making assumptions about them. The model and assumptions used are discussed in Note 26.

Decommissioning costs

Decommissioning costs will be incurred by the Group at the end of the operating life of certain of the Group's facilities and properties. The ultimate decommissioning costs are uncertain and cost estimates can vary in response to many factors including changes to relevant legal requirements, the emergence of new restoration techniques or experience at other sites. The expected timing and amount of expenditure can also change, for example, in response to changes in reserves or changes in laws and regulations or their interpretation. As a result, there could be significant adjustments to the provisions established which would affect future financial results. Note 20 includes details of this reserve and related assumptions.

3.3 Summary of Significant Accounting Policies

(a) Foreign currencies

The consolidated financial statements are presented in US dollars, which is the Group's presentational currency. The US dollar is also the Company's functional currency. Each entity in the Group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. The Company's Russian subsidiaries' functional currency is the Russian Rouble. Transactions in foreign currencies are initially recorded at the rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date, including foreign exchange differences arising on intercompany loans from the Company in the Russian subsidiaries. All differences are taken to profit or loss. Non-monetary items are translated using the exchange rates ruling as at the date of the initial transaction.

The assets and liabilities of foreign operations are translated into US dollars at the rate of exchange ruling at the balance sheet date and their income statements are translated at the average exchange rates for the year. The exchange differences arising on the translation are taken directly to a separate component of equity. On disposal of a foreign entity, the deferred cumulative amount recognised in equity relating to that particular foreign operation is recognised in profit or loss.

The relevant average and closing exchange rates for 2007 and 2008 were:

	2008		2007	
US$1 =	Closing	Average	Closing	Average
Russian Rouble	**29.477**	**24.870**	24.511	25.579
Euro	**0.710**	**0.683**	0.679	0.731
British Pound	**0.691**	**0.545**	0.501	0.500

(b) Business Combinations and Goodwill

On the acquisition of a subsidiary, the purchase method of accounting is used whereby the purchase consideration is allocated to the identifiable assets, liabilities and contingent liabilities on the basis of fair value at the date of acquisition. Those petroleum reserves and resources that are able to be reliably valued are recognised in the assessment of fair values on acquisition. Other potential reserves, resources and rights, for which in management's opinion, values cannot be reliably determined, are not recognised. When the cost of acquisition exceeds the fair values attributable to the Group's share of the identifiable net assets the difference is treated as purchased goodwill. If the fair value attributable to the Group's share of the identifiable net assets exceeds the cost of acquisition, the difference is immediately recognised in the Income Statement.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to the Group's cash-generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Notes to the Financial Statements (continued)

3. Accounting policies (continued)

(c) Oil and gas exploration, evaluation and development expenditure

Oil and gas exploration, evaluation and development expenditure is accounted for using the successful efforts method of accounting.

Pre-licence costs

Pre-licence costs are expensed in the period in which they are incurred.

Exploration and evaluation costs

Payments to acquire the legal right to explore and costs directly associated with an exploration well are capitalised at cost as an intangible asset until the drilling of the well is complete and the results have been evaluated. These costs include employee remuneration, materials and fuel used, rig costs and payments made to contractors. If oil is not found, the exploration expenditure is written off as a dry hole. If extractable oil is found and, subject to further appraisal activity, which may include the drilling of further wells, is likely to be developed commercially, the costs continue to be carried as an intangible asset. All such carried costs are subject to technical, commercial and management review as well as review for impairment at least once a year to confirm the continued intent to develop or otherwise extract value from the discovery. If this is no longer the case, the costs are written off. When proved reserves of oil are determined and development is sanctioned, the relevant expenditure is transferred to oil and gas properties after impairment is assessed and any resulting impairment loss is recognised.

Development costs

Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, is capitalised within oil and gas properties and depreciated from the commencement of production.

(d) Oil and gas properties and other property, plant and equipment

Oil and gas properties and other property, plant and equipment are stated at cost, less accumulated depreciation.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the decommissioning obligation, and for qualifying assets, relevant borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The net proceeds/costs of pilot production are allocated to oil and gas properties.

Depreciation

Oil and gas properties are depreciated on a unit-of-production basis over the proved and probable reserves of the field concerned. The unit-of-production rate for the amortisation of field development costs takes into account expenditures incurred to date, together with sanctioned future development expenditure. As at 31 December 2008 production, other than pilot production, which is offset against capitalised costs where it occurs prior to development sanction, had not commenced and therefore no depreciation has been charged to the 2008 Income Statement.

Other property, plant and equipment are generally depreciated on a straight-line basis over their estimated useful lives at the following annual rates:

- Land and buildings – 3% or remaining term of the lease, whichever is shorter
- Plant and machinery – 10% to 30%
- Motor vehicles – 20%

(e) Impairment of property, plant and equipment and intangible assets

At each balance sheet date, the Group reviews the carrying amounts of its property, plant and equipment and intangible assets to determine whether there is any indication that those assets may be impaired. If such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of any impairment loss.

The recoverable amount is determined as the higher of the fair value less costs to sell for the asset and the asset's value-in-use. If the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the Income Statement so as to reduce the carrying amount in the balance sheet to its recoverable amount.

Fair value is determined as the amount that would be obtained from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. Direct costs of selling the asset are deducted. Fair value for oil and gas assets is generally determined as the present value of the estimated future cash flows expected to arise from the continued use of the asset, including any expansion prospects, and its eventual disposal, using assumptions that a market participant could take into account. These cash flows are discounted by an appropriate discount rate to arrive at a net present value (NPV) of the asset.

Value-in-use is determined as the present value of the estimated future cash flows expected to arise from the continued use of the asset in its present form and its eventual disposal. Value-in-use is determined by applying assumptions specific to the Group's continued use and cannot take into account future development. These assumptions are different to those used in calculating fair value and consequently the value-in-use calculation is likely to give a different result (usually lower) to a fair value calculation.

Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

(f) Leasehold land payments

Leasehold land payments are upfront payments to acquire long-term leasehold interests in land. These payments are stated at cost and amortised on a straight-line basis over the respective period of the leases.

(g) Financial assets - investment in subsidiaries

Investments in subsidiaries are stated at cost and are reviewed for impairment if there are indications that the carrying value may not be recoverable.

(h) Cash and cash equivalents

Cash and cash equivalents on the balance sheet comprise cash at bank and on hand and short-term deposits with an original maturity of three months or less.

