



# PETRO KAMCHATKA

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") for PetroKamchatka Plc ("PetroKamchatka", "the Corporation", "us" or "we"), prepared as at January 30, 2012, provides a review of the Corporation's unaudited financial results for the six months ended November 30, 2011 (the "Reporting Date"). The MD&A should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes of the Corporation for the three months ended August 31, 2011, the six months ended November 30, 2011 and the audited consolidated financial statements and accompanying notes of the Corporation for the year ended May 31, 2011. The condensed consolidated financial statements and all figures in this MD&A are presented in United States dollars, unless otherwise indicated.

The financial statements referred to above and other information with respect to the Corporation are available on PetroKamchatka's website ([www.petrokamchatka.com](http://www.petrokamchatka.com)) and in public filings available on SEDAR ([www.sedar.com](http://www.sedar.com)).

### Transition to International Financial Reporting Standards

The interim condensed consolidated financial statements and the MD&A have been prepared in accordance with International Financial Reporting Standards ("IFRS") representing generally accepted accounting principles ("GAAP") for publicly accountable enterprises listed in Canada. PetroKamchatka's transition date to IFRS was June 1, 2010. Comparative figures for 2011 and PetroKamchatka's consolidated financial position as at June 1, 2010 have been restated to IFRS from the previous Canadian GAAP ("Previous GAAP"). Reconciliations to IFRS from Previous GAAP consolidated financial statements, including the impact of the transition on the Company's reported financial position and financial performance; and the nature and effect of significant changes in accounting policies from those used in the Company's consolidated financial statements for the year ended May 31, 2011 are summarized in note 15 to the unaudited condensed consolidated financial statements.

### CORPORATE OVERVIEW

PetroKamchatka was incorporated on December 23, 2008 under the Companies (Jersey) Law 1991. The head office of the Corporation is located at 9 Esplanade, St. Helier, Jersey, JE23QA. It is principally engaged in exploration for oil and natural gas in the Kamchatka Peninsula of Russia which activity is conducted pursuant to exploration licenses granted to Russian subsidiaries and affiliates of its wholly-owned Cyprus subsidiary, PetroKamchatka Resources Ltd. ("PKR"). The common shares of the Company are listed for trading on the TSXV (trading symbol: "PKP"). The Corporation acquired PKR on November 23, 2009. As the Corporation was considered a continuation of PKR, the continuity of interest basis of accounting was followed.

The Corporation has the following subsidiaries and affiliates:

Name of Subsidiary or Affiliate	Country of Incorporation	Ownership Percentage		
		August 31, 2011	May 31, 2011	June 1, 2010
PetroKamchatka Resources Ltd.	Cyprus	100%	100%	100%
OJSC LukinCholot	Russia	90%	90%	90%
CJSC Kehta-Exploration	Russia	100%	100%	100%
CJSC Kingi-Exploration	Russia	100%	100%	100%
CJSC Palana-Exploration	Russia	100%	100%	100%
CJSC Tvayan-Exploration	Russia	100%	100%	100%
CJSC Tigil Exploration (affiliate)	Russia	50%	50%	50%
CJSC Icha Exploration (affiliate)	Russia	50%	50%	50%
Nabesche River Exploration Ltd.	Canada	100%	100%	100%
PetroKamchatka Services Inc.	Canada	100%	100%	100%

PKR owns 90% of OJSC LukinCholot (“LukinCholot”) which in turn owns 50% of the shares of CJSC Tigil Exploration and CJSC Icha Exploration (the “joint interest entities”). PKR is the direct owner of the other subsidiaries.

KNOC Kamchatka Petroleum Limited (“KKPL”), a company owned 55% by Korea National Oil Corporation (“KNOC”), owns the other 50% of the joint interest entities. This effectively provides the Corporation with an indirect, net 45% interest in the joint interest entities. The other 10% of LukinCholot is owned by the Koryakia Property Fund, an investment agency of the Koryakia Okrug Administration, Kamchatka. That entity’s indirect beneficial interest in the joint interest entities is 5%, being 10% of 50%. LukinCholot and KKPL split the cost to carry the 5% interest of the Koryakia Okrug Administration, which means that the Corporation pays 47.5% of costs and KKPL pays 52.5%. On August 11, 2009, PKR increased its percentage ownership in LukinCholot from 85% to 90%. This effectively increased the Corporation’s indirect share of costs from 46.25% prior to August 2009 to 47.5% after July 2009.

