Producing Results

PetroNeft Resources plc
Annual Report and Accounts 2010
Годовой Отчет 2010

Producing six years of strategic progress

Since incorporation, the primary strategy of PetroNeft has been to bring its existing oil fields to production, thereby generating sufficient cash flows to enable the exploration of the many remaining prospects. This was achieved in 2010.

Licence commitments met
With the drilling of three additional wells leading to the discovery of the Kondrashevskoye oil field the initial five-year licence commitments were met two years ahead of schedule.
September 2008

Drilling commences
Three wells drilled to delineate the Lineynoye and Tungolskoye oil fields and discover the West Lineynoye oil field.
March 2007

Stock market listing
Admission to AIM and ESM Markets completed.
September 2006

US$23.5m
raised in private placings and at IPO.
February 2006 to September 2006

Field work commences
Commencement of the acquisition over 1,000 km of new 2D seismic data at Licence 61 following the reprocessing and re-interpretation of over 2,500 km of vintage 2D seismic data.
February 2006

Looking to the future
Preliminary Development Feasibility Study, which included planned pipeline development and funding requirements on the Lineynoye and Tungolskoye Oil Fields, was completed.
February 2007

Pilot production
First pilot production from Lineynoye and West Lineynoye oil fields.
February 2008

2005

A positive start.
We acquired Licence 61 in the Tomsk Oblast, Russia and began establishing a local team. Licence 61 believed to contain two existing oil fields at Lineynoye and Tungolskoye and numerous prospects.

2006

Learning the potential of our assets.
The reprocessing of old well logs and seismic data from Licence 61 enhances our confidence as to the quality of Licence 61 and determines the future drilling priorities.

2007

Steady progress on all fronts.
2P reserves were increased by 81% from 33.5 mmbbls to 60.6 mmbbls following the discovery of the West Lineynoye oil field and delineation of the Lineynoye and Tungolskoye oil fields. Work on development plan for Lineynoye oil field also commenced.

2008

Firm foundations laid but a frustrating year.
2P reserves were increased to 70 mmbbls with the discovery of the Kondrashevskoye oil field and the Board sanctioned the development of the Lineynoye oil fields. However the financial crisis delayed our plans.

Oil transport agreement

Crude Oil Transportation and Custody Transfer agreement signed with Imperial Energy. This 25-year deal allows PetroNeft to use Imperial's pipeline to transport our oil to market.

August 2009

Further reserve growth

Discovery of the Arbuzovskoye oil field at Licence 61 and the addition of reserves at Licence 67 saw proved and probable reserves grow by 37% from 71 to 97 mmbbls.

November 2010

Debt and equity fundings

US$30 million debt facility agreed with Macquarie Bank and US$43 million equity raised leaving the Group fully funded for 2011 expansion programme.

May and October 2010

3,100 bopd

production reached in March 2011

Funded for production

Placing of new ordinary shares to raise US$27 million – enough to build the 60km pipeline, the oil processing facilities and commence drilling production wells in 2010.

September 2009

Year-round production achieved

To achieve this we constructed a 60km pipeline from our Lineynoye oil field to Imperial Energy's facilities at Kiev-Eganskoye and oil processing and storage facilities at the Lineynoye oil field. We also drilled nine new production wells to supplement the two existing wells at Lineynoye.

August 2010

2011 and beyond

Five new exploration wells

2011 will see a five well exploration programme target additional reserves of approximately 120 mmbbls net to PetroNeft.

17 new production wells

At Licence 61, 2011 will see 17 additional production wells drilled at the Lineynoye oil field and three exploration wells also drilled in the Licence area.

Expansion of processing facilities

The current design capacity of the process facilities is 7,400 bfpd which will be expanded to 14,800 bfpd in 2011.

2009

Preparing to produce.
The Company prepared the facilities, equipment and staff necessary to achieve year-round production in 2010.

2010

A transformational year.
The Group went from being just an exploration company to an exploration and production company. 2P reserves also grew by a further 37% to 97 mmbbls.

2011

PetroNeft Resources plc is an international oil and gas exploration and production company focused on Russia.

Lift this flap to discover more

What is our key objective or goal?

PetroNeft's aim is to deliver shareholder value by developing oil and gas assets in Russia.

↗ more info on p2

How will we achieve these objectives?

Using the combined skills, experience and resources of the Group's Directors and employees to maximise the value of these assets by seeking to bring our existing discoveries into production as rapidly as possible and by exploiting additional opportunities.

↗ more info on p2

What assets does the business currently hold?

The main assets of the Company are a 100% interest in a 4,991km^2 oil and gas licence (Licence 61) and a 50% operating interest in a 2,447km^2 oil and gas licence (Licence 67). Both licences are located in the Tomsk Oblast in Russia's prolific Western Siberian Oil and Gas Basin.

↗ more info on p2-5

What are the values which guide our corporate behaviour?

Our core values are based in honesty, hard work, professionalism, respect for others and teamwork throughout the Group.

↗ more info on p9

What is our ambition for the future?

We are confident that we will continue to grow our production and have additional significant reserve bookings in 2011, based on the quality of our five well exploration/delineation well programme.

↗ more info on p12-15

Why should you invest in PetroNeft?

With production now established and set to grow each year in the coming years PetroNeft has a solid foundation from which to explore the many remaining exploration prospects within our current portfolio.

↗ more info on p9

find out more at **www.petroneft.com**

Producing progress

Operational Highlights

- Year-round production commenced on schedule in Q3 2010.
- Group 2P reserves increase 37% to 96.9 mmbbls.
- Production reached 3,100 bopd from nine wells.
- Drilling of 17 additional production wells planned for 2011 underway.
- Commenced five well exploration programme targeting 120 million barrels of reserves in 2011.

Financial Highlights

- Commencement of oil sales in Q4 2010.
- Capital expenditure of US$42 million in 2010; a fully-funded US$53 million spend planned for 2011.
- Successful oversubscribed US$43 million equity placing in October 2010.
- Macquarie US$30 million Loan facility signed in May 2010, improved terms agreed in April 2011.

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Forward Looking Statements

This report contains forward-looking statements. These statements relate to the Group's future prospects, developments and business strategies. Forward-looking statements are identified by their use of terms and phrases such as 'believe', 'could', 'envisage', 'potential', 'estimate', 'expect', 'may', 'will' or the negative of those, variations or comparable expressions, including references to assumptions.

The forward-looking statements in this report are based on current expectations and are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by those statements. These forward-looking statements speak only as at the date of this announcement. Pages 1 to 7 were approved by the Board on 20 May 2011.

About PetroNeft

Producing oil from an expanding asset base

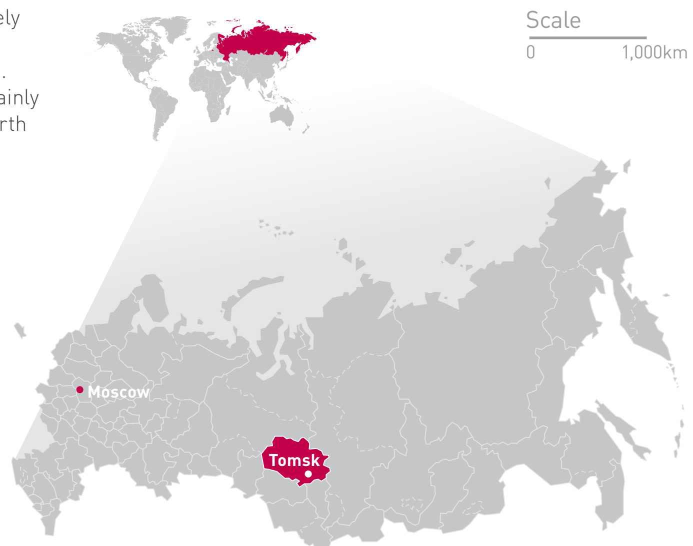
Our Assets

The main assets of the Company are a 100% interest in a 4,991km^2 oil and gas licence (Licence 61) in the Tomsk Oblast in Russia and a 50% operating interest in a 2,447km^2 oil and gas licence (Licence 67) also located in the Tomsk Oblast. Both licences are located in the prolific Western Siberian Oil and Gas Basin.

Tomsk Oblast

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% 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.



62%
percentage of exports from the region that oil accounts for

210,000
bopd produced (approximately)

History

The Group has its origins in PetroNeft LLC, a Texas-based company, which was established in 2003 as an oil and gas investment and consultancy company focused principally on the Russian market. In May 2005, PetroNeft LLC acquired a Russian company, Stimul-T, which had acquired a 100% interest in Licence 61 following a competitive auction process in the November 2004 Tomsk Licence Auction. PetroNeft Resources plc was incorporated on 15 September 2005 and was admitted to the London AIM and Dublin ESM Markets in September 2006.

Strategy

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. In the short term this is to be achieved through the growth of production at Licence 61 and a rigorous appraisal and exploration programme on Licences 61 and 67, by seeking to bring the existing discoveries into production as rapidly as possible and by exploiting the additional opportunities already identified and summarised in the Ryder Scott Report.

In addition to operations on Licences 61 and 67, the company continues to evaluate new projects for acquisition. The objective is to acquire new Core Exploration and Production Areas that satisfy the Group's strict technical and legal evaluation criteria. While the main focus for new acquisitions will be the West Siberian Basin, the company will also consider projects in other areas within the Russian Federation.

Scale
0 100km

Strezhevoy
61
67
Kargasok
Parabel
Kolpashevo
Tomsk

PetroNeft
Rosneft
Gazprom
Gazpromneft
ONGC (Imperial Energy)
TNK BP
Other
Oil Pipeline
Gas Pipeline

Scale
0 20km

Licence 67
Licence 67 contains the Ledovoye oil field and numerous prospects and leads including the Cheremshanskaya prospect.

Licence 61
Licence 61 contains five known oil fields: Lineynoye, Tungolskoye, West Lineynoye, Kondrashevskoye and Arbuzovskoye, and over 25 Prospects and Leads that are currently being explored.

The objective is to acquire new Core Exploration and Production Areas that satisfy the Group's strict technical and legal evaluation criteria.

Pictures (from left to right):
- Production drilling rig on Pad #1 at the Lineynoye oil field.
- Workover rig operations at the Lineynoye oil field.

Our Assets in Detail

As well as five discovered oil fields in Licence 61 there are 25 additional prospects to be explored. Licence 67 has one oil field and a number of prospects including some structures with wells that have tested oil. Total proved and probable reserves for the two licences is 97 mmbbls net to PetroNeft.

Licence 61

Licence 61 development plan

The development of Licence 61 commenced in 2010 with the drilling of nine new production wells at Pad #1 at the Lineynoye oil field. This is continuing in 2011 with the drilling of 17 new production wells at Pads 2 and 3 also at Lineynoye using two drilling rigs. In 2012 it is planned to introduce a third rig and commence bringing the other fields into production. Exactly which fields are brought into production in 2012 is dependent on the results of the 2011 exploration programme.

New field discovered in 2010

In November 2010 we discovered the Arbuzovskoye oil field about 10km east of the Lineynoye oil field. Ryder Scott attribute 13 mmbbls of proved and probable reserves to this field.

Exploration of Licence 61 2011

Following the success discovering the Arbuzovskoye oil field, three exploration/delineation wells will be drilled at Licence 61 in 2011 commencing in April 2011 at the following locations:

- Kondrashevskoye (No. 5 on below map).
- Sibkrayevskaya (No. 20 on below map).
- North Varyakhskaya (No. 8 on below map).

The first well will be a delineation well at the Kondrashevskoye oil field which is seeking to prove additional reserves above the current 8 mmbbls of proved and probable reserves booked by Ryder Scott.

The second well will be a high impact exploration well at the Sibkrayevskaya prospect targeting over 40 mmbbls of reserves. This prospect is following up on potential by-passed oil pay identified from a re-interpretation of the electric logs from a well drilled here in 1972.

The third well drilled at Licence 61 in 2011 will be at the North Varyakhskaya prospect. This well is targeting reserves of between 5 and 10 mmbbls. The prospect is less than 10km from the central processing facilities at the Lineynoye oil field and if successful could be brought into production in 2012.

Further exploration of Licence 61

After the above 2011 exploration programme there still remains a considerable suite of exploration prospects at Licence 61. The southern half of the Licence area in particular contains many prospects with multiple pay objectives.

Future exploration programmes at Licence 61 could include using the all weather road in the southern end of Licence 61 to gain access to potential drill locations on the Tuganskaya, Traverskaya, Kirillovskaya and Balkinskaya prospects. This could include the use of a mobile rig to conduct a five to seven well exploration programme in 2012/13.

Licence 61

5 Oil Fields

1 Lineynoye oil field
2 Tungolskoye oil field
3 West Lineynoye oil field
5 Kondrashevskoye oil field
7 Arbuzovskoye oil field

25 Prospects

2 Tungolskoye West Lobe and North (2)
4 Lineynoye Lower
6 West Korchegskaya (Lower Jurassic)
8 Arbuzovskaya North and 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

Licence 67

Licence Summary

- 25 year exploration and production licence.
- To be developed 50:50 with Arawak Energy.
- PetroNeft is the operator.
- Auction price US$1.42 million.
- 55 million barrels of C3 Russian Registered Reserves.
- 2P reserves of 14 mmbbls confirmed at Ledovoye oil field.

2010 work programme

The first stage in the appraisal of Licence 67 was the reprocessing of vintage well and seismic data. Well log data from 21 wells within and around Licence 67 was digitised and reprocessed. 4,300km of 2D seismic acquired in over 15 different surveys in the 1980s and 1990s was reprocessed using common parameters and reanalysed using modern software.

This work was completed in the fourth quarter of 2010 and used to determine the work programme for 2011.

Ryder Scott reported on the Licence for the first time at the end of 2010 and have estimated proved and probable reserves of 14 mmbbls net to PetroNeft at the Ledovoye oil field. They have also identified reserve potential of 92.5 mmbbls at eight other prospects and leads.

Exploration of Licence 67 2011

In 2011 two exploration wells will be drilled at Licence 67 targeting over 60 mmbbls of reserves at the following locations:

- Cheremshanskaya
- Ledovoye

The first well drilled will be at Cheremshanskaya. This well is following up on two old wells drilled in the 1960s and 1970s where we have identified potential by-passed pay. Ryder Scott estimate that there could be over 60 mmbbls of reserves net to PetroNeft at this prospect.

The second well will delineate the Ledovoye oil field but also follow up on potential by-passed pay at the Lower Cretaceous horizon where the Company estimates there could be up to 15 mmbbls of reserves net to PetroNeft.

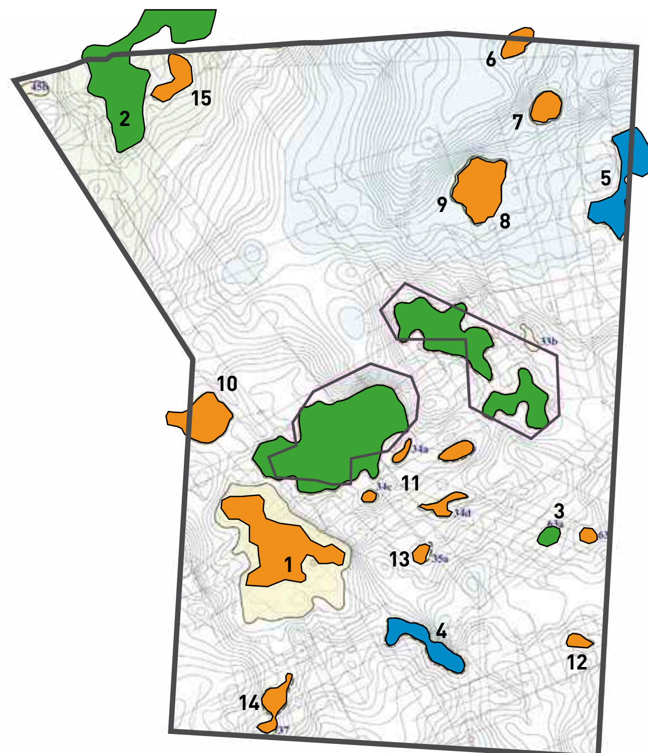
Licence 67

Drilled Structures

1. Cheremshanskaya
2. Ledovoye oil field
3. Sklonovaya
4. North Pionerskaya
5. Bolotninskaya

Identified Prospects and Leads

6. Levo-Ilyakskaya
7. Syglynigaiskaya
8. Grushevaya
9. Grushevaya Stratigraphic trap
10. Malostolbovaya
11. Nizhenolomovaya Terrasa Gp.
12. Baikalskaya
13. Malocheremshanskaya
14. East Chermshanskaya
15. East Ledovoye



Drilled Structure with oil show or test
Drilled Structure with no oil shows reported
Undrilled Structure or Stratigraphic Trap
Excluded area with producing oil fields

Scale

0 25km

Our Reserves

Central oil processing facilities at the Lineynoye oil field – September 2010.

Producing reserves

Year-round production commenced in 2010.