(i) Financial assets

Financial assets within the scope of IAS 39 Financial Instruments: Recognition and Measurement ('IAS 39') are classified as financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, or available-for-sale financial assets, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs. The Group determines the classification of its financial assets on initial recognition and, where allowed and appropriate, re-evaluates this designation at each financial year-end.

The Group does not have held-to-maturity investments or available-for-sale financial assets.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurements, loans and receivables are carried at amortised cost using the effective interest method less any allowance for impairment. Gains and losses are recognised in profit or loss when the loans and receivables are de-recognised or impaired, as well as through the amortisation process.

The Group assesses at each balance sheet date whether a financial asset or group of financial assets is impaired. If there is objective evidence that an impairment loss on assets carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the assets is reduced through use of an allowance account. The amount of the loss is recognised in profit or loss.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed, to the extent that the carrying value of the asset does not exceed its amortised cost at the reversal date. Any subsequent reversal of an impairment loss is recognised in profit or loss.

In relation to trade receivables, a provision for impairment is made when there is objective evidence (such as the probability of insolvency or significant financial difficulties of the debtor) that the Group will not be able to collect all of the amounts due under the original terms of the invoice. The carrying amount of the receivable is reduced through use of an allowance account. Impaired debts are de-recognised when they are assessed as uncollectible.

(j) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss includes financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit or loss.

Financial liabilities are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Gains or losses on liabilities held for trading are recognised in profit or loss.

Notes to the Financial Statements (continued)

3. Accounting policies (continued)

(k) Provisions

General

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Group expects some or all of a provision to be reimbursed, for example, under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

A contingent liability is disclosed where the existence of an obligation will only be confirmed by future events or where the amount of the obligation cannot be measured with reasonable reliability. Contingent assets are not recognised, but are disclosed where an inflow of economic benefits is probable.

Decommissioning provision

A decommissioning provision is recognised when the Group has an obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of obligation can be made. A corresponding amount equivalent to the provision is also recognised as part of the cost of the related property, plant and equipment or in exploration and evaluation expenditure. The amount recognised is the estimated cost of decommissioning, discounted to its present value. Changes in the estimated timing of decommissioning or decommissioning cost estimates are dealt with prospectively by recording an adjustment to the provision, and a corresponding adjustment to property, plant and equipment or in exploration and evaluation expenditure.

(l) Taxes

Current income tax

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date. Current income tax relating to items recognised directly in equity is recognised in equity and not in the Income Statement.

Deferred income tax

Deferred income tax is provided using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred income tax liabilities are recognised for all taxable temporary differences, except:

- where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilised except:

- where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred income tax assets are recognised only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilised.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised. Unrecognised deferred income tax assets are reassessed at each balance sheet date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date.

Deferred income tax relating to items recognised directly in equity is recognised in equity and not in the Income Statement.

Deferred income tax assets and deferred income tax liabilities are offset if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

(m) Share-based payments

Employees (including senior executives) of the Group receive remuneration in the form of share based payment transactions, whereby employees render services as consideration for equity instruments ('equity-settled transactions').

Equity-settled transactions

The cost of equity-settled transactions with employees is measured by reference to the fair value at the date on which they are granted. The fair value is determined by an external valuer using an appropriate pricing model, further details of which are given in Note 26.

The cost of equity-settled transactions is recognised, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award ('the vesting date'). The cumulative expense recognised for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the Group's best estimate of the number of equity instruments that will ultimately vest. The profit or loss charge or credit for a period represents the movement in cumulative expense recognised as at the beginning and end of that period.

No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting, irrespective of whether or not the market condition is satisfied, provided that all other performance and/or service conditions are satisfied.

Where the terms of an equity-settled award are modified, the minimum expense recognised is the expense as if the terms had not been modified. An additional expense is recognised for any modification, which increases the total fair value of the share-based payment arrangement, or is otherwise beneficial to the employee as measured at the date of modification.

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any expense not yet recognised for the award is recognised immediately. However, if a new award is substituted for the cancelled award, and designated as a replacement award on the date that it is granted, the cancelled and new awards are treated as if they were a modification of the original award, as described in the previous paragraph.

Where appropriate the dilutive effect of outstanding options is reflected as additional share dilution in the computation of earnings per share.

(n) Share issue expenses

Costs of share issues are written off against the premium arising on the issues of share capital.

(o) Operating leases

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement at inception date, or whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset.

Operating lease payments are recognised as an expense in profit or loss on a straight line basis over the lease term.

(p) Finance revenue

Interest income is recognised as the interest accrues (using the effective interest rate) to the net carrying amount to the financial asset.

Notes to the Financial Statements (continued)

3. Accounting policies (continued)

3.4 Future Changes in Accounting Policies

New standards and interpretations issued but not yet effective

International Accounting Standards (IAS/IFRSs)		Effective date*
IFRS 1 and IAS 27	Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate (Amendment)	1 January 2009
IFRS 2	IFRS 2 – Vesting Conditions and Cancellations (Amendment)	1 January 2009
IFRS 3	Business Combinations (Revised January 2008)	1 July 2009
IFRS 7	Financial instruments: Disclosures (Amendment)	1 January 2009
IFRS 8	Operating Segments	1 January 2009
IAS 1	Presentation of Financial Statements (Revised September 2007)	1 January 2009
IAS 23	Borrowing Costs (Revised March 2007)	1 January 2009
IAS 27	Consolidated and Separate Financial Statements (Amendment)	1 July 2009
IAS 32 and IAS 1	Puttable Financial Instruments and Obligations Arising on Liquidation (Amendment)	1 January 2009
IAS 39	Eligible Hedged Items (Amendment)	1 July 2009
	Improvements to IFRS	Various effective dates

International Financial Reporting Interpretations Committee (IFRIC)		Effective date
IFRIC 12	Service Concession Arrangements	1 January 2008*
IFRIC 13	Customer Loyalty Programmes	1 July 2008*
IFRIC 15	Agreements for the Construction of Real Estate	1 January 2009
IFRIC 16	Hedges of a Net Investment in a Foreign Operation	1 October 2008*
IFRIC 17	Distributions of Non-Cash Assets to Owners	1 July 2009
IFRIC 18	Transfers of Assets from Customers	1 July 2009

* The effective dates stated here are those given in the original IASB/IFRIC standards and interpretations. As the Group prepares its financial statements in accordance with IFRS as adopted by the European Union, the application of new standards and interpretations will be subject to their having been endorsed for use in the EU via the EU Endorsement mechanism. In the majority of cases this will result in an effective date consistent with that given in the original standard or interpretation, but the need for endorsement restricts the Group's discretion to early adopt standards.

