PUBLIC JOINT STOCK COMPANY
"NATIONAL JOINT STOCK COMPANY
"NAFTOGAS OF UKRAINE"

CONSOLIDATED FINANCIAL STATEMENTS

For the Year Ended 31 December 2010
Together with Independent Auditor's Report

BDO

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Independent Auditor's Report

To the shareholder of Public Joint Stock Company "National Joint Stock Company "Naftogas of Ukraine"

We have audited the accompanying consolidated financial statements of Public Joint-Stock Company "National Joint Stock Company "Naftogas of Ukraine" (referred to herein as the "Company") and its subsidiaries (collectively referred to herein as the "Group"), which comprise the consolidated statement of financial position as at 31 December 2010, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS"), and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

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BDO is the brand name for the BDO network and for each of the BDO Member Firms.

BDO

Basis for Qualified Opinion

i. We did not observe the stock-taking of inventories as at 31 December 2010 as this dated preceded our appointment as the Group auditors. Owing to the fact that these assets are a component part of operating results estimation, we were not able to determine necessary adjustments to the financial results of the Group.

ii. As discussed in Note 8 to the consolidated financial statements, the Company has an investment in its associate, JSC Ukrnafta, with the carrying amount under the equity method of UAH 4,250 million as at 31 December 2010 (31 December 2009: UAH 6,794 million). International Accounting Standard ("IAS") 28, *Investments in Associates*, requires application of the equity method to investments in associates, under which the investment in an associate is initially recognized at cost and its carrying amount is increased or decreased to recognize the Group's share of the profit or loss of the investee after the date of acquisition. Since JSC Ukrnafta did not issue IFRS consolidated financial statements for 2010 and 2009 by the date of the issue of the accompanying consolidated financial statements, the Group did not reflect any changes in the amount of its equity method investment for 2010 and 2009 (except for dividends accrual). We were unable to determine the effect of such departure from IFRS.

iii. As further discussed in Note 8 to the consolidated financial statements, the Company has investments in certain subsidiaries and associates carried at cost (less the allowance for impairment) of UAH 1,024 million and UAH 856 million as at 31 December 2010 and 31 December 2009, respectively. IAS 27, *Consolidated and Separate Financial Statements*, and IAS 28, *Investments in Associates*, require the Company to consolidate all subsidiaries and to apply the equity method to all investments in associates in its consolidated financial statements. We were unable to determine the effect of these departures from IFRS.

Qualified Opinion

In our opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraphs, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2010, and its financial performance and its cash flows for the year then ended, in accordance with International Financial Reporting Standards.

Emphasis of Matter

(i) We draw attention to Note 2 to the consolidated financial statements which indicates that the Group incurred a net loss attributable to the parent company's owners of UAH 11,980 million for the year ended 31 December 2010. As described in Note 2, the dependence of the Group on the achievement of its financial plan including the Group's ability to obtain capital contribution from State in a form of Ukrainian State Bonds and implement necessary measures for their monetization, along with other matters as set forth in Note 2, indicate the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern.

(ii) We draw attention to Note 18 to the consolidated financial statements, which discloses the fact that the operations and financial performance of the Group are dependent on the ability of the Group to prolong its agreement with the State Property Fund of Ukraine (further - the "Agreement") which regulates the operational management of certain state-owned assets, forming an essential part of the Group's property, plant and equipment. This Agreement, being concluded for a one year term, has been prolonged automatically each year since neither party has initiated its termination. At the date the Management signed these consolidated financial statements, the contract was not terminated.

(iii) We further draw attention to Note 18 to the consolidated financial statements, which discloses the principles for determining the payments for the Group's use of the state-owned assets. The Group has made an estimate of these payments, and as a result has concluded that no obligation arises from the use of the state-owned assets as at 31 December 2010 and 31 December 2009. Due to the absence in the Agreement of a precise formula to calculate the amount, an uncertainty exists that the mechanism of the computation adopted by the Group might be challenged by the State authorities. The ultimate outcome of this uncertainty cannot presently be determined, and, accordingly, no provision for any liability that may result has been made in the consolidated financial statements as at 31 December 2010 and 31 December 2009.

(iv) We draw attention to the fact that non-financial results disclosed in Notes 4 and 8 herein, have not been audited.

12 December 2011
BDO LLC

CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2010
(in millions of Ukrainian hryvnia)

	Notes	*2010*	*2009*
Income from sales	5.1	92,743	65,496
Subsidies from the State Budget	5.2	3,424	4,131
Cost of sales	5.3	(85,399)	(63,849)
Gross profit		**10,768**	**5,778**
Other operating income	5.4	1,149	942
Other operating expenses	5.5	(13,790)	(19,326)
Operating loss		**(1,873)**	**(12,606)**
Finance costs	5.7	(5,664)	(6,470)
Finance income		178	369
Share of profit from associates and joint-ventures	8	44	39
Foreign exchange loss, net	5.6	(30)	(886)
Loss before tax		**(7,345)**	**(19,554)**
Income tax	6	(4,810)	(3,147)
Loss for the year		**(12,155)**	**(22,701)**
Loss attributable to:			
Owners of the parent		(11,980)	(22,470)
Minority shareholders		(175)	(231)
		(12,155)	**(22,701)**

These consolidated financial statements were authorised for issue on behalf of the Board of the Company on 12 December 2011.

Chairman of the Board — Y. Bakulin

Chief Accountant — T. Aldarkina

Notes on pages 11 - 56 are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2010
(in millions of Ukrainian hryvnia)

	Notes	*2010*	*2009*
Loss for the reporting year		(12,155)	(22,701)
Other comprehensive income / (loss)			
Property, plant and equipment revaluation	7	(52)	41,961
Effect of income tax	6	12	(10,490)
		(40)	31,471
Effect of changes in income tax rate	6	7,434	-
		7,434	-
Net gain on financial investments available for sale		30	148
Effect of income tax	6	(5)	(37)
		25	111
Changes of provision for decommissioning liability		(2)	(19)
Effect of income tax	6		5
		(2)	(14)
Other comprehensive income for the reporting year, net of taxes		7,417	31,568
Total comprehensive (loss) / income for the reporting period, net of taxes		(4,738)	8,867
Comprehensive (loss) / income, attributable to:			
Parent owners		(4,563)	9,098
Minority shareholders		(175)	(231)
		(4,738)	8,867

Notes on pages 11 - 56 are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

As at 31 December 2010

(in millions of Ukrainian hryvnia)

	Notes	*2010*	*2009*
ASSETS			
Non-current assets			
Property, plant and equipment	7	123,452	124,511
Intangible assets		61	59
Investments	8	5,991	18,753
Deferred tax assets	6	5,404	3,862
Other non-current assets		567	598
		135,475	**147,783**
Current assets			
Inventories	9	17,828	32,588
Trade and other receivables	10	16,683	9,256
Prepayments and other current assets	11	20,783	2,054
Prepaid income tax		218	490
Restricted cash		36	106
Cash and cash equivalents	20	2,654	1,780
		58,202	**46,274**
TOTAL ASSETS		**193,677**	**194,057**
EQUITY AND LIABILITIES			
Equity attributable to the Parent's owners			
Share capital	12	34,097	28,321
Revaluation reserve		91,752	84,379
Accumulated losses and other reserves		(44,842)	(32,492)
		81,007	**80,208**
Minority interest		416	560
Total equity		**81,423**	**80,768**
Long-term liabilities			
Loans and borrowings	13	38,430	13,353
Provisions	14	880	922
Other long-term liabilities		470	213
Deferred tax liabilities	6	14,175	21,697
Unregistered contributed capital	16	7,400	5,776
		61,355	**41,961**
Current liabilities			
Advances received and other current liabilities	15	26,636	13,766
Accounts payable	17	8,312	12,434
Loans and borrowings	13	5,458	28,636
Provisions	14	4,356	16,492
Income tax liabilities		6,137	-
		50,899	**71,328**
Total liabilities		**112,254**	**113,289**
TOTAL EQUITY AND LIABILITIES		**193,677**	**194,057**

Notes on pages 11 - 56 are an integral part of these consolidated financial statements

CONSOLIDATED STAMENTS OF CHANGES IN EQUITY

As at 31 December 2010

(in millions of Ukrainian hryvnia)

	Equity attributable to the Parent's owners					
	Share capital (Note 12)	*Revaluation reserve*	*Accumulated loss and other reserves*	*Total*	*Minority interest*	*Total*
As at 01 January 2009	**9,721**	**53,021**	**(10,284)**	**52,458**	**742**	**53,200**
Net loss for the year	-	-	(22,470)	(22,470)	(231)	(22,701)
Other comprehensive income	-	31,457	111	31,568	-	31,568
Total comprehensive income/(loss)	-	**31,457**	**(22,359)**	**9,098**	**(231)**	**8,867**
Transfer of revaluation reserve on disposed, property, plant and equipment, net of tax	-	(99)	99	-	-	-
Assets transfer from shareholder	-	-	52	52	49	101
Paid- in share capital (Note 12)	18,600	-	-	18,600	-	18,600
As at 31 December 2009	**28,321**	**84,379**	**(32,492)**	**80,208**	**560**	**80,768**
Net loss for the year	-	-	(11,980)	(11,980)	(175)	(12,155)
Other comprehensive income	-	7,394	23	7,417	-	7,417
Total comprehensive income/(loss)	-	**7,394**	**(11,957)**	**(4,563)**	**(175)**	**(4,738)**
Transfer of revaluation reserve on disposed, property, plant and equipment, net of tax	-	(21)	21	-	-	-
Assets transfer from shareholder	-	-	32	32	31	63
Paid-in share capital (Note 12)	5,776	-	-	5,776	-	5,776
Companies takeover	-	-	(446)	(446)	-	(446)
As at 31 December 2010	**34,097**	**91,752**	**(44,842)**	**81,007**	**416**	**81,423**

Notes on pages 11 - 56 are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENT OF CASH FLOWS

As at 31 December 2010
(in millions of Ukrainian hryvnia)

	2010	*2009*
Operating activities		
Loss before tax	(7,345)	(19,554)
Non-cash adjustments to reconcile profit before tax to net cash flows		
Finance costs	5,664	6,470
Finance income	(178)	(369)
Loss on disposal of property, plant and equipment	41	41
Depreciation	5,863	3,676
Loss from impairment of property, plant and equipment	207	4,478
Gain from sale of investments available for sale	-	(139)
Loss / (Profit) from increase / impairment of investments available for sale	(12)	426
Accrual/ (write-off) of provisions	1,573	13,797
Income from write-off of accounts payable	(399)	(667)
Unrealised exchange loss	30	569
Share in profit from investments in associates and joint-ventures	(44)	(39)
Working capital adjustments:		
Trade and other receivables	(7,434)	(5,336)
Inventories	14,763	(19,801)
Prepayments and other current and non-current assets	(18,420)	381
Trade and other payables	(21,419)	5,719
Advances and other liabilities	18,094	997
	(9,016)	(9,351)
Income tax paid	(4,357)	(4,521)
Subsidies received from the State Budget	3,424	4,131
Interest received	7	105
Net cash flow from operating activities	**(9,942)**	**(9,636)**
Investing activities		
Proceeds from property, plant and equipment sale	33	228
Purchase of property, plant and equipment and intangible assets	(5,087)	(5,549)
Purchase of deposits	(579)	-
Placement of deposits	-	(341)
Restricted cash	70	438
Net cash flow used in investing activities	**(5,563)**	**(5,224)**
Financing activities		
Proceeds from borrowings	22,998	10,155
Repayment of borrowings	(20,874)	(6,077)
Interest paid	(4,874)	(4,155)
Proceeds from sale of Ukrainian State Bonds contributed to share	17,610	14,113
Dividends received	1,519	-
Net cash flow received from financing activities	**16,379**	**14,036**
Net increase/(decrease) of cash and cash equivalents	874	(824)
Cash and cash equivalents at 1 January	1,780	2,604
Cash and cash equivalents at 31 December	2,654	1,780
Supplemental disclosure of non-cash investing activity		
Assets transfer from shareholder	63	101

Notes on pages 11 - 56 are an integral part of these consolidated financial statements

1. Corporate information

Public joint stock company "National Joint Stock Company "Naftogas of Ukraine" ("Naftogas of Ukraine" or the "Company") was created under the laws of Ukraine as an open joint stock company. The Company was founded in 1998 in accordance with the resolution of the Cabinet of Ministers of Ukraine dated 25 May 1998 on "Incorporation of National Joint Stock Company "Naftogas of Ukraine".

Naftogas of Ukraine is a 100% state-owned Company, which owns stakes in various companies forming the national system of oil and gas production, refinery, distribution and transportation. Nine subsidiaries (further – "consolidated subsidiaries"), forming an essential part of the oil and gas system of Ukraine, were consolidated into these financial statements (Note 3.1). The cumulative unaudited statutory net revenues, total assets and net assets of Naftogas of Ukraine and the consolidated subsidiaries represent 98% (2009: 97%), 98% (2009: 98%) and 98% (2009: 99%) of the respective total indicators of Naftogas of Ukraine and all its subsidiaries.

The Company and its consolidated subsidiaries (the "Group") concentrate its business in three principal areas:

- production of oil, gas and refinery products;
- oil and gas transportation;
- wholesale distribution of oil, gas and petroleum products;

The principal activities of the Group are further described in Note 4.

The Group conducts its business and has its major production facilities located in Ukraine.

The Company's legal address is 6, B. Khmel'nytskogo Street, Kyiv, Ukraine.

2. Going concern

As of 31 December 2010 the Group's current liabilities exceeded its current assets by UAH 7,303 million (2009: UAH 25,054 million) and the loss attributable to equity holders of the parent for the year ended 31 December 2010 amounted to UAH 11,980 million (2009: UAH 22,470 million).