The Corporation’s strategy for achieving growth is to source and operate onshore exploration projects having the potential for large, low-cost reserves. To the Reporting Date, the Company had indirectly secured seven onshore exploration licenses in Kamchatka, representing an aggregate 3,281,755 net hectares. The seven licenses were: Tigil, Icha, Urginskaya, Pustaretskaya, Palanskaya, Ichinskaya and Vorovskaya. In fiscal 2010, the Company drilled two unsuccessful wells on its Tigil Block. These were the Corporation’s first and only wells drilled to date. Shortly thereafter, in the first quarter of fiscal 2011, the Corporation surrendered the Urginskaya, Pustaretskaya and Palanskaya exploration licenses back to the Russian Federal Ministry of Natural Resources (“MNFR”) as part of its capital monitoring process. Subsequently, the Tigil exploration license expired on December 31, 2010. Later, on March 28, 2011, the Icha exploration license was terminated by the MNFR based upon an application for early surrender from the shareholders of the jointly controlled entity holding the license. The shareholders had determined that the mapped prospects on that license were non-commercial on a fully risked basis.

At the Reporting Date, the Corporation continues to hold 100% interests in the Ichinskaya and Vorovskaya exploration licenses, representing 567,200 net hectares and 399,900 net hectares respectively. The Ichinskaya and Vorovskaya exploration licenses, scheduled to expire in September 2014, require the Corporation to meet minimum seismic, drilling and completion work commitments to maintain the licenses. At May 31, 2011, the Corporation determined that it did not have sufficient capital to complete its minimum commitments under the terms of the licenses. As a result, the Corporation recognized a write down at May 31, 2011 of the carrying value of these licenses of \$75,044.

The Corporation estimates that aggregate expenditures of approximately \$49 million would be required to meet the seismic and drilling work commitments of the Ichinskaya and Vorovskaya exploration licenses. In early

2012 the Corporation decided to seek early relinquishment of the Ichinskaya and Vorovskaya exploration licenses back to the MNFR.

On September 10, 2011, a wholly-owned Russian subsidiary of the Corporation received a new 5 year exploration license in Kamchatka from the Russian Federal Agency for Subsoil Use. The license, named 'Tigilskaya', is effectively the previously-held Tigil License, but with expanded acreage to the east. In total, the license covers 416,400 net hectares. It was granted on the basis of a work commitment to acquire 500 km of 2-D seismic prior to September 10, 2014 of which 200 km must be acquired prior to September 10, 2013. The work commitment also requires the drilling of two exploration wells: the first by September 10, 2015; and the second by September 10, 2016. The Corporation estimates expenditures of approximately \$51 million will be required to meet the minimum seismic and drilling work commitments of the Tigilskaya license. The Corporation is seeking partners to farm-in on its aggregate Kamchatka acreage.

When the exploration licenses in Tigil and Icha terminated, there were no future operations in these entities and the operating agreements with KKPL relating to Tigil and Icha expired. At May 31, 2011, the Corporation recognized a provision of \$795,451 as its estimated share of future costs to wind-up the joint venture. A substantial portion of this provision results from employee severance payments required under Russian law. There are no future operating benefits to be derived from the joint venture after the expiry of the exploration licenses. During the six months ended November 30, 2011, the provision for wind-up costs decreased by \$403,373 resulting in a remaining provision as at November 30, 2011 of \$392,078. On August 18, 2011, as part of the joint venture wind-up process, the shareholders of Tigil and Icha approved the terms and conditions of an auction to liquidate a mobile drilling rig and other equipment located in Russia. The auction was held on October 4, 2011, in Petropavlovsk, Kamchatka. The shareholders and their affiliates and other third parties were entitled to bid at the auction which was co-chaired by representatives from KKPL and LukinCholot. A wholly-owned Russian subsidiary of the Corporation was the highest bidder. From October 4, 2011, the Corporation's subsidiary owns 100% of the equipment, including a mobile drilling rig, and is responsible for 100% of ongoing costs of ownership. The fair value of the drilling rig and equipment at the time of acquisition was approximately \$8.0 million. A fair value adjustment in the second quarter resulted in an increase to property and equipment of \$3,600,628, deferred tax liability of \$1,587,885 and revaluation of property and equipment income of \$1,684,878.