Since acquiring Licence 61 in 2005, Group proved and probable reserves have grown by 247% to 97 mmbbls. This has been achieved through a systematic programme of reprocessing and interpreting old seismic data and well logs, acquiring new 2D seismic data, drilling seven exploration/delineation wells and acquiring a new Licence – Licence 67. The Group now has six oil fields and numerous prospects and leads adding upside potential.

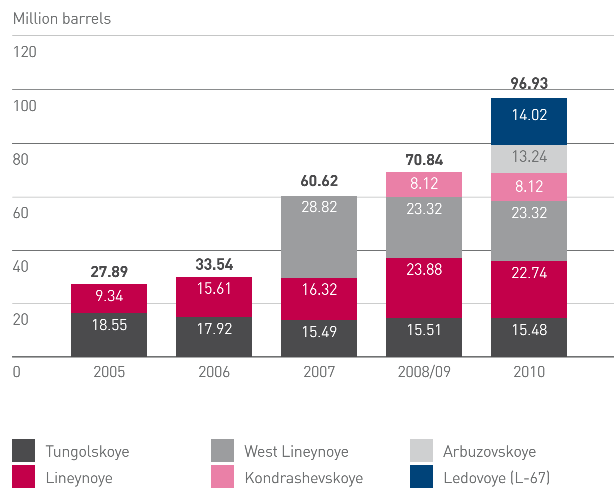
2010 saw the commencement of production from just one of these six oil fields, Lineynoye at Licence 61. Nine new production wells were drilled using one production drilling rig. We also built a 60km pipeline at Licence 61 which enables year-round production and is capable of handling future production from the other four oil fields at Licence 61 and any future discoveries from the range of prospects there. The central processing facility built at the Lineynoye oil field will also act as a hub for other oil fields within the Licence area and its capacity is being expanded in 2011 to handle the production growth expected in the coming years. The pipeline and processing facility are designed to allow relatively straightforward and low cost capacity expansion.

2P Reserve Growth

97

million barrels

Licences 61 & 67[1]



- 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') Petroleum Resources Management System ('PRMS') rules.
- Oil water contact is not defined at Kondrashevskoye – reserves could approach 20 million bbls if the oil water contact is at the 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. The reserves for Arbuzovskoye and Ledovoye will be registered in 2011.

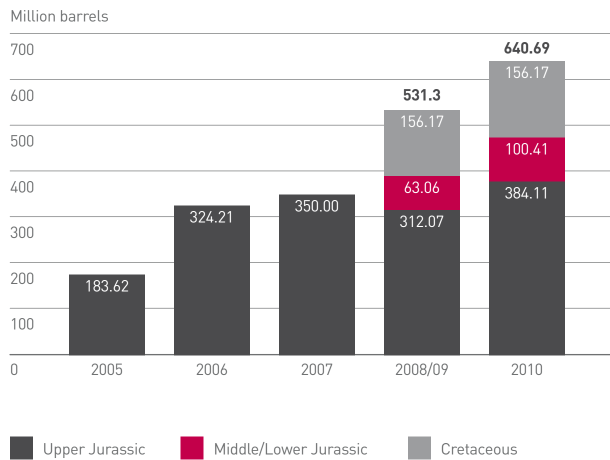
[1] Source: Ryder Scott – Petroleum Consultants reports for Licence 61 and Licence 67 as at 1 January 2011

3P & P4 Reserve Growth

641

million barrels

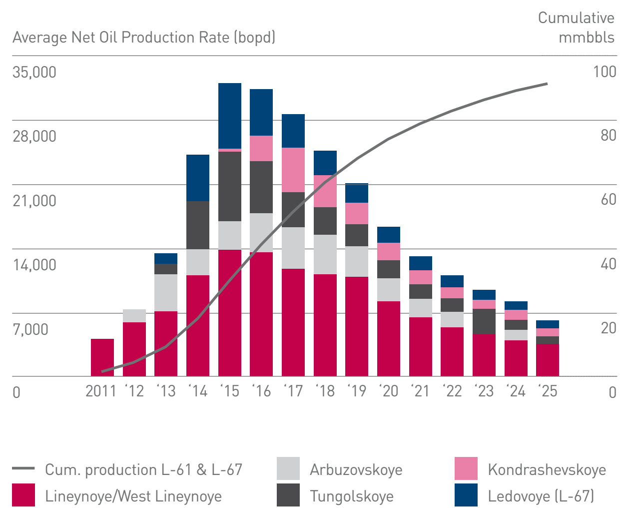
Licences 61 & 67[1]



- 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') Petroleum Resources Management System ('PRMS') rules.
- All prospect possible reserves are based on structures with unequivocal four-way dip closure at the reservoir horizon as identified by 2D seismic data.

Annual Production Forecast

Licences 61 & 67[1]



- The forecast is based on the Company's 2P reserves of 96.9 million bbls – six existing oil fields only.
- 2P reserves remaining after 2025 are 5.2 million bbls.

Questions and Answers

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

Strategy:

To date, PetroNeft has confined its activities to the Tomsk region of Russia. Is the Company considering acquiring assets outside of Tomsk or even outside of Russia?

The Company has built up an excellent team of professionals to support our operations in Tomsk and therefore will seek to further develop and add to existing assets in Tomsk to leverage our knowledge and experience in the area. However, as well as looking at new opportunities in Tomsk, we have been and will continue to look at potential acquisitions in Western Siberia in general and further afield within the Russian Federation. We look at auctions of licences by the state as well as the potential acquisition of existing licences from their current owners. Our focus is on field sizes of between 10 and 50 million barrels and it remains our intention to build a portfolio of assets of this size that have near-term production potential and longer term exploration upside. The Company's expertise is within the Russian Federation where we see ample opportunity, so there are no plans to look at assets outside Russia at the present time.

Production:

The Company frequently mentions that it has to use hydraulic fracturing to enhance the flow rates from its oil wells. What is hydraulic fracturing and why is it necessary?

Our oil fields are similar to many oil fields in Western Siberia where the permeability and porosity of the reservoir sandstones that contain the oil reserves are moderate to poor in quality. This means that the natural flow rates will tend to be low because the rock is tight and there are not sufficient conduits for the oil to flow through. Hydraulic fracturing is a method used around the world to improve the permeability of tight reservoirs. The economics of a field can be improved substantially by the use of hydraulic fracturing as it typically boosts production significantly thereby accelerating the recovery of oil from the reservoir.

The process involves the injection of a special fluid, primarily water, at very high pressure into the sandstone oil reservoir. The high pressure causes fractures to be created in the rocks. Then a proppant of synthetic or ceramic sand is injected into the new artificially created fractures to ensure the fractures stay open once the pressure is released. Oil should then flow at higher flow rates because of the enhanced permeability created by the hydraulic fracturing process. Once the process is complete the frac tubing is removed and an electric submersible pump is installed in the well. Typically it will then take about ten days for all of the fluids injected during the hydraulic fracturing process to clear out of the well and a stabilised oil production rate to be achieved.

Are there any lessons from the 2010 production drilling programme and how will the 2011 and future drilling programmes be influenced by these lessons?

Yes, there are a number of lessons learned from the 2010 drilling programme. The principal lesson is that it is very difficult to predict the level of near bore damage which can occur during the drilling and completion processes and therefore the resulting flow rates before fracture stimulation. We have implemented some changes to the drilling and completion practices for 2011 that may alleviate the issue, but it is unlikely that all damage can be eliminated. Given that we plan to fracture stimulate most of our production wells this is not necessarily a long-term problem for each well as fracture stimulation will substantially cure the effects of near bore damage.

We have also learned from the first batch of fracture stimulation wells. We achieved varying results based on the size of the frac and corresponding quantity of proppant used during the hydraulic fracturing process. These lessons will influence our future programmes.

What are the Company's 2011 and 2012 production targets?

Because of the lessons learned during the 2010 drilling campaign we have decided to move the target production date to the end of the first quarter in each calendar year. This will ensure that all of the wells drilled in the previous calendar year will have been fracture stimulated and returned to stable production and therefore the rates are more easily predicted at that stage.

The target production by the end of the first quarter of 2012 is between 7,000 and 8,000 bopd and the target by the end of the first quarter of 2013 is between 10,000 and 12,000 bopd.

Tax Incentives:

Have there been any recent changes to the tax regime in Russia?

In November 2010 the Russian Duma passed a change to increase the rate of Mineral Extraction Tax ("MET") by about 5% with effect from 1 January 2012 and by a similar amount from 1 January 2013. While this has been passed by the Duma there is ongoing lobbying by the industry to reverse the change particularly in the context of the Government's stated objective to reduce the tax burden on the upstream oil industry.

Two other tax changes that would see the overall tax burden that PetroNeft will pay decrease are also being discussed. The first is the introduction of a reduced rate of MET for oil fields where the initial recoverable reserves are below five million tonnes (about 35 million barrels). It is likely that PetroNeft's Arbuzovskoye, Kondrashevskoye and Tungolskoye oil fields would qualify for a reduction of between 30% and 45% in the MET liability for production at these oil fields. This draft law passed the first stage vote in the Russian Duma in early April 2011, however there are several further stages before it could get signed into law by the President.

The second proposed change is to reduce the top rate of export duty on crude oil exports from 65% to 60%. This would not only reduce the tax burden on export sales but would likely lead to better pricing of oil sold on the domestic market in Russia.

Funding:

What funding needs does PetroNeft have over the short and medium-term and how will these be met?

In October 2010 the Company raised US$43 million through a placement of new ordinary shares. Also, in April 2011 the Company agreed terms to re-finance the US$30 million loan from Macquarie Bank on improved terms. As at the date of the re-financing only US$11.2 million of the Macquarie loan remained outstanding. The funds provided by the placing of new shares and the Macquarie debt facility are sufficient to fund the 2011 programme to drill five exploration wells, 17 production wells and to double the capacity of the oil processing facilities at Lineynoye from 7,400 bopd to 14,800 bopd. It is expected that the cash flows from the increased production that will result from the additional 17 production wells together with the increased debt capacity of the business will enable us to fund the continuing development of the Group's existing assets in the coming years.

The Group is actively looking to add to its portfolio of assets and depending on the size and nature of such opportunities additional equity funding may be an important element of the funding mix for such acquisitions.

Culture:

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

Our culture and core values are based on the past experiences and common beliefs of the Board and our Russian management team. We take pride in the experience and make-up of our Board and management team and the corporate governance policies that we have put in place. Our core values are based in honesty, hard work, professionalism, respect for others and teamwork throughout the Group. We seek to treat our employees well in terms of rewards and work environment. We also strive 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.

Investment Case for Petroneft:

Why should I invest in PetroNeft?

PetroNeft has a superb asset base with its interest in two licences in Tomsk. With production now established and set to grow each year in the coming years the Group has a solid foundation from which to explore the many remaining exploration prospects within our current portfolio. The Group is also funded for production growth in the coming years through internally generated cash flows and the debt capacity that such cash flows generate. The production growth and exploration upside provide many opportunities for investors to generate excellent returns.

Chairman's Statement

PetroNeft is fortunate to have a highly experienced and dedicated team and this knowledge and experience have enabled us to meet the array of challenges facing the Group in recent years.

A Transformational Year

2010 was an important year. PetroNeft achieved its primary goal of bringing its existing oil fields into production, having completed the construction of a 60km pipeline and oil processing facilities at the Lineynoye oil field as well as drilling nine new production wells. 2011 will see further development and production growth with the planned addition of 17 new production wells at the Lineynoye oil field.

2010 also saw further exploration success with the discovery of the Arbuzovskoye oil field at Licence 61 and the addition of reserves at Licence 67 which had been acquired following an auction in December 2009. In 2010 proved and probable reserves grew by 37% from 71 million barrels of oil ("mmbbls") to 97 mmbbls. 2011 will see a five well exploration programme target additional reserves approximately 120 mmbbls net to PetroNeft.

Production

Following the successful completion of a 25 year Crude Oil Transportation and Custody Transfer agreement with Imperial Energy ("Imperial") in August 2009, PetroNeft completed the construction of a 60km pipeline from the Lineynoye oil field to Imperial's facility at Kiev-Eganskoye in the first half of 2010. Oil storage and processing facilities were also constructed at the Lineynoye oil field in 2010 with an initial capacity of 7,400 barrels of fluid per day ("bfpd") which will be added to in 2011 to bring capacity to 14,800 bfpd. These two major construction projects were completed on schedule and largely within budget.

Nine new production wells were also drilled at the Lineynoye oil field and put into production. A programme of hydraulic fracturing was carried out on the nine new wells and production reached 3,100 bopd once this programme was completed and the wells had cleaned up. The Group plans to drill 17 new development wells in 2011. The Group is targeting production in a range of between 7,000 and 8,000 bopd by the end of Q1 2012 when all of these 17 new wells, together with the existing wells, will have been fracture stimulated and returned to production.

Reserves Growth

In March 2010 the Board took the decision to drill an exploration well at the Arbuzovskaya prospect in Licence 61. This well was drilled in October and November 2010 and led to the discovery of the Arbuzovskoye oil field. Ryder Scott has assessed that there are 13 mmbbls of proved and probable reserves at Arbuzovskoye. Ryder Scott undertook its first review of Licence 67 which was acquired in January 2010 following a December 2009 state auction. Proved and probable reserves at the Ledovoye field were assessed at 28 mmbbls (14 mmbbls net to PetroNeft).

Pictures (from left to right):
- Alexander Tarasenko, Shift Manager Stimul-T.
- Fire water tanks under construction at Lineynoye Central Processing Facilities.
- Gas powered piston generators at the Lineynoye oil field use associated gas for power generation.

Successful Debt and Equity Financing

PetroNeft successfully raised US$43 million in October 2010 through a placing of new shares which enabled the Group to commence the Phase 1 project to develop the Lineynoye and West Lineynoye oil fields and become self-financing.

During 2010 we entered into a US$30 million debt facility with Macquarie Bank Limited. This facility gave the Group the ability to complete the nine well production drilling programme in 2010 and to drill the Arbuzovskoye exploration well that led to the discovery of a new oil field.

It remains the Board's intention to fund the Company with a mixture of debt and equity for business development purposes and to accelerate the appraisal and development programme on Licences 61 and 67.

Business Development

The principal near-term objective of the Group remains the development of the northern oil fields on Licence 61. However, we have not lost sight of our longer-term objective of securing assets outside of Licence 61 to provide growth for the future.

The acquisition of Licence 67 (Ledovy) was a first step in this growth. This new acreage materially enhances the Company's footprint in the Tomsk Oblast and is in line with our stated growth strategy. PetroNeft was able to win this auction because of its highly experienced management team and ability to be flexible and responsive to the opportunity. In January 2010, Arawak Energy ("Arawak") exercised their option under the August 2008 Area of Mutual Interest Agreement to acquire 50% of Licence 67 and we look forward to working with Arawak to develop this asset. PetroNeft will be the Operator for Licence 67.

We continue to actively examine a number of acquisition opportunities in the Tomsk region and elsewhere in Russia and hope to update shareholders in more detail in the coming months.

Corporate Development

We have added a number of senior management positions to the Group this past year as we moved from an exploration to an exploration and production company. These positions were carefully considered and we selected candidates who met both the immediate and long-term needs of the Group. The headcount has increased from 63 to 144 during 2010 principally due to the increased number of professionals and operatives required to run a producing oil field and the associated facilities.

I would like to welcome all new employees to the Group and thank all of our employees, old and new, for their hard work in 2010 to achieve our goal of getting into production.

Summary

2010 was a transformational year for the Group. The commencement of production means that the Group will generate significant cash in the coming years to enable it to expand its reserve base both through exploration and delineation in current Licence areas and through business development opportunities in Tomsk and further afield in Russia.

PetroNeft is fortunate to have a highly experienced and dedicated team and this knowledge and experience have enabled us to meet the array of challenges facing the Group in recent years. I am confident that this team will enable PetroNeft to continue to add shareholder value.

Finally, I know that I speak for all the Directors, management and staff of the Group 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 development project is now well underway and 2010 is set to be a transformational year for the Group.

General

2010 saw PetroNeft enter year-round production for the first time. This was a culmination of our efforts in recent years and the result of the valued support of our shareholders and employees. To get to production we had to construct a 60km pipeline from our Lineynoye oil field to Imperial Energy's facilities at Kiev-Eganskoye and construct oil processing and storage facilities at the Lineynoye oil field. We also drilled nine new production wells which will be supplemented by two existing wells at Lineynoye.

Also in 2010 PetroNeft drilled one exploration at Licence 61 well which resulted in the discovery of the Arbuzovskoye oil field.

At Licence 61, 2011 will see 17 additional production wells drilled at the Lineynoye oil field and three exploration wells also drilled in the Licence area.

Having won the rights to Licence 67 at a state auction in late 2009 we spent 2010 completing the acquisition as well as gathering, digitising, reprocessing and analysing all the old well and seismic data associated with the Licence which has led to the booking of additional proved and probable reserves and an exciting two well exploration programme planned for 2011.