Over the past years the Ukrainian gas market experienced a number of significant transformations, which, as a consequence, led to substantial increase of purchased price of imported natural gas for the Group. Meanwhile the Group's ability to pass on immediate increases in natural gas prices to its certain categories of ultimate customers is limited since the Government of Ukraine (further–the Government), as stated in Note 18, regulates tariffs and, either directly or through government agencies, regulates the maximum tariffs and prices the Group may charge for its principal sales activities. As a consequence of the increase in the price of natural gas and the impact of the global financial and economic crisis, starting from January 2009, demand for gas from Ukrainian industrial customers has decreased significantly. In 2010 the market stabilized and demand for natural gas increased. The payment discipline of different categories of customers also deteriorated. This decrease in demand for gas and the deterioration of the payment discipline among gas customers as well as consequences of the Arbitration Tribunal decision (Note 14) may negatively influence the ability of the Group to obtain sufficient cash inflow from its operating activities to settle its obligations in respect of bank loans, interest, payables for gas and other liabilities on their due dates.

To react to the increase in the price of imported gas, in 2009 and 2010 the Government adopted a number of consecutive increases in tariffs to raise the selling prices for gas consumed by certain categories of customers. Also any possible future increase in imported gas prices may require the Government to adopt a further change in tariffs to raise the selling prices on the domestic market and (or) require the Government to provide subsidies to the Group from the State budget.

With the purpose to improve situation the Group and the Government implemented a series of actions on the gradual transition to direct contracts with gas suppliers and the resumption of gas distribution services to the industrial sector directed at restoring the Group's monopoly status in the Ukrainian market.

On 19 January 2009, the Company entered into an agreement with JSC Gazprom in respect of gas transit for the period 2009-2019. According to the agreement, the tariff on gas transit through the territory of Ukraine in 2009 will be USD 1.7 per one hundred kilometres for transit services per one thousand of cubic meters of gas. Starting from 2010, the tariff is calculated using a formula approach. In 2010, it increased on approximately by 56% compared to 2009 and in 2011 it increased on approximately by 8% as to the reporting year.

On 19 January 2009, the Company entered into an agreement with JSC Gazprom (hereafter – the "Agreement") on gas supply for the period 2009-2019. According to the Agreement, the price for gas is calculated using a formula approach.

On 21 April 2010, the Company concluded an addendum to Agreement with JSC Gazprom. According to addendum to Agreement, price of imported gas decreases for the amount of decrease of custom charges, if such correction is envisaged by Decree of government of Russian Federation relating to custom duties for natural gas supply from the territory of Russian Federation to Ukraine. Following the adoption of the Decree staring from II quarter of 2010 the Company received imported gas at discounted price.

Management of the Group believes that it is appropriate to prepare these consolidated financial statements on a going concern basis as the Group and the Government has undertaken several initiatives aimed at improving the financial performance and liquidity of the Group, including, but not limited to the following:

- The financial plan of the Company for 2011 (hereafter – the "financial plan"), approved by the Government on 11 March 2011, natural gas prices for population will increase from 1 April 2011 by 20% and starting from 01 July 2011 the prices will rise by 10%.At the date of issue of these consolidated financial statements, decision about natural gas prices increasing for population was not adopted by the Government and NKRE. The prices of gas for the residential customers and local heating entities, which sell heat to the residential customers increased from 1 August 2010 by 50%.
- The financial plan for 2011 assumes a quarterly increase in the sale price of natural gas for industries and budget organizations. At the date of the consolidated financial statements the NERC decision to raise the price of gas for industrial consumers and budget organizations from 01 January, 1 April, 1 July and 1 October 2011 by 4.3%, 11.9%, 18, 4% and 11.9% respectively against the previous period was approved. In 2011 the price for industrial enterprises and budgetary organizations were increased by a total of 54.6%.
- The financial plan assumes an increase in heat energy tariffs from 01 January 2011 by 15%, and offers a double increase in tariffs by 26% from 15 April 2011 and from 01 October 2011. At the date of these consolidated financial statements of the decision to raise tariffs on heat energy from 01 January 2011 to 15% was approved by NERC and other tariff increases were implemented
- Financial plan provides for increasing the statutory fund of the Company by UAH 8,5 billion by issuing shares of current nominal value and their subsequent exchange for sovereign bonds (further—the "sovereign bonds"). In January-August 2011, the Group received sovereign bonds nominal at nominal value of UAH 8,5 billion as a contribution to statutory fund. All sovereign bonds were monetized. In October, following changes to the financial plan for 2011, the Group received extra sovereign bonds for UAH 4 billion as a contribution to the statutory fund.

Management believes that the combination of the aforementioned initiatives, when fully enacted, will provide the Group with additional funds that will enable it to settle current debts as they fall due and to continue to operate as a going concern.

However, the dependence of the Group on the successful achievement of management's plans and government actions creates a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business. These consolidated financial statements do not include any adjustments relating to recoverability and classification of recorded asset amounts or to amounts and classification of liabilities that may be necessary if the Group is unable to continue as a going concern.

3.1. Basis of preparation

The consolidated financial statements have been prepared on a historical cost basis, except for property, plant and equipment and financial instruments that have been measured at fair value. The consolidated financial statements are presented in Ukrainian hryvnia (UAH) and all values are rounded to the nearest million, except when otherwise indicated.

Statement of compliance

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Basis of consolidation

The consolidated financial statements comprise the financial statements of the parent company, PJSC "Naftogas of Ukraine", and its consolidated subsidiaries as at 31 December each year. The financial statements of the consolidated subsidiaries are prepared for the same reporting year as the parent company, using consistent accounting policies. All intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions that are recognized in assets, were eliminated in full. 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.

Minority interests represent the portion of profit or loss and net assets not held by the Group and are presented separately in the consolidated income statement and within equity in the consolidated statement of financial position, separately from the parent shareholder's equity.

The consolidated financial statements as at 31 December 2010 and for the year then ended comprise the financial statements of Naftogas of Ukraine and the following nine subsidiaries:

Name and principal activities	*Equity interest*
Production of oil, gas and refinery products	
Subsidiary Company ("SC") Ukrgasproduction	100%
State JSC Chornomornaftogas	100%
Oil and gas transportation	
SC Ukrtransgas	100%
PJSC Ukrtransnafta	100%
Wholesale distribution of oil, gas and refinery products	
SC Gas of Ukraine	100%
PJSC Dnipropetrovskgas	51%
PJSC Luganskgas	51%
PJSC Zaporizhgas	50% +1 share
PJSC Mykolayivgas	50% +1 share

3.2. Changes in accounting policies

The accounting policies adopted are consistent with those of the previous year except as follows. The Group has adopted the following new (amended) standards and interpretations of International Financial Reporting Interpretation Committee (further—IFRIC) as of 1 January 2010:

Starting from 1 January 2010 the following updated standards and interpretations came into force:

- IFRIC Interpretation 17, Distributions of Non-cash Assets to Owners;
- Amendment to IAS 39, Financial Instruments: Recognition and Measurement-"Hedged items";
- IFRS 2 Share-based Payment- group cash-settled share-based payment transactions;
- IFRS 3, Business Combinations.

When the adoption of the standard or interpretation is deemed to have an impact on the financial statements or performance of the Group, its impact is described below:

Improvements to IFRS

In April 2009 the IASB issued omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. Most of the amendments come into force for annual reports starting since or after 1 January 2010. There are separate transitional provisions for each standard. The adoption of the following amendments resulted in changes to accounting policies but did not have any impact on the financial position or performance of the Group.

Amendments included in IFRS Amendments issued in April 2009 did not have any impact on the financial position or performance of the Group, except for the following amendments resulted in changes to accounting policies:

- IFRS 5, *Non-current Assets Held for sale and Discontinued Operations* clarifies that requirements of information disclosure of non-current assets, disposal groups held for sale, as well as discontinued operations are set forth in IFRS 5. Requirement as to the information disclosure set forth in other IFRSs are applied only if there is special requirement for alike non-current assets or discontinued operations.
- IFRS 8 *Operating Segments* clarifies that assets and liabilities of the segment are to be disclosed only in case these assets and liabilities are included in the estimate used by an executive body responsible for operating decisions-making. The amendment did not have any effect to the Group's financial statements as the Group does not disclose segment information.
- *IAS 7, Statement of Cash Flows* clarifies that only costs resulting in asset recognition may be classified as cash flows from investing activities.
- *IAS 36 Impairment of Assets:* The amendment clarifies that the largest unit allowed for the use in goodwill distribution acquired from business combination, is an operating segment in accordance with IFRS 8 to aggregate for reporting purposes. The amendment did not have any effect to the Group's financial statements as annual reviews for impairment are performed.

3.3. Significant accounting judgments, estimates and assumptions

The preparation of the consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amount of assets, liabilities and contingent liabilities at the date of consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Estimates and judgments are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. However, actual outcomes can differ from these estimates.

Judgments

In the process of applying the Group's accounting policies, management has made certain judgments, apart from those involving estimations, which have a significant effect on the amounts recognised in the financial statements. These judgments include, inter alia, the appropriateness of the going concern assumption.

Estimates and assumptions

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

Tax and other regulatory compliance risks

Ukrainian legislation and regulations regarding taxation and other operational matters, including currency exchange control and custom regulations, continue to evolve. Legislation and regulations are not always clearly written and are subject to varying interpretations by local, regional and national authorities, and other Governmental bodies. Instances of inconsistent interpretations are not unusual. Management believes that its interpretation of the relevant legislation is appropriate and that the Group has complied with all regulations and paid or accrued all taxes and withholdings that are applicable. At the same time it is a risk that transactions and interpretations that have not been challenged in the past may be challenged by the authorities in the future, although this risk significantly diminishes with the passage of time. It is not practical to determine the amount of unasserted claims that may manifest, if any, or the likelihood of any unfavourable outcome.

Revaluation of property, plant and equipment and investment properties

The Group carries its property plant and equipment at fair value, with changes in fair value being recognized in consolidated statement of comprehensive income. The Group engaged independent valuation specialists to determine fair value as at 31 December 2009. The results obtained using different valuation approaches provided evidence of the existence of economic obsolescence (the cost of assets exceeded the future: economic benefit that could be obtained from the use of the asset). Therefore, the fair value of specialized assets, representing the majority of assets being revalued, was determined using the cost approach as adjusted for the amount of economic obsolescence. The fair value of non-specialized assets was determined using the market approach.

Provision for litigation

The Group is a defendant in a number of lawsuits with its counterparties. The provision for litigation represents management's assessment of the probable losses resulting from a negative outcome of the lawsuits.

Pension and other post employment benefits

The cost of defined benefit pension plans is determined using actuarial valuations. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates and future pension increases. Due to the long term nature of these plans, such estimates are subject to significant uncertainty.

Allowance for impairment of trade and other receivables

The Group regularly reviews its trade and other receivables, prepayments made to suppliers and other receivables to assess impairment. The Group uses its experienced judgment to estimate the amount of any impairment loss in cases where a contractor is in financial difficulties.

Impairment of non-financial assets

Property, plant and equipment and intangible assets are tested for impairment when circumstances indicate there may be a potential impairment. Factors the Group considers important which could trigger an impairment review include the following: significant fall in market values; significant underperformance relative to historical or projected future operating results; significant changes in the use of the assets or the strategy for the overall business, including assets that are decided to be phased out or replaced and assets that are damaged or taken out of use, significant negative industry or economic trends and other factors.

Estimation of recoverable amounts of assets is based on management evaluations, including estimates of future performance, revenue generating capacity of the assets, assumptions of the future market conditions, technological developments, changes in regulations and other factors. These assumptions are reflected in the calculation of the asset's value-in-use amounts and include projections of the future cash flows and the selection of the appropriate discount rate. The Group evaluates such estimates as at the date of the financial statements, therefore actual results could differ from those estimates. Changes in circumstances and in management's evaluations and assumptions may give rise to impairment losses in the relevant periods. As at 31 December 2010 the amount of impairment loss based on management assumptions was evaluated by independent valuation specialists.

Useful life of property, plant and equipment

The Group assesses the remaining useful life of items of property, plant and equipment at least at each financial year end. If expectations differ from previous estimate, the changes are accounted for as a change in accounting estimates in accordance with IAS 8 "Accounting policies, Changes in Accounting Estimates and Errors". These estimates may have an impact on the amount of the carrying values of property, plant and equipment in the consolidated statement of financial position and in depreciation recognized in the consolidated income statement.

Estimation of oil and gas reserves

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Estimates of oil and gas reserves are inherently imprecise, require the application of professional judgment and are subject to future revision. Accordingly, financial and accounting measures (such as the discounted cash flows, depreciation, depletion and amortization charges, and asset retirement provisions) that are based on proved reserves are also subject to change.

Proved reserves estimates are attributed to future development projects only where there is a significant commitment to project funding and execution and for which applicable governmental and regulatory approvals have been secured or are reasonably certain to be secured. Furthermore, estimates of proved reserves only include volumes for which access to market is assured with reasonable certainty. All proved reserves estimates are subject to revision, either upward or downward, based on new information, such as from development drilling and production activities or from changes in economic factors, including product prices, contract terms or development plans. In general, changes in the technical maturity of hydrocarbon reserves resulting from new information becoming available from development and production activities have tended to be the most significant cause of annual revisions.

In general, estimates of reserves for undeveloped or partially developed fields are subject to greater uncertainty over their future life than estimates of reserves for fields that are substantially developed and depleted.

Changes to the Group's estimates of proved reserves, particularly proved developed reserves, also affect the amount of depreciation, depletion and amortization recorded in the consolidated financial statements for property, plant and equipment related to hydrocarbon production activities. These changes can for example be the result of production and revisions. A reduction in proved developed reserves will increase depreciation, depletion and amortization charges (assuming constant production) and increase costs.

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 costs estimates can vary in response to many factors including changes to relevant legal requirements, the emergence of new restoration techniques or experience at other production 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.