IFRS 2 Share-based Payments – Vesting Conditions and Cancellations

This amendment to IFRS 2 Share-based Payments restricts the definition of 'vesting condition' to a condition that includes an explicit or implicit requirement to provide services. Any other conditions are non-vesting conditions, which have to be taken into account to determine the fair value of the equity instruments granted. In the case that the award does not vest as the result of a failure to meet a non-vesting condition that is within the control of either the entity or the counterparty, this must be accounted for as a cancellation. The Group has not entered into share-based payment schemes with non-vesting conditions attached and, therefore, does not expect significant implications on its accounting for share-based payments.

IFRS 8 Operating Segments

This IFRS replaces IAS 14 Segment Reporting and adopts a management approach to segment reporting. The information reported would be that which management uses internally for evaluating the performance of operating segments and allocating resources to those segments. The Group does not expect this new standard to affect the current disclosure on segment reporting.

IAS 1 Presentation of Financial Statements (Revised)

The revised IAS 1 Presentation of Financial Statements separates owner and non-owner changes in equity. The statement of changes in equity will include only details of transactions with owners, with all non-owner changes in equity presented as a single line. In addition, the Standard introduces the statement of comprehensive income: it presents all items of income and expense recognised in profit or loss, together with all other items of recognised income and expense, either in one single statement, or in two linked statements. The Group is still evaluating whether it will have one or two statements.

IAS 23 Borrowing Costs (Revised)

This standard has been revised to require capitalisation of borrowing costs when such costs relate to qualifying asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. In accordance with the transitional requirements in IAS 23, the Group will adopt this as a prospective change. Accordingly, borrowing costs will be capitalised on qualifying assets with a commencement date after 1 January 2009. No changes will be made for borrowing costs incurred to this date that have been expensed.

The Directors do not anticipate that the adoption of the remaining standards and interpretations will have a material impact on the Group's financial statements in the period of initial application.

4. Segment information

The Group's primary format for segment reporting is business segments and the secondary format is geographical segments. The risk and returns of the Group's operations are primarily determined by the nature of the activities that the Group engages in, rather than the geographical location of these operations. This is reflected by the Group's organisational structure and the Group's internal financial reporting systems. At present the Group has one reportable operating segment, which is oil exploration and production. As a result, there are no further disclosures required in respect of the Group's primary reporting segment.

Secondary reporting format – Geographical segments

The Group does not have sales reported in the income statement as revenues and costs arising from the sale of production testing in the exploration and evaluation phase are offset against the related assets. Substantially all of the Group's capital expenditures are in Russia.

Total Assets

Total assets are allocated based on where the assets are located:

	2008 US$	2007 US$
Russia	48,032,845	37,915,033
Ireland	1,697,947	5,119,259
United States	8,298	5,464
	49,739,090	43,039,756

5. Administrative expenses – exceptional, year ended 31 December 2007

The exceptional item of US$815,827 in 2007 relates to amounts due to an independent contractor in respect of surveying and engineering work on a proposed pipeline route to the Raskino pumping station. In December 2007, the Group entered into a protocol of intent with Russian company, Bashneft, to connect a pipeline from the Group's Licence area to Bashneft's Lukpaiskaya pumping station, a route some 90 km shorter than original route to Raskino. Some of the work carried out by the independent contractor will be used in the design and engineering of field facilities and the new pipeline route; however the amount charged to the 2007 Income Statement relates to those works that are not transferable to the revised route.

A provision of US$477,084 as at 31 December 2007 relating to the amounts payable under the above contract is disclosed in Note 20. This provision was settled in 2008.

6. Operating loss

	2008 US$	2007 US$
Operating loss is stated after charging (crediting):		
Included in administration expenses		
Depreciation of property, plant and equipment	233,829	42,527
Amortisation of leasehold land payments	4,184	–
Foreign exchange loss/(gain) on intra group loans	3,010,932	(386,239)
Other foreign exchange loss/(gain)	1,225,010	(439,127)
Minimum lease payments recognised as an operating expense	125,516	96,518
Auditors' remuneration	167,840	107,975

7. Finance revenue

	2008	2007
Bank interest receivable	128,487	465,395
	128,487	465,395

Notes to the Financial Statements (continued)

8. Employees

Number of employees

The average monthly number of employees (including the Directors) during the period was:

	2008 Number	2007 Number
Directors	7	6
Senior Management	5	5
Support Staff	45	18
	57	29

	2008 US$	2007 US$
Employment costs (including Directors)		
Wages and salaries	2,309,840	1,440,519
Social welfare costs	290,849	149,729
Share-based payment expense	727,164	958,468
	3,327,853	2,548,716

An amount of US$739,915 (2007: US$501,493) included in employment costs were capitalised during the year.

Directors' emoluments

	2008 US$	2007 US$
Remuneration and other emoluments – Executive Directors	780,124	765,009
Remuneration and other emoluments – Non-Executive Directors	80,177	77,432
Ex-gratia payment to retiring director	92,704	–
Remuneration and other emoluments payable in shares	45,065	–
Share-based payment expense	338,082	460,125
	1,336,152	1,302,566

9. Income Tax

The tax expense comprises:

	2008 US$	2007 US$
Current income tax		
Current income tax charge	31,734	106,329
Deferred tax		
Relating to origination and reversal of temporary differences	174,276	145,940
Income tax expense reported in the Income Statement	206,010	252,269

Reconciliation of the total tax charge

The tax assessed for the year differs from that calculated by applying the standard rate corporation tax in the Republic of Ireland of 12.5%. The differences are explained below:

	2008 US$	2007 US$
Loss before income tax	**(7,705,958)**	(2,950,993)
Accounting loss multiplied by Irish standard rate of tax of 12.5%	**(963,245)**	(368,874)
Share-based payment expense	**90,895**	119,808
Effect of higher tax rates on investment income	**103,005**	131,101
Non-deductible expenses	**431,568**	284,962
Tax deductible timing differences	**(265,064)**	(305,500)
Other	**83,381**	28,479
Losses available at higher rates	**(667,432)**	(333,309)
Taxable losses not utilised	**1,392,902**	695,602
Total tax expense reported in the Income Statement	**206,010**	252,269

Deferred income tax

Deferred income tax at 31 December relates to the following:

	2008 US$	2007 US$
Deferred income tax liability		
Accrued interest income	**546,984**	372,708
	546,984	372,708

The Group has tax losses which arose in Russia that are available for offset against future taxable profits of the companies in which the losses arose. Deferred tax assets, which expire in 8 to 10 years, of US$982,000 have not been recognised in respect of these losses as they may not be used to offset taxable profits elsewhere in the Group and they have arisen in subsidiaries that have been loss making for some time.