Licence 61 – Oil Field Development

In 2009 the focus had been on optimising the development plan in order to reduce the funding requirement to get to year-round production. A key part of this was the signature in August 2009 of the 25 year agreement with Imperial Energy whereby Imperial would accept PetroNeft's crude oil using existing tank facilities at the Kiev-Eganskoye field and transport the crude oil to its Custody Transfer Point at Zavyalovo for transfer into the Transneft system. Shortly afterwards PetroNeft raised the necessary funds to build the pipeline and oil processing facilities and commence the drilling of production wells.

In 2010 we constructed the 60km pipeline and oil processing facilities and drilled nine new oil production wells and one water source well at Lineynoye oil field. The current design capacity of the process facilities is 7,400 bfpd which will be expanded to 14,800 bfpd in 2011. Water injection facilities to handle excess produced water and future water injection will also be installed in 2011. The initial facilities design emphasised the installation of gas piston power generators to utilise associated gas from the oil production to generate electricity for the camp, facilities and field needs and thereby minimise the flaring of associated gas.

Drilling from Pad 1 commenced in April 2010 utilising one production drilling rig. The drilling programme has been designed around the Russian BU 3000 EUK production drilling rig which is cost efficient and technically proven in the area. The drilling of the nine production wells and one water source well for future water flood operations was completed in October 2010. The initial well took about 30 days to drill; however, at the end of the programme the wells were taking just 15 days to drill. The subsequent completion operation which involved a workover rig took about ten days per well. First production commenced on schedule in August 2010. The geology of the drilling programme was in line with expectations and we were pleased that some of the thickest net pay wells (up to 17.9 m) were the northernmost drilled and close to the Pad 2 location.

Initial production rates from the wells have been quite variable, from 50 to 450 bopd, even though many wells appear to have very similar characteristics on the well-logs. We attribute much of this variation to near bore reservoir damage caused during the drilling and completion processes. In the main, the post fracture stimulation rates have been from 350 to 700 bopd except for two wells (110 and 117) where, because of nearby water sands, we did not carry out a large sized fracture stimulation. Based on the well performance after fracture stimulation, we feel we can improve on the design of the fracture stimulation for each well in the future. Some of the key lessons learned and actions undertaken to improve production and guidance in the future are as follows:

- We find that the formation damage from the drilling and completion processes can be quite variable from well to well so it is hard to predict the initial production rates. Hence in the future we will move our year-end production guidance to the end of the first quarter and thereby allow all of the new wells to be fracture stimulated and returned to production.
- Production drilling rigs are now required to have brand new 4-stage mud cleaning systems which should help to reduce some of the formation damage caused during the drilling process.
- We plan to carry out a fracture stimulation programme on up to eight of the new wells being drilled at Pad 2 and Pad 3 in the third quarter. While such a programme was previously believed to be uneconomic because of the high cost of transporting the necessary equipment and materials by helicopter we have found that it can be very economic provided the heavy materials are moved to the field in advance by winter roads. Therefore we have, in the first quarter of 2011, purchased over 600 tonnes of proppant for this programme together with some of the basic equipment used in the fracture stimulation process such as the high strength tubing used and the special proppant bins used for feeding the proppant into the system during the process and transported it to the field by winter road. This basic equipment can be reused in future fracture stimulation programmes. The remaining wells at Pad 2 and Pad 3 will be fracture stimulated next winter and should be competed and returned to production by the end of March 2012.
- Based on the well performance after fracture stimulation we have learned that in the future we should err on the side of larger volume hydraulic fracturing in order to gain the optimum rate of production and delay and minimise the decline in production rate.
- We have purchased our own workover rig so that in the future we can have better control over the quality of the equipment and well completion processes and thereby help to reduce formation damage and the time required to return wells to production after the hydraulic fracturing process. We will also directly employ our own workover rig crew in order to establish consistent quality of operations.

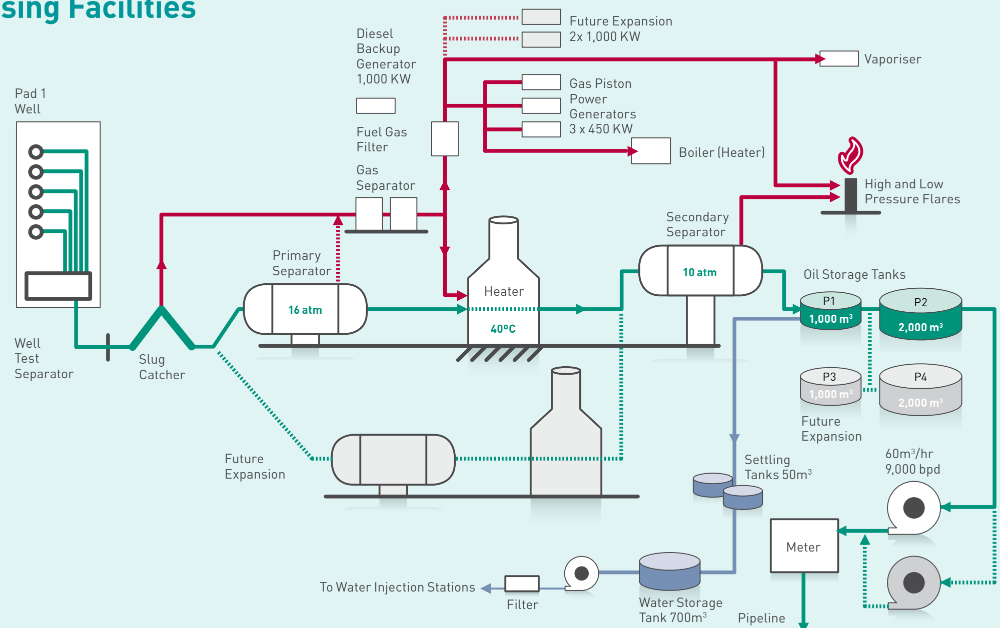
While we have learned some lessons along the way, we are very pleased with the results of the first production wells and the production achieved to date. In early 2011 the production drilling rig has been moved from Pad 1 to Pad 2 and a second production drilling rig has been mobilised to drill from Pad 3. Drilling from Pad 2 has now commenced and the first well contained 18.2 m of net oil pay, which is the most to date in the field development. Drilling from Pad 3 will commence shortly.

Schematic of Oil Processing Facilities

Current capacity:
370,000 tons/year
7,400 bfpd; expanding to 14,800 bfpd in 2011.

Key:
- **Oil**
- **Gas**
- **Water**

Dotted lines indicate expansion in 2011.



Notes:
1. **No gas dehydration**
2. **Gas stabilisation**
3. **Oil storage 2 days**
4. **Pumping 2 x 50%**
5. **No gas compression**
6. **Power – gas piston engine generators**

Chief Executive Officer's Report
continued

Licence 61 – Exploration, Delineation and Reserve Expansion

The financial crisis slowed the progress of exploration and delineation of Licence 61. However, exploration drilling recommenced in the fourth quarter of 2010 with the drilling of the Arbuzovskoye No. 1 well and the discovery of a new field containing about 13 million barrels of 2P reserves at Arbuzovskoye. In 2011 three further exploration/delineation wells will be drilled at Licence 61. The wells are a delineation well at Kondrashevskoye, followed by exploration wells at Sibkrayevskaya and North Varyakhskaya. This programme targets about 60 million barrels in potential reserves.

While the current focus is the exploration and quick tie-in of new fields in the vicinity of the Lineynoye Central Processing Facilities, we have a significant portfolio of prospects in the southern portion of the Licence, of which many have potential in multiple horizons including the Cretaceous. An all weather road is available through a significant portion of this part of the Licence and crosses over some prospects. We have initiated a feasibility study to ascertain what prospects we could access via the all weather road, with the intention of undertaking a five to seven well exploration programme using a mobile rig. However we do not envision drilling in this area until 2012-2013.

Business Development

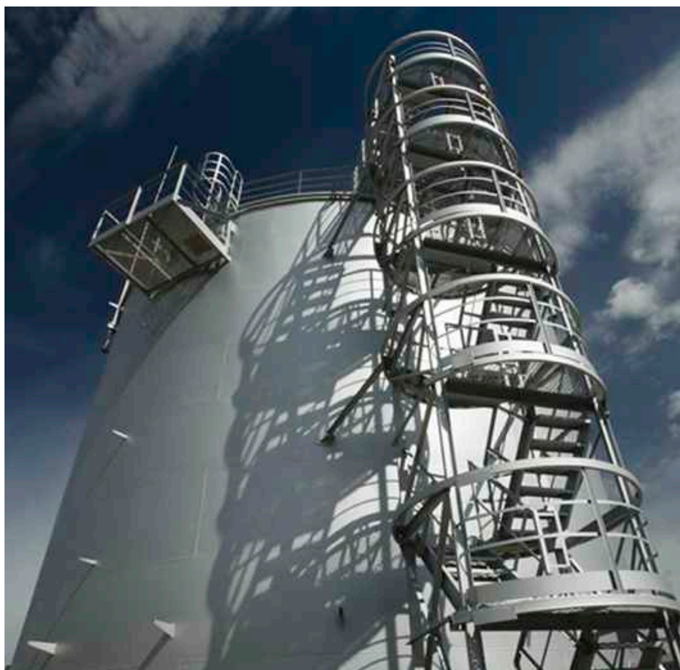
The Group actively pursues opportunities in the Tomsk Region and Russia in general. These include potential corporate acquisitions and participating in State Auctions. The Group has developed a high technical and economic standard with regard to acquisitions and many opportunities do not meet this test. However, our experience shows that there are quality opportunities available and we just need to be patient and deliberate in our search.

This work came to fruition in December 2009 with the acquisition of Licence 67 at a State Auction in the Tomsk region. The gross bid consideration was 42 million Roubles (US$1.42 million).

Licence 67 (Ledovy)

Licence 67 was registered in January 2010. This new acreage materially enhances the Group's footprint in the Tomsk Oblast and is an important step forward in our growth strategy. While there was a very short time frame and minimal amount of data available before the auction, the Group was able to quickly make a comprehensive evaluation of the block and win the auction due to the past knowledge and relationships of its Tomsk staff. Highlights of Licence 67 activities in 2010 are as follows:

- Approximately 4,415km of vintage 2D seismic and 21 wells in the area have been digitised and reprocessed with modern software.
- The reprocessed data was the basis for a comprehensive reinterpretation of the structure, stratigraphy and petroleum potential of the area.
- Ryder Scott estimates the 2P reserves at the Ledovoye oil field to be 14.0 million barrels net to PetroNeft.
- Ryder Scott estimates the 3P reserves and exploration resources to be 110 million barrels net to PetroNeft.
- Two exploration/delineation wells are planned for 2011 targeting an additional 60 million barrels plus in reserves.



Pictures (from left to right):
- Oil storage tank at Central Processing Facilities.
- Boiler at Central Processing Facilities.
- Rig floor on production drilling rig.

Needless to say we are very excited about the results of the comprehensive reinterpretation of the hydrocarbon potential of Licence 67. We have been able to book reserves at Ledovoye oil field and feel we have a quality prospect to drill at Cheremshanskaya. The Cheremshanskaya No. 1 well was drilled in 1962 and while oil shows were reported while drilling, the well was not properly tested due to drilling problems. The recent log re-evaluation shows by-passed pay in three separate intervals in the well. Ryder Scott estimates the potential reserves in the structure to be in excess of 60 million barrels net to PetroNeft.

In the second half of 2011, PetroNeft plans to drill additional exploration/delineation wells on the Ledovoye oil field and the Cheremshanskaya prospect. Both wells will be drilled parallel to existing wells in order to optimise the coring and testing of potential by-passed pay zones in the vintage wells drilled in 1973 and 1962 respectively.

Arawak Area of Mutual Interest

Licence 67 is within Western Siberia and thus falls within the 2008 Area of Mutual Interest agreement between PetroNeft and Arawak. Under this agreement, Arawak have exercised their option to take a 50% interest in the Licence and finance 50% of all costs including the acquisition cost. PetroNeft will be the Operator of the Licence. While we have been working together during 2010 on Licence 67, the formal legal agreement governing our relationship with Arawak was signed in February 2011 and the various conditions precedent under the agreement are expected to be completed in June 2011.

Health, Safety and Environmental

The Group is fully committed to high standards of Health, Safety and Environmental (HSE) management. More details of our HSE activities are included in the HSE report on page 16.

Personnel

The Company made two important senior management appointments in 2011.

In April 2010, Michail Dronov was appointed to the Group as Chief Development Geologist. Michail has over 25 years experience in the development of oil and gas fields in the Tomsk region. He most recently worked as Chief Geologist for LLC STS-Service. He has an advanced degree from Tomsk Polytechnic University in the development of oil and gas fields.

In December 2010, Yuriy Chimur was appointed Head of Field Production. Yuriy has 17 years experience in oil and gas field production and was most recently Chief Engineer for LLC Aliansneftegaz and LLC Nord Imperial. He has degrees from Tomsk Polytechnic University in reservoir engineering and oil and gas field operation.

Conclusion

2010 has been a transformational year for PetroNeft. We have gone from being just an exploration company to an exploration and production company. This is not an easy transition and we are very proud of our staff in Tomsk for their efforts in accomplishing this difficult goal both on schedule and within budget. Now that the Lineynoye Central Processing Facilities are in place our near-term efforts will be focused on monetising the nearby fields which will be tied-in to the Lineynoye Central Processing Facility in the coming years.

We are also very excited with the results of our comprehensive re-evaluation of all of the vintage seismic and well data on Licence 67. This new acreage materially enhances our footprint in the Tomsk Oblast and is an important step forward in PetroNeft's stated growth strategy.

The Group is confident that we will continue to grow our production and have additional significant reserve bookings in 2011, based on the quality of our five well exploration/delineation well programme. PetroNeft looks forward to further building its business and asset base in the region in 2011 and beyond.

Dennis Francis
Chief Executive Officer

Chief Development Geologist, Mikhail Dronov, was appointed in April 2010.

Ryder Scott Estimated Reserves in Oil Fields (net to PetroNeft*)

Oil Field Name	Proved	Proved & Probable	Proved, Probable, & Possible
	1P mmbo	2P mmbo	3P mmbo
Licence 61			
Lineynoye	5.2	22.8	28.5
Tungolskoye	1.4	15.5	19.6
West Lineynoye	2.7	23.3	29.2
Kondrashevskoye	0.6	8.1	26.1
Arbuzovskaya	1.9	13.2	16.6
	11.8	82.9	120.0
Licence 67*			
Ledovoye	1.5	14.0	17.4
	13.3	96.9	137.4

- All oil in discovered fields is in the Upper Jurassic section.
  Reserves were determined in accordance with the Society of Petroleum Engineers ("SPE") Petroleum Resources Management System ("PRMS") rules.

* Licence 67 will be co-developed with Arawak Energy and the reserves above reflect PetroNeft's 50% share.

Health, Safety and Environmental Report

The Group is fully committed to high standards of Health, Safety and Environmental (HSE) management and being socially responsible 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 Stimul-T, has primary responsibility for all aspects of HSE 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

The Group has a Labour Safety and Industrial Security Department headed up by Elena Morgunova. The role of the 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 employees of the Group and employees of contractors are adequately trained in the use of relevant equipment.
- Monitor all contracts the Group enters into in order to ensure contractors are informed of the labour safety policies of the Group.
- Carry out regular site inspections to ensure full compliance.
- Develop and deliver labour safety and industrial security training to Group employees.
- Maintain an Emergency Response Plan for explosion and fire hazard facilities of the Group.
- Develop and get approved by state authorities:
  - Regulation for control of industrial safety compliance at hazardous facilities.
  - Regulation for order of accident investigation at hazardous industrial facilities of the Group.
- Maintain a vaccination and insurance programme for tick-borne encephalitis, a disease common in the West Siberian environment.

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 Licence 61 was carried out before any drilling work commenced in 2007. This was to establish the state of the environment within Licence 61 in advance of any major works. A similar assessment commenced at Licence 67 in 2010 and will be completed in the first half of 2011.

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.

In 2010 the main activities from an environmental perspective were:

- Environmental monitoring system has been introduced at Lineynoye field.
- Planning and approvals for 2011 production drilling and field development and exploration/delineation programmes.
- The first stage of Environmental Baseline Study for Licence 67.
- Preparation of programme for environmental and subsoil monitoring in Licence 67.

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

Compliance and Inspections

The Group reports on its HSE activities to various statutory authorities in Russia on a quarterly and annual basis and is also subject to regular inspections by various bodies. Inspections relating to compliance with Natural Resource Management Law (Rosprirodnadzor) in relation to the newly constructed facilities at Lineynoye took place in 2010 and 2011 and no significant issues arose from these inspections.

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 2010 we also made contributions to orphanages in the Tomsk Oblast and contributed to social programs run in the Alexandrovskoye region of Tomsk where Licence 61 is located.

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

At work in the Laboratory at Lineynoye Central Processing Facility: Ilgiza Aslyamova – Head of Chemical Analysis Laboratory.