The decommissioning provision represents the present value of decommissioning costs relating to oil and gas properties, which are expected to be incurred up to 2023. These provisions have been created based on the Group's internal estimates. Assumptions, based on the current economic environment, have been made which management believe are a reasonable basis upon which to estimate the future liability. These estimates are reviewed regularly to take into account any material changes to the assumptions. However, actual decommissioning costs will ultimately depend on 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 on future oil and gas prices, which are inherently uncertain.

Fair Value of Financial Instruments

Where the fair value of financial assets and financial liabilities recorded in the statement of financial position cannot be derived from active markets, they are determined using valuation techniques including the discounted cash flows model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

Deferred Tax Asset

Deferred tax assets are recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary' difference can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and level of future taxable profits together with future tax planning strategies.

3.4 Summary of significant accounting policies

All accounting policies described below relate to the Company and its consolidated subsidiaries defined in "Basis of consolidation" above.

Foreign currency translation

The consolidated financial statements are presented in Ukrainian hryvnia ("UAH"), which is the functional and presentation currency of the Company and each of its subsidiaries. Transactions in foreign currencies are initially recorded in the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the reporting date. All differences are taken to the income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Accounting for the effects of hyperinflation

The Ukrainian economy was regarded as being hyperinflationary for the ten-year period ended 31 December 2000. As such, the Group has applied IAS 29, Financial Reporting in Hyperinflationary Economies ("IAS 29") to restate the non-monetary assets and liabilities, and equity items originated during the period of hyperinflation to measuring units current at 31 December 2000 using the Consumer Price Index as published by the Ministry of Statistics of Ukraine. These values, adjusted for the effect of hyperinflation, were used as a basis for accounting in subsequent accounting periods.

Property, plant and equipment

Following initial recognition at cost, property, plant and equipment is measured at fair value less depreciation and impairment charged subsequent to the date of the revaluation.

Valuations are performed frequently enough to ensure that the fair values of revaluated assets do not differ materially from its carrying amount.

Any revaluation surplus is credited to the asset revaluation reserve included in the equity section of the statement of financial position, except to the extent that it reverses a revaluation decrease of the same asset previously recognized in income statement, in which case the increase is recognized in income statement. A revaluation deficit is recognized in profit or loss, except that a deficit directly offsetting a previous surplus on the same asset is directly offset against the surplus in the asset revaluation reserve. Upon disposal, any revaluation reserve relating to the particular asset being sold is transferred to retained earnings.

When each major inspection is performed, its cost is recognized in the carrying amount of the plant and equipment as a replacement if the recognition criteria are satisfied.

An item of property, plant and equipment is derecognized upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the income statement in the year the asset is derecognized.

An asset's residual value, useful life and method of depreciation are reviewed and adjusted, if appropriate, at each financial year end.

The estimated costs of dismantling oil and gas production facilities, including abandonment and decommissioning costs are included as a component of oil and gas properties and depleted on a unit-of- production basis.

Depreciation for property, plant and equipment, excluding oil and gas properties, is calculated on a straight line basis over the useful life of the assets. Depreciation, depletion and amortization of capitalized costs of oil and gas properties are calculated using the unit-of-production method for each field based upon proved developed reserves.

Property, plant and equipment includes technological oil and gas which is required to be held in the pipelines and storage facilities to enable conducting operating activity of the transporting companies of the Group.

Exploration and evaluation costs

During the geological and geophysical phase, costs are charged against income as incurred. Once the legal right to explore has been acquired, costs directly associated with exploration are capitalised until the drilling of the well is complete and the results have been evaluated and included in construction in progress carrying value. These costs include employee remuneration, materials and fuel used, rig costs and payments made to contractors. If no reserves are found, the exploration asset is tested for impairment, if extractable hydrocarbons are found and, subject to further appraisal activity, which may include the drilling of further wells, are likely to be developed commercially, the costs continue to be carried as an asset while sufficient/continued progress is made in assessing the commerciality of the hydrocarbons. All such carried costs are subject to technical, commercial and management review as well as review for impairment at least one a year to confirm the continued intent to develop or otherwise extract value from discovery. When this is no longer the case, the costs are written off. When proved reserves of oil are determined and development is sanctioned, the relevant expenditure is transferred to oil and gas properties after impairment is assessed and any resulting impairment loss is recognized.

Concession Agreement (production sharing agreement)

The Company entered into Concession Agreement for oil exploration and exploitation (hereinafter - the Agreement) with the Arab Republic of Egypt and Egyptian General Petroleum Corporation (hereinafter - EGPC) dated 13/12/2006.

The agreement includes the following conditions.

Audited Company oil exploration and exploitation costs are subject to reimbursement at the expense of produced hydrocarbons, but not less than 25% of the actual production to their full repayment.

All the extracted hydrocarbons are subject to allocation between the Company and EGPC depending on production volumes for each of the reporting periods. The Company's share in the production is defined in the Agreement as 15% to 19%.

EGPC becomes the owner of all gained and such property owned by the Company, which is refunded to the Company as reimbursement of costs in connection with the works undertaken by the Company or the Company-Operator.

Rights to movable and real property is automatically and gradually transferred by EGPC Company since it is subject to reimbursement pursuant to the provisions of the Agreement; however, every right to movable and real property is transferred automatically by EGPC Company when its total value is reimbursed the Company pursuant to the provisions of the Agreement or termination of such Agreement for all property-related works, whether it is compensated or not, depending on whichever takes place earlier.

The concession agreement provides after the estimation of proved hydrocarbon reserves as at 13 December 2011, a production during the period of 25 years.

The costs of exploration and appraisal that did not result in detection of hydrocarbons deposits are reported as expense of the period. Those costs that led to the discovery of deposits (production expenses) are recorded within the capital costs of conducting the test for impairment at the date of the audit of hydrocarbon reserves. After that date a test of impairment for such assets is performed, considering the most probable date of recovery of their value due to hydrocarbon production, or a complete write-off is held in case of insufficient supply of hydrocarbons to cover the capitalized costs in the future.

Investment in associate

The Group's investment in its associate is accounted for using the equity method of accounting. An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a joint venture.

Under the equity method, the investment in the associate is carried in the statement of financial position at cost plus post acquisition changes in the Group's share of net assets of the associate. Goodwill relating to the associate is included in the carrying amount of the investment and is not amortized. The income statement reflects the share of the results of operations of the associate. Where there has been a change recognized directly in the equity of the associate, the Group recognizes its share of any changes and discloses this, when applicable, in the statement of changes in equity. Unrealized profits and losses resulting from transactions between the Group and the associate are eliminated to the extent of the interest in the associate.

The share of profit of associates is shown on the face of the income statement. This is the profit attributable to equity holders of the associate and therefore is profit after tax and non-controlling interests in the subsidiaries of the associates.

The financial statements of the associate are prepared for the same reporting period as the parent company. Where necessary, adjustments are made to bring the accounting policies in line with those of the Group.

After application of the equity- method, the Group determines whether it is necessary to recognize an additional impairment loss on the Group's investment in its associates. The Group determines at each reporting date whether there is any objective evidence that the investment in the associate is impaired. If this is the case the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying value and recognizes the amount in the income statement.

Upon loss of significant influence over the associate, the Group measures and recognizes any retaining investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retaining investment and proceeds from disposal is recognized in profit or loss.

Interest in joint ventures

The Group has interests in joint ventures which are jointly controlled entities. A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control, and a jointly controlled entity is a joint venture that involves the establishment of a separate entity in which each venturer has an interest The Group recognizes its interest in the joint venture using the equity method applied as described above in the accounting policy for investments in associates.

The financial statements of the joint venture are prepared for the same reporting period as the parent company. Adjustments are made where necessary to bring the accounting policies into line with those of the Group.

Adjustments are made in the Group's consolidated financial statements to eliminate the Group's share of intragroup balances, income and expenses and unrealized gains and losses on transactions between the Group and its jointly controlled entity. Losses on transactions are recognized immediately if the loss provides evidence of a reduction in the net realizable value of current assets or an impairment loss. The joint venture is proportionately consolidated until the date on which the Group ceases to have joint control over the joint venture.

The Group reassesses the level of its influence over associates and joint-ventures, when the following circumstances exist: 1) the investor has failed to obtain representation on the investee's board of directors; 2) the investee is opposing the investor's attempts to exercise significant influence; 3) the investor is unable to obtain timely financial information or cannot obtain information, required to apply the equity method: or 4) a group of shareholders that holds the majority ownership of the investee operates without regard to the views of the investor.
When these circumstances individually or in the aggregate reduce the level of influence over associates or/and interest in joint-ventures the Group determines the classification and measurement of such investments in accordance with of IAS 39.

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 capitalized 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.

Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses. Internally generated intangible assets, excluding capitalized development costs, are not capitalized and expenditure is reflected in the income statement in the year in which the expenditure is incurred.

Intangible assets are amortized over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortization period and the amortization method for an intangible asset is reviewed at least at each financial year end. Changes in

the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortization period or method, as appropriate, and treated as changes in accounting estimates. The amortization expense on intangible assets is recognized in the income statement in the expense category consistent with the function of the intangible asset.

Impairment of non-financial assets

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash- generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs to sell, an appropriate valuation model is used.

These calculations are corroborated by valuation multiples, quoted share prices for publicly traded securities or other available fair value indicators.

Impairment losses are recognized in the income statement in those expense categories consistent with the function of the impaired asset, except for property previously revaluated where the revaluation was taken to equity. In this case the impairment is also recognized in equity up to the amount of any previous revaluation.

An assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the Group makes an estimate of recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the income statement unless the asset is carried at revaluated amount, in which case the reversal is treated as a revaluation increase.

Associates and joint-ventures

After application of the equity method, the Group determines whether it is necessary to recognize an additional impairment loss of the Group's investment in its associates and joint-ventures. The Group determines at each reporting date whether there is any objective evidence that the investment in associate or joint-venture is impaired. If this is the case the Group calculates the amount of impairment as being the difference between fair value of the associate and the acquisition cost and recognizes the respective amount through profit or loss.

Financial assets

Initial recognition and measurement

Financial assets in the scope of IAS 39 are classified as financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, available-for-sale financial assets, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The Group determines the classification of its financial assets at initial recognition.

When financial assets are recognized initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss less directly attributable transaction costs.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the marketplace (regular way trades) are recognized on the trade date, i.e., the date that the Group commits to purchase or sell the asset.

The Group's financial assets include cash and short-term deposits, accounts and notes receivable, loans to employees (included in other current and non-current assets) and unquoted financial instruments.

As at 31 December 2010 and 2009, none of the Group's financial assets were classified as financial assets at fair value through profit and loss.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification as follows:

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement loans and receivables are subsequently carried at amortized cost using the effective interest rate method (EIR), less any allowance for impairment. Amortized cost is calculated taking into account any discount or premium on acquisition and fee or costs that are an integral part of the EIR. The EIR amortization is included in finance income in the income statement. The losses arising from impairment are recognized in the statement of comprehensive income in other operating expenses.

Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturities are classified as held-to-maturity when the Group has the positive intention and ability to hold to maturity. After initial measurement held-to-maturity investments are measured at amortized cost using the effective interest method (EIR) less impairment. Gains and losses are recognized in the consolidated statement of comprehensive income in finance costs when the investments are derecognized or impaired. Amortized cost is calculated taking into account any discount or premium on acquisition and fee or costs that are an integral part of the EIR. The EIR amortization is included in finance income in the income statement. The losses arising from impairment are recognized in the income statement in finance costs. The Group did not have any held-to-maturity investments during the years ended 31 December 2010 and 2009.

Available-for-sale financial assets

After initial measurement, available-for-sale financial investments are subsequently measured at fair value with unrealized gains or losses recognized as other comprehensive income in the available-for-sale reserve until the investment is derecognized, at which time the cumulative gain or loss is recognized in other operating income, or determined to be impaired, at which time the cumulative loss is recognized in the statement of comprehensive income in finance costs and removed from the available-for-sale reserve.

The Group evaluated its available-for-sale financial assets whether the ability and intention to sell them in the near term is still appropriate. When the Group is unable to trade these financial assets due to inactive markets and management's intent significantly changes to do so in the foreseeable future, the Group may elect to reclassify these financial assets in rare circumstances. Reclassification to loans and receivables is permitted when the financial asset meets the definition of loans and receivables and has the intent and ability to hold these assets for the foreseeable future or maturity. Reclassification to held-to-maturity is permitted only when the company has the intent and ability to hold these financial assets for maturity.

For a financial asset reclassified out of the available-for-sale category, any previous gain or loss on that asset that has been recognized in equity is amortized to profit or loss over the remaining life of the investment: using the EIR. Any difference between the new amortized cost and the expected cash flows is also amortized over the remaining life of the asset using the EIR. If the asset is subsequently determined to be impaired then the amount recorded in equity is reclassified to profit and loss.

The fair value of investments that are actively traded in organized financial markets is determined by reference to quoted market bid prices at the close of business on the reporting date. Fair value of investment where there is no active market is carried at cost net of impairment.

Derecognition of financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognized where:

- the rights to receive cash flows from the asset have expired; or
- the Group retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a pass-through arrangement; or
- the Group has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

When the Group has transferred its rights to receive cash flows from an asset or has entered into a pass-through arrangement, and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognized to the extent of the Group's continuing involvement in the asset.

Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Impairment of financial assets

The Group assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred loss event') and that loss event has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the debtors or a group of debtors is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganization and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

Assets carried at amortized cost

For financial assets carried at amortized cost the Group first assesses individually whether objective evidence of impairment exists individually for financial assets that are individually significant, or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognized are not included in a

collective assessment of impairment.

If there is objective evidence that an impairment loss has 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 yet been incurred). The present value of the estimated future cash flows is discounted at the financial assets original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate.