Factors that may affect future tax charges

The Group expects to commence oil production in Russia in the future. Such production is likely to result in taxable profits in Russia, where the applicable tax rate is 20% following a change to Russian tax legislation, which reduced the rate from 24% with effect from 1 January 2009.

10. Loss per Ordinary Share

Basic loss per ordinary share amounts are calculated by dividing net loss for the year attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the year.

Basic and diluted earnings per ordinary share are the same as the potential ordinary shares are anti-dilutive.

	2008 US$	2007 US$
Numerator		
Net loss attributable to equity shareholders of the parent for basic and diluted loss	**(7,911,968)**	(3,203,262)
	(7,911,968)	(3,203,262)
Denominator		
Weighted average number of ordinary shares for basic and diluted earnings per ordinary share	**207,499,468**	183,670,598
	207,499,468	183,670,598
Basic and diluted loss per ordinary share - US dollar cent	**(3.81)**	(1.74)

Notes to the Financial Statements (continued)

10. Loss per Ordinary Share (continued)

The Company has instruments in issue that could potentially dilute basic earnings per ordinary share in the future, but are not included in the calculation for the reasons outlined below:

- Employee Share Options – Refer to Note 26 for the total number of shares related to the outstanding options that could potentially dilute basic earnings per share in the future. These potential Ordinary Shares are anti-dilutive for the years ended 31 December 2008 and 2007;
- At 31 December 2007, 2,673,498 shares were subject to a warrant which was exercised in June 2008.

11. Oil and gas properties

	Oil and gas properties US$
Cost	
At 1 January 2008	–
Additions	16,767,510
Transfer from exploration and evaluation assets	11,202,901
Transfer from property, plant and equipment	281,243
Translation adjustment	(4,481,674)
At 31 December 2008	23,769,980

In accordance with IFRS 6, once commercial viability is demonstrated the capitalised exploration and evaluation costs are transferred to oil and gas properties or intangibles, as appropriate after being assessed for impairment.

In June 2008, following successful testing of the Lineynoye No. 8 delineation well, the Board of PetroNeft Resources plc sanctioned the development of the Lineynoye and West Lineynoye oil fields. The No. 8 well was required in order to confirm that the fields were commercially viable.

Exploration and evaluation costs of US$11,202,901 were identified and this amount was transferred to oil and gas properties including an allocation of US$1,983,440 of the initial cost of acquiring the Licence area. Further expenditure of US$16,767,510 was incurred in 2008 relating to these fields including US$9,542,923 on 65 km of pipe required for construction of a pipeline from Lineynoye to Lukpaiskaya. The net costs of the pilot production project in early 2008 were allocated to oil and gas properties.

In assessing whether an impairment is required in the carrying value of an asset, its carrying value is compared with its recoverable amount. Assets are tested for impairment either individually or as part of a cash generating unit. The recoverable amount is the higher of the asset's fair value less costs to sell and value-in-use. The impairment calculation is most sensitive to the following assumptions:

- Production volumes;
- Discount rates;
- Commodity prices.

Estimated production volumes are based on detailed data for the fields and take into account development plans for the fields agreed by management as part of the long-term planning process estimated by Ryder Scott Petroleum Consultants in their annual report on the Group's reserves as at 31 December 2008. It is estimated that, if all production were to be reduced by 15% for the whole of the next 15 years, this would not be sufficient to reduce the excess of recoverable amount over the carrying amounts of the oil and gas properties to zero. Consequently, management believes no reasonably possible change in the production assumption would cause the carrying amount of oil and gas properties to exceed their recoverable amount.

The Group estimates fair value less costs to sell using a discounted cash flow model. The future cash flows are adjusted for risks specific to the asset and discounted using a pre-tax discount rate of 31%. Management also believes that currently there is no reasonably possible change in discount rate which would cause the carrying amount of the oil and gas properties to exceed their recoverable amount.

It is estimated that if the long-term price of Urals blend crude oil fell by 15% for the whole of the next 15 years, this would not be sufficient to reduce the excess of recoverable amount over the carrying amounts of the oil and gas properties to zero.

12. Property, Plant and Equipment

Group	Land and buildings US$	Plant and machinery US$	Motor vehicles US$	Total US$
Cost				
At 1 January 2007	261,883	24,694	50,467	337,044
Additions	87,249	1,116,377	19,499	1,223,125
Translation adjustment	23,342	49,945	4,597	77,884
At 1 January 2008	**372,474**	**1,191,016**	**74,563**	**1,638,053**
Additions	**–**	**1,157,574**	**–**	**1,157,574**
Transfer to oil and gas properties	**–**	**(281,243)**	**–**	**(281,243)**
Translation adjustment	**(61,669)**	**(335,799)**	**(12,561)**	**(410,029)**
At 31 December 2008	**310,805**	**1,731,548**	**62,002**	**2,104,355**
Depreciation				
At 1 January 2007	941	1,395	–	2,336
Charge for the period	969	30,596	10,962	42,527
Translation adjustment	113	1,275	478	1,866
At 1 January 2008	**2,023**	**33,266**	**11,440**	**46,729**
Charge for the year	**19,036**	**199,582**	**15,211**	**233,829**
Translation adjustment	**(3,315)**	**(35,980)**	**(4,305)**	**(43,600)**
At 31 December 2008	**17,744**	**196,868**	**22,346**	**236,958**
Net book values				
At 31 December 2008	**293,061**	**1,534,680**	**39,656**	**1,867,397**
At 31 December 2007	370,451	1,157,750	63,123	1,591,324
At 31 December 2006	260,942	23,299	50,467	334,708

Company	Plant and machinery US$
Cost	
At 1 January 2007	4,599
Additions	4,822
At 1 January 2008	**9,421**
Additions	**1,245**
At 31 December 2008	**10,666**
Depreciation	
At 1 January 2007	1,073
Charge for the period	1,884
At 1 January 2008	**2,957**
Charge for the period	**2,009**
At 31 December 2008	**4,966**
Net book values	
At 31 December 2008	**5,700**
At 31 December 2007	6,464
At 31 December 2006	3,526