## **SECOND QUARTER 2012 UPDATE**

In May, 2011, the Corporation announced it had signed a non-binding Letter of Intent whereby the Corporation would issue common shares in exchange for the outstanding shares of Advastor Services Ltd. ("Advastor"), a Cyprus entity. Advastor owns 100% of four Russian entities which in turn hold six exploration licenses in northern European Russia, an established oil and gas producing region close to existing production and transportation infrastructure. The transaction is subject to due diligence and for the Corporation to complete a financing of a minimum of \$30 million. As at January 27, 2012, a definitive binding agreement has not been reached with Advastor. Therefore, PetroKamchatka continues to review additional opportunities to enter other oil-producing basins in Russia, typically involving privately-held acreage with post-exploration risk hydrocarbons that require access to the capital markets to be further developed.

During the six month period ended November 30, 2011, the Corporation continued its cost-monitoring program in order to preserve capital.

At November 30, 2011, the Corporation's working capital was \$2,608,441 (May 31, 2011 - \$1,991,870) including cash of \$1,456,761 (May 31, 2011 - \$4,045,212). In the first half of 2012 the Corporation's investment in a drilling rig of \$2,312,500, at November 30, 2011, was reclassified to current assets, as that asset is available for immediate sale. The investment was previously recognized as non-current asset. This fair value of drilling rig is based current market conditions, estimated maintenance costs required to return the drilling rig to safe operating conditions as provided by rig manufacturers, and estimated transportation and storage costs. The fair value is based on estimates and the actual sale proceeds from the drilling rig may differ materially from these estimates. The Corporation has no debt.

The Corporation's capital expenditures on property and equipment in the three and six month periods ended November 30, 2011 amounted to \$30,915 and \$9,720 and \$764,882 respectively for the three and six month periods ended November 30, 2010.

## SELECTED FINANCIAL INFORMATION

The consolidated financial information for PetroKamchatka includes the Corporation and its subsidiaries as well as its proportionate share of the accounts of its joint interest entities.

Financial Results	Three months ended November 30,	
	2011	2010
Expenses		
Equipment operating expenses and other	\$ (60,947)	\$ 533,615
General and administration	\$ 692,245	\$ 540,929
Other expenses (recovery)	\$ (18,632)	\$ –
Share-based compensation	\$ 8,664	\$ 89,039
Depreciation	\$ 550,764	\$ 223,876
Impairment	\$ 1,824,760	\$ –
Loss before interest and income taxes	\$ 2,996,854	\$ 1,387,456
Finance expense	\$ 39,015	\$ 2,425
Deferred income tax recovery	\$ (69,076)	\$ –
<b>Net loss for the period</b>	<b>\$ 2,966,793</b>	<b>\$ 1,389,881</b>
Other comprehensive (income) loss		
Foreign exchange differences on translation of foreign operations	\$ 235,905	\$ 27,386
Revaluation of property and equipment	\$ (1,684,878)	\$ –
<b>Total comprehensive loss for the period</b>	<b>\$ 1,517,820</b>	<b>\$ 1,417,267</b>
Total comprehensive loss attributable to:		
Shareholders of the corporation	\$ 1,446,820	\$ 1,319,932
Non-controlling interest in subsidiary	\$ 71,000	\$ 97,335
<b>Net loss and comprehensive loss for the period</b>	<b>\$ 1,515,820</b>	<b>\$ 1,417,267</b>
Net loss per share – basic and diluted	\$ (0.01)	\$ (0.00)
Weighted average number of common shares outstanding – basic and diluted	490,396,137	489,739,640
Cash flow provided by (used in) operations	\$ (1,452,484)	\$ (1,512,495)
Cash flow used in investing	\$ (30,915)	\$ (9,270)
Cash flow provided by financing	\$ –	\$ –
Increase (decrease) in cash and cash equivalents	\$ (1,483,399)	\$ (1,521,765)
Cash and cash equivalents	\$ 1,456,761	\$ 5,398,600
Working capital	\$ 2,608,441	\$ 4,849,003
Total assets	\$ 11,543,788	\$ 31,974,101
Total liabilities	\$ 3,119,689	\$ 1,928,058
Total equity attributable to owners of the Corporation	\$ 10,506,537	\$ 30,152,029