Principal Risks and Uncertainties

The principal risks and uncertainties affecting the Group and the actions taken by the Group to mitigate these risks and uncertainties are:

Risk Category	Risk Issue	Mitigation
Country Risks	**Political – federal risks**	Fields/acquisitions below 500 million boe are not considered strategic to the Russian state.
		State is encouraging small operators.
	Political – local risks	Tomsk Oblast administration is very supportive of development.
		Local management are well respected in region.
	Ownership of assets	Licences were acquired at government auctions. Work programme for Licence 61 is complete. Work programme for Licence 67 is not onerous.
		25 year Licence term can be extended based on approved production plan.
	Changes in tax structure	Fiscal system is stable – recent and proposed changes largely benefit upstream oil and gas companies.
		Proactive lobbying effort made 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 substantive alignment.
Financial Risks	**Availability of finance**	US$43 million equity raised October 2010 in significantly over subscribed placing, US$30 million bank facility agreed in May 2010 and refinanced on improved terms in April 2011.
	Oil price	Robust project sanction economics – conservative base case assumptions. Board will consider use of appropriate hedging instruments.
	Industry cost inflation	Rigorous contracting procedures with competitive tendering. Also the relationship of the Dollar/Rouble exchange rate to the oil price provides a natural balance between costs and income.
	Uninsured events	Comprehensive insurance programme in place.
Other Risks	**HSE incidents**	HSE standards set and monitored regularly across the Group.
	Export quota	Equal access to export quotas available for all oil producers using Transneft.
		Conservative assumption in economics – domestic net back price now largely in alignment with export net back.
	Third-party pipeline access	25 year transportation agreement in place.
	Transneft pipeline access	Available capacity and access confirmed.
		East Siberia-Pacific Ocean (ESPO) pipeline allows export of oil to Pacific market.

Financial Review

As a result of the equity funding and the Macquarie loan facility the Group's 2011 capital investment programme is fully funded.

2010 saw the culmination of our efforts in recent years to optimise the economics of the development of our oil fields in order to be able to fund the commencement of production thereby achieving our stated aim of monetising our existing oil fields. Year-round production commenced on schedule in late August 2010 following the construction of the 60km pipeline and the oil processing facilities.

During the year we entered into a debt facility with Macquarie Bank Limited and raised additional finance from the equity markets. We also re-commenced exploration at Licence 61.

In 2011 we will continue to grow our production through the drilling of 17 additional production wells at the Lineynoye oil field. We will also drill five exploration wells across our two Licence areas in 2011.

Key Financial Metrics

	2010 US$	2009 US$
Revenue	**5,155,646**	509,710
Cost of sales	**(4,284,181)**	(420,566)
Gross profit	**871,465**	89,144
Gross margin	**17%**	17%
Administrative expenses		
Overheads	**(5,601,591)**	(3,430,687)
Share-based payment expense	**(460,500)**	(464,100)
Foreign exchange loss on intra-group loans	**(137,054)**	(537,683)
Other foreign exchange gain/(loss)	**285,038**	(410,056)
	(5,914,107)	(4,842,526)
Finance revenue	**126,595**	173,296
Finance expense	**(1,356,918)**	(20,644)
Income tax expense	**(852,429)**	(318,472)
Loss for the year attributable to equity holders of the Parent	**(7,125,394)**	(6,471,552)
Capital expenditure in the year	**41,646,953**	6,153,603
Net proceeds of equity share issues	**40,793,563**	25,863,882
Bank and cash balance at year-end (including restricted cash)	**25,281,881**	15,726,479

Net Loss

The net loss for the year increased to US$7,125,394 from US$6,471,552 in 2009. The main reason for the increase in losses relates to an increase of US$2,170,904 in overheads partly due to the addition of new staff at our Tomsk operations during the year and the depreciation charge for non-current assets, constructed during the year.

2010 Capital expenditure of US$42 million

Production Wells	$20m
Equipment and facilities	$13m
Pipeline	$3m
Exploration	$5m

Revenue, Cost of Sales and Gross Margin

Revenue from oil sales was US$5,155,646 for the year. A gross margin of 17% was achieved. Cost of sales includes depreciation of US$530,235. We would expect this margin to improve in future periods as many of the costs will not rise proportionally as production grows. We produced 189,508 barrels of oil in the period and sold 158,295 barrels of oil achieving an average oil price of US$33 per barrel. All of our oil was sold on the domestic market in Russia.

Finance Costs

Finance costs of US$1,356,918 relate to interest on bank loans, discount on deposit paid for pipeline usage, arrangement fees in relation to the Macquarie Bank loan facilities and the unwinding of discount on decommissioning provision. A more detailed analysis is given at Note 7 on page 44.

Finance Revenue

Finance revenue of US$126,595 (2009: US$173,296) arises from interest earned on bank deposits.

Taxation

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

Capital Investment

Several major capital projects were completed in 2010 and further significant investment is planned in 2011. 2010 projects included:

- Construction of a 60km pipeline from Lineynoye oil field to Imperial Energy's facility at Kiev-Eganskoye.
- Construction of oil processing, oil storage and crew facilities at the Lineynoye oil field.
- Drilled and completed nine new production wells and one water source well at the Lineynoye oil field.
- Drilled one exploration well that led to the discovery of the Arbuzovskoye oil field

In 2011 the Group intend to invest US$53 million, the largest amount it has ever invested in a single year in the following projects:

- Drill, complete and carry out fracture stimulation on 17 new production wells at Pads 2 and 3 in the Lineynoye oil field.
- Double the capacity of the oil processing facilities at Lineynoye from 7,400 bfpd to 14,800 bfpd.
- Drill three exploration wells at Licence 61, namely, Kondrashevskoye No. 2, Sibkrayevskaya No. 372 and North Varyakhskaya No. 1.
- Drill two exploration wells at Licence 67, namely, Cheremshanskaya No. 3 and Ledovoye No. 2a. As Licence 67 is 50% owned by Arawak Energy they will contribute 50% of these costs.

Current and Future Funding of PetroNeft

In May 2010 PetroNeft entered into a loan facility with Macquarie Bank Limited for up to US$30 million. At peak the maximum drawn on this loan was US$16 million, however this had been reduced to US$14.2 million by year-end 2010. In April 2011 a revised facility was agreed for up to US$75 million with immediate availability of US$30 million subject to the satisfaction of conditions precedent primarily related to the perfection of security over certain physical assets of the Group's Russian subsidiaries.

In October 2010 PetroNeft raised US$43 million through a private placing of new ordinary shares. The placing was significantly over-subscribed. The placing was co-ordinated by the Group's joint-brokers, Davy and Canaccord Genuity who were assisted by Renaissance Capital. The shares were placed with both new and existing shareholders and the proceeds used to finance the Group's exploration and development programme.

As a result of the equity funding and the Macquarie loan facility the Group's 2011 capital investment programme is fully funded. It is also expected that operating cash flows and debt capacity of the Group's producing assets will enable the Group to continue investment in 2012 and beyond in order to bring its other oil fields into production.

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 24 to the consolidated financial statements.

Investor Relations

During 2010, the CEO and CFO held regular meetings with analysts and institutional investors and the fund raising in October 2010 further widened the base of institutional investors in the Company. In September 2010 PetroNeft hosted a group of analysts and shareholders in Tomsk including a visit to the Lineynoye oil field. This visit helped to increase the amount of analyst coverage of PetroNeft.

The target for 2011 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 March 2011 the Group's website, www.petroneft.com, was upgraded and re-launched bringing easier navigation and additional tools and information for users.

Significant Shareholders

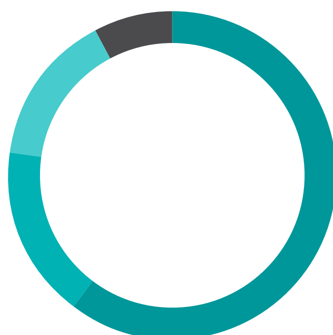
So far as the Directors are aware, the names of the persons other than the Directors who, directly or indirectly, are interested in 3% or more of the Issued Share Capital at 4 May 2011 are as follows:

Name of Shareholder	Ordinary Shares	Percentage
JP Morgan Chase & Co	37,687,500	9.06%
BlueGold Capital Management LLP	29,618,768	7.12%
Macquarie Bank Limited	25,628,047	6.16%
Ali Sobraliev	23,014,273	5.53%
Pictet & Cie.	14,153,213	3.40%
Arawak Energy	14,114,344	3.39%
Wasatch Advisers Inc.	14,023,048	3.37%

Paul Dowling
Chief Financial Officer

2011 Planned capital expenditure of US$53 million

Production Wells	$32m
Equipment and facilities	$9m
Exploration – L61	$8m
Exploration – L67	$4m



Board of Directors

David Golder[1]

Non-Executive Chairman (Age 63)

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 40 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.

Dennis Francis[2]

Chief Executive Officer and Executive Director (Age 62)

Mr. Francis has been Chief Executive Officer and an Executive Director of the Company since its formation in 2005. He has over 39 years experience in the petroleum industry and was with Marathon for 30 years. From 1990, Mr. Francis was the 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.

Paul Dowling[3]

Chief Financial Officer and Executive Director (Age 39)

Mr. Dowling joined the Company in October 2007 and was appointed to the Board of Directors in April 2008. He has 20 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). He is also a non-executive Director of Moesia Oil & Gas plc, an unlisted company, focused on oil and gas exploration and development in Central and Eastern Europe.

Dr. David Sanders[4]

General Legal Counsel, Executive Director and Company Secretary (Age 62)

Dr. Sanders has been General Legal Counsel, Executive Director and Company Secretary of the Company since its formation in 2005. He is an attorney at law and has over 33 years experience in the petroleum industry, including 20 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.

Gerard Fagan[5]

Non-Executive Director (age 62)

Mr. Fagan was appointed as a Non-Executive Director on 8 September 2010. He is a member of the Audit Committee and a member of the Remuneration Committee. Mr. Fagan previously worked with Smurfit Kappa Group plc ("Smurfit Kappa") for 23 years before his retirement as Group Financial Controller in September 2009. During this time he had global responsibility for controlling financial operations of Smurfit Kappa, a company with turnover of €7 billion and operations in over 30 countries worldwide. Mr. Fagan has vast experience in mergers and acquisitions, corporate finance, accounting, taxation, insurance and corporate governance. He is both a Chartered and Chartered Certified Accountant and has previously served on the audit committee of the Institute of Chartered Accountants in Ireland. Mr. Fagan is also a Non-Executive Director of Liffey Reinsurance Company Limited, The Baxendale Insurance Company Limited, Bramshott Management Limited and Bramshott Europe Fund plc.

Thomas Hickey[6]

Independent Non-Executive Director (Age 42)

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 is Corporate Development Director of Petroceltic International plc, an AIM listed oil and gas company focused on the Middle East-North Africa and the Mediterranean basin. 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 and exploration success. 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 fundraising, stock exchange requirements, mergers and acquisitions, flotation and related transactions. Mr. Hickey is a Commerce graduate of University College Dublin and a Fellow of the Irish Institute of Chartered Accountants. He is also a non-executive Director of Ikon Science Limited, a UK geological software company.

Vakha Sobraliev[7]

Non-Executive Director (Age 56)

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.

Directors' Report
For the year ended 31 December 2010

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 2010.

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 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 Chairman's Statement, Chief Executive Officer's Report and in the Financial Review.

Results and Dividends
The loss for the year before tax amounted to US$6,272,965 (2009: US$6,153,080). After a tax charge of US$852,429 (2009: US$318,472) the loss for the year amounted to US$7,125,394 (2009: US$6,471,552). The Directors do not recommend payment of a dividend. Accordingly, an amount of US$7,125,394 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 2009, 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 12 to 15 and the Financial Review on pages 18 to 19. The key financial metrics used by management are set out in the Financial Review on page 18.

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) 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.

PetroNeft satisfies all of these requirements. 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, overall corporate governance 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, Gerard Fagan 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 and preliminary announcement, accounting principles, policies and practices, internal controls and overseeing the relationship with the external auditor and the results of their audit.

Remuneration Committee
The members of the Remuneration Committee are David Golder, Gerard Fagan, Thomas Hickey and Vakha Sobraliev. It is chaired by David Golder. The Remuneration Committee's responsibilities include, among other things, determining the policy and elements of remuneration for Executive Directors, 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 appointment of Gerard Fagan as a Non-Executive Director of the Board means that the percentage of Non-Executive Directors on the Board is now above 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. Shareholders are also welcome to telephone or email the Company at any time.

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, where presentations, reserve reports and other materials are also available.

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 to 21.

In accordance with Article 83 of the Articles of Association, David Golder and Paul Dowling retire by rotation and, being eligible, offer themselves for re-election. Gerard Fagan, having been appointed to the Board on 8 September 2010, also retires in accordance with Article 86 of the Articles of Association and being eligible offers himself for election.

Directors, Company Secretary and Their Interests
The Directors and Company Secretary who held office at 31 December 2010 had no interest, other than those shown below, in the Ordinary Shares of the Company. All interests shown below are beneficial interests.

	Ordinary Shares As at 4 May 2011	Ordinary Shares As at 31 December 2010	Ordinary Shares As at 1 January 2010
David Golder	3,165,458	3,165,458	3,165,458
Dennis Francis	22,570,416	22,570,416	22,570,416
Paul Dowling	206,583	206,583	192,531
David Sanders	2,213,235	2,213,235	2,213,235
Vakha Sobraliev	–	–	–
Gerard Fagan	200,000	200,000	–
Thomas Hickey	1,726,283	1,726,283	1,587,614

Directors' Report (continued)
For the year ended 31 December 2010

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

Director	Options held as at 1 January 2010	Granted in Year	Exercised in Year	Options held as at 31 December 2010	Exercise price
David Golder	615,000	120,000	–	735,000	£0.19 – £0.66
Dennis Francis	1,540,000	330,000	–	1,870,000	£0.19 – £0.66
Paul Dowling	855,000	280,000	–	1,135,000	£0.19 – £0.66
David Sanders	1,440,000	280,000	880,000	840,000	£0.19 – £0.66
Vakha Sobraliev	555,000	100,000	–	655,000	£0.19 – £0.36
Gerard Fagan	–	150,000	–	150,000	£0.66
Thomas Hickey	453,000	100,000	110,000	443,000	£0.19 – £0.66

Details of the terms and conditions of the option scheme are included in Note 28 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 2009, 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 performance targets which include elements relating to shareholder return and individual performance.

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.

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. Certain Directors elected to receive a portion of their remuneration for 2008, 2009 and 2010 in shares instead of cash.

In US Dollars	2010					2009
Director	Basic remuneration*	Bonuses*	Pension	Share-based payment	Total remuneration	Total remuneration
Executive Directors						
Dennis Francis	246,712	127,805	–	48,198	422,715	442,333
Paul Dowling	216,838	103,277	10,615	34,283	365,013	342,729
David Sanders	219,787	71,639	–	41,829	333,255	373,582
Former Executive Director						
Des Burke	–	–	–	–	–	40,268
	683,337	302,721	10,615	124,310	1,120,983	1,198,912
Non-Executive Directors						
David Golder	33,474	–	–	14,222	47,696	48,985
Gerard Fagan	8,316	–	–	1,252	9,568	–
Thomas Hickey	26,494	–	–	11,388	37,882	38,316
Vakha Sobraliev	13,247	–	–	10,570	23,817	24,923
	81,531	–	–	37,432	118,963	112,224
Total Directors remuneration	764,868	302,721	10,615	161,742	1,239,946	1,311,136

* certain amounts were paid in shares instead of cash.

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 2009. 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.

Political Donations

The Company did not make any political donations during the year.

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 20 Holles Street, Dublin 2, Ireland.

Important Events after the Balance Sheet Date

In April 2011 PetroNeft signed a new loan facility agreement with Macquarie Bank Limited for up to US$75 million subject to the satisfaction of conditions precedent primarily related to the perfection of security over certain physical assets of the Group's Russian subsidiaries.

Auditors

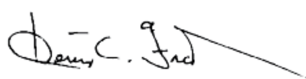
Ernst & Young, Chartered Accountants, have indicated their willingness to continue in office in accordance with the provisions of Section 160(2) of the Companies Act, 1963.

Annual General Meeting

Your attention is drawn to the Notice of Meeting set out on page 61.

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 30,081,975 Ordinary Shares.

Approved by the Board on 10 May 2011



Dennis Francis
Director

Paul Dowling
Director

Independent Auditor's 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 2010, which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, 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 30. 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 2009. 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, Health, Safety and Environmental 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 2010, 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 2009.

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.