Notes to the Financial Statements (continued)

13. Exploration and evaluation assets

Group	Exploration & evaluation expenditure US$
Cost	
At 1 January 2007	11,139,043
Additions	16,765,968
Translation adjustment	1,510,275
At 1 January 2008	**29,415,286**
Additions	**7,550,215**
Transfer to oil and gas properties	**(11,202,901)**
Russian VAT refund transferred to current assets	**(3,311,690)**
Translation adjustment	**(3,766,139)**
At 31 December 2008	**18,684,771**
Net book values	
At 31 December 2008	**18,684,771**
At 31 December 2007	29,415,286
At 31 December 2006	11,139,043

Exploration and evaluation expenditure represents active exploration projects. These amounts will be written off to the Income Statement as exploration costs unless commercial reserves are established, or the determination process is not completed and there are no indications of impairment. The outcome of ongoing exploration, and therefore whether the carrying value of these assets will ultimately be recovered, is inherently uncertain.

Prior to 2008, PetroNeft's Russian subsidiaries had not received any refunds of Russian VAT incurred on the work carried out to date. The amount due as at 31 December 2007 was US$3,311,690 and it had been accounted for at that date as part of exploration and evaluation expenditure as the Group was uncertain whether this amount would be recoverable. This matter was resolved during the year and the subsidiaries started receiving Russian VAT refunds in April 2008. All Russian VAT refunds due are now accounted for in current assets.

14. Financial assets

Company	Investment in Subsidiaries US$
Cost	
At 1 January 2007	8,473,166
Advances to subsidiary undertakings (Note 25)	21,192,488
Capital contribution in respect of share-based payment expense	309,782
Acquisition of subsidiary undertaking (Note 16)	186,110
At 1 January 2008	**30,161,546**
Advances to subsidiary undertakings (Note 25)	**9,568,537**
Capital contribution in respect of share-based payment expense	**319,186**
At 31 December 2008	**40,049,269**
Net book values	
At 31 December 2008	**40,049,269**
At 31 December 2007	30,161,546
At 31 December 2006	8,473,166

Details of the Company's holding in direct and indirect subsidiaries at 31 December 2008 are as follows:

Name of subsidiary	Registered Office	Proportion of Ownership Interest	Proportion of Voting power held	Principal Activity
WorldAce Investments Limited	3 Themistocles Dervis Street, Nicosia, Cyprus	100%	100%	Holding Company
LLC Stimul-T	147, Prospekt Lenina, Tomsk, 634009, Russia	100%	100%	Oil and Gas exploration
LLC Lineynoye	147, Prospekt Lenina, Tomsk, 634009, Russia	100%	100%	Construction
LLC Pervomayka	Pobedy, Kolpashevo, Tomsk, 634460, Russia	100%	100%	Property Holding

15. Leasehold land payments

	2008 US$	2007 US$
Net book value at 1 January	**186,110**	–
Acquired on acquisition (Note 16)	**–**	186,110
Translation adjustment	**(917)**	–
Amortisation	**(4,184)**	–
Net book value at 31 December	**181,009**	186,110

Leasehold land payments relate to a lease held by LLC Pervomayka. The term of the lease expires in 2052.

16. Business combinations

Acquisitions in 2007

On 17 December 2007, the Company acquired 100% of the voting shares of LLC Pervomayka, an unlisted non-trading company based in Russia. The fair value of the identifiable assets and liabilities of LLC Pervomayka as at the date of acquisition and the corresponding carrying amounts immediately before the acquisition were:

	Fair value recognised on acquisition US$	Previous carrying value US$
Leasehold land	186,110	4,500
Net assets	186,110	4,500
Goodwill arising on acquisition	–	
Consideration, satisfied by cash	186,110	

17. Trade and other receivables

Group	2008 US$	2007 US$
Russian VAT	**2,083,341**	–
Other receivables	**351,943**	131,701
Other receivables from related parties (Note 25)	**591,974**	–
Prepayments	**40,478**	3,411,040
	3,067,736	3,542,741

Company	2008 US$	2007 US$
Amounts owed by subsidiary undertakings	**16,846,818**	7,983,851
Prepayments and accrued income	**63,447**	41,458
	16,910,265	8,025,309

Notes to the Financial Statements (continued)

17. Trade and other receivables (continued)

The Directors consider that the carrying amount of trade and other receivables approximates their fair value.

Other receivables are non-interest bearing and are normally settled on 60-day terms.

Amounts owed by subsidiary undertakings are interest-bearing. Interest is charged at rates ranging from 6% to 10%.

At time of approval of the financial statements all of the Russian VAT outstanding as at 31 December 2008 had been recovered.

18. Cash and Cash Equivalents

Group	2008 US$	2007 US$
Cash at bank and in hand	2,168,197	8,304,295
	2,168,197	8,304,295

Company	2008 US$	2007 US$
Cash at bank and in hand	1,659,810	5,077,802
	1,659,810	5,077,802

Bank deposits earn interest at floating rates based on daily deposit rates. Short-term deposits are made for varying periods of between one day and one month depending on the immediate cash requirements of the Group, and earn interest at the respective short-term deposit rates.

19. Trade and other payables

Group	2008 US$	2007 US$
Trade payables	2,268,180	55,217
Trade payables to related parties (Note 25)	1,106,407	362,200
Corporation tax	6,346	–
Other taxes and social welfare costs	174,120	79,987
Other payables	75,762	46,919
Accruals and deferred income	257,746	306,824
	3,888,561	851,147

Company	2008 US$	2007 US$
Trade payables	11,600	1,602
Corporation tax	6,346	–
Other taxes and social welfare costs	62,537	35,188
Other payables	40,283	46,919
Accruals and deferred income	257,746	290,745
	378,512	374,454

The Directors consider that the carrying amount of trade and other payables approximates their fair value.

Trade and other payables are non-interest bearing and are normally settled on 60-day terms.

Trade payables and accruals principally comprise amounts outstanding for trade purchases and ongoing costs.

20. Provisions

20.1 Decommissioning Costs – Non current

	2008 US$	2007 US$
At 1 January	131,243	–
Additions	172,462	131,243
Unwinding of discount	17,062	–
Translation adjustment	(66,121)	–
At 31 December	254,646	131,243

The decommissioning provision represents the present value of decommissioning costs relating to the Russian oil interests, which are expected to be incurred up to 2030. These provisions have been created based on the Group's internal estimates. Assumptions, based on the current economic environment, have been made which management believe are a reasonable basis upon which to estimate the future liability.