	<b>Six months ended November 30,</b>	
<b>Financial Results</b>	<b>2011</b>	<b>2010</b>
Expenses		
Equipment operating expenses and other	\$ (9,183)	\$ 697,055
General and administration	\$ 1,518,437	\$ 1,137,981
Other expenses (recovery)	\$ 119,008	\$ –
Share-based compensation	\$ 32,064	\$ 233,054
Depreciation	\$ 945,433	\$ 447,752
Impairment	\$ 1,824,760	\$ –
Loss before interest and income taxes	\$ 4,430,519	\$ 2,515,842
Finance expense	\$ 30,603	\$ –
Deferred income tax recovery	\$ (69,076)	\$ –
<b>Net loss for the period</b>	<b>\$ 4,392,046</b>	<b>\$ 2,515,842</b>
Other comprehensive (income) loss		
Foreign exchange differences on translation of foreign operations	\$ 460,075	\$ 34,368
Revaluation of property and equipment	\$ (1,684,878)	\$ –
<b>Total comprehensive loss for the period</b>	<b>\$ 3,167,243</b>	<b>\$ 2,550,210</b>
Total comprehensive loss attributable to:		
Shareholders of the corporation	\$ 3,045,618	\$ 2,444,124
Non-controlling interest in subsidiary	\$ 121,625	\$ 105,986
<b>Net loss and comprehensive loss for the period</b>	<b>\$ 3,167,243</b>	<b>\$ 2,550,210</b>
Net loss per share – basic and diluted	\$ (0.01)	\$ (0.00)
Weighted average number of common shares outstanding – basic and diluted	490,396,137	489,606,631
Cash flow provided by (used in) operations	\$ (2,500,429)	\$ (1,737,441)
Cash flow used in investing	\$ (30,915)	\$ (764,882)
Cash flow provided by financing	\$ –	\$ –
Increase (decrease) in cash and cash equivalents	\$ (2,531,344)	\$ (2,502,323)
Cash and cash equivalents	\$ 1,456,761	\$ 5,398,600
Working capital	\$ 2,608,441	\$ 4,849,003
Total assets	\$ 11,543,788	\$ 31,974,101
Total liabilities	\$ 3,119,689	\$ 1,928,058
Total equity attributable to owners of the Corporation	\$ 10,506,537	\$ 30,152,029

## RESULTS OF OPERATIONS

### Equipment Operating Expenses and Other

Total 'equipment operating expenses and other' during the three and six months ended November 30, 2011 amounted to recoveries of \$60,947 and \$9,183 respectively, net of VAT recoveries. The Corporation's share of estimated expenses to wind-up its joint venture with KKPL of \$795,451 were accrued at May 31, 2011. The provision was reduced in the three months ended August 31, 2011 by \$249,201 to \$546,250 at August 31, 2011. Revisions in the three months ended November 30, 2011, reduced the provision for wind-up costs to

\$392,078 resulting in a recovery in the current reporting period. Total 'equipment operating expenses and other' during the three and six months ended November 30, 2010 were \$533,615 and \$697,055 respectively.