Ernst & Young
Chartered Accountants and Registered Auditors
Dublin
10 May 2011

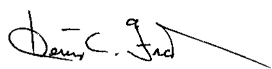
Consolidated Income Statement
For the year ended 31 December 2010

	Note	2010 US$	2009 US$
Continuing operations			
Revenue	4	**5,155,646**	509,710
Cost of sales		**(4,284,181)**	(420,566)
Gross profit		**871,465**	89,144
Administrative expenses		**(5,777,053)**	(4,304,843)
Loss on oil and gas properties	5	**–**	(1,552,350)
Exchange loss on intra-Group loans	5	**(137,054)**	(537,683)
Operating loss	5	**(5,042,642)**	(6,305,732)
Finance revenue	6	**126,595**	173,296
Finance costs	7	**(1,356,918)**	(20,644)
Loss for the year for continuing operations before taxation		**(6,272,965)**	(6,153,080)
Income tax expense	9	**(852,429)**	(318,472)
Loss for the year attributable to equity holders of the Parent		**(7,125,394)**	(6,471,552)
Loss per share attributable to ordinary equity holders of the Parent			
Basic and diluted – *US Dollar cent*	10	**(1.97)**	(2.53)

Consolidated Statement of Comprehensive Income
For the year ended 31 December 2010

	2010 US$	2009 US$
Loss for the year attributable to equity holders of the Parent	**(7,125,394)**	(6,471,552)
Currency translation adjustments	**(33,696)**	(770,566)
Total comprehensive loss for the year attributable to equity holders of the Parent	**(7,159,090)**	(7,242,118)

Approved by the Board on 10 May 2011



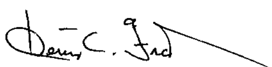
Dennis Francis
Director

Paul Dowling
Director

Consolidated Balance Sheet
As at 31 December 2010

	Note	2010 US$	2009 US$
Assets			
Non-current Assets			
Oil and gas properties	12	**62,143,801**	27,165,261
Property, plant and equipment	13	**1,674,216**	1,776,108
Exploration and evaluation assets	14	**21,391,491**	18,217,242
Leasehold land payments	16	**–**	176,825
		85,209,508	47,335,436
Current Assets			
Inventories	17	**907,947**	–
Trade and other receivables	18	**8,064,978**	4,909,915
Cash and cash equivalents	19	**22,781,881**	15,726,479
Restricted cash	19	**2,500,000**	–
		34,254,806	20,636,394
Assets held for sale	11	**2,020,678**	–
		36,275,484	20,636,394
Total Assets		**121,484,992**	67,971,830
Equity and Liabilities			
Capital and Reserves			
Called up share capital	23	**5,624,840**	4,724,013
Share premium account		**122,082,388**	81,328,170
Share-based payment reserve		**3,641,064**	2,368,929
Retained loss		**(25,877,797)**	(18,752,403)
Currency translation reserve		**(5,828,332)**	(5,794,636)
Other reserves		**336,000**	336,000
Equity attributable to equity holders of the Parent		**99,978,163**	64,210,073
Non-current Liabilities			
Provisions	22	**743,670**	269,654
Deferred tax liability	9	**1,636,475**	826,129
		2,380,145	1,095,783
Current Liabilities			
Trade and other payables	20	**5,401,479**	2,665,974
Interest bearing loans and borrowings	21	**13,725,205**	–
		19,126,684	2,665,974
Total Liabilities		**21,506,829**	3,761,757
Total Equity and Liabilities		**121,484,992**	67,971,830

Approved by the Board on 10 May 2011



Dennis Francis
Director

Paul Dowling
Director

Consolidated Statement of Changes in Equity
For the year ended 31 December 2010

	Share capital US$	Share premium US$	Share-based payment and other reserves US$	Currency translation reserve US$	Retained loss US$	Total US$
At 1 January 2009	2,919,041	57,193,950	2,240,829	(5,024,070)	(12,280,851)	45,048,899
Loss for the year	–	–	–	–	(6,471,552)	(6,471,552)
Currency translation adjustments	–	–	–	(770,566)	–	(770,566)
Total comprehensive loss for the year	–	–	–	(770,566)	(6,471,552)	(7,242,118)
New share capital subscribed	1,797,899	25,560,368	–	–	–	27,358,267
Transaction costs on issue of share capital	–	(1,494,385)	–	–	–	(1,494,385)
Remuneration and other emoluments paid in shares	7,073	68,237	–	–	–	75,310
Share-based payment expense	–	–	464,100	–	–	464,100
At 31 December 2009	4,724,013	81,328,170	2,704,929	(5,794,636)	(18,752,403)	64,210,073
At 1 January 2010	**4,724,013**	**81,328,170**	**2,704,929**	**(5,794,636)**	**(18,752,403)**	**64,210,073**
Loss for the year	**–**	**–**	**–**	**–**	**(7,125,394)**	**(7,125,394)**
Currency translation adjustments	**–**	**–**	**–**	**(33,696)**	**–**	**(33,696)**
Total comprehensive loss for the year	**–**	**–**	**–**	**(33,696)**	**(7,125,394)**	**(7,159,090)**
New share capital subscribed	**872,841**	**42,307,945**	**–**	**–**	**–**	**43,180,786**
Transaction costs on issue of share capital	**–**	**(2,387,223)**	**–**	**–**	**–**	**(2,387,223)**
Share options exercised	**27,406**	**813,714**	**–**	**–**	**–**	**841,120**
Remuneration and other emoluments paid in shares	**580**	**19,782**	**–**	**–**	**–**	**20,362**
Share-based payment expense	**–**	**–**	**460,500**	**–**	**–**	**460,500**
Share-based payment expense – Macquarie warrants *(note 21)*	**–**	**–**	**811,635**	**–**	**–**	**811,635**
At 31 December 2010	**5,624,840**	**122,082,388**	**3,977,064**	**(5,828,332)**	**(25,877,797)**	**99,978,163**

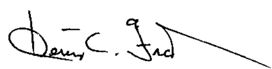
Consolidated Cash Flow Statement
For the year ended 31 December 2010

	Note	2010 US$	2009 US$
Cash flows from operating activities			
Loss before taxation		**(6,272,965)**	(6,153,080)
Adjustment to reconcile loss before tax to net cash flows			
Non-cash			
Depreciation and amortisation		**811,949**	215,693
Share-based payment expense		**460,500**	464,100
Unwinding of discount on decommissioning provision		**20,787**	20,644
Discount on deposit paid for pipeline usage		**342,053**	–
Write off of leasehold land payments		**176,825**	–
Loss on disposal of oil and gas properties		**–**	1,552,350
Remuneration and other emoluments paid in shares		**20,362**	75,310
Finance revenue		**(126,595)**	(173,296)
Other finance costs		**994,078**	–
Working capital adjustments			
(Increase)/decrease in trade and other receivables		**(3,444,866)**	1,988,854
Increase in inventories		**(808,561)**	–
Increase/(decrease) in trade and other payables		**2,944,919**	(408,533)
Income tax received		**–**	23,163
Net cash flows used in operating activities		**(4,881,514)**	(2,394,795)
Investing activities			
Purchase of oil and gas properties		**(32,006,996)**	(5,402,567)
Advance payments to contractors		**(3,883,284)**	(2,635,111)
Advance payment to purchase License 67		**–**	(1,160,556)
Purchase of property, plant and equipment		**(217,524)**	(291,838)
Disposals of property, plant and equipment		**1,154**	–
Exploration and evaluation payments		**(3,736,142)**	(812,550)
Increase in restricted cash		**(2,500,000)**	–
Interest received		**161,961**	137,930
Net cash used in investing activities		**(42,180,831)**	(10,164,692)
Financing activities			
Proceeds from issue of share capital		**43,180,786**	27,358,267
Transaction costs of issue of shares		**(2,387,223)**	(1,494,385)
Proceeds from exercise of share options		**841,120**	–
Proceeds from loans and borrowings		**16,000,000**	–
Transaction costs on loans and borrowings		**(584,467)**	–
Payments of loans and borrowings		**(1,788,000)**	–
Interest paid		**(835,467)**	–
Net cash received from financing activities		**54,426,749**	25,863,882
Net increase in cash and cash equivalents		**7,364,404**	13,304,395
Translation adjustment		**(309,002)**	253,887
Cash and cash equivalents at the beginning of the year		**15,726,479**	2,168,197
Cash and cash equivalents at the end of the year	19	**22,781,881**	15,726,479

Company Balance Sheet
As at 31 December 2010

	Note	2010 US$	2009 US$
Non-current Assets			
Property, plant and equipment	13	9,136	7,844
Financial assets	15	40,368,922	40,280,658
		40,378,058	40,288,502
Current Assets			
Trade and other receivables	18	75,051,933	29,457,794
Cash and cash equivalents	19	21,001,248	13,944,861
Restricted cash	19	2,500,000	–
		98,553,181	43,402,655
Total Assets		138,931,239	83,691,157
Equity and Liabilities			
Capital and Reserves			
Called up share capital	23	5,624,840	4,724,013
Share premium account		122,082,388	81,328,170
Share-based payment reserve		3,641,064	2,368,929
Retained loss		(8,854,833)	(6,569,543)
Other reserves		336,000	336,000
Equity attributable to equity holders of the parent		122,829,459	82,187,569
Non-current Liabilities			
Deferred tax liability	9	1,636,475	826,129
		1,636,475	826,129
Current Liabilities			
Trade and other payables	20	740,100	677,459
Interest bearing loans and borrowings	21	13,725,205	–
		14,465,305	677,459
Total Liabilities		16,101,780	1,503,588
Total Equity and Liabilities		138,931,239	83,691,157

Approved by the Board on 10 May 2011



Dennis Francis
Director

Paul Dowling
Director

Company Statement of Changes in Equity
For the year ended 31 December 2010

	Share capital US$	Share premium US$	Share-based payment and other reserves US$	Retained loss US$	Total US$
At 1 January 2009	2,919,041	57,193,950	2,240,829	(4,654,272)	57,699,548
Loss for the year	–	–	–	(1,915,271)	(1,915,271)
Total comprehensive loss for the year	–	–	–	(1,915,271)	(1,915,271)
New share capital subscribed	1,797,899	25,560,368	–	–	27,358,267
Transaction costs on issue of share capital	–	(1,494,385)	–	–	(1,494,385)
Remuneration and other emoluments paid in shares	7,073	68,237	–	–	75,310
Share-based payment expense	–	–	464,100	–	464,100
At 31 December 2009	4,724,013	81,328,170	2,704,929	(6,569,543)	82,187,569
At 1 January 2010	**4,724,013**	**81,328,170**	**2,704,929**	**(6,569,543)**	**82,187,569**
Loss for the year	**–**	**–**	**–**	**(2,285,290)**	**(2,285,290)**
Total comprehensive loss for the year	**–**	**–**	**–**	**(2,285,290)**	**(2,285,290)**
New share capital subscribed	**872,841**	**42,307,945**	**–**	**–**	**43,180,786**
Transaction costs on issue of share capital	**–**	**(2,387,223)**	**–**	**–**	**(2,387,223)**
Share options exercised	**27,406**	**813,714**	**–**	**–**	**841,120**
Remuneration and other emoluments paid in shares	**580**	**19,782**	**–**	**–**	**20,362**
Share-based payment expense	**–**	**–**	**460,500**	**–**	**460,500**
Share-based payment expense – Macquarie warrants *(note 21)*	**–**	**–**	**811,635**	**–**	**811,635**
At 31 December 2010	**5,624,840**	**122,082,388**	**3,977,064**	**(8,854,833)**	**122,829,459**

Company Cash Flow Statement
For the year ended 31 December 2010

	Note	2010 US$	2009 US$
Cash flows from operating activities			
Loss before taxation		**(1,432,861)**	(1,596,799)
Adjustment to reconcile loss before tax to net cash flows			
Non-cash			
Depreciation of property, plant and equipment		**3,517**	2,281
Share-based payment expense		**225,975**	232,711
Write off of financial assets		**224,546**	–
Remuneration and other emoluments paid in shares		**20,362**	75,310
Finance revenue		**(3,405,833)**	(1,276,343)
Other finance costs		**1,739,347**	–
Working capital adjustments			
Increase in trade and other receivables		**(42,094,642)**	(11,591,597)
Increase in trade and other payables		**25,985**	236,457
Income tax received		**–**	23,163
Net cash flows used in operating activities		**(44,693,604)**	(13,894,817)
Investing activities			
Purchase of property, plant and equipment		**(4,809)**	(4,425)
Investment in subsidiaries	15	**(78,285)**	–
Increase in restricted cash		**(2,500,000)**	–
Interest received		**199,821**	124,396
Net cash provided by investing activities		**(2,383,273)**	119,971
Financing activities			
Proceeds from issue of share capital		**43,180,786**	27,358,267
Transaction costs of issue of shares		**(2,387,223)**	(1,494,385)
Proceeds from exercise of share options		**841,120**	–
Proceeds from loans and borrowings		**16,000,000**	–
Transaction costs on loans and borrowings		**(584,467)**	–
Payment of loans and borrowings		**(1,788,000)**	–
Interest paid		**(835,467)**	–
Net cash received from financing activities		**54,426,749**	25,863,882
Net increase in cash and cash equivalents		**7,349,872**	12,089,036
Translation adjustment		**(293,485)**	196,015
Cash and cash equivalents at the beginning of the year		**13,944,861**	1,659,810
Cash and cash equivalents at the end of the year	19	**21,001,248**	13,944,861

Notes to the Financial Statements
For the year ended 31 December 2010

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. The Company is listed on the Alternative Investments Market ('AIM') of the London Stock Exchange and the Enterprise Securities Market ('ESM') of the Irish Stock Exchange. The address of the registered office and the business address in Ireland is 20 Holles Street, Dublin 2. The Company is domiciled in the Republic of Ireland.

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

2. Accounting Policies
2.1 Basis of Preparation
The financial statements have been prepared on a historical cost basis except for derivative financial instruments that have been measured at fair value. The financial statements are presented in US Dollars ('US$').

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').

2.2 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.

2.3 Significant Accounting Judgments, Estimates and Assumptions
The preparation of the Group's consolidated financial statements in compliance with IFRS requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities and disclosed contingent liabilities at the end of the reporting period and the amounts of revenues and expenses recognised during the reporting period. Estimates and judgements are continuously evaluated and are based on management's experience and other factors, including expectations of the future events that are believed to be reasonable under the circumstances. However, uncertainty about these assumptions and estimates could result in outcomes that require an adjustment to the carrying amount of the asset or liability affected in future periods.

(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 Consolidated Income Statement as exploration costs unless commercial reserves are established, or the determination process is not completed. The outcome of ongoing exploration, and therefore whether the carrying value of these assets will ultimately be recovered, is inherently uncertain.

The Group has capitalised intangible exploration and evaluation assets in accordance with IFRS 6 *Exploration for and Evaluation of Mineral Resources*, 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, discount rate, development, operating and offtake costs and other matters. The carrying amount of intangible exploration and evaluation assets at 31 December 2010 is US$21.4 million (2009: US$18.2 million).

Carrying value of oil and gas properties
Certain oil and gas properties are depreciated using the unit-of-production ('UOP') basis at a rate calculated by reference to proved and probable reserves.

The calculation of the UOP rate of amortisation could be impacted to the extent that actual production in the future is different from current forecast production based on proved and probable reserves. This would generally result from significant changes in any of the factors or assumptions used in estimating reserves.

These factors could include:
- Changes in proved and probable reserves;
- The effect on proved and probable reserves of differences between actual commodity prices and commodity price assumptions; and
- Unforeseen operational issues.

(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:

Reserves base

Certain oil and gas properties are depreciated on a unit-of-production basis at a rate calculated by reference to proved and probable reserves, determined in accordance with the Society of Petroleum Engineers Petroleum Resources Management System 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 the 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 an export price of US$80 and a Russian domestic price of US$38.

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 determine a suitable discount rate in order to calculate the present value of those cash flows.

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

Impairment of financial assets

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

Share-based payment transactions

The Group measures the cost of equity-settled transactions 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 28.

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. Refer to Note 22 for details of this provision and related assumptions.

2.4 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 to 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.

The relevant average and closing exchange rates for 2010 and 2009 were:

	2010		2009	
US$1 =	Closing	Average	Closing	Average
Russian Rouble	**30.538**	**30.434**	30.272	31.815
Euro	**0.7546**	**0.7549**	0.698	0.719
British Pound	**0.6465**	**0.6803**	0.628	0.641

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

2. Accounting Policies (continued)
2.4 Summary of Significant Accounting Policies (continued)
(b) Business combinations and goodwill
Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the acquirer measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition costs incurred are expensed and included in administrative expenses.

When the Group acquires a business, it assesses the financial assets and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic circumstances and pertinent conditions as at the acquisition date. This includes the separation of embedded derivatives in host contracts by the acquiree.

If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date through profit or loss.

Any contingent consideration to be transferred by the acquirer will be recognised at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration which is deemed to be an asset or liability, will be recognised in accordance with IAS 39 either in profit or loss or as a change to other comprehensive income. If the contingent consideration is classified as equity, it should not be remeasured until it is finally settled within equity.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in profit or loss.

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 each of the Group's cash-generating units that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

(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 are capitalised at cost as intangible assets. If no future activity is planned, the carrying value of these costs is written off. Costs directly associated with an exploration well are capitalised 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 hydrocarbons are 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 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. The net proceeds or costs of pilot production are allocated to exploration and evaluation costs.

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 on a unit-of-production basis other than certain non-production related equipment and facilities which are expected to have a shorter useful economic life and are depreciated on a straight-line basis.