These estimates are reviewed regularly to take into account any material changes to the assumptions. However, actual decommissioning costs will ultimately depend upon future market prices for the necessary decommissioning works required, which will reflect market conditions at the relevant time. Furthermore, the timing of decommissioning is likely to depend on when the fields cease to produce at economically viable rates. This in turn will depend upon future oil prices, which are inherently uncertain.

20.2 Onerous contract – Current

	2008 US$	2007 US$
At 1 January	477,084	–
Additions (Note 5)	–	477,084
Settled in year	(477,084)	–
At 31 December	–	477,084

This contract relates to an accrual as at 31 December 2007 for the balance due for surveying and engineering works on a proposed pipeline route to the Raskino pumping station as detailed in Note 5. The amount of US$477,084 was settled in 2008.

21. Share capital – Group and Company

	2008 €	2007 €
Authorised Ordinary shares of €0.01 each	6,000,000	6,000,000
	6,000,000	6,000,000

Allotted, called up and fully paid equity	Number of Shares	Called up share capital US$
At 1 January 2007	176,625,258	2,132,436
Issued in the year	15,199,137	209,493
Share options exercised in the year	132,000	1,935
At 1 January 2008	**191,956,395**	**2,343,864**
Issued in the year	**34,527,141**	**532,538**
Warrant exercised in the year	**2,673,498**	**41,621**
Share options exercised in the year	**66,000**	**1,018**
At 31 December 2008	**229,223,034**	**2,919,041**

The proceeds of the share issues in 2007 and 2008 were used to finance expenditure on oil and gas properties, exploration and evaluation costs and corporate overhead.

Notes to the Financial Statements (continued)

22. Financial risk management objectives and policies

The Group and Company's principal financial instruments comprise cash and cash equivalents. The main purpose of these financial instruments is to provide finance for the Group and Company's operations. The Group has various other financial assets and liabilities such as receivables and trade payables, which arise directly from its operations.

The Group also enters into derivative transactions, primarily forward currency contracts. The purpose is to manage the currency risks arising from the Group and Company's operations and its sources of finance.

It is the Group and Company's policy that no trading in derivatives be undertaken.

The main risks arising from the Group and Company's financial instruments are foreign currency risk, credit risk, liquidity risk, interest rate risk and capital risk. Management reviews and agrees policies for managing each of these risks which are summarised below.

Foreign currency risk

The Group undertakes certain transactions denominated in foreign currencies. Hence, exposures to exchange rate fluctuations arise. Exchange rate exposures are managed within approved policy parameters utilising forward exchange contracts where appropriate.

At 31 December 2008 and 31 December 2007, the Group had no outstanding forward exchange contracts.

Foreign currency sensitivity analysis

The Group's principal currency exposures arise in the currencies of Russian rouble, Euro, UK sterling and US dollar. The Group has an exposure to US dollars because the functional currency of its Russian subsidiaries is Russian roubles. A change in the US dollar:Russian rouble exchange rate will therefore result in a foreign exchange gain or loss on the US dollar denominated balances in these subsidiaries.

In accordance with IFRS 7, the impact of foreign currencies has been determined based on the balances of financial assets and liabilities at 31 December 2008. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and largely results from trade payables and receivables, and adjusts their translation at the period end for a 5% change in foreign currency rates. A positive number below indicates an increase in profit and other equity where the US dollar strengthens 5% against the relevant currency. For a 5% weakening of the US dollar against the relevant currency, there would be an equal and opposite impact on the profit and other equity, and the balances following would be negative.

If the US dollar had gained/(lost) 5% against all currencies significant to the Group at 31 December 2008 loss would have been US$82,689 lower/(higher) (2007: US$253,744 lower/(higher)) and net equity would have been US$108,057 lower/(higher) (2007: US$415,068 lower/(higher)).

Credit risk

Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the Group. As the Group does not, as yet, have any sales to third parties, this risk is limited. At 31 December 2008, the Group has a receivable of US$591,974 arising from co-shared helicopter services with a related party (refer to note 25). This amount is overdue at year-end due to a dispute between the parties. The Directors are confident that the amount will be received in full.

The Group and Company's financial assets comprise receivables and cash and cash equivalents. The credit risk on cash and cash equivalents is limited because the counterparties are banks with high credit ratings assigned by international credit-rating agencies. The Group and Company's exposure to credit risk arise from default of its counterparty, with a maximum exposure equal to the carrying amount of cash and cash equivalents in its consolidated balance sheet.

The Group does not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics. The Group defines counterparties as having similar characteristics if they are connected entities.

Liquidity risk management

Liquidity risk is the risk that the Group will not have sufficient funds to meet liabilities. Ultimate responsibility for liquidity risk management rests with the Board of Directors, which has built an appropriate liquidity risk management framework for the management of the Group and Company's short, medium and long-term funding and liquidity management requirements. The Group manages liquidity risk by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities. Cash forecasts are regularly produced to identify the liquidity requirements of the Group. To date, the Group has relied on shareholder funding to finance its operations. The Group had no borrowing facilities at 31 December 2008.

The Group and Company's financial liabilities as at 31 December 2008 and 31 December 2007 were all payable on demand.

The expected maturity of the Group and Company's financial assets (excluding prepayments) as at 31 December 2008 and 31 December 2007 was less than one month.

The Group expects to meet its other obligations from operating cash flows with an appropriate mix of funds, equity instruments and debt financing (refer to Note 2). The Group further mitigates liquidity risk by maintaining an insurance programme to minimise exposure to insurable losses.

The group had no derivative financial instruments as at 31 December 2008 and 31 December 2007.

Interest rate risk

The Group and Company's exposure to the risk of changes in market interest rates relates primarily to the Group and Company's holdings of cash and short term deposits.

It is the Group and Company's policy as part of its disciplined management of the budgetary process to place surplus funds on short term deposit in order to maximise interest earned.

The effect of a 10% reduction in interest rates obtainable on cash and short term deposits would be to increase loss before tax by US$10,310 (2007: US$46,540).