The Corporation also owns a 46.25% interest in a drilling rig (the "HighKelly rig") which is available for immediate sale at the Reporting Date. The HighKelly rig is currently stored at a secure facility in Shanghai, China. The remaining 53.75% of the HighKelly rig is owned by KKPL. The Corporation's share of storage, legal, inspection and other costs relating to its net interest in the HighKelly rig are also included in 'equipment operating expenses and other'. In the three and six month periods ended November 30, 2011, these expenses amount to \$24,205 and \$40,576 respectively and during the three and six month periods ended November 30, 2010, \$24,892 and \$47,869 respectively.

On August 18, 2009, KKPL initiated an arbitration proceeding in The International Court of Arbitration against the manufacturer of the rig in respect of an alleged claim by KKPL that the manufacturer failed to comply with certain of its contractual obligations to manufacture and deliver a customized rig to KKPL in compliance with specific contracted requirements. Pursuant to KKPL's request for arbitration, KKPL is seeking damages for the alleged breach. KKPL has agreed to suspend arbitration proceedings against the manufacturer until June 30, 2012, in order for the Corporation and KKPL to work towards a sale of the HighKelly rig.

### General and Administrative Expenses

General and administrative expenses for the three months ended November 30, 2011 were \$692,245 and \$540,929 for the three months ended to November 30, 2010. For the six months ended November 30, 2011 and November 30, 2010 general and administrative expenses were \$1,518,437 and \$1,137,981 respectively. The main reason for this increase is a reduction in indirect overhead recoveries from the Tigil and Icha joint ventures following the termination of joint venture operations upon the expiry or surrender of exploration licenses. The Corporation continues its ongoing efforts to monitor and reduce costs in order to preserve capital.

### Other Expenses

Other expense represents the recognition of a provision for onerous contracts relating to non-cancellable office leases in Canada. In 2008, the Corporation entered into two leases for office space in Canada. Due to changes in its activities, the Corporation has ceased to completely use this office space as at the Reporting Date. The leases expire on June 30, 2013. Management estimates that 75% of the office space is surplus to its needs. The obligation for 75% of the discounted future payments has been provided for as 'onerous contract.' The provision is net of an estimate of sublease income that may be realizable.

Undiscounted future net minimum lease payments for these leases before recoveries, if any, by fiscal year are as follows:

Fiscal year 2012 remaining	\$ 132,000
Fiscal year 2013	264,000
Fiscal year 2014	22,000
	<hr/>
	\$ 418,000

### Share-Based Compensation

The calculation of share-based compensation under IFRS differs from that under Previous GAAP. Under Canadian GAAP, the Corporation recognized an expense related to its share-based payments on a straight-line basis through the date of full vesting and did not incorporate a forfeiture multiple. Under IFRS, the Company recognizes the expense over the individual vesting periods for the graded vesting awards and estimates a forfeiture rate. IFRS 2 was not applied to equity instruments which vested before the Transition Date. Under IFRS, share-based compensation expense for the three month periods ended November 30, 2011 and 2010 amounted to \$8,664 and \$89,039 respectively. Share-based compensation expense for the six month periods ended November 30, 2011 and 2010 amounted to \$32,064 and \$233,054 respectively. The decrease is mainly the result of expired and forfeited options and revaluation of non-employee options in the current year.

The prior period amount included \$31,875 in share compensation to directors in exchange for services. There is no comparable share compensation in the first half of fiscal 2012.

### **Depreciation Expense**

Under IFRS, depreciation expense is recorded for all periods including those periods when the equipment is idle. The only time depreciation is not recorded is when equipment is held-for-sale. Despite the liquidation auction referred to above, which was planned as part of a process to wind up the joint venture between the Corporation and KKPL relating to Tigil and Icha, the Corporation considers that the equipment is being held for use. Depreciation expense recorded in the three month periods ended November 30, 2011 and 2010 was \$550,764 and \$223,876 respectively and for the six months ended November 30, 2011 and 2010, \$945,433 and \$447,752 respectively.