(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.

Depreciation
Oil and gas properties are depreciated on the following basis:
- Production related items including the wells, production facility and pipeline 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 to extract these reserves. The related depreciation is included within cost of sales.
- Certain non-production related equipment and facilities which are expected to have a shorter useful economic life are depreciated on a straight-line basis over their estimated useful lives at annual rates ranging from 10% to 30%. The related depreciation is included within administrative expenses.

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% to 7% or remaining term of the lease, whichever is shorter.
- Plant and machinery – 10% to 35%.
- Motor vehicles – 14% to 35%.

(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 Consolidated 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 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, less impairment 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 or loans and receivables, 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 or financial assets at fair value through the Consolidated Income Statement.

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 rate method ('EIR') less any allowance for impairment. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR. The EIR amortisation is included in finance revenue in the Consolidated Income Statement. The losses arising from impairment are recognised in the Consolidated Income Statement in finance costs.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

2. Accounting Policies (continued)
2.4 Summary of Significant Accounting Policies (continued)
(i) Financial assets (continued)
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 amount of the loss is recognised in the Consolidated Income Statement.

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 the Consolidated Income Statement.

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 written-off when they are assessed as uncollectible.

(j) Financial liabilities
Financial liabilities within the scope of IAS 39 are classified as financial liabilities at fair value through profit or loss, loans and borrowings, or as derivatives, as appropriate. The Group determines the classification of its financial liabilities at initial recognition.

All financial liabilities are recognised initially at fair value and in the case of loans and borrowings, plus directly attributable transaction costs.

The Group's financial liabilities include trade and other payables and loans and borrowings.

Financial liabilities at fair value through profit or loss
Financial liabilities at fair value through profit or loss include financial liabilities held for trading and financial liabilities designated upon initial recognition at fair value through the Consolidated Income Statement.

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 the Consolidated Income Statement.

Interest bearing loans and borrowings
After initial recognition, interest bearing loans and borrowings are subsequently measured at amortised cost using the effective interest rate method. Gains and losses are recognised in the Consolidated Income Statement when the liabilities are derecognised as well as through the effective interest rate method ('EIR') amortisation process.

Amortised cost is calculated by taking into account any discount or premium on acquisition and fee or costs that are an integral part of the EIR. The EIR amortisation is included in finance cost in the Consolidated Income Statement.

Derecognition
A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

When an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in the Consolidated Income Statement.

(k) Inventories
Inventories are stated at the lower of cost and net realisable value. Cost of producing and processing crude oil is accounted on weighted average basis. This cost includes all costs incurred in the normal course of business in bringing each product to its present location and condition.
The cost of crude oil includes appropriate proportion of depreciation, depletion and amortisation ('DD&A') and overheads based on normal capacity. Net realisable value of crude oil is based on estimated selling price in the ordinary course of business less any costs expected to be incurred to completion and disposal.

(l) Non-current assets held for sale and discontinued operations
Non-current assets classified as held for sale are measured at the lower of their carrying amount and fair value less costs to sell.

Non-current assets once classified as held for sale are not depreciated or amortised.

(m) 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 Consolidated 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 liability

A decommissioning liability is recognised when the Group has a present legal or constructive 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. The amount recognised is the estimated cost of decommissioning, discounted to its present value. A corresponding amount equivalent to the provision at the time of recognition is recognised as part of the cost of the related oil and gas properties or in exploration and evaluation expenditure. 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 oil and gas properties or exploration and evaluation expenditure. The unwinding of the discount on the decommissioning provision is included as a finance cost.

(n) 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 reporting date, in the countries where the Group operates and generates taxable income.

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:

- 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:

- 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.

(o) Revenue recognition

Revenue from the sale of crude oil is recognised when the significant risks and rewards of ownership have been transferred, which is when title passes to the customer. This generally occurs when product is physically transferred into a pipe or other delivery mechanism.

Revenue is stated after deducting sales taxes, excise duties and similar levies.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

2. Accounting Policies (continued)
2.4 Summary of Significant Accounting Policies (continued)
(p) Borrowing costs
Borrowing costs directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalised as part of the cost of the respective assets. All other borrowing costs are expensed in the period they occur. Borrowing costs consist of interest and other costs that an entity incurs in connection with the borrowing of funds.

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

In situations where equity instruments are issued and some or all of the goods or services received by the entity as consideration cannot be specifically identified, the unidentified goods or services received (or to be received) are measured as the difference between the fair value of the share-based payment transaction and the fair value of any identifiable goods or services received at the grant date. This is then capitalised or expensed as appropriate.

Equity-settled transactions
The cost of equity-settled transactions 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 28.

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. 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 income statement charge or credit for a period represents the movement in cumulative expense recognised as at the beginning and end of that period and is recognised in employee benefits expense.

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

Where the terms of an equity-settled transaction are modified, the minimum expense recognised is the expense as if the terms had not been modified, if the original terms of the awards are met. An additional expense is recognised for any modification that increases the total fair value of the share-based payment transaction, 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. This includes any award where non-vesting conditions within the control of either the entity or the employee are not met. 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. All cancellations of equity-settled transaction awards are treated equally.

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

(r) Share issue expenses
Costs of share issues are written off against the premium arising on the issue of share capital.

(s) 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 the Consolidated Income Statement on a straight line basis over the lease term.

(t) Finance revenue
For all financial instruments measured at amortised cost, interest income or expense is recorded using the effective interest rate, which is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or liability. Interest income is included in finance revenue in the income statement.

(u) Defined contribution pension costs
Pension benefits are funded over the employees' period of service by way of contributions to a defined contribution scheme. Contributions are charged to the Consolidated Income Statement in the year to which they relate.

2.5 Changes in Accounting Policy and Disclosures

International Accounting Standards (IAS/IFRSs) and IFRS Interpretations Committee (IFRIC) Interpretations adopted during the financial year

The Group has adopted the following new and amended IFRS and IFRIC interpretations in respect of the 2010 financial year-end:

		Effective date
International Accounting Standards (IAS/IFRSs)		
IFRS 2	Share-based Payment – Group Cash-settled Share-based Payment Transactions	1 January 2010
Amendment to IFRS 3 and IAS 27	Business Combinations and Consolidated and Separate Financial Statements	1 July 2009
IAS 39	Financial Instruments: Recognition and Measurement – Eligible Hedged items	1 July 2009
Improvements to IFRSs (May 2008)	– Amendment to IFRS 5 Non-current Asset Held for sale and Discontinued Operations	
Improvements to IFRSs (April 2009)	– Amendments applicable in respect of the 2010 financial year-end	
IFRS Interpretations Committee		
IFRIC 17	Distributions of Non-Cash Assets to Owner	1 July 2009

The application of the standards and interpretations noted above did not result in material changes in the Group's Consolidated Financial Statements.

IFRS and IFRIC Interpretations effective in respect of the 2011 financial year-end

The Group has not applied the following standards and interpretations that have been issued but are not yet effective:

		Effective date
International Accounting Standards (IAS/IFRSs)		
Amendment to IAS 24	Related Party Disclosures	1 January 2011
Amendment to IAS 32	Financial Instruments: Presentation – Classification of Rights Issues	1 February 2010
	Improvements to IFRSs (May 2010)	Various effective dates
IFRS Interpretations Committee		
Amendment to IFRIC 14	Prepayments of a Minimum Funding Requirement	1 January 2011
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments	1 July 2010
	Improvements to IFRSs	Various effective dates

The standards and interpretations addressed above will be applied for the purposes of the Group Consolidated Financial Statements with effect from the dates listed. Their application is not currently envisaged to have a material impact on the Group's Consolidated Financial Statements.

IFRS and IFRIC Interpretations effective subsequent to the 2011 financial year-end

		Effective date
International Accounting Standards (IAS/IFRSs)		
IFRS 9	Financial Instruments	1 January 2013
Amendment to IAS 12	Income Taxes	1 January 2012
Improvements to IFRS 7	Transfers of Financial Assets	1 July 2011
Amendments to IAS 12	Deferred Tax: Recovery of Underlying Assets	
1 January 2012		
	Improvements to IFRSs	Various effective dates

IFRS 9 is yet to be endorsed in full by the EU. IFRS 9 as issued reflects the initial phases of the replacement of IAS 39 and applies to classification and measurement of financial assets and financial liabilities. In subsequent phases, hedge accounting and derecognition will be addressed. The adoption of the initial phases of IFRS 9 will have an effect on the classification and measurement of the Group's financial assets and financial liabilities, which will be quantified in conjunction with the other phases when issued.

The IAS 12 amendment is not anticipated to have a material impact on the Group's Consolidated Financial Statements.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

3. Segment Information

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 reporting segment.

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.

Management monitors and evaluates the operating results for the purpose of making decisions consistently with operating profit or loss in the consolidated financial statements.

Geographical segments

All of the Group's sales are in Russia. Substantially all of the Group's capital expenditures are in Russia.

Non-current assets

Assets are allocated based on where the assets are located:

	2010 US$	2009 US$
Russia	85,200,373	47,327,592
Ireland	9,135	7,844
	85,209,508	47,335,436

4. Revenue

	2010 US$	2009 US$
Revenue from crude oil sales	5,155,646	509,710
	5,155,646	509,710

All revenue arises from sales to third parties based in the Russian Federation. More than 99% of revenue or US$ 5,139,106 (2009: Nil) arises from sales of crude oil to NTK Finko.

5. Operating Loss

	Note	2010 US$	2009 US$
Operating loss is stated after charging:			
Included in cost of sales			
Cost of inventory recognised as an expense		4,284,181	–
Included in administration expenses			
Amortisation on leasehold land payments		–	4,184
Impairment of leasehold land payment	16	176,825	–
Foreign exchange loss on intra-Group loans		137,054	537,683
Other foreign exchange (gains)/losses		(285,038)	410,056
Operating lease rentals – land and buildings		308,349	157,395
Depreciation of property, plant and equipment			
Included in administrative expenses		117,177	193,683
Included in cost of sales		9,595	–
Capitalised during year		129,134	–
	13	255,906	193,683
Depreciation of oil and gas properties			
Included in cost of sales		520,640	17,826
Included in administrative expenses		164,537	–
Included in closing inventories		99,386	–
	12	784,563	17,826
Auditors' remuneration			
-Audit of group financial statements		244,564	216,646
-Other assurance services		–	–
-Tax advisory services		20,556	–
		265,120	216,646

Loss on oil and gas properties

The loss on oil and gas properties in the previous year of US$1,552,350 relates to expenditure connected with the previous pipeline route from Lineynoye to Lukpaiskaya in the Khanty-Mansiysk District, 65km to the north of Licence 61. In August 2009 the Group entered into a new crude oil transportation agreement with Imperial Energy, which meant that the pipeline would now be built on a southerly 60km route to Imperial's facility at Kiev-Eganskoye. Certain costs incurred in respect of the engineering and design and permitting associated with the northerly route to Lukpaiskaya were therefore written off. Further included in the loss on oil and gas properties recognised in 2009 is a US$168,333 loss on disposal of pipe not required in the new southerly route.

6. Finance Revenue

	2010 US$	2009 US$
Bank interest receivable	126,595	173,296
	126,595	173,296

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

7. Finance Costs

	2010 US$	2009 US$
Interest on bank loans	**643,542**	–
Unwinding of discount on decommissioning provision (*Note 22*)	**20,787**	20,644
Discount on deposit paid for pipeline usage (see *below*)	**342,053**	–
Share-based payment in relation to US$5 million loan facility (*Note 21*)	**350,536**	–
	1,356,918	20,644

During the year the Group paid a deposit of US$400,000 to Nord Imperial for the usage of their pipeline. This deposit will be returned at the end of the contract which is in 2033. In the consolidated financial statements this deposit has been discounted and the discount of US$342,053 has been taken to finance costs in the current year.

8. Employees

Number of employees	2010 Number	2009 Number
The average numbers of employees (including Directors) during the year was:		
Directors	**7**	6
Senior Management	**5**	5
Support Staff	**88**	43
	100	54

Employment costs (including Directors)	2010 US$	2009 US$
Wages and salaries	**3,969,500**	2,040,329
Social welfare costs	**520,945**	187,014
Share-based payment expense	**460,500**	464,100
Contributions to defined contribution pension plan	**14,602**	9,386
	4,965,547	2,700,829

An amount of US$1,389,177 (2009: US$678,711) in employment costs was capitalised during the year.

Directors' emoluments	2010 US$	2009 US$
Remuneration and other emoluments – Executive Directors	**982,662**	979,643
Remuneration and other emoluments – Non-Executive Directors	**64,564**	85,366
Remuneration and other emoluments payable in shares	**20,362**	30,245
Contributions to defined contribution pension plan	**10,615**	9,386
Share-based payment expense	**161,743**	206,496
	1,239,946	1,311,136

9. Income Tax

The tax expense comprises:	2010 US$	2009 US$
Current income tax		
Current income tax charge	**42,083**	39,327
Deferred tax		
Relating to origination and reversal of temporary differences	**810,346**	279,145
Income tax expense reported in the Consolidated Income Statement	**852,429**	318,472

All income tax charge relates to interest income received by the Company.

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:

	2010 US$	2009 US$
Loss before income tax	**(6,272,965)**	(6,153,080)
Accounting loss multiplied by Irish standard rate of tax of 12.5%	**(784,121)**	(769,135)
Share-based payment expense	**57,563**	58,013
Effect of higher tax rates on investment income	**425,729**	159,543
Non-deductible expenses	**464,060**	330,054
Tax deductible timing differences	**(560,665)**	(69,964)
Other	**448,038**	168,847
Losses available at higher rates	**(481,094)**	(264,671)
Taxable losses not utilised	**1,282,919**	705,785
Total tax expense reported in the Consolidated Income Statement	**852,429**	318,472

Deferred tax

Deferred tax at 31 December relates to the following:

Group and Company

	2010 US$	2009 US$
Deferred tax liability		
Accrued interest income	**1,636,475**	826,129
	1,636,475	826,129

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. Net deferred tax assets of US$3.8 million (2009: US$1.8 million), which expire in seven to ten years, 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 over recent years.

Factors that may affect future tax charges

The Group commenced year-round oil production in Russia during 2010. Such production is likely to result in taxable profits in Russia in future, where the applicable tax rate is 20%.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

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.

	2010 US$	2009 US$
Numerator		
Loss attributable to equity shareholders of the Parent for basic and diluted loss	**(7,125,394)**	(6,471,552)
	(7,125,394)	(6,471,552)
Denominator		
Weighted average number of Ordinary Shares for basic and diluted earnings per Ordinary Share	**361,023,606**	255,724,257
Diluted weighted average number of shares	**361,023,606**	255,724,257
Loss per share:		
Basic and diluted – *US Dollar cent*	**(1.97)**	(2.53)

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 28 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 2010 and 2009.
- Warrants – At 31 December 2010, 6,200,000 Ordinary Shares are subject to warrants being exercised (refer to Note 28). These potential Ordinary Shares are anti-dilutive for the year ended 31 December 2010. There were no warrants outstanding at 31 December 2009.

11. Assets Held For Sale
In January 2010 Licence 67 was registered thereby completing the acquisition. Under the August 2008 Area of Mutual Interest agreement, Arawak Energy ('Arawak') exercised their option to participate as a 50% partner in the development of License 67, which will be operated by PetroNeft through a jointly controlled entity. The legal agreements and documentation relating to the jointly controlled entity are expected to be completed in June 2011 when the assets held for sale will transfer to the jointly controlled entity. No impairment is expected on these assets upon transfer.

The major classes of assets and liabilities reclassified as held for sale as at 31 December 2010 are as follows:

	2010 US$
Assets	
Exploration and evaluation assets	**2,020,678**
	2,020,678

12. Oil and Gas Properties

Group	Wells US$	Equipment and facilities US$	Pipeline US$	Total US$
Cost				
At 1 January 2009	13,426,925	715,508	9,627,547	23,769,980
Additions	2,105,146	38,712	3,859,608	6,003,466
Disposals	–	–	(2,277,934)	(2,277,934)
Transfer to property, plant and equipment	(10,816)	174	–	(10,642)
Translation adjustment	(112,765)	(16,784)	(172,234)	(301,783)
At 1 January 2010	**15,408,490**	**737,610**	**11,036,987**	**27,183,087**
Additions	**19,999,210**	**12,816,849**	**3,244,417**	**36,060,476**
Transfer from property, plant and equipment	**–**	**48,884**	**–**	**48,884**
Translation adjustment	**(194,658)**	**(49,843)**	**(107,368)**	**(351,869)**
At 31 December 2010	**35,213,042**	**13,553,500**	**14,174,036**	**62,940,578**
Depreciation				
At 1 January 2009	–	–	–	–
Charge for the year	16,316	1,510	–	17,826
At 1 January 2010	**16,316**	**1,510**	**–**	**17,826**
Charge for the year	**535,613**	**217,360**	**31,590**	**784,563**
Translation adjustment	**(1,862)**	**(2,820)**	**(930)**	**(5,612)**
At 31 December 2010	**550,067**	**216,050**	**30,660**	**796,777**
Net book values				
At 31 December 2010	**34,662,975**	**13,337,450**	**14,143,376**	**62,143,801**
At 31 December 2009	15,392,174	736,100	11,036,987	27,165,261

The net book value at 31 December 2010 includes US$17,288,826 (2009: US$21,242,291) in respect of assets under construction, which are not yet being depreciated.