The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the profit and loss. Interest income continues to be accrued on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of finance income in the statement of comprehensive income. Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to the Group. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is credited to finance costs in the statement of comprehensive income.

Available-for-sale financial investments

For available-for-sale financial investments, the Group assesses at each reporting date whether there is objective evidence that an investment or a group of investments is impaired.

In the case of equity investments classified as available-for-sale, objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost. 'Significant' is to be evaluated against the original cost of the investment and 'prolonged' against the period in which the fair value has been below its original cost. Where there is evidence of impairment, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that investment previously recognized in the profit and loss – is removed from other comprehensive income and recognized in the profit and loss. Impairment losses on equity investments are not reversed through the profit and loss; increases in their fair value after impairment are recognized directly in other comprehensive income.

In the case of debt instruments classified as available-for-sale, impairment is assessed based on the same criteria as financial assets carried at amortized cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortized cost and the current fair value, less any impairment loss on that investment previously recognized in the income statement.

Inventories

Inventories are valued at the lower of cost and net realizable value. Cost is determined either using the FIFO or the weighted average methods and comprises cost of direct materials, labour and a proportion of manufacturing overheads based on normal operating capacity but excluding borrowing costs.

Net realizable value is the estimated selling price in the ordinary course of business, less estimated costs of completion and the estimated costs necessary to make the sale.

Cash and cash equivalents

Cash and cash equivalents include cash in hand and cash at banks with an original maturity of three months or less.

Restricted cash

Restricted cash comprises deposits or bank accounts restricted in use as a result of the Group's commitment to withdraw the funds for designated purposes only. When the restriction is expected to expire within twelve months after the reporting date the restricted cash is classified as a current asset; otherwise, it is classified as a non-current asset.

Financial liabilities

Initial recognition and measurement

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 designated as hedging instruments in an effective hedge, as appropriate. The Group determines the classification of its financial liabilities at initial recognition.

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

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

Subsequent measurement

After initial recognition, trade and other payables with fixed maturity are measured at amortized cost using the effective interest rate method. Those that do not have fixed maturity are stated at cost.

Interest-bearing loans and borrowings are subsequently measured at amortized cost using the effective interest rate method. Gains and losses are recognized in the profit and loss when the liabilities are derecognized as well as through the effective interest rate method (EIR) amortization process.

Amortized 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 amortization is included in finance cost in the statement of comprehensive income.

Derecognition of financial liabilities

A financial liability is derecognized 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 recognized in the income statement.

Provisions

General

Provisions are recognized 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 recognized as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as a finance

cost.

Decommissioning liability

Decommissioning liability is recognized 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. A corresponding amount equivalent to the provision is also recognized as part of the cost of the related property, plant and equipment. The amount recognized is the estimated costs of decommissioning, discounted to their present value. Changes in the estimated timing of decommissioning or decommissioning costs estimates are dealt with prospectively by recording an adjustment to the provision, and a corresponding adjustment to property, plan and equipment. The unwinding of the discount of the decommissioning provision is included as a finance cost.

The Group recognizes neither the deferred tax asset regarding the temporary differences on the decommissioning liability nor the corresponding deferred tax liability regarding the temporary difference on a decommissioning asset.

Employee benefits

State pension scheme

The Group makes current contributions to the state pension scheme on behalf of its employees. Contributions are calculated as a percentage of current gross salary. Such expense is charged to the income statement in the period the related compensation is earned by the employee.

Defined benefit plans

In addition to the contributions to the Ukrainian state pension scheme referred to above, the Group participates in a mandatory State defined retirement benefit plan, which provides for early pension benefits for employees working in certain workplaces with hazardous and unhealthy working conditions.

Also there is a formal agreement between certain of the Group's entities and their employees, which provides for a certain lump-sum payment to an employee on retirement, periodic payments to retired persons, and lump-sum payments to employees when they reach a certain age.

The amount of benefit depends on the employee's years of service and other factors. These benefits are unfunded. The cost of providing benefits under the plan is determined using the projected unit credit actuarial valuation method. Actuarial gains and losses are recognized as income or expense when the net cumulative unrecognized actuarial gains and losses for each individual plan at the end of the previous reporting year exceeds the higher of 10% of the present value of the defined benefit obligation and 10% of the fair value of plan assets at that date. These gains or losses are recognized over the expected average remaining working lives of the employees participating in the plan.

The past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. If the benefits are already vested immediately following the introduction of, or changes to, a pension plan, past service cost is recognized immediately.

The defined benefit liability comprises the present value of the defined benefit obligation (using a discount rate based on high quality corporate bonds), less past service costs and actuarial gains and losses not yet recognized and less the fair value of plan assets out of which the obligations are to be settled. Plan assets are assets that are held by a long-term employee fund or qualifying insurance policies. Plan assets are not available to the creditors of the Group, nor can they be paid directly to the Group. Fair value is based on market information and in the case of quoted securities it is the

published bid price. The value of any defined benefit asset recognized is restricted to the sum of any past service cost and actuarial gains and losses not yet recognized and the present value of any economic benefits available in the form of refunds from the plan or reductions in the future contributions to the plan.

Government grants

Government grants are recognized where there is reasonable assurance that the grant will be received and all attaching conditions will be complied with. When the grant relates to an expense item, it is recognized as income over the period necessary to match the grant on a systematic basis to the costs that it is intended to compensate. Where the grant relates to an asset, it is recognized as deferred income and released to income in equal annual amounts over the expected useful life of the related asset.

Leases

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement at inception date of 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.

Group as a lessee

Leases, which do not transfer to the Group substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognized as an expense in the income statement on a straight line basis over the lease term.

Group as a lessor

Leases where the Group does not transfer substantially all the risks and benefits of ownership of the asset are classified as operating leases. Initial direct costs incurred in negotiating an operating lease are added to the carrying amount of the leased asset and recognized over the lease term on the same bases as rental income.

Revenue recognition

Revenue is recognized to the extent that it is probable that economic benefits will flow to the Group and the revenue can 'be reliably measured. Revenue is measured at the fair value of the consideration received, excluding discounts, rebates, and other sales taxes or duty. The following specific recognition criteria must also be met before revenue is recognized:

Sale of goods (oil and gas)

Revenue from sale of goods (oil and gas) is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer usually on dispatch of the goods. This generally occurs when a product is physically transferred into a pipeline or other delivery mechanism.

Sale of services

Revenues from services are recognized when such services are rendered and revenue can be reliably measured.

Interest income

Revenue is recognized as the interest accrues (using the effective interest method, that is, the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument to the net carrying amount of the financial asset).

Dividends

Revenue is recognized when the Group's right to receive payment is established.

Taxes

Current income tax

Current 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. The current income tax charge of the Group is calculated in accordance with Ukrainian taxation regulations and is based on the taxable income and tax allowable expenses reported by the Group in its tax return. The corporate income tax rate was 25% in 2010 (2009: 25%).

Deferred tax

Deferred income tax is provided using the liability method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax liabilities are recognized for all taxable temporary differences, except:

1. where the deferred tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
2. 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 recognized 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 utilized except:

1. where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
2. in respect of deductible temporary^ differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred tax assets are recognized 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 utilized.

The carrying amount of deferred income tax assets is reviewed at each reporting 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 utilized. Unrecognized deferred income tax assets are reassessed at each reporting date and are recognized 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 realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting date.

Deferred income tax relating to items recognized directly in equity is recognized in equity and not in profit or loss.

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

In December 2010, Ukraine adopted a tax code that stipulates new principles of construction and functioning of the taxation system in the country and will be effective from January 2011, and in part regarding corporate income tax- from April 2011. New Tax Code provides, inter alia, also the convergence of financial and tax accounting. For the calculation of income tax the following income tax rates will apply:

before 1 April 2011 - 25 %;

from 1 April 2011 to 31 December 2011 - 23 %;

from January 2012 to 31 December 2012 - 21 %;

from 1 January 2013 to 31 December 2013 - 19 %;

from 1 January 2014 - 16 %.

Taking into account the instability of tax policy, assessment of deferred tax assets and liabilities was based on judgments of management of the Group, which were based on information available at the time of this consolidated financial statements.

Value added tax

Revenues, expenses and assets are recognized net of the amount of value added tax (VAT) except: where VAT incurred on a purchase of assets or services is not recoverable from the taxation authority, in which case VAT is recognized as part of the cost of acquisition of the asset or as the part of the expense items as applicable.

The net amount of VAT recoverable from, or payable to, the taxation authority is included as part of receivables or payables in the statement of financial position.

Contingencies

Contingent liabilities are not recognized in the financial statements unless it is probable that an outflow of economic resources will be required to settle the obligation and it can be reasonably estimated. Contingent liabilities are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

Reclassifications

Certain reclassifications were made in the comparative information on property, plant and equipment as at 31 December 2009 in order to conform with current year classification. These reclassifications had no impact on the performance of aggregate income and net assets of the Group.

3.5 Standards issued, but not yet effective

The following standards and interpretations have not been implemented as they will only be applied for the first time in future periods. They may result in consequential changes to the accounting policies and other notes disclosures. The Group does not expect the impact of such changes on the financial statements to be material.

IAS 24, Related Party Disclosures (Revised)

Revised IAS 24, issued in November 2009, simplifies the related party disclosures and clarifies the definition of Related Party. Previously, the entity under the control or significant influence of the

government had to disclose all transactions with other entities under the control or significant influence of the government. Revised standard requires disclosure of these transactions only if they are significant individually or in aggregate. The revised IAS 24 becomes effective for annual periods beginning on or after 1 January 2011. Currently the Group assesses the impact of the new standard.

Amendments to IAS 32, Financial Instruments: Presentations - Classification of Rights Issues

In October 2009, IASB issued amendments to IAS 32. The amendments are effective for annual periods beginning on or after 1 January 2010, with earlier adoption permitted. According to the amendments, definition of financial liabilities in IFRS (IAS) 32 is changed so that the right to acquire additional shares, some options and warrants will be classified as equity instruments. It can be applied if all holders of non-derivative equity instruments of a class on a pro rata basis are given the rights for a fixed number of additional shares in exchange for a fixed amount of cash in any currency. The Group believes that these amendments will not have any effect on its financial statements.

IFRS 9, Financial Instruments

In November 2009, IASB published first part of IFRS 9 Financial Instruments. This standard gradually replaces IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 becomes effective for annual reporting periods beginning on or after 1 January 2013. The early application of the first part of standard is permitted for annual periods ending on or after 31 December 2009. The first part of IFRS 9 introduces new requirements for classifying and measuring financial assets. In particular, for the purpose of further evaluation, all financial assets should be classified at amortized cost or fair value with revaluation through profit or loss, with the possible choice of revaluation disclosure of unconditional equity instruments, which are not intended for trading, through other comprehensive income. Currently the Group assesses the impact of this standard, and selects the start date of application.

Amendments to IAS 19, Employee Benefits

In June 2011, IASB issued amendments to IAS 19. These amendments come into effect for annual periods beginning on or after 1 January 2013, with earlier adoption permitted. According to the amendments, the order of accounting for actuarial gains and losses and the cost of services of previous periods and sequestration of pension plans, the definition of termination benefits was changed. Actuarial gains and losses can not be carried forward with using corridor method or recognized in profit or loss. The cost of services of past periods will be recognized in the period, in which the change in terms of pension plan occurred; benefits, to which an employee did not have rights, now will not be distributed for the entire period of service in the future. Sequestration of pension plan will be the case only if there is a significant reduction in the number of employees.

Gains/losses arising as a result of sequestration of pension plan will be accounted for as the cost of services of previous periods. There will also be introduced additional disclosure requirements in order to represent the characteristics of employees remuneration plans, the amounts recognized in financial statements, as well as risks arising from defined benefit plans the plans, implemented by several employers. Currently Group assesses the impact of this standard, and selects the start date of application.

IFRIC Interpretation 19 Extinguishing Financial Liabilities with Equity Instruments

IFRIC Interpretation 19 was issued 26 November 2009 and comes into force for annual reporting periods starting on or after 1 July 2010. IFRIC Interpretation 19 clarifies the IFRS requirements as to the company's and its creditor's revision of the financial liabilities, when the creditor agrees to accept shares or other equity instruments of the company to settle the financial liability partially or in full. The Company believes that this Interpretation will not have impact on financial position of the Group.

Improvements to IFRS

Improvements to IFRS (published in May 2010). The IASB issued "Improvements to IFRS" - a set of amendments to IFRS. The amendments were not applied as they shall enter into force for annual periods beginning on or after 1 July 2010, or on or after 1 January 2011. For each standard there are some transitional provisions. The amendments included in the "Improvements to IFRS", published in May 2010, will have an impact on accounting policies, financial position or results of financial activities of the Group, as described below.

- IFRS 3, *Business Combinations* restricts the scope of application of the right to chose evaluation model of minority interests. It stated that only components of the shares of non-controlling shareholders, which are not shares and now give their holders the right to a proportionate share in the net assets of the company, in case of liquidation shall be measured at fair value or at proportion of the identifiable net assets of the company purchased, and which relate to such shares. The Group believes that these amendments to IFRS 3 will have no effect on its financial statements.
- IFRS 7, *Financial Instruments: Disclosures* introduced amendments as to disclosure of quantitative information and information regarding credit risk. The Group expects that additional requirements will have minimal impact, since the information is already available.
- IAS 34, *Interim Financial Reporting* adds requirements as to disclosure of circumstances, which affect the fair value and classification of financial instruments, as well as the transfer of financial instruments between the levels of the hierarchy of fair value assessment, changes in the order of financial assets classification and changes in contingent liabilities and assets.
- Amendments to IFRS 1, IAS 1, IAS 27 and IFRIC Interpretations 13 will not have impact on accounting policy, financial position and financial results of the Group.