Depreciation was calculated on a more explicitly-defined component basis using revised estimates of depreciation rates, estimated useful lives and residual values. In addition, instead of depreciation based on historical costs, the depreciation is calculated on the basis of the amount of fair value, an election made by the Corporation under IFRS. Fair value is considered to be the greater of fair value based on value-in-use; or fair value based on estimated selling price less estimated costs to sell. The fair value determinations were based on independent appraisals of the equipment at the Corporation's Transition Date to IFRS and at May 31, 2011. The equipment is presently stored in Kamchatka pending future seismic and drilling assignments. The adjustment to fair value at the Transition Date of \$4,447,941 under IFRS required a reduction of \$2,495,456 in the carrying value of equipment from that measured under Previous GAAP. The acquisition of the remaining 53.75% of the equipment in October, 2011 resulted in a fair value increase of \$4,001,628.

### **Net Financing Costs (Income)**

In the three month periods ended November 30, 2011 and 2010 net financing expense amounted to \$39,015 and \$2,425 respectively. In the six month periods ended November 30, 2011 and 2010 net financing expense was \$30,603 and \$nil respectively. The Corporation has no term debt and no bank lines of credit or banking facilities, other than for depositing funds.

### **Other Comprehensive Income or Loss**

In the three month period ended November 30, 2011 foreign exchange differences on translation of foreign operations resulted in comprehensive loss of \$235,905 compared to comprehensive loss of \$27,386 in the three months ended November 30, 2010. In the six months ended November 30, 2011 and 2010 foreign exchange differences on translation of foreign operations resulted in a comprehensive loss of \$460,075 and \$34,368 respectively. PetroKamchatka is exposed to foreign currency fluctuations as it holds cash and incurs capital expenditures and expenses in Russian roubles, Euros, Pounds Sterling and Canadian Dollars and is exposed to fluctuations in exchange rates of these currencies relative to the US dollar. There were no forward foreign exchange rate contracts in place as at November 30, 2011 or at any time during the reporting periods ended November 30, 2011 or May 31, 2011 or thereafter. The Corporation has determined that the functional currencies for each legal entity in the following countries were as follows:

Jersey – USD;  
Cyprus – USD;  
Russia – RUR;  
Canada – CAD.

In the three and six month periods ended November 30, 2011 the Corporation recognized a revaluation gain on the acquisition of 50% interest in the mobile drilling rig and equipment acquired in October, 2012. A fair value adjustment in the second quarter resulted in an increase to property and equipment of \$3,600,628, deferred tax liability of \$1,587,885 and revaluation of property and equipment income of \$1,684,878. This gain was partially offset by a \$2,121,710 reduction in the fair value of the HighKelly rig during the same period of which \$1,824,760 was recorded as an impairment in profit and loss and \$296,950 was recorded as a reduction of 'Revaluation reserve'.

## **Allocation of Loss to Shareholders and Non-Controlling Interest in Subsidiary**

Under Previous GAAP, the reporting emphasis was solely towards the shareholders of the Corporation. Under IFRS, the reporting emphasis is on the entity with recognition of non-controlling interests ("NCIs") in subsidiaries if any. Under Previous GAAP, minority interest in losses was not recognized. Under IFRS, losses applicable to a NCI in a subsidiary are allocated even if doing so causes the NCI to have a deficit balance. LukinCholot has a 10% shareholder. The recognition of the NCI's interest in LukinCholot's losses is recognized prospectively from the Transition Date under IFRS elections for First-time Adoptors of IFRS. In the three month periods ended November 30, 2011 and 2010, the NCI's share of net loss recognized in the periods was \$44,147 and \$74,429 respectively. The NCI's share of total comprehensive loss for the same periods was \$71,000 and \$97,335. The Corporation's share of the net loss in the three month periods ended November 30, 2011 and 2010 was \$2,922,646 and \$1,315,452 respectively. The Corporation's share of total comprehensive loss in these periods was \$1,446,820 and \$1,319,932 respectively.