Additions are construction works mainly in relation to production wells, Central Procession Facility (CPF) and oilfield infrastructure.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

13. Property, Plant and Equipment

Group	Land and buildings US$	Plant and machinery US$	Motor vehicles US$	Total US$
Cost				
At 1 January 2009	310,805	1,731,548	62,002	2,104,355
Additions	–	61,592	81,217	142,809
Transfer from oil and gas properties	–	10,642	–	10,642
Disposals	–	–	–	–
Translation adjustment	(8,164)	(41,743)	2,513	(47,394)
At 1 January 2010	**302,641**	**1,762,039**	**145,732**	**2,210,412**
Reclassification	**800,795**	**(800,795)**	**–**	**–**
Additions	**1,669**	**171,706**	**45,818**	**219,193**
Transfer to oil and gas properties	**–**	**–**	**(48,884)**	**(48,884)**
Disposals	**–**	**–**	**(17,869)**	**(17,869)**
Translation adjustment	**(5,390)**	**(13,086)**	**(1,200)**	**(19,676)**
At 31 December 2010	**1,099,715**	**1,119,864**	**123,597**	**2,343,176**
Depreciation				
At 1 January 2009	17,744	196,868	22,346	236,958
Charge for the year	7,872	174,591	11,220	193,683
Translation adjustment	(65)	3,742	(14)	3,663
At 1 January 2010	**25,551**	**375,201**	**33,552**	**434,304**
Charge for the year	**64,365**	**176,496**	**15,045**	**255,906**
Disposals	**–**	**–**	**(16,715)**	**(16,715)**
Translation adjustment	**(444)**	**(3,804)**	**(287)**	**(4,535)**
At 31 December 2010	**89,472**	**547,893**	**31,595**	**668,960**
Net book values				
At 31 December 2010	**1,010,243**	**571,971**	**92,002**	**1,674,216**
At 31 December 2009	277,090	1,386,838	112,180	1,776,108

Company	Plant and machinery US$
Cost	
At 1 January 2009	10,666
Additions	4,425
At 1 January 2010	**15,091**
Additions	**4,809**
At 31 December 2010	**19,900**
Depreciation	
At 1 January 2009	4,966
Charge for the year	2,281
At 1 January 2010	**7,247**
Charge for the year	**3,517**
At 31 December 2010	**10,764**
Net book values	
At 31 December 2010	**9,136**
At 31 December 2009	7,844

14. Exploration and Evaluation Assets

Group	Exploration and evaluation expenditure US$
Cost	
At 1 January 2009	18,684,771
Additions	7,328
Translation adjustment	(474,857)
At 1 January 2010	**18,217,242**
Additions	**5,367,284**
Reclassified as assets held for sale (*Note 11*)	**(2,020,678)**
Translation adjustment	**(172,357)**
At 31 December 2010	**21,391,491**
Net book values	
At 31 December 2010	**21,391,491**
At 31 December 2009	18,217,242

Exploration and evaluation expenditure represents active exploration projects. These amounts will be written off to the Consolidated 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.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

14. Exploration and Evaluation Assets (continued)

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.

Additions in 2010 relate mainly to drilling of an exploration well in Arbuzovskoye oilfield and the purchase of the license and exploration works in relation to Licence 67. All expenditure in connection with License 67 has been reclassified as assets held for sale at year-end (refer to Note 11).

15. Financial Assets

Company	Investment in subsidiaries US$
Cost	
At 1 January 2009	40,049,269
Capital contribution in respect of share-based payment expense	231,389
At 1 January 2010	**40,280,658**
Capital contribution in respect of share-based payment expense	**234,525**
Additions	**78,285**
Impairment of investment in Pervomayka	**(224,546)**
At 31 December 2010	**40,368,922**
Net book values	
At 31 December 2010	**40,368,922**
At 31 December 2009	40,280,658

Based on the fact that the Board has no plans to develop the refinery site at Pervomayka, the decision was taken to write off the carrying amount of the investment.

In January 2010 a new Russian subsidiary was formed named LLC Granite Construction. This will take over the activities of Lineynoye which will then be utilised as the licence holder of Licence 67 in conjunction with Arawak Energy Limited who will hold a 50% interest in Lineynoye.

In August 2010 a new Russian subsidiary was formed named LLC Dolomite. This entity will be used as a licence holder for future licence acquisitions.

In December 2010 a new Dutch subsidiary was formed named Russian BD Holdings BV. This entity will be used as a holding company and will own 100% of LLC Lineynoye.

Details of the Company's holding in direct and indirect subsidiaries at 31 December 2010 are as follows:

Name of subsidiary	Registered Office	Proportion of ownership interest	Proportion of voting power held	Principal activity
WorldAce Investments Limited	3 Themistocles Street, Nicosia, Cyprus	100%	100%	Holding company
Stimul-T	147 Prospekt Lenina, Tomsk 634009, Russia	100%	100%	Oil and Gas exploration
Lineynoye	147 Prospekt Lenina, Tomsk 634009, Russia	100%	100%	Oil and Gas exploration
Pervomayka	Pobedy, Kolpashevo, Tomsk 634460, Russia	100%	100%	Property holding
Granite Construction	147 Prospekt Lenina, Tomsk 634009, Russia	100%	100%	Construction
Dolomite	147 Prospekt Lenina, Tomsk 634009, Russia	100%	100%	Oil and Gas exploration
Russian BD Holdings B.V.	Prins Bernhardplein 200, 1097 JB Amsterdam, the Netherlands	100%	100%	Holding company

16. Leasehold Land Payments

	2010 US$	2009 US$
Net book value at 1 January	**176,825**	181,009
Amortisation	**–**	(4,184)
Impairment during year	**(176,825)**	–
Net book value at 31 December	**–**	176,825

Based on the fact that the Board has no plans to develop the refinery site at Pervomayka, the decision was taken to write off the carrying amount of the leasehold land.

17. Inventories

	2010 US$	2009 US$
Oil stock	**709,890**	–
Materials	**198,057**	–
	907,947	–

18. Trade and Other Receivables

	2010 US$	2009 US$
Russian VAT	**3,251,701**	806,392
Other receivables	**691,674**	120,531
Advances to and receivables from related parties (Note 27)	**1,957,647**	942,660
Advances to contractors	**1,925,637**	1,692,451
Prepayments	**238,319**	187,325
Prepayment for Licence 67	**–**	1,160,556
	8,064,978	4,909,915

Company	2010 US$	2009 US$
Amounts owed by subsidiary undertakings	**74,813,378**	29,297,783
Prepayments and accrued income	**238,555**	160,011
	75,051,933	29,457,794

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 0% to 10%.

19. Cash and Cash Equivalents and Restricted Cash

Group	2010 US$	2009 US$
Cash at Bank and in Hand	**22,781,881**	15,726,479
Restricted cash	**2,500,000**	–
	25,281,881	15,726,479

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

19. Cash and Cash Equivalents and Restricted Cash (continued)

Company	2010 US$	2009 US$
Cash at bank and in hand	**21,001,248**	13,944,861
Restricted cash	**2,500,000**	–
	23,501,248	13,944,861

At 31 December 2010 restricted cash amounting to US$2.5 million is being held in a Macquarie Debt Service Reserve Account ("DSRA"). This account is part of the security package held by Macquarie and may be offset against the loan in the event of a default on the loan or by agreement between the parties.

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.

20. Trade and Other Payables

	2010 US$	2009 US$
Trade payables	**3,858,187**	1,924,521
Trade payables to related parties (Note 27)	**614,078**	6,501
Corporation tax	**105,569**	68,836
Other taxes and social welfare costs	**176,804**	206,387
Other payables	**128,099**	38,819
Accruals and deferred income	**518,742**	420,910
	5,401,479	2,665,974

Company	2010 US$	2009 US$
Trade payables	**224,218**	216,374
Corporation tax	**105,569**	68,836
Other taxes and social welfare costs	**112,398**	74,556
Accruals and deferred income	**297,915**	317,693
	740,100	677,459

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.

21. Interest-Bearing Loans and Borrowings

	Effective interest rate %	Maturity	2010 US$	2009 US$
Macquarie Bank – US$30,000,000 loan facility	17.21%	30 November 2011	**13,725,205**	–

On 30 March 2010, PetroNeft entered into a US$5 million loan facility with Macquarie Bank ("Macquarie"). As part of this agreement, Macquarie was granted 4.7 million warrants over the ordinary shares of PetroNeft at a strike price of Stg30p, exercisable any time up to 28 February 2012. The loan was set to mature on 30 June 2011.

On 28 May 2010 the US$5 million facility was re-financed with a new loan facility agreement for up to US$30 million with Macquarie. Under this agreement Macquarie was granted an additional one million warrants at a strike price of Stg37.81p exercisable any time up to 28 May 2014 and the possibility to acquire up to an additional one million warrants at a strike to be determined based on a 15% premium to the volume weighted average share price up to the date of issue of any additional warrants. There was also a 1% cash arrangement fee associated with this new loan facility.

On 19 August 2010 Macquarie was granted an additional 500,000 warrants at a strike price of Stg50.1p in connection with US$30 million facility.

On the basis that Macquarie committed significant technical, engineering and legal resources to negotiating and agreeing the loan facility and subsequent draw downs, the warrants granted to Macquarie were in lieu of arrangement fees. The cost of the warrants fall within the scope of IFRS 2 *Share-based Payment*. This share-based payment expense constitutes a transaction cost under IAS 39 *Financial Instruments: Recognition and Measurement* and is included in the initial carrying amount of the loan facility and amortised over the duration of the loan. The total share-based payment expense in connection with warrants granted to Macquarie during the year amounted to US$0.8 million of which an amount of US$350,536 was expensed to the income statement on extinguishment of the US$5 million loan facility.

Total transaction costs, including share-based payment expense, incurred in connection with the US$30 million facility amounted to US$1.0 million, and are applied against the proceeds. The effective interest rate will be applied to the liability to accrete the transaction costs over the period of the loan.

Borrowing costs relating to drilling of development wells and construction of other oil and gas properties that have been capitalised within oil and gas properties during the period amount to US$745,300 (2009: Nil). The average capitalisation rate employed to determine the amount of borrowing costs eligible for capitalisation was 17.21%. Only borrowing costs incurred up to September 2010 (start of production) were capitalised. Certain OGP items (wells, central processing facility, pipeline), shares in WorldAce Investments Ltd, shares in LLC Stimul T, certain bank accounts and inventories are pledged as a security for the loan facility agreement.

During the year the Group was in breach of certain financial and non-financial covenants and conditions subsequent to the loan agreement, relating primarily to receipt of certain amount of cash by sale of oil, certain financial ratios and registration of pledge over certain assets of the Group in favour of Macquarie and submitting the documents. These conditions were waived by Macquarie in a letter prior to year-end, such that the Group was not in breach as at the year-end. The Group received another waiver letter post year-end to facilitate the finalisation of the new loan agreement which contains revised financial and non-financial covenants.

22. Provisions

Decommissioning costs – non-current	2010 US$	2009 US$
At 1 January	**269,654**	254,646
Arising during the year	**457,219**	–
Unwinding of discount	**20,787**	20,644
Translation adjustment	**(3,990)**	(5,636)
At 31 December	**743,670**	269,654

The decommissioning provision represents the present value of decommissioning costs relating to the Group's Russian oil interests, which are expected to be incurred near 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. A discount rate of 8.17% (2009: 9%) is used for the assessment of the provision. The charge relating to the unwinding of the discount on the provision is reflected in finance costs in the Consolidated Income Statement.

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.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

23. Share Capital – Group and Company

	2010 €	2009 €
Authorised		
600,000,000 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 Ordinary Shares	Called up share capital US$
At 1 January 2009	229,223,034	2,919,041
Issued in the year	120,640,209	1,797,899
Remuneration and other emoluments paid in shares	504,468	7,073
At 1 January 2010	**350,367,711**	**4,724,013**
Issued in the year	63,125,000	872,841
Remuneration and other emoluments paid in shares	42,721	580
Share options exercised in the year	1,997,000	27,406
At 31 December 2010	**415,532,432**	**5,624,840**

The Company issued 63,125,000 new shares for consideration of US$43.2 million during the year. The net proceeds of this share issue of US$40.8 million are being used to finance expenditure on oil and gas properties, exploration and evaluation costs and corporate overhead.

24. 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. The Group and Company entered into forward currency contracts during the year, however there are no contracts outstanding as at 31 December 2010. The Group and Company did not enter any derivative transactions during 2009.

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 commodity price risk, foreign currency risk, credit risk, liquidity risk, interest rate risk and capital risk. The Board reviews and agrees policies for managing each of these risks which are summarised below.

Foreign currency risk

The Group and the Company undertake 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 2010 and 2009, the Group and the Company had no outstanding forward exchange contracts.

Foreign currency sensitivity analysis

The Group's and the Company'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. The Company has an exposure to US Dollars because payments to some suppliers are effected in Euro and in UK Sterling, and the Company has bank accounts in Russian Rouble, Euro, UK Sterling and US Dollar.

In accordance with IFRS 7, the impact of foreign currencies is determined based on the balances of financial assets and liabilities at 31 December 2010. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and largely results from payables and receivables, and adjusts their translation at the period end for a 5% change in foreign currency rates. A positive number below indicates a reduction in loss and increase in 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 loss 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 and Company at 31 December, the impact on loss and Equity for the Group and the Company is shown below.

Group	2010 US$	2009 US$
Impact on loss [lower/(higher)]	28,886	168,280
Impact on net equity [lower/(higher)]	116,724	783,521

Company	2010 US$	2009 US$
Impact on loss and net equity [lower/(higher)]	27,693	694,441

Credit risk

Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the Group.

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. As the Group or the Company does not have any significant receivables outstanding from third parties, this risk is limited.

The Group and the Company do not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics. The Group and the Company define counterparties as having similar characteristics if they are connected entities.

Liquidity risk management

Liquidity risk is the risk that the Group and the Company 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 and the Company manage 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 and the Company. To date, the Group and the Company have relied on shareholder funding and normal trade credit to finance its operations. As at 31 December 2010 the Group and the Company have an outstanding loan facility with Macquarie bank (see Note 21).

Loan facility is repayable on 30 November 2011. The rest of Group and Company's financial liabilities as at 31 December 2010 and 2009 are all payable on demand.

The expected maturity of the Group and Company's financial assets (excluding prepayments) as at 31 December 2010 and 2009 was less than one month.

The Group and the Company expect to meet its other obligations from operating cash flows and debt financing. The Group and the Company further mitigate liquidity risk by maintaining an insurance programme to minimise exposure to insurable losses.

The Group and the Company had no derivative financial instruments as at 31 December 2010 and 31 December 2009.

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 which are on variable rates ranging from 0.2% to 5.75%.

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 (e.g. from 10% to 9%) obtainable on cash and short term deposits would be to increase Group loss before tax by US$12,660 (2009: US$17,330) and Company loss before tax by US$340,583 (2009: US$127,634).

Capital risk management

The Group and the Company manage 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 and the Company manage its capital structure and makes adjustments to it in light of changes in economic conditions. To maintain or adjust its capital structure, the Group and the Company may issue new shares or raise debt. No changes were made in the objectives, policies or processes during the years ended 31 December 2010 and 31 December 2009. The capital structure of the Group and the Company 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.

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

24. Financial Risk Management Objectives and Policies (continued)

Group	2010 US$	2009 US$
External borrowings	13,725,205	–
Less cash and cash equivalents	(22,781,881)	(15,726,479)
Net cash	(9,056,676)	(15,726,479)
Equity	99,978,163	64,210,073
Net debt ratio	-9%	-24%

Company	2010 US$	2009 US$
External borrowings	13,725,205	–
Less cash and cash equivalents	(21,001,248)	(13,944,861)
Net cash	(7,276,043)	(13,944,861)
Equity	122,829,459	82,187,569
Net debt ratio	-6%	-17%

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 2010 and 2009, the Group had no outstanding contracts designated as hedges.

25. Loss of Parent Undertaking
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 Income Statement 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$2,285,290 (2009: US$1,915,271).

26. Capital Commitments
26.1 Details of capital commitments at the balance sheet date are as follows:

	2010 US$	2009 US$
Contracted for but not provided in the financial statements	26,320,142	13,274,160
Including contracted with related parties	22,714,974	7,899,735

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

	2010 US$	2009 US$
Within one year	70,771	44,759
After one year but not more than five years	102,535	26,940
More than five years	433,630	58,152
	606,936	129,851

27. Related Party Disclosures

Transactions between PetroNeft Resources plc and its subsidiaries, Stimul-T, Lineynoye, Granite, Pervomayka, Dolomite, WorldAce Investments have been eliminated on consolidation. Details of transactions between the Group and other related parties are disclosed below.