Amendments to IFRS 7 *Financial Instruments: Disclosures*

These amendments were published in October 2010 and become effective for annual reporting periods beginning on or after 1 July 2011. These amendments impose additional disclosure requirements for the transferred financial asset which were not derecognized. The Group believes that this amendment will have no impact on its financial position.

Amendment to IAS 12, Income Tax - Deferred Tax: Recovery of Underlying Assets. In December 2010, the IASB issued amendments to IAS 12 that become effective for annual reporting periods beginning on or after 1 January 2012. In accordance with amendments fair value treated deferred tax of the investment property and of the assets not amortized within the scope of application of IAS to which revaluation model is applied, will be determined based on the assumption of the carrying amount recoverability through the sale of asset. Currently the Group is evaluating the effect of this amendment to its financial statements.

On 12 May 2011, the IASB published four new standards applied for annual reporting periods, beginning on or after 1 January 2013. Early application is encouraged.

IFRS 10, Consolidated Financial Statements

IFRS 10, Consolidated Financial Statements provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. The standard sets out requirements for situations when control is difficult to assess, including cases involving potential voting rights, agency relationships, control of specified assets and circumstances in which voting rights are not the dominant factor in determining control. In addition IFRS 10 introduces specific application guidance for agency relationships. The standard also contains accounting requirements and consolidation procedures, which are carried over unchanged from IAS 27. IFRS 10 replaces the consolidation requirements in SIC-12 *Consolidation—Special Purpose Entities* and IAS 27 *Consolidated and Separate Financial Statements*. The Group does not at present envisage that there will be any effect of the adoption of IFRS 10 to its financial position and performance.

IFRS 11, Joint Arrangements

IFRS 11 Joint Arrangements improves the accounting for joint arrangements by introducing a principle-based approach that requires a party to a joint arrangement to recognise its rights and obligations arising from the arrangement. The classification of a joint arrangement is determined by assessing the rights and obligations of the parties arising from that arrangement. There are only two types of arrangements provided in the standard - joint operation and joint venture. IFRS 11 also eliminates proportionate consolidation as a method to account for joint arrangements. IFRS 11 supersedes IAS 31 Interests in Joint Ventures and SIC-13 Jointly Controlled Entities—Non-monetary Contributions by Venturers. The Group does not at present envisage that there will be any effect of the adoption of IFRS 11 to its financial position and performance.

IFRS 12, Disclosure of Interests in Other Entities

IFRS 12 Disclosure of Interests in Other Entities is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. Adoption of the standard may require new disclosures to be made in the consolidated financial statements of the Group but will have no impact on its financial position or performance.

IFRS 13 Fair Value Measurement.

IFRS 13 Fair Value Measurement defines fair value, and sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. The standard applies when other IFRSs require or permit fair value measurements. It does not introduce any new requirements to measure an asset or a liability at fair value, change what is measured at fair value in IFRSs or address how to present changes in fair value. The adoption of IFRS 13 may have an effect on the measurement of the Group's assets and liabilities accounted for at fair value. Currently the Group is evaluating the possible effect of the adoption of IFRS 13 to its financial position and performance.

4. Segment information

For management purposes, the Group is organised into business units based on the nature of the production processes and has the following three reportable operating segments as follows:

- Production of oil, gas and refinery products;
- Oil and gas transportation;
- Wholesale distribution of oil, gas, petroleum products and other.

The production of oil, gas and refinery products segment explores, develops and produces oil, gas and gas condensate and processes it into refined products.

The oil and gas transportation segment is principally involved in the transit of Russian oil and gas to European countries and the Commonwealth of Independent States ("CIS") as well as oil and gas deliveries to Ukrainian refineries and Ukrainian wholesale and certain ultimate customers.

Companies in the oil, gas and other products wholesale distribution segment are involved in purchasing and selling of natural gas, oil, condensate and refined petroleum products to/from legal entities.

Management monitors the operating results of its business units in making decisions about resource allocation and separately for the purpose of performance assessment.

Transfer prices between operating segments are determined by the Company and are not necessarily on an arm's length basis.

Below is a brief overview of the business of the main subsidiaries involved in the operations of the reporting segments:

Production of oil, gas and refinery products

Ukrgasproduction

Ukrgasproduction conducts prospecting and production drilling, and is the main producer of natural gas and gas condensate in Ukraine. Ukrgasproduction is comprised of four natural gas exploration and production enterprises, a drilling company and a gas condensate processing department comprising three gas processing plants. Ukrgasproduction is also involved in production of liquefied petroleum gas, light oil and other petroleum products. In 2010, Ukrgasproduction produced approximately 14,833 million cubic meters of gas (2009: 15,234 million cubic meters), 533 thousand metric tons of condensate and gas (2009: 585 thousand metric tons), and 154 thousand metric tons of crude oil (2009: 156 thousand metric tons). Ukrgasproduction sells almost all gas produced within the Group.

Chornomornaftogas

Chornomornaftogas carries out exploration, development and production of natural gas and crude oil in the Crimea, the Black Sea and the Sea of Azov, and provides transportation and gas storage. Chornomornaftogas has 13 natural gas fields, 2 gas condensate and 2 oil fields, 45 gas distributing stations, owns 1 underground gas depository with a capacity of approximately 1 billion cubic meters, and pipelines having a total length of approximately 1.2 thousand kilometres. Chornomornaftogas has facilities for offshore operations including a specialised port, an engineering fleet, comprising 21 ships and 11 fixed offshore gas production platforms, 2 sea floating platforms. In 2010 Chornomornaftogas produced approximately 1,051 million cubic meters of natural gas (2009: 1,040 million cubic meters).

Oil and gas transportation

Ukrtransgas

Ukrtransgas carries out natural gas transportation and storage within Ukraine (in Crimea such functions are also fulfilled by Chornomornaftogas), gas deliveries to customers, transit of Russian gas to Europe and the CIS, as well as oversees gas transport infrastructure maintenance and construction. Ukrtransgas operates six regional pipeline branches with a total pipeline length of approximately 36.8 thousand kilometres. Ukrtransgas also operates 12 underground gas depositories with a total capacity of approximately 31 billion cubic meters.

During 2010 Ukrtransgas transported approximately 150 billion cubic meters of natural gas (2009: 141 billion cubic meters of natural gas), of which approximately 66% was transported to the Western border of Ukraine and to the CIS (2009: 68%) and the remainder to Ukrainian consumers.

Natural gas transportation tariffs for local customers are regulated by the State through orders of the NKRE.

During 2020 tariffs for natural gas transportation for Gazprom (Russian Federation) were set by bilateral agreements between PJSC "Naftogas of Ukraine" and Gazprom.

Ukrtransnafta

Ukrtransnafta's principal activities include transit of Russian and Central Asian oil to European countries and oil deliveries to Ukrainian refineries. Ukrtransnafta operates 18 oil pipelines with a total length of approximately 4.7 thousand kilometres, 51 oil transfer stations and 11 storage plants, comprising 79 oil storage tanks. In 2010, the total volume of oil transported through pipelines was 30 million tons (2009: 39 million tons).

Oil transportation tariffs are regulated by the State through orders of NKRE or set by direct agreements with Russian suppliers.

Wholesale distribution of oil, gas, refinery products and other

Gas of Ukraine

Gas of Ukraine distributes natural gas to state-owned, industrial customers and regional gas supply and distribution companies. In 2010, the total volume of distributed natural gas was 44,031 million cubic meters (2009: 39,589 million cubic meters).

Regional Gas Supply and Distribution companies

Dnipropetrovskgas, Luganskgas, Zaporizhgas, and Mykolayivgas are engaged in the transportation and distribution of natural gas to residential and other customers.

The following tables present revenue and profit and certain asset and liability information relating to the Group's business segments:

Year ended 31 December 2010

	Production of oil, gas and refinery products	*Oil and gas transportation*	*Wholesale distribution of oil, gas, petroleum products and other*	*Adjustment, eliminations and unallocated items*	*Total*
Revenue					
Third party	3,330	30,688	58,725	-	92,743
Inter-segment	4,132	11,856	63,010	(78,998)	-
Total revenue	**7,463**	**42,543**	**121,735**	**(78,998)**	**92,743**
Subsidies from State budget	-	-	3,424	-	3,424
Results					
Impairment of property, plant and equipment	(158)	(48)	(1)	-	(207)
Depreciation and amortisation	(2,841)	(2,777)	(244)	-	(5,863)
Share of profit of joint-ventures	44	-	-	-	44
Segment profit/ (loss) before tax	**(256)**	**2,599**	**348**	**(10,035)** [1]	**(7,344)**
Assets					
Investments in associate and joint ventures	308	3	4,250	-	4,561
Capital expenditure	4,444	682	721	-	5,847
Operating assets	**38,469**	**86,798**	**46,842**	**21,568** [2]	**193,677**
Operating liabilities	**5,794**	**10,998**	**24,469**	**70,993** [3]	**112,254**

1. Individual segment's profit/ (loss) before income tax does not include net foreign exchange loss (UAH 30 million), other operating income (UAH 1,149 million) and other operating expenses (UAH 11,154 million) as these items of income/expenses are not distributable to activities of reportable operating segments and management monitors them on a group basis.
2. Individual segment's assets do not include other non-current assets (UAH 567 million) and prepaid income tax, prepayments and other current assets (UAH 21,001 million) as these assets are managed on a group basis.
3. Individual segment's liabilities do not include other long-term liabilities (UAH 469 million) and advances and other current liabilities (UAH 26,636 million); and long-term and short-term borrowings (UAH 38,430 million and UAH 5,458 million) as these liabilities are managed on a group basis.
4. Capital expenditure consists of additions of property, plant and equipment (UAH 4,305 million) and increase in construction in progress and prepaid construction (UAH 1,541 million).

Year ended 31 December 2009

	Production of oil, gas and refinery products	*Oil and gas transportation*	*Wholesale distribution of oil, gas, petroleum products and other*	*Adjustment, eliminations and unallocated items*	*Total*
Revenue					
Third party	3,344	16,472	45,680	-	65,496
Inter-segment	3,190	11,641	2,714	(17,545)	-
Total revenue	**6,534**	**28,113**	**48,394**	**(17,545)**	**65,496**
Subsidies from State budget	-	-	4,131	-	4,131
Results					
Impairment of property, plant and equipment	(1,387)	(3,091)	-	-	(4,478)
Depreciation and amortization	(1,644)	(1,784)	(248)	-	(3,676)
Share of profit/(loss) of an associate and joint-venture	39	-	-	-	39
Segment profit/ (loss) before income tax	**(539)**	**2,243**	**(1,988)**	**(19,270)** [1]	**(19,554)**
Assets					
Investments in associates and joint ventures	282	2	6,794	-	7,078
Capital expenditure	4,632	898	444	-	5,974
Operating assets	**36,673**	**90,046**	**64,193**	**3,145** [2]	**194,057**
Operating liabilities	**6,628**	**16,954**	**27,964**	**61,744** [3]	**113,289**

1. Individual segment's profit/(loss) before income tax does not include net foreign exchange loss (UAH 886 million), other operating income (UAH 942 million) and other operating expenses (UAH 19,326 million) as these items of income/expenses are not distributable to activities of reportable operating segments and management monitors them on a group basis.
2. Individual segment's assets do not include other non-current assets (UAH 598 million) and prepayments and other current assets (UAH 2,544 million) as these assets are managed on a group basis.
3. Individual segment's liabilities do not include other long-term liabilities (UAH 213 million) and advances and other current liabilities (UAH 13,766 million); and long-term and short-term borrowings (UAH 13,353 -million and UAH 28,636 million) as these liabilities are managed on a group basis.
4. Capital expenditure consists of additions of property, plant and equipment (UAH 4,640 million) and increase in construction in progress and prepaid construction (UAH 1,334 million).

5. Revenues and expenses

5.1 Revenue

	2010	*2009*
Sale of oil and gas	58,129	45,116
Revenues from oil and gas transportation	30,688	16,472
Sale of petroleum products	2,586	2,259
Other sales	1,340	1,649
	92,743	65,496

5.2 Subsidies from the State budget

Subsidies from the State budget represents compensation from the State budget for losses originated as a result of the difference between the purchase price of imported gas and the selling price to local heating entities. During the year ended 31 December 2010 cash inflows related to the compensation from the State budget amounted to UAH 3,424 million (2009: UAH 4,131 million)

5.3 Cost of sales

	2010	*2009*
Cost of purchased oil, gas and petroleum products	63,764	40,629
Depreciation, depletion and amortisation	5,863	3,676
Oil and gas transportation costs	5,273	5,912
Personnel expenses	3,768	3,900
Rent and other production taxes	2,430	2,431
Repair and maintenance costs	1,789	927
Cost of other sales and other expenses	1,442	1,507
Research, development and exploration costs	863	389
Impairment of property, plant and equipment	207	4,478
	85,399	63,849

Rent and other production taxes include rent tax (royalty). The basis for the rent tax calculation is the quantity of crude oil, condensate or natural gas produced.

5.4 Other operating income

	2010	*2009*
Gain on payables written-off following expiration of period of limitation	399	667
Gain on pension plan sequester (Note 14)	128	-
Release of provision for litigation	44	-
Reversal of loss on impairment of investments available for sale	12	-
Gain on investments disposal	-	139
Other operating income	566	136
	1,149	942

5.5 Other operating expenses

	2010	*2009*
Fines, penalties and litigation costs	10,840	11,680
Bad debt expenses	1,340	5,560
Marketing, agent and professional costs	605	163
Other operating expenses	590	712
Forwarding and other ancillary costs	325	723
Charity and social assets maintenance	49	21
Loss on disposal of property, plant and equipment	41	41
Loss on impairment of investments available for sale	-	426
	13,790	19,326

Fines, penalties and litigation costs mostly consist of the amounts related to decision of the Arbitration Tribunal in favour of RUE and necessary payment of extra tax amounts (Note 14).