Capital risk management

The Group manages its capital to ensure that entities in the Group will be able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance. The Group manages its capital structure and makes adjustments to it, in light of changes in economic conditions. To maintain or adjust its capital structure, the Group may issue new shares or raise debt. No changes were made in the objectives, policies or processes during the years ended 31 December 2008 and 31 December 2007. The capital structure of the Group consists of equity attributable to equity holders of the parent, comprising issued capital, reserves and retained losses as disclosed in the consolidated statement of changes in equity.

Fair values

The carrying amount of the Group and Company's financial assets and financial liabilities is a reasonable approximation of the fair value.

Hedging

At the year ended 31 December 2008 and 31 December 2007, the Group had no outstanding contracts designated as hedges.

23. Loss of holding Company

The Company is availing of the exemption set out in section 148(8) of the Companies Act 1963 and section 7(1) (a) of the Companies (Amendment) Act 1986 from presenting its individual profit and loss account to the annual general meeting and from filing it with the Registrar of Companies. The amount of the loss dealt with in the parent undertaking for the year was US$3,067,866 (2007: US$1,316,025).

24. Capital commitments

24.1 Details of capital commitments at the balance sheet date are as follows:

	2008 US$	2007 US$
Contracted for but not provided in the financial statements	–	7,395,527
Authorised by the Directors but not yet contracted for	–	–

The commitments relate to future payments due under drilling contracts entered into by the Group during 2007 which were completed in 2008.

24.2 Future minimum rentals payable under non-cancellable operating leases as at 31 December are as follows:

	2008 US$	2007 US$
Within one year	57,890	68,954
After one year but not more than five years	37,197	–
More than five years	–	–
	95,087	68,954

Notes to the Financial Statements (continued)

25. Related party disclosures

Transactions between PetroNeft Resources Plc and its subsidiary LLC Stimul-T have been eliminated on consolidation. Details of transactions between the Group and other related parties are disclosed below.

In February 2006 LLC Stimul-T entered into a contract with Nizhnevartovskservis ("NVS") for the drilling of 3 wells in 2007. The contract was a "Turnkey" contract under which NVS assumed substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract was approximately US$11.98 million. Vakha Sobraliev, a director of PetroNeft Resources Plc, is the principal of NVS. Payments totalling US$ 447,461 were made in 2008 (2007: US$6,024,003). An amount of US$2,472 is outstanding as at 31 December 2008 to NVS (2007: US$362,200).

In 2007, LLC Stimul-T entered into a contract with Tomskburgneftegaz ("TBNG") for the drilling of 3 wells in 2008. The contract was a "Turnkey" contract under which TBNG assumed substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract was approximately US$10.47 million. Vakha Sobraliev, a director of PetroNeft Resources Plc, is the principal of TBNG. Payments totalling US$6,937,093 were made in 2008 (2007: US$3,084,232). An amount of US$1,103,935 is outstanding as at 31 December 2008 to TBNG (2007: US$Nil).

Any differences between the total contract amount and amounts paid relate to movements in the rouble/dollar exchange rate.

LLC Stimul-T invoiced US$697,868 to TBNG in 2008 for the shared use of helicopter services where the service provider billed the entire amount to LLC Stimul-T. At 31 December 2008, an amount of US$591,974 remained outstanding due to a dispute between the parties. The Directors are confident that the amount will be received in full.

LLC Stimul-T invoiced US$42,408 to TBNG and US$23,066 to NVS in 2008 for supply of crude oil as part of the 2008 pilot production programme. No amounts are outstanding in this regard as at 31 December 2008.

Remuneration of key management

Compensation of key management personnel amounted to US$1,275,262 and US$1,074,568 for the years ended 31 December 2008 and 31 December 2007, respectively, which corresponds to short-term employee benefits. The share-based payment expense pertaining to key management amounted to US$445,039 and US$663,845 for the years ended 31 December 2008 and 31 December 2007, respectively. Key management comprise the Directors of the Company, the General Director and Executive Director of the Russian subsidiary LLC Stimul-T, and the Chief Geologist.

Transactions with subsidiaries

The Company had the following transactions with its subsidiaries during the years ended 31 December 2008 and 31 December 2007:

- The Company made contributions to the assets of LLC Stimul-T in the amounts of US$9,531,169 and US$20,849,110 during the years ended 31 December 2008 and 31 December 2007 respectively.
- The Company granted an interest bearing loan to LLC Stimul-T in the amount of US$7,954,382 during the year ended 31 December 2008.
- The Company earned interest on loans to LLC Stimul-T in the amounts of US$697,104 and US$583,410 during the years ended 31 December 2008 and 31 December 2007 respectively. All interest on loans to LLC Stimul-T remains outstanding.
- The Company charged amounts of US$211,481 and US$193,644 for technical services provided to LLC Stimul-T during the years ended 31 December 2008 and 31 December 2007 respectively.
- The Company made contributions to the assets of LLC Lineynoye in the amount of US$331,855 and US$653,160 during the years ended 31 December 2008 and 31 December 2007 respectively.
- The Company made contributions to the assets of LLC Pervomayka in the amount of US$24,699 during the year ended 31 December 2008.

26. Share-based payments

The expense recognised for employee services during the year is US$727,164 (2007: US$958,468). The Group share-based payment plan is described below. There were no cancellations or modifications to any of the plans during 2008 and 2007.

Under the Group share option plan, employees of the Group can receive conditional awards of share options depending on their performance, seniority and length of service. The options typically vest in four instalments and are subject to vesting conditions such as milestones for the Company such as drilling, production and shareholder return. The maximum term for options is seven years. There are no cash settlement alternatives.

Movement in the year

The fair value of the options is estimated at the grant date using an option pricing model considering the terms and conditions upon which the instruments were granted. The following table illustrates the number and weighted average exercise prices (WAEP) of, and movements in, share options during the year.

	2008 Number	2008 WAEP	2007 Number	2007 WAEP
Outstanding as at 1 January	7,963,000	€0.297/£0.32	6,815,000	€0.297
Granted during the year	2,525,000	£0.36	1,280,000	£0.32
Forfeited during the year	(350,000)	€0.295/£0.36	–	–
Exercised during the year	(66,000)	€0.295	(132,000)	€0.295
Outstanding at 31 December	10,072,000	€0.32/£0.31	7,963,000	€0.297/£0.32
Exercisable at 31 December	4,219,600	€0.297/£0.32	2,044,500	€0.297/£0.32

The range of exercise prices for options outstanding at the year-end is €0.295 to €0.42 (2007: €0.295 to £0.32).