In 2009 Stimul-T entered into a contract with LLC Tomskburneftegaz (TBNG) for the drilling of nine wells in 2010. Under this contract TBNG assumes substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract is US$9.5 million. Payments of US$8,243,900 (2009: US$1,057,032) were made during 2010 in relation to this contract of which US$Nil (2009: US$942,660) are shown as advance payments as at 31 December 2010. As at 31 December 2010 the outstanding amount payable to TBNG is US$77,309 (2009: Nil). Vakha Sobraliev, a Director of PetroNeft, is the principal of TBNG.

In 2010 Stimul-T entered into a contract with TBNG for the drilling of well #1 in Arbuzovskoye oilfield in 2010. Under this contract TBNG assumes substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract is US$2.1 million. Payments of US$1,587,817 were made during 2010 in relation to this contract. As at 31 December 2010 the outstanding amount payable to TBNG is US$455,587.

In 2010 Stimul-T entered into a contract with TBNG for the drilling of pad #2 in Lineynoye oilfield in 2011 and 2012. Under this contract TBNG assumes substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract is US$9.8 million. Payments of US$1,248,775 were made during 2010 in relation to this contract and are shown as advance payments as at 31 December 2010.

In 2010 Stimul-T entered into a contract with TBNG for the drilling of pad #3 in Lineynoye oilfield in 2011 and 2012. Under this contract TBNG assumes substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract is US$9.5 million. Payments of US$694,954 were made during 2010 in relation to this contract and are shown as advance payments as at 31 December 2010.

In 2010 Stimul-T entered into a contract with TBNG for the drilling of well #2 of Kondrashevskoye oilfield and well #372 of Sibkraevskaya area in 2011. Under this contract TBNG assumes substantially all liabilities in relation to the health and safety, environmental and other risks associated with drilling operation. The total value of the contract is US$5.6 million. No transactions have taken place in relation to this contract in 2010.

An amount of US$103,516 (2009: US$Nil) was received from TBNG during 2010 in relation to shared use of helicopter services, where the service provider billed the entire amount to Stimul-T. Balance of US$5,529 (2009: US$Nil) is outstanding from TBNG at 31 December 2010.

An amount of US$42,091 (2009: US$Nil) was received from TBNG during 2010 for fines for not meeting all contract conditions. Balance of US$8,389 (2009: US$Nil) is outstanding from TBNG at 31 December 2010.

Stimul-T invoiced US$Nil (2009: US$15,945) to TBNG for supply of crude oil.

A total of US$ 81,182 (2009: US$2,407) is outstanding to other parties, related to Vakha Sobraliev, a Director of PetroNeft for repair works on wells and transportation services. Payments of US$444,644 (2009: US$23,066) were made to these entities during the year.

Remuneration of key management

Key management comprise the Directors of the Company, the Vice President of Business Development and Operations, the General Director and the Executive Director of the Russian subsidiary Stimul-T, along with both the Chief Geologist and the Chief Engineer of Stimul-T. Their remuneration during the year was as follows:

Remuneration of key management	2010 US$	2009 US$
Compensation of key management	**1,755,774**	1,307,504
Contributions to defined contribution pension plan	**10,615**	9,386
Share-based payment expense	**264,099**	290,242
	2,030,488	1,607,132

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

27. Related Party Disclosures (continued)
Transactions with subsidiaries
The Company had the following transactions with its subsidiaries during the years ended 31 December 2010 and 2009:

- The Company granted interest bearing loans to Stimul-T in the amounts of US$31,866,972 and US$9,931,514 during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company granted interest bearing loans to Lineynoye in the amount of US$843,006 and US$1,189,230 during the year ended 31 December 2010 and 31 December 2009 respectively.
- The Company granted interest bearing loans to Granite Construction in the amount of US$810,000 and US$Nil during the year ended 31 December 2010 and 31 December 2009 respectively.
- The Company granted interest bearing loans to Dolomite in the amount of US$10,050,000 and US$Nil during the year ended 31 December 2010 and 31 December 2009 respectively. This loan was repaid in full during 2010.
- The Company granted non-interest bearing loans to WorldAce Investments in the amount of US$8,501,342 and US$Nil during the year ended 31 December 2010 and 31 December 2009 respectively.
- The Company earned interest on loans to Stimul-T in the amounts of US$3,115,747 and US$1,109,247 during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company earned interest on loans to Lineynoye in the amounts of US$116,855 and US$7,334 during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company earned interest on loans to Granite Construction in the amounts of US$8,775 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively.
- All interest on loans to Stimul-T, Lineynoye and Granite Construction remains outstanding as at 31 December 2010.The Company earned interest on loans to Dolomite in the amounts of US$67,000 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively. This interest was paid in full as at 31 December 2010.
- The Company charged amounts of US$232,828 and US$213,640 for technical services provided to Stimul-T during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company made contributions to the assets of Pervomayka in the amount of US$13,739 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company made contributions to the assets of Granite Construction in the amount of US$40,432 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company made contributions to the assets of Dolomite in the amount of US$314 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively.
- The Company made contributions to the assets of Russian BD Russia B.V. in the amount of US$23,800 and US$Nil during the years ended 31 December 2010 and 31 December 2009 respectively.

28. Share-Based Payment
Share options
The expense recognised for employee services during the year is US$460,500 (2009: US$464,100). The Group share-based payment plan is described below. There was no cancellation or modification to the plan during 2010 and 2009.

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 tranches and are subject to the achievement of vesting conditions related to 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.

	2010 Number	2010 WAEP	2009 Number	2009 WAEP
Outstanding as at 1 January	**13,537,000**	**€0.297/£0.272**	10,072,000	€0.297/£0.347
Granted during the year	**5,390,000**	**£0.66**	3,465,000	£0.1925
Forfeited during the year	**(70,000)**	**£0.3261**	–	–
Exercised during the year	**(1,997,000)**	**€0.3029/£0.3467**	–	–
Outstanding at 31 December	**16,860,000**	**€0.295/£0.44**	13,537,000	€0.297/£0.272
Exercisable at 31 December	**7,158,200**	**€0.295/£0.342**	4,219,600	€0.297/£0.32

The range of exercise prices for options outstanding at the year-end is £0.19 to £0.66 (2009: £0.19 to €0.42).

The weighted average remaining contractual life for the share options outstanding as at 31 December 2010 was 5 years (2009: 5 years).

The weighted average fair value of options granted during the year was £0.282 (2009: £0.096).

The weighted average share price of exercised options at the date of exercise in 2010 was £0.575. No options were exercised in 2009.

The weighted average share price of forfeited options in 2010 was £0.3261. No options were forfeited in 2009.

The following table lists the inputs to the models used for the years ended 31 December 2010 and 2009:

Grant date	2010 December Share price growth-based	2010 December TSR-based	2009 December
Dividend yield	0%	0%	0%
Expected volatility	70%	70%	75%
Risk-free interest rate	1.6%	1.6%	2.8%
Expected life of option	7	7	7
Expected early exercise %	100%	100%	5%
Share price at date of grant and exercise price	£0.66	£0.66	£0.19
Model used	Monte Carlo	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, taking into account the impact of financial crisis, which lead to extraordinary volatility, and also the fact that the Group has recently moved out of its early pure appraisal and development phase into a more stable production phase, which is likely to lead to reduction in volatility in the future. It 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.

Share-based payment – Macquarie loans

Movement in the year

The fair value of the warrants 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, warrants during the year.

	2010 Number	2010 WAEP	2009 Number	2009 WAEP
Outstanding as at 1 January	–	–	–	–
Granted during the year	6,200,000	£0.33	–	–
Outstanding at 31 December	6,200,000	£0.33	–	–
Exercisable at 31 December	6,200,000	£0.33	–	–

The range of exercise prices for warrants outstanding at the year-end is £0.30 to £0.50 (2009: Nil).

The weighted average remaining contractual life for the warrants outstanding as at 31 December 2010 was 1.71 years (2009: Nil).

The weighted average fair value of warrants granted during the year was £0.09 (2009: Nil).

Notes to the Financial Statements (continued)
For the year ended 31 December 2010

28. Share-Based Payment (continued)
Share-based payment – Macquarie loans (continued)

The following table lists the inputs to the models used for valuing the warrants and the calculated value:

	August 2010	May 2010	March 2010
Dividend yield	0%	0%	0%
Expected volatility	70%	70%	70%
Risk-free interest rate	1.5%	2%	1.3%
Expected life of warrant	3.8	4	1.9
Expected early exercise	Financially optimal	Financially optimal	Financially optimal
Share price at date of grant	£0.47	£0.32	£0.31
Exercise price	£0.5012	£0.3781	£0.3000
Model used	Binomial	Binomial	Binomial
Total fair value of warrant	US$182,000	US$224,000	US$406,000

The expected life of the warrants 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, taking into account the impact of financial crisis, which lead to extraordinary volatility, and also the fact that the Group has recently moved out of its early pure appraisal and development phase into a more stable production phase, which is likely to lead to reduction in volatility in the future. It 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.

29. Important Events After the Balance Sheet Date
In April 2011 PetroNeft signed a new loan facility agreement with Macquarie Bank Limited for up to US$75 million subject to the satisfaction of conditions precedent primarily related to the perfection of security over certain physical assets of the Group's Russian subsidiaries.

30. Approval of Financial Statements
The financial statements were approved, and authorised for issue, by the Board of Directors on 10 May 2011.

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 Wednesday 22 June 2011, for the purposes of considering and, if thought fit, passing, the following Resolutions, of which Resolutions numbered 1, 2, 3, 4, 5, 6 and 7 will be proposed as Ordinary Resolutions and Resolutions numbered 8, 9 and 10 will be proposed as Special Resolutions.

Ordinary Business

1. To receive, consider and adopt the accounts for the year ended 31 December 2010 together with the Directors' and Auditors' Reports thereon.

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

4. To elect Mr. Fagan as a Director.

5. To re-appoint Ernst & Young, Chartered Accountants, as Auditors and to authorise the Directors to fix the remuneration of the Auditors.

Special Business

6. That the authorised share capital of the Company be and is hereby increased from €6,000,000 divided into 600,000,000 Ordinary Shares of €0.01 each to €8,000,000 by the creation of 200,000,000 new Ordinary Shares of €0.01 ranking equally in all respects with the other existing issued and unissued Ordinary Shares of €0.01 each.

7. That, in substitution for all existing authorities of the Directors pursuant to Section 20 of the Companies (Amendment) Act, 1983, the Directors be and are hereby generally and unconditionally authorised pursuant to Section 20 of the Companies (Amendment) Act, 1983 to exercise all the powers of the Company to allot relevant securities (within the meaning of the said Section 20) up to a maximum amount equal to the aggregate nominal value of the authorised but unissued share capital of the Company as at the date of passing of this Resolution. The authority hereby conferred shall expire (unless previously renewed, varied or revoked by the Company in general meeting) 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 the close of business on 22 September 2012, save that the Company may before such expiry make an offer or agreement which would or might require relevant securities to be allotted after such expiry and the Directors may allot relevant securities in pursuance of such offer or agreement notwithstanding that the authority hereby conferred has expired.

8. 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 Resolution numbered 7 above 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 Companies Act 1990 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 shareholders holding ordinary shares 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 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 the close of business on 22 September 2012, 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.

9. That the Articles of Association of the Company (the "Articles") be and are hereby amended by:

   a) The deletion of the existing Article Nos. 1, 40 (e), 60, 61 (a), 80, 108 and 122;

   b) The insertion of new Article Nos. 1, 5, 9, 10, 22, 45, 65, 66 (a), 85, 87, 114, 120, 121, 122, 131, 136, 137 and 140 which are set out in the form of Articles which have been signed for identification by the Chairman of the meeting and which have been available for inspection at the registered office, and on the website of, the Company since the date of this Notice; and

   c) The re-numbering of the Articles (and cross-references within the Articles) to reflect the changes referred to in this Resolution 9.

Notice of Annual General Meeting (continued)

10. That the Memorandum of Association of the Company be and is hereby amended by the insertion of the following new object in clause 3(1)(r) and the renumbering of the existing objects to reflect the change in this Resolution 10:

"(r) As an object of the Company and as a pursuit in itself or otherwise, and whether for the purpose of making a profit or avoiding a loss or for any other purpose whatsoever, to engage in currency, interest rate, equity, commodity bond and credit derivative transactions and any other financial or other transactions of whatever nature, including any transaction for the purpose of, or capable of being for the purposes of, avoiding, reducing, minimising, hedging against or otherwise managing the risk of any loss, cost expense or liability arising, or which may arise, directly or indirectly, from a change or changes in any interest rate, currency exchange rate, equity values or the credit worthiness of third parties or in the price or value of any property, asset, commodity, index or liability or from any other risk or factor affecting the Company's undertaking and business, including but not limited to, dealings, whether involving purchases, sales or otherwise in any currency, spot and forward exchange rate contracts, forward rate agreements, caps, floors and collars, futures, options, swaps, credit derivatives and any other currency, interest rate, equity, commodity, bond, credit and other hedging arrangements and such other instruments as are similar to, or derivatives of, any of the foregoing."

Dated this 10th day of May 2011
By Order of the Board

David Sanders
Company Secretary
Registered Office:
20 Holles Street
Dublin 2

Note
The Memorandum and Articles of Association of the Company as well as a copy of the Memorandum and Articles of Association showing the amendments that would be made if Resolutions 9 and 10 are passed is available for inspection: (i) on the Company's website, http://petroneft.com, and during normal business hours on any weekday (public holidays excepted) at the registered office of the Company at 20 Holles Street, Dublin 2, Ireland from the date of this letter to the close of the Annual General Meeting; and (ii) at the location of the Annual General Meeting for at least 15 minutes before, and during, the meeting.

Notes

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.
bfpd	Barrels of fluid per day.
boe	Barrel of oil equivalent.
bopd	Barrels of oil per day.
C1	Proved resources according to Russian standards.
C2	Probable resources according to Russian standards.
C3	Possible resources according to Russian standards.
Company	PetroNeft Resources plc.
CSR	Corporate and Social Responsibility.
Custody Transfer Point	Facility/location at which custody of oil transfers to another operator.
ESM	Enterprise Securities Market of the Irish Stock Exchange.
ESPO pipeline	East Siberia-Pacific Ocean pipeline which is expected to be completed in 2012.
Exploration resources	An undrilled prospect in an area of known hydrocarbons with unequivocal 4-way dip closure at the reservoir horizon.
Hydraulic fracturing, fracture stimulation	The process of cracking open the rock formation around a well bore to increase productivity.
Group	Company and its subsidiary undertakings.
HSE	Health, Safety and Environment.
IAS	International Accounting Standard.
IFRIC	IFRS 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. It contains five known oil fields, Lineynoye, Tungolskoye, West Lineynoye, Arbuzovskoye and Korchegskaya, and 24 Prospects and Leads that are currently being explored.
Licence 67	The Group's Exploration and Production Licence in the Tomsk Oblast, Russia. It contains two existing drilled structures, Ledovoye and Sklonavaya, that have previously tested oil.
Lineynoye	Limited Liability Company Lineynoye, a wholly owned subsidiary of PetroNeft, registered in the Russian Federation.
m	Metres.
mmbbls	Million barrels.
mmbo	Million barrels of oil.
Oil pay	A formation containing producible hydrocarbons.
P1	Proved reserves according to SPE standards.
P2	Probable reserves according to SPE standards.
P3	Possible reserves according to SPE standards.
Pervomayka	Limited Liability Company Pervomayka, a wholly-owned subsidiary of PetroNeft, registered in the Russian Federation.
PetroNeft	PetroNeft Resources plc.
SPE	Society of Petroleum Engineers.
Spud	To commence drilling a well.
Stimul-T	Limited Liability Company Stimul-T, a wholly-owned subsidiary of PetroNeft, based in the Russian Federation.
TSR	Total Shareholder Return.
VAT	Value Added Tax.
WAEP	Weighted Average Exercise Price.

Group Information

Directors*

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

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

Paul Dowling
(Chief Financial Officer)

David Sanders (U.S. citizen)
(General Legal Counsel)

Gerard Fagan
(Appointed 8 September 2010)
(Non-Executive Director)

Thomas Hickey
(Non-Executive Director)

Vakha Sobraliev (Russian citizen)
(Non-Executive Director)

Registered Office and Business Address

20 Holles Street
Dublin 2
Ireland

Secretary

David Sanders

Auditor

Ernst & Young
Chartered Accountants
Harcourt Centre
Harcourt Street
Dublin 2
Ireland

Nominated and ESM Adviser

Davy
49 Dawson Street
Dublin 2
Ireland

Joint Brokers

Davy
49 Dawson Street
Dublin 2
Ireland

Canaccord Genuity
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United Kingdom

Principal Bankers

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Citypoint
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United Kingdom

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Dublin 2
Ireland

KBC Bank Ireland
Sandwith Street
Dublin 2
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Registrar

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PetroNeft Resources plc Annual Report and Accounts 2010

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