5.6 Foreign currency exchange loss

Foreign exchange losses at the amount of UAH 30 million (2009: UAH 886 million) relate to translation of balances denominated in foreign currencies, including UAH 30 million (2009: UAH 569 million) related to translation of borrowings.

5.7 Finance costs

	2010	*2009*
Interest expenses	5,105	4,747
Finance expense related to the loan restructuring	-	302
Total interest expense	5,105	5,049
Unwinding of discount on long-term receivables	-	38
Other finance costs	559	1,383
Total finance expense	5,664	6,470

Other finance costs mostly consist of interests on tax debt restructuring amounted to UAH 337 million (2009: UAH 1,163 million).

6. Income tax

The components of income tax expense for the years ended 31 December were:

	2010	*2009*
Current income tax charge	6,435	5,745
Deferred tax benefit relating to origination and reversal of temporary differences	(1,625)	(2,598)
Income tax expense reported in the consolidated statement of comprehensive income	4,810	3,147

Reconciliation between income tax expenses and the product of accounting loss multiplied by the statutory tax rate for the years ended 31 December 2010 and 2009 is as follows:

	2010	*2009*
Accounting loss before income tax	(7,345)	(19,554)
Hypothetical tax at statutory income tax rate of 25% (2009:25%)	(1,836)	(4,889)
Non-taxable income	(39)	(52)
Expenses not included in gross expenses	4,442	3,911
Taxable income not recognized in financial accounting	3,421	3,272
Effect of changes in tax rates and tax laws	(656)	-
Change in unrecognized temporary differences	(502)	905
Income tax expense	4,810	3,147

Change in unrecognized temporary differences resulted from deferred tax assets of UAH 3,217 million (2009: UAH 3,719 million) which have not been recognised in respect of trade and other receivables because it is not probable that future taxable profit will be available to allow realisation of this temporary difference.

As companies included in these consolidated financial statements are separate tax payers, the deferred tax assets and liabilities are presented on an individual basis as follows:

	2010	*2009*
Deferred tax asset	5,404	3,862
Deferred tax liability	(14,175)	(21,697)
Net deferred tax liability	(8,769)	(17,835)

Deferred income tax at 31 December 2010 relates to the following:

	2009	*Reported in consolidated income statement*	*Reported in the statement of comprehensive income*	*2010*
Deferred tax asset / (liability)				
Trade and other receivables	1,345	431	-	1,776
Advances received and other liabilities	1,695	1,163	-	2,858
Provisions	1,438	(670)	1	769
Inventories	73	1	-	74
Prepayments and other current assets	(116)	195	-	79
Investments	(262)	(28)	(5)	(295)
Other non-current assets	34	(25)	-	9
Property, plant and equipment	(22,066)	588	7,445	(14,033)
Other long-term liabilities	24	(30)	-	(6)
Net deferred tax liability	(17,835)	1,625	7,441	(8,769)

Deferred income tax at 31 December 2009 relates to the following:

	2008	*Reported in consolidated income statement*	*Reported in the statement of comprehensive income*	*2009*
Deferred tax asset / (liability)				
Trade and other receivables	1,248	97	-	1,345
Advances received and other liabilities	868	827	-	1,695
Provisions	727	706	5	1,438
Inventories	189	(116)	-	73
Prepayments and other current assets	66	(182)	-	(116)
Investments	(251)	26	(37)	(262)
Other non-current assets	(38)	72	-	34
Property, plant and equipment	(12,778)	1,202	(10,490)	(22,066)
Other long-term liabilities	58	(34)	-	24
Net deferred tax liability	(9,911)	2,598	(10,522)	(17,835)

7. Property, plant and equipment

As at 31 December property, plant and equipment comprised the following:

	2010	*2009*
PP&E, depreciated cost	114,172	116,887
Construction on progress and prepayment for construction	9,280	7,624
	123,452	124,511

As at 31 December property, plant and equipment comprised the following:

	2010	*2009*
Revaluated amount		
Pipelines and related equipment	53,692	53,869
Producing oil and gas properties	19,347	17,975
Machinery and equipment	9,613	7,613
Buildings	13,207	11,456
Technological oil and gas	21,262	21,138
Drilling and exploration equipment	1,214	1,212
Other fixed assets	2,306	3,624
	120,641	116,887

	2010	*2009*
Accumulated depreciation		
Pipelines and related equipment	(2,232)	-
Producing oil and gas properties	(1,605)	-
Machinery and equipment	(1,035)	-
Buildings	(908)	-
Technological oil and gas	-	-
Drilling and exploration equipment	(200)	-
Other fixed assets	(489)	-
	(6,469)	-

	2010	*2009*
Depreciated cost of PP&E		
Pipelines and related equipment	51,460	53,869
Producing oil and gas properties	17,742	17,975
Machinery and equipment	8,578	7,613
Buildings	12,299	11,456
Technological oil and gas	21,262	21,138
Drilling and exploration equipment	1,014	1,212
Other fixed assets	1,817	3,624
	114,172	116,887

The Group performed independent valuation of construction in progress as at 31 December 2009. Increase in carrying amount arising from revaluation, amounting to UAH 1,094 million (net of income tax UAH 274 million (Note 6)) was credited to equity. Impairment of construction in progress amounted to UAH 1,089 million.

Property, plant and equipment consisted of the following:

	Pipelines and related equipment	*Producing oil and gas properties*	*Machinery and equipment*	*Buildings*	*Technological oil and gas*	*Drilling and exploration equipment*	*Other fixed assets*	*Total*
Net carrying amount as at								
1 January 2009	**48,300**	**10,611**	**2174**	**3,368**	**12,274**	**936**	**1363**	**79,026**
Additions	1,338	874	453	255	220	81	1,419	4,640
Disposals	(117)	-	(6)	(2)	(138)	-	(6)	(269)
Depreciation for the year	(1,893)	(942)	(357)	(208)	-	(114)	(312)	(3,826)
Impairment	(1,451)	(224)	(920)	(422)	-	(221)	(151)	(3,389)
Revaluation	12,403	7,459	3,263	7,118	8,782	737	1,105	40,867
Change in provision for well abandonment	-	-	-	-	-	(162)	-	(162)
Reclassification as the result of revaluation	(4,711)	197	3,006	1,347	-	(45)	206	-
As at 31 December 2009	**53,869**	**17,975**	**7,613**	**11,456**	**21,138**	**1,212**	**3,624**	**116,887**
Reclassification	(775)	183	875	1,507	-	(165)	(1,625)	-
As at 01 January 2010 (after reclassification)	**53,094**	**18,158**	**8,488**	**12,963**	**21,138**	**1,047**	**1,999**	**116,887**
Additions	599	1,197	1,132	268	188	170	324	**3,878**
Disposals	(1)	(8)	(7)	(24)	(13)	(3)	(17)	**(73)**
Depreciation for the year	(2,232)	(1,605)	(1,035)	(908)	-	(200)	(489)	**(6,469)**
Impairment	-	-	-	-	(51)	-	-	**(51)**
As at 31 December 2010	**51,460**	**17,742**	**8,578**	**12,299**	**21,262**	**1,014**	**1,817**	**114,172**

As at 31 December 2009 the Group obtained the independent valuation of its property, plant and equipment. The valuation of fixed assets was performed in accordance *with International Valuation Standards*. The results obtained using different valuation approaches provided evidence of the existence of economic obsolescence (the cost of assets exceeded the future economic benefit that could be obtained from the use of the asset). Therefore, the fair value of specialized assets, representing the majority of assets being revaluated was determined using the cost approach as adjusted for the amount of economic obsolescence. The fair value of non-specialized assets was determined using the market approach.

As at 31 December 2010, expenditures on tangible exploration and evaluation assets of UAH 5,665 mln, including those UAH 553 mln from concession agreements, (31 December 2009: UAH 4,177 mln, including those UAH 199 mln of concession agreements) are reported in the construction in progress.

Depreciated value of government property not subject to privatization (Note 18) operated by the Group amounted to UAH 81 billion as at 31 December 2010 (2009: UAH 83 billion).

Certain property, plant and equipment with a cost of UAH 234 million were fully depreciated and are still in use as of 31 December 2010 (2009: UAH 0 million).

Certain of the Group's property, plant and equipment with a carrying value of UAH 55 million were pledged as collateral for loans and borrowings as at 31 December 2010 (2009: UAH 30 million) (Note 13). Additionally, property, plant and equipment together with all other assets of the Company were pledged as collateral for unpaid tax debt (except for provisions and property rights totalling UAH 93 million) (Note 18).

Useful Lives

The following useful lives of assets were set in 2010 and 2009:

Pipelines and related equipment	10-50 years
Machinery and equipment	5-50 years
Buildings	5-60 years
Drilling and exploration equipment	12 years
Other fixed assets	5-20 years
Technological oil and gas	Not amortised

Other fixed assets comprise vehicles, fixtures, furniture, office and other equipment.

Technological oil is required to be held in the pipelines to enable the Group to operate the pipelines.

Technological gas is required to be held in gas storage facilities to enable the Group operate the gas storage facilities.

Depreciation, depletion and amortisation of producing oil and gas properties are calculated using the unit-of- production method for each field based upon proved developed reserves.

8. Investments

	2010	*2009*
Investment in associate	4,250	6,794
Investments available-for-sale, net of provision for impairment of UAH 436 million in 2010 and 2009	385	10,819
Other investments, net of provision for impairment of UAH 407 mullion and UAH 419 million in 2010 and 2009, respectively	1,044	856
Investments in joint ventures	312	284
	5,991	18,753

Investment in associate

Investment in associate represents investment in PJSC Ukrnafta in which the Group holds 50%+1 share and exercises significant influence.

Ukrnafta is the largest oil producing company in Ukraine. Ukrnafta is composed of six extraction divisions, three drilling and exploration divisions, three gas processing plants and a number of research, auxiliary and support units. In 2010, Ukrnafta produced approximately 2,486 thousand metric tons of crude oil and condensate (2009: 2,825 thousand metric tons), 2,445 million cubic meters of gas (2009: 2,947 million cubic meters), and 160.4 thousand metric tons of liquefied gas (2009: 180 thousand metric tons).

Since PJSC Ukmafta has not issued IFRS consolidated financial statements for 2010 and 2009 as at the date of these consolidated financial statement, Group did not record any changes in the amount of investments in Ukrnafta relating to 2010 and 2009 that should be accounted by equity method.

At the general meeting of shareholders of PJSC Ukrnafta in January 2010, it was decided to pay out dividends for 2006-2008. Group's share in total amount of dividends declared for payment is reported in changes in value of investments.

The movement in investments in Ukrnafta was as follows:

	2010	*2009*
Balance at 1 January	6,794	6,794
Share of results	-	-
Decrease in associate's equity	-	-
Distribution of dividends	(2,544)	-
Balance at 31 December	4,250	6,794

Investment in joint ventures

The following table illustrates summarised information on the financial position and operations of the Group's joint ventures (share attributable to the Group):

	2010	*2009*
Current assets	182	87
Non-current assets	228	237
	410	324
Current liabilities	(71)	(40)
Non-current liabilities	(27)	-
	(98)	(40)
Net assets	312	284
Income from sale	323	146
Operating costs	(262)	(89)
Profit before taxation	61	57
Income tax	(17)	(18)
Net profit	44	39

Investments available for sale

As of 31 December 2009, available for sale investments included OVDP contributed to share capital of the Company (Note 12) or OVDP contributed for additional shares which were not registered (Note 16) and unsold as of year-end of UAH 10.3 billion maturing in 2017-2022 and with effective yield of 9.5%. Subsequently, in January-April 2010 these OVDP were sold to Ukrainian banks.

As of 31 December 2009, available-for-sale investments included quoted shares at fair value of UAH 385 million (2009: UAH 356 million). In April 2010, the High Court (King's Bench Division) Commercial Court of England and Wales levied distraint upon shares or net proceeds in the event of sale.

Other investments

Several investees of the Company have not prepared financial statements under IFRS and, consequently, it was not practicable to consolidate these investments or account for these companies under the equity method in the accompanying consolidated financial statements of the Group. Thus, such investments are presented as other investments and carried at cost, net of impairment, in the

consolidated financial statements. The Company reassesses impairment reserve for such investments at each reporting date.

9. Inventories

	2010	*2009*
Crude oil, natural gas and petroleum products	12,112	30,424
Tools and spare parts	4,794	1,253
Materials for extraction, drilling and gas processing	255	209
Other goods, materials and supplies	667	702
	17,828	32,588

As at 31 December 2010, certain of the Group's inventories amounting to approximately UAH 12 billion (2009: UAH 9 billion) were pledged as security for outstanding loans (Note 13).

10. Trade and other receivables

	2010	*2009*
Trade accounts and notes receivable from third parties	22,985	11,055
Trade accounts and notes receivable from related parties (Note 19)	10,705	15,028
Other receivables	2,920	2,070
	36,610	28,153
Less: Allowance for impairment	(19,927)	(18,897)
	16,683	9,256

	2010	*2009*
Balance as at 1 January	18,897	13,778
Increase for the year	1,340	5,560
Used for the year	(310)	(441)
Balance as at 31 December	19,927	18,897

As at 31 December 2010 and 2009, the analysis of trade and other receivables that were past due is as follows:

			Past due but not impaired				
	Total	*Neither past due nor impaired*	*<30 days*	*30-60 days*	*60-90 days*	*90-120 days*	*>120 days*
2010	16,683	3,888	6,452	2,201	1,010	630	2,502
2009	9,256	6,069	858	250	182	31	1,866

11. Prepayments and other current assets

	2010	*2009*
Prepayments to suppliers	21,067	1,115
Recoverable value added tax	135	221
Prepaid taxes other than income tax	242	1,956
	21,444	3,292
Less: Allowance for impairment	(661)	(1,238)
	20,783	2,054

12. Equity

As at 31 December 2009, the registered, issued and fully paid share capital of the Company was UAH 5,564,714,000 comprising 5,564,714 common shares with a par value of UAH 1,000 per share.