The weighted average remaining contractual life for the share options outstanding as at 31 December 2008 was 5.2 years (2007: 5.8 years).

The weighted average fair value of options granted during the year was £0.17 (2007: £0.15).

The weighted average share price of the exercised options at the date of exercise was €0.38.

The following table lists the inputs to the models used for the years ended 31 December 2008 and 31 December 2007:

Grant date	2008 February	2007 December	2006 November	2006 September
Dividend yield	0%	0%	0%	0%
Expected volatility	60%	45%	48%	48%
Risk free interest rate	4.4%	5%	3.71%	3.62%
Expected life of option	7	7	7	7
Expected early exercise %	5%	5%	5%	5%
Share price	£0.36	£0.32	€0.42	€0.30
Model used	Binomial/ Monte Carlo	Binomial/ Monte Carlo	Binomial/ Monte Carlo	Binomial/ Monte Carlo

The expected life of the options is based on the expectation of management and is not necessarily indicative of exercise patterns that may occur. The expected volatility was determined based on historical data of peer companies, and reflects the assumption that historical volatility is indicative of future trends, which may also not necessarily be the actual outcome. The fair value is measured at the grant date.

27. Approval of financial statements

The financial statements were approved, and authorised for issue, by the Board of Directors on 3 June 2009.

Notice of Annual General Meeting

Notice is hereby given that the Annual General Meeting of PetroNeft Resources plc will be held at the Herbert Park Hotel, Ballsbridge, Dublin 4 at 11.00 am on Monday 14 September 2009, for the purposes of considering and, if thought fit, passing, the following Resolutions of which Resolutions numbered 1, 2, 3 and 4 will be proposed as Ordinary Resolutions and Resolution numbered 5 will be proposed as a Special Resolution.

Ordinary Business

1. To receive, consider and adopt the accounts for the year ended 31 December 2008 together with the Directors' and Auditors' reports thereon.

2. To re-elect Mr. Hickey as a Director, who retires by rotation in accordance with Article 83 of the Articles of Association of the Company.

3. To re-elect Mr. Sobraliev as a Director, who retires by rotation in accordance with Article 83 of the Articles of Association of the Company.

4. To reappoint Ernst & Young, Chartered Accountants, as Auditors and to authorise the Directors to fix the remuneration of the Auditors.

Special Business

5. That the Directors be and are hereby empowered pursuant to Sections 23 and 24 (1) of the Companies (Amendment) Act, 1983 to allot equity securities (within the meaning of the said Section 23) for cash pursuant to the authority conferred by Article 5(a) of the Articles of Association of the Company as if the said Section 23 does not apply to any such allotment provided that this power shall be limited to the allotment of equity securities;

   a) in connection with the exercise of any options or warrants to subscribe granted by the Company;

   b) (including, without limitation any shares purchased by the Company pursuant to the provisions of the 1990 Act and held as Treasury Shares) in connection with any offer of securities, open for a period fixed by the Directors, by way of rights, open offer or otherwise in favour of ordinary shareholders and/or any persons having a right to subscribe for or convert securities into ordinary shares in the capital of the Company (including, without limitation, any person entitled to options under any of the Company's share option schemes or any other person entitled to participate in any of the Company's profit sharing schemes for the time being) and subject to such exclusions or other arrangements as the Directors may deem necessary or expedient in relation to legal or practical problems under the laws of or the requirements of any recognised body or stock exchange in, any territory; and

   c) up to an aggregate nominal value equal to the nominal value of 10% of the Issued Share Capital of the Company from time to time:

   each of (a), (b) and (c) above being separate powers, which powers shall expire on the earlier of the date of the next annual general meeting of the Company held after the date of passing of this Resolution and at the close of business on 14 December 2010, save that the Company may before such expiry make an offer or agreement which would or might require equity securities to be allotted after such expiry and the Directors may allot equity securities in pursuance of such offer or agreement as if the power conferred hereby had not expired.

David Sanders
Secretary

for and on behalf of the Board.
One Earlsfort Centre
Earlsfort Terrace
Dublin 2
3 June 2009

Notes

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Glossary

1P	Proved reserves according to SPE standards
2P	Proved and probable reserves according to SPE standards
3P	Proved, probable and possible reserves according to SPE standards
AGM	Annual General Meeting
AIM	Alternative Investment Market of the London Stock Exchange
API Gravity	A specific gravity scale developed by the American Petroleum Institute (API) for measuring the relative density of various petroleum liquids, expressed in degrees
bbl	Barrel
boe	Barrel of oil equivalent
bopd	Barrels of oil per day
Company	PetroNeft Resources plc
CSR	Corporate and Social Responsibility
Custody Transfer Point	Facility/location at which custody of oil transfers to another operator
ESPO pipeline	East Siberia-Pacific Ocean pipeline which is expected to be completed in 2012
Group	Company and its subsidiary undertakings
IAS	International Accounting Standard
IEX	Irish Enterprise Exchange of the Irish Stock Exchange
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
km	Kilometres
km^2/ sq km	Square kilometres
KPI	Key Performance Indicator
Licence 61	The Group's Exploration and Production Licence in the Tomsk Oblast, Russia
mmbbl	Million barrels
mmbo	Million barrels of oil
P1	Proved reserves according to SPE standards
P2	Probable reserves according to SPE standards
P3	Possible reserves according to SPE standards
PetroNeft	PetroNeft Resources plc
SPE	Society of Petroleum Engineers
Spud	To commence drilling a well
TSR	Total Shareholder Return
VAT	Value Added Tax
WAEP	Weighted Average Exercise Price

Group Information

Directors[1]

David Golder (U.S. citizen)
Non-Executive Chairman

Dennis Francis (U.S. citizen)
Chief Executive Officer

Paul Dowling
Chief Financial Officer
(Appointed on 29 April 2008)

David Sanders (U.S. citizen)
Executive Director and General Legal Counsel

Vakha Alvievich Sobraliev (Russian citizen)
Non-Executive Director

Thomas Hickey
Non-Executive Director

[1] *Irish Citizens unless otherwise stated*

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Secretary
David Sanders

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Chartered Accountants
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Nominated and IEX Adviser
Davy
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Ireland

Bankers
AIB Bank
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Ireland

JP Morgan Chase Bank
Texas Market
Baton Rouge
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Registered Number
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The PEFC Council (Programme for the Endorsement of Forest Certification schemes) provides an assurance mechanism to purchasers of wood and paper products that they are promoting the sustainable management of forests.

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