As at 1 January 2009, the value of share capital of UAH 9,721 million has been determined in accordance with the provisions of IAS 29, applying conversion factors derived from the Consumer Price Index to the amount of the Company's share capital.

In July 2009, according to the Resolution of the Cabinet of Ministers of Ukraine dated 8 July 2009, the Company's share capital was increased by UAH 18.6 billion. The increase was financed by OVDP maturing in 2017-2019 and with an effective yield of 9.5%. In August 2009 - April 2010, these OVDP were sold to Ukrainian banks at par value and yield. In January 2010, these OVDP were sold to Ukrainian banks at par value and yield.

In October 2010, according to the Resolution of the Cabinet of Ministers of Ukraine dated 12 October 2010, the Company's statutory capital was increased by UAH 5.8 billion. The increase was performed through the contribution of OVDP with maturity 2019-2022 and the effective yield rate of 9.5%.

13. Loans and borrowings

Non-current loans and borrowings were comprised of the following as at 31 December 2010 and 2009:

Bank	*Loan currency*	*Effective interest rate, %*	*Maturity date*	*2010*	*2009*
Guaranteed Notes	USD	9.50	2014	13,001	12,724
Unsecured bank borrowings from foreign banks	USD	5.61-8.25	2013	3,781	685
Borrowings from state-owned banks	UAH	12.47-18.21	2016	22,575	82
Unsecured loans from state agencies	UAH	12.00	2012	119	178
Other loans and borrowings	UAH /USD	16.00	2010	176	881
				39,652	14,550
Current portion of long-term debt				(1,222)	(1,197)
Total non-current debt				38,430	13,353

On 5 November 2009, the Company restructured its debt to foreign banks of USD 1,597 million (including USD 500 million represented by Eurobonds with maturity in 2009 and Unsecured bank borrowings from foreign banks with maturity in 2009-2012). The rights and interests of the lenders under such term loan facilities were exchanged by the lenders for the corresponding principal amounts of Guaranteed Notes (the "Notes"). Notes are unconditionally and irrevocably guaranteed by the Cabinet of Ministers of Ukraine (acting on behalf of Ukraine) represented by the Minister of Finance of Ukraine.

The Notes will bear interest at a rate of 9.5% per annum. Interest on the Notes is payable semi-annually in arrear on 30 March and 30 September in each year, commencing on 30 March 2010. On 30 March 2010, the Company repaid accrued interest amount related to the Notes according to the repayment schedule.

The Notes will mature on 30 September 2014 and will be redeemed at par on that date.

Secured bank loans from foreign banks - Chornomornaftogas

Loan Agreements with the Black sea Bank of Trade and Development (ChBTR) were signed on 12 August 2004 and 31 October 2007 to the total amount of USD 20,000 thousand and USD 21,000 thousand with original maturities of 15 August 2011 and 15 September 2014, respectively.

Loan Agreements with ChBTR include material contractual obligations of financial and non-financial nature.

As at 31 December 2010, Chornomornaftogas does not meet any requirements of financial indicators of loan agreements with ChBTR dated 12 August 2004 and 31 October 2007.

Failure to comply with loan agreements' liabilities enables ChBTR to require immediate repayment of these loans. Thus, outstanding loan amount from ChBTR are classified as current liabilities as at 31 December 2010.

On 11 August 2011, ChBTR agreed not to use its right to require from Chornomornaftogas the contractual liabilities.

As at 31 December 2010 and 2009, short-term loans and borrowings included:

	Loan currency	*Effective interest rate, %*	*2010*	*2009*
Loans from foreign banks	USD	9.50	2	-
Loans from Ukrainian banks	UAH / USD	10.50 - 23.00	3,961	27,163
Secured bank loans from foreign banks - Chornomornaftogas	USD	Libor + 3.50-3.95%	146	-
Other loans and borrowings	UAH	15.95	127	276
			4,236	27,439
Current portion of long-term debt			1,222	1,197
Total short-term debt			5,458	28,636

Bank loans from Ukrainian Bank Institutions

In 2010, the Group concluded agreements with state banks Ukreximbank and Oschadbank to the total amount of UAH 22 billion for the prolongation of the maturity date from 2010 to 2011-2015.

Certain short-term and long-term loans and borrowings are secured by claims under certain contracts in total amount of UAH 24 billion (2009: UAH 80 billion), inventories and property, plant and equipment of the Group (Notes 7 and 9).

14. Provisions

	Decommissioning provision	*Pension benefits obligation*	*Provision for litigation*	*Total*
As at 1 January 2010	266	727	16,421	17,414
Charged during a year	25	176	1,617	1,818
Discount amortization	37	2	-	39
Used	(20)	(106)	(13,733)	(13,859)
Sequester	-	(128)	-	(128)
Write-off of previously charged amounts	(3)	-	(45)	(48)
As at 31 December 2010	305	671	4,260	5,236
Current portion 2010	9	87	4,260	4,356
Non-current portion 2010	296	584	-	880
	305	671	4,260	5,236
Current portion 2009	8	63	16,421	16,492
Non-current portion 2009	258	664	-	922
	266	727	16,421	17,414

Decommissioning provision

The decommissioning provision represents the present value of decommissioning costs relating to oil and gas properties.

Provision for litigation

The Group is a defendant in a number of court and arbitration proceedings. The provision for litigation represents the management's assessment of the probable outflow of the Group's resources arising from a negative (adverse) outcome of these court and arbitration proceedings.

The principal components of the amount of provision for litigation are related to the arbitration awards rendered in disputes between the Company and Rosukrenergo AG, the natural gas supplier to Ukraine before 2009 (further – "RUE") resulting in the Company's liability in favour of RUE of UAH 11.2 billion consisting of amounts described below.

- With regard to counterclaims filed by RUE and the Company to each other in 2008 and 2009, the arbitration tribunal appointed under the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce (the Arbitration Tribunal) in March 2010 ruled that the Company and RUE pay each other certain amounts of principal debt and penalties under certain contracts to which they were the parties resulting (after offset) in the Company's liability in favour of RUE of approximately USD 197 million (which UAH equivalent is approximately UAH 1.6 billion).
- In January 2009, the Company entered into an assignment agreement with Gazprom JSC and Gazprom Export LLC ("Assignment Agreement"). According to Assignment Agreement the Company acquired the right of claim to RUE in the amount of USD 1.7 billion. Subsequently, the Company withdrawn and appropriated natural gas belonging to RUE and stored in the storage facilities of the Company's subsidiary based on a gas storage contract in the volume of 11 billion cubic meters.

  In this regard, RUE made a submission in the arbitration proceedings between the Company and RUE claiming that the Company must compensate the value of the appropriated natural gas and pay penalties.

In June 2010, the Arbitration Tribunal ruled that the Company transfer to RUE the volume of natural gas in question (11 billion cubic meters) and 1.1 billion cubic meters of natural gas in discharge of a 10% penalty liability due to RUE under the gas storage contract between RUE and the Company (12.1 billion cubic meters in aggregate). The Arbitration Tribunal noted that the Company had expressly reserved its right of claim to RUE under the Assignment Agreement. The Company's management believes that in accordance with the Assignment Agreement and the underlying contracts the Company is entitled to receive USD 1.7 billion from RUE. Since the Company's management expects to exercise this right of claim against RUE as well as to return the 12.1 billion cubic meters of natural gas to RUE, the estimated amount of the provision (after offset) related to this Arbitration Tribunal is UAH 9.6 billion.

In 2010, the Company discharged all its liabilities to RUE as provided by the decision of the Arbitral Tribunal.

As at 31 December 2010, the provision was charged for purchased from Ukrnafta gas at regulated NKRE tariffs in amount of 2 335 million UAH (2009: 2 005 million UAH) associated with natural gas extraction produced by the entity; judgments might be given not in favor of the Group.

As at 31 December 2010, the provision was charged based on judgments on determination of tax liabilities of the Group in amount of 1 709 million UAH (2009: 596 million UAH).

Pension benefit obligations

The following tables summarise the components of net benefit expense recognised in the consolidated income statement and amounts recognised in the consolidated statement of financial position for the pension benefit plan.

Changes in pension obligations for the years ended 31 December, were as follows:

	2010	*2009*
Balance as at 1 January	727	628
Payment	(106)	(105)
Current services	60	68
Interest expenses for employee benefits	113	90
Cost of previously provided services	2	51
Sequester	(128)	-
Actuarial (loss) / profit	3	(5)
Balance as at 31 December	671	727

Pension payment obligations as at 31 December are as follows:

	2010	*2009*
Present cost of unsecured liabilities	632	794
Non-recognized actuarial profit / (loss)	52	(51)
Non-recognized past cost of provided services	(13)	(16)
Benefit liability recognised in the consolidated statement of financial position	671	727

As at 31 December employee benefit liabilities are analysed as follows:

	2010	*2009*
Non-current portion	584	664
Current portion	87	63
	671	727

In 2010 the company of the Group liquidated one pension plan related to payments to non-working retirees and decreased significantly payment parameters of other plans. Total sequester of the pension plans comprised UAH 128 million.

The principal assumptions used in determining retirement benefit obligations for the Group's plan are shown below:

	2010 %	*2009* %
Future salary increase	10-15	10-15
Discount rate	15	15-16
Turnover rate	3-20	3-10

15. Advances received and other current liabilities

	2010	*2009*
Advance received from JSC Gazprom	12,369	6,139
Taxes and similar charges payable	11,868	1,048
Other advances received from clients	1,432	237
Remuneration obligations	600	578
Interest-bearing restructured tax liabilities	26	5,569
Other liabilities	341	195
	26,636	13,766

In 2010, the Company received prepayment in amount of UAH 14,158 million from JSC Gasprom for the gas transportation through Ukraine.

16. Unregistered contributed capital

In October 2010, according to the Resolution of the Cabinet of Ministers of Ukraine dated 12 October 2010, the Company received from Shareholder OVDP for the amount of UAH 7.4 billion maturing in 2015-2017 and with an effective yield of 9.5%. Shareholder made this contribution of OVDP to pay for additional shares of the Company. At the date of these consolidated financial statements the Company obtained a temporary certificate of registration of shareholders, but shares in the amount of contributed OVDP were not issued and not registered by the State Securities and Stock Market Commission.

In November-December 2010, the Company sold these OVDP to state banks at par and yield.

17. Trade and other accounts payable

	2010	*2009*
Trade accounts and notes payable	3,041	9,035
Trade accounts and notes payable to related parties (Note 19)	5,271	3,399
	8,312	12,434

18. Commitments and contingencies

Operating environment

The Ukrainian economy while deemed to be of market status continues to display certain characteristics consistent with that of an economy in transition. These characteristics include, but are not limited to, low levels of liquidity in the capital markets, high inflation and the existence of currency controls which cause the national currency to be illiquid outside of Ukraine. The stability of the Ukrainian economy will be significantly impacted by the Government's policies and actions with regard to administrative, legal, and economic reforms. As a result, operations in Ukraine involve risks that are not typical for developed markets.

The Ukrainian economy is vulnerable to market downturns and economic slowdowns elsewhere in the world. The ongoing global financial crisis has resulted in decreased national gross product, considerable instability in the capital markets, significant deterioration in the liquidity of banks, much tighter credit conditions in Ukraine. Despite the stabilization actions taken by the Ukrainian government in order to support the banking sector and provide for Ukrainian banks and companies' stability, there is an uncertainty regarding the ability to access to capital sources and the cost of capital for the Group and its counteragents. This may affect the Group's financial position, operating results and economic perspectives.

The management believes it has taken all appropriate measures to support the sustainability of the Group's business in the current circumstances. However, further deterioration in the areas described above could negatively affect the Group's results and financial position in a manner not currently determinable.

Legal

In the ordinary course of business, the Company is subject to legal actions and complaints as a defendant. Where the risk of outflow of financial resources associated with such legal actions and complaints is deemed to be probable and the amount is measured with sufficient reliability, the Group has accounted for those contingencies as a component of provision for litigation (Note 14). Where management of the Group estimates the risk of financial resources outflow as possible or amount cannot be measured reliably, the Group does not make a provision for contingent liabilities. Those contingent liabilities are disclosed in these consolidated financial statements. Such contingencies may materialise in the future if outflow of resources will become probable. As at 31 December 2010, management estimates legal contingencies for open claims to be approximately up to UAH 1.9 billion.

Tax risks

The Group's operations and financial position will continue to be affected by developments in Ukraine including the application of existing and future legislation and tax regulations.

As at 31 December 2010 the Group had overdue tax debts mainly originated in periods before the reporting one. The tax authorities have appealed to the court to collect this debt and pledged assets according to established procedures of the Company as collateral for outstanding tax debt.

The Group is a defendant in a number of lawsuits with the tax authorities. Where the risk of outflow of additional resources caused by the uncertainties associated with the Ukrainian legislation and a regulation regarding taxation is deemed to be probable and the amount is reasonably determinable, the Group has accounted for those contingencies as a component of provision for litigation (Note 14).

Additionally, the Group has identified possible tax contingencies, which based on management best estimates are not required to be accrued. Such contingencies may materialise and require the Group to pay additional amount of taxes and other withholdings. As at 31 December 2010, management estimates such contingencies not to exceed UAH 5 billion.

State influence over Group's operations

The operation of oil and gas facilities is of great importance to Ukraine for various reasons including economic, strategic and national security considerations. The Ukrainian government is able to exercise significant control over the Group's operations through its ownership rights in Naftogas of Ukraine. Such influence may result in social and economic initiatives that may have a negative impact on the Group's current and future operations. Management is unable to estimate the level of influence that may be imposed in the future and the potential impact on its financial position and results of operations.

State regulation of the Group

The Government of Ukraine, represented by the Cabinet of Ministers of Ukraine, is the sole owner of Naftogas of Ukraine. The Ukrainian government controls the Group's operations through participation in the shareholders' meetings and Supervisory Board as well as through the appointment of the Chairman of the Board and deputies.

The Government and regulatory agencies (such as NKRE) monitor the Group's compliance with the Ukrainian regulations set for the oil and gas market. The government reserves the general authority to regulate tariffs and, directly or through government agencies, regulates the upper level of the tariffs and prices for principal activities of the Group. This fact together with other economic, juridical and financial uncertainties in Ukraine has and may continue to have implications on the future activity of the Group.

Ukrainian law mandates the government to identify those companies in strategic industry sectors, the privatisation of which is prohibited. Currently, Naftogas of Ukraine and its subsidiaries are identified as such companies.

The Government has previously required Naftogas of Ukraine to supply goods and services to customers at prices that may not be in the best interest of the Group. The Government sets the price level for gas delivered by Naftogas of Ukraine to the end customers. Pursuant to its charter, Naftogas of Ukraine was formed with a view to securing the effective functioning and development of the Ukrainian oil and gas infrastructure and satisfy customer demand for energy resources. The negative effect to the Group's financial position will depend on the extent that the Government requires these functions to override profit-maximisation.

Possible return of subsidiaries and Group assets to the State

In 1998, upon creation of the Company, the Government contributed to the statutory fund of Naftogas of Ukraine shares of certain joint-stock companies established by the State. These joint-stock companies included SJSC Long-Distance Pipeline "Druzhba" and SJSC Prydniprovsky long-distance pipeline, in 2001 reorganised into JSC Ukrtransnafta, Ukrspetstransgas, Chornomornaftogas, Ukrnafta and fifty four regional gas distribution companies. The Government may transfer ownership or control of all or part of Naftogas of Ukraine's equity interests in such joint-stock companies and the whole Ukrainian oil and gas transportation systems and storage facilities forming state-owned assets not subject to privatisation (see below) to other companies or Government agencies, which could have a material adverse effect on Naftogas of Ukraine's operations.

State property not subject to privatisation

In 1998, the Company entered into an agreement "On use of state property not subject to privatisation" (further - the "Agreement") with the State Property Fund and received into operational management oil and gas transportation systems of Ukraine. Pursuant to the Agreement, the Company is required, inter alia, to manage oil and gas trunk and distribution pipelines owned by the State of Ukraine and forming state property (further – "state property not subject to privatisation"), keep the state property in good operational condition, utilise it for the intended use and transfer 50% of profits derived from such exploitation to the State. The amount of such transfer can be reduced by the amount of reinvestments for renovating and technical development of the Group's assets, as agreed with the Ministry of Economy (see below).

The Agreement's term is one year and it is prolonged automatically each year, unless terminated by notice from either party, and is binding on the legal successors of each party. Historically, the agreement has been prolonged automatically, since neither party initiated its termination. It may be terminated in case the assets' that are the subject of the Agreement cease to be state property, or if a court decides that a breach of the terms and conditions of the Agreement has occurred.

As the state property not subject to privatisation forms an essential part of the Group's business (Note 7), the future operations and financial performance of the Group is dependent on the prolongation of the Agreement. The Company's management believes that despite any potential change in the provisions of the Agreement, the Group will act as operator of the state property in the oil and gas sector for the foreseeable future.

Determination of profits derived from the use of State property not subject to privatisation

According to the terms and conditions of the agreement "On use of state property not subject to privatisation" (see above), the Group is liable to the State for use of these assets. The agreement stipulates the payments to the State to be estimated as 50% of the profit earned from use of the assets as reduced by the amount of reinvestments for renovating and technical development of the Group assets, as agreed with the State.

The Agreement does not provide for a mechanism for calculation of the state share of profit generated from the assets under operational management. Also, the mechanism for reconciling the qualifying investments between the Group and the State has never been enacted. Therefore, there is an uncertainty as to the measurement of the liability to the State, if any, resulting from the use of the state-owned assets. Historically, the Group never paid any fees related to usage of the above-mentioned assets. The Group believes that had the mechanism for calculating the state portion of profit been determined by the State, the target investments made by the Group would be in excess of 50% of profit earned from the use of the assets. Accordingly, no provision for potential liability in this regard is recognised in these consolidated financial statements.

Licensing

The State has control over the licensing for conducting oil and gas exploration and production in Ukraine. In accordance with the current legislation, separate licenses are required for exploration, development and production activities for each oil and gas field. The legislation also requires obtaining licenses for oil and gas transportation, supply and storage. Licenses are given for a period from two to twenty years with a right to prolong them for a similar period.

Capital commitments

According to the agreements for the acquisition of property, plant and equipment, and exploration and development of oil and gas fields, the Group undertaken obligations in total amount of UAH 163 million to be fulfilled during 2011 (2010: UAH 231 million).

19. Related party disclosures

As the Group is controlled by the State, the majority of related party transactions the Group entered in are with related parties controlled by the State and with non-consolidated investees.

The following table provides the total amount of trading transactions that have been entered into with related parties for the year ended 31 December 2010:

	Sales	*Purchases*	*Amounts due from related parties*	*Amounts due to related parties*
Non-consolidated subsidiaries and associates not accounted for under equity method	9,776	1,058	1,817	3,797
Associates and joint-ventures	-	5	-	809
Other related parties – state-owned entities	1,610	943	745	665
	11,386	2,006	2,562	5,271

As at 31 December 2009	*Increase / (decrease) of interest rate (per cent)*	*Effect to profit before tax*
Change of interest rate (LIBOR)	+1%	2
Change of interest rate (LIBOR)	-0,25%	-

Credit risk

The Group trades on credit with legal entities. It is the Group's policy that customers who wish to trade on credit terms are subject to credit verification procedures and significant receivable balances are monitored on an ongoing basis. However, the Group currently is following state imposed regulations (see Note 18) and is mandated to supply significant volumes of natural gas to the population and state-owned entities irrespective of their creditworthiness, with the result that the Group's exposure to bad debts may be significant.

With respect to credit risk arising from other financial assets of the Group, which comprise cash and cash equivalents, and certain available-for-sale financial assets, the Group's exposure to credit risk arises from default of the counterparty, with a maximum exposure equal to the carrying amount of these instruments.

The Group has not entered into transactions designed to hedge against these credit risks.

Concentration risk

Financial instruments that potentially subject the Group to significant concentration risk consist principally of prepayments to suppliers and trade accounts payable. Concentration risk with respect to prepayments to suppliers and accounts payable is relatively high due to a continuous increase in the share of purchases from the same major suppliers. In 2010 the Group purchased gas predominantly from Gazprom.

Capital risk management

The Group considers debt and shareholder's equity to be its primary capital resources. The primary objective of the Group's capital management is to insure that it maintains a strong credit rating and healthy capital ratios in order to support its business.

The Group monitors capital using a gearing ratio, which is net debt divided by equity plus net debt. The Group includes within net debt, interest bearing loans and borrowings, trade and other payables, less cash and cash equivalents.

The Group's capital management policies aim to ensure and maintain an optimal capital structure to reduce the overall cost of capital and flexibility relating to the Group's access to capital markets.

	2010	*2009*
Interest bearing loans and borrowings (Note 13)	43,888	41,989
Accounts payable (Note 17)	8,312	12,434
Less: cash and cash equivalents (Note 20)	(2,654)	(1,780)
Net debt	49,546	52,643
Equity	81,007	80,208
Equity and net debt	130,553	132,851
Gearing ratio	38%	40%

Liquidity risk

The Group's objective is to maintain a balance between continuity of funding and flexibility through the use of credit terms provided by suppliers and bank loans. The Group analyses aging of its assets and maturity of its liabilities and plans its liquidity depending on expected repayment of various

instruments. In case of insufficient or excessive liquidity the Group reallocates resources and funds to provide optimal financing of its business needs.

As at 31 December 2010, cash and cash equivalents included cash on current bank accounts in local currency of UAH 2,599 million and foreign currency of UAH 55 million (2009: UAH 1,504 million and UAH 276 million).

The Group's principal sources of funds have been obtained from its cash flow from operating activity and loans and facilities provided by a number of lenders as described in Note 14. Credit facilities are used by the Group primarily for financing its investment in property, plant and equipment and working capital. As at 31 December 2010, the Group's current assets exceeded its current liabilities by UAH 7,303 million (2009: current liabilities exceeded current assets by UAH 25,054 million).

The table below summarises the maturity profile of the Group's financial liabilities as at 31 December 2010 based on contractual undiscounted payments.

Year ended 31 December 2010	*On demand*	*Less than 3 months*	*From 3 to 12 months*	*From 1 to 2 years*	*From 2 to 5 years*	*Over 5 years*	*Total*
Fixed-rate interest bearing loans and borrowings	(1)	(445)	(4,409)	(528)	(19,108)	(1,897)	(26,388)
Variable-rate interest bearing and borrowings	(146)	(369)	(360)	-	(16,625)	-	(17,500)
Trade and other payables	(1,033)	(1,667)	(341)	-	-	-	(3,041)
Payables to related parties	(10)	(800)	(4,461)	-	-	-	(5,271)
Other liabilities	-	(2,056)	(11,868)	-	-	-	(13,924)
Long-term liabilities	-	-	(13)	(170)	(191)	(96)	(470)
Non-interest bearing liabilities	(1,043)	(4,523)	(16,683)	(170)	(191)	(96)	(22,705)
	(1,190)	5,336)	(21,452)	(698)	(35,924)	(1,993)	(66,594)

Year ended 31 December 2009	*On demand*	*Less than 3 months*	*From 3 to 12 months*	*From 1 to 2 years*	*From 2 to 5 years*	*Over 5 years*	*Total*
Fixed-rate interest bearing loans and borrowings	(5)	(3,454)	(28,105)	(1,733)	(16,549)	-	(49,846)
Variable-rate interest bearing and borrowings	-	(20)	(436)	(59)	(98)	-	(613)
Trade and other payables	(899)	(3,049)	(5,051)	-	-	(36)	(9,035)
Payables to related parties	(90)	(709)	(2,600)	-	-	-	(3,399)
Other liabilities	(1,945)	(1,502)	(4,006)	-	-	-	(7,453)
Long-term liabilities	(9)	(4)	(16)	(44)	(87)	(53)	(213)
Non-interest bearing liabilities	(2,943)	(5,264)	(11,673)	(44)	(87)	(89)	(20,100)
	(2,948)	(8,738)	(40,214)	(1,836)	(16,734)	(89)	(70,559)

21. Fair value of financial instruments

As at 31 December 2010 and 2009, the carrying value of the Group's financial instruments approximates their fair values.

The carrying value of cash and cash equivalents, trade and other receivables, trade payables and other current liabilities approximate their fair value due to short-term maturities of these instruments. The fair value of long term financial liabilities is estimated by discounting the future contractual cash flows at the current market interest rate available to the Group for similar financial instruments. Fair value of quoted instruments is based on price quotation at the reporting date.

22. Subsequent events

A. In May 2011, the Law was adopted "On certain issues of debts for consumed natural gas and electric energy" No3319-VI, according to which debts for natural gas (including restructured debt) of entities producing, transporting and supplying heating energy, including liquidated enterprises, entities supplying natural at regulated tariffs, National Joint-Stock Company Naftogas of Ukraine and its subsidiaries SC Gas of Ukraine, SC Ukrtransgas, SC Ukrgasbydobuvannya, SLSC Chornomornaftogas accounted as at 1 January 2010 and unpaid at the date the Law became effective, are to be written-off.

   According to the management estimates, the write-off amount may be UAH 11,4 billion. As at 31 December 2010, the provision had been charged in full to that debt amount.

B. In May 2011, the Law of Ukraine was adopted "On changes in the Tax Code of Ukraine regarding issues of natural gas and electric energy taxation" No3320-VI, according to which the following items are to be written-off:

   - Tax debt as at 1 January 2011, including tax debts that arose due to the violation of tax, currency and customs legislation;
   - Non-agreed cash obligations and penalties with pending administrative or court dispute as determined by regulatory bodies as at 1 January 2011;
   - Deferred tax liabilities (considering interest accrued to the deferred amounts) on income tax and value added tax.

   Respective decisions on write-off of the above amounts are made by regulatory bodies within their competence as provided for the write-off of bad tax debts. Per management's estimates, tax liabilities to be written-off under the Law, may be UAH 16 billion.

C. According to the Resolution of the Cabinet of Ministers of Ukraine No46 dated 26 August 2011 and the Resolution of the Cabinet of Ministers of Ukraine No528 dated 23 May 2011 the Company's share capital was increased by UAH 7.4 billion and UAH 5 billion, respectively through contributing OVDP at corresponding par value.

D. According to the Resolution of the Cabinet of Ministers of Ukraine No1053 dated 10 October 2011, the National Joint-Stock Company Naftogas of Ukraine is liable to transfer during a month to the State Property Fund of Ukraine holdings of shares of gas distribution and gas supply entities aimed at their further privatization. Subject to transfer are holdings of shares based on the terms: for investments with ownership share less than 25% - the whole package, if NJSC Naftogas of Ukraine owns more than 25%, holding of shares exceeding 25% is subject to transfer.

E. According to the Decree of the Ministry of Energy and Coal Industry of Ukraine № 656 dated 27 October 2011 the activities of Subsidiary of "Gas of Ukraine" National Joint Stock Company "Naftogas of Ukraine" are ceased through its restructuring– joining the National Joint-Stock Company Naftogas of Ukraine and Subsidiary of Budivelnik, National Joint Stock Company Naftogas of Ukraine. Measures to reorganize Subsidiary "Gas of Ukraine" should be completed before 25 December 2012.