In the six month periods ended November 30, 2011 and 2010, the NCI's share of net loss recognized in the periods was \$78,377 and \$107,373 respectively. The NCI's share of total comprehensive loss for the same periods was \$121,625 and \$105,986. The Corporation's share of net loss in the six month periods ended November 30, 2011 and 2010 was \$4,313,709 and \$2,408,469 respectively. The Corporation's share of total comprehensive loss in these periods was \$3,045,618 and \$2,444,124 respectively.

## **Recognition of Impairments Under IFRS**

At the Transition Date, the adjustment of the carrying value of equipment to fair value of \$4,447,941 under IFRS required a reduction of \$2,495,456 in the carrying value of equipment from that measured under Previous GAAP. In the three and six month periods ended November 30, 2011 the Corporation recorded an impairment of the carrying value to the fair value of the investment in drilling rig of \$2,121,710 of which \$296,950 was applied against prior period revaluation gains included in 'Equity' and the balance, \$1,824,760, was included in profit and loss.

## **Net Loss and Cash Used in Operations**

The total comprehensive loss for the three and six months ended November 30, 2011 was \$1,517,820 and \$3,167,243 respectively and for the three and six months ended November 30, 2010, \$1,417,267 and \$2,550,210 respectively.

Cash flow used in operations in the three and six months ended November 30, 2011 was \$1,452,484 and \$2,500,429 compared to cash flow used in operations for the three and six months ended November 30, 2010 of \$1,512,495 and \$1,737,441. The change in 'cash flow used in operations' was mainly due to a net reduction in the monetization of non-cash working capital, a decrease in equipment operating expenses and increased general and administration expenses due to lower recoveries from joint venture operations.

## SUMMARY OF QUARTERLY RESULTS

	For the three month periods ended			
	Previous GAAP – note 1		IFRS	
	February 28, 2010	May 31, 2010	August 31, 2010	November 30, 2010
Revenue	\$ -	\$ -	\$ -	\$ -
Expenses				
Equipment operating expense and other (recovery)	\$ -	\$ -	\$ 163,440	\$ 533,615
General and administration	\$ -	\$ -	\$ 597,055	\$ 540,929
Share-based compensation	\$ -	\$ -	\$ 175,890	\$ 89,039
Depreciation	\$ -	\$ -	\$ 223,876	\$ 223,876
Impairments	\$ -	\$ 30,965,917	\$ -	\$ -
Other expenses (income)	\$ 993,747	\$ 1,188,332	\$ -	\$ -
Total expenses	\$ 993,747	\$ 32,154,249	\$ 1,160,261	\$ 1,387,456
Net financing (income) expense	\$ (64)	\$ (69,003)	\$ (2,425)	\$ 2,425
Deferred income tax	\$ -	\$ -	\$ -	\$ -
Net loss for the period	\$ (993,683)	\$ (32,085,246)	\$ 1,157,836	\$ 1,389,881
Other comprehensive (income) loss				
Foreign exchange differences on translation of foreign operations	\$ -	\$ -	\$ (24,893)	\$ 27,386
Revaluation of property and equipment	\$ -	\$ -	\$ -	\$ -
Changes in fair value of available-for-sale financial assets	\$ -	\$ -	\$ -	\$ -
Net comprehensive (income) loss for the period	\$ (993,683)	\$ (32,085,246)	\$ (24,893)	\$ 27,386
Total comprehensive loss for the period	\$ (993,683)	\$ (32,085,246)	\$ 1,132,943	\$ 1,417,267
Loss attributable to:				
Shareholders of the Corporation	\$ (993,683)	\$ (32,085,246)	\$ 1,126,958	\$ 1,315,452
Non-controlling interest in subsidiary	\$ -	\$ -	\$ 5,985	\$ 74,429
Weighted average number of common shares outstanding – basic and diluted	488,498,041	488,498,041	489,475,067	489,739,640
Net loss per share – basic and diluted	\$ (0.00)	\$ (0.08)	\$ (0.00)	\$ (0.00)
Cash flow provided by (used in) operations	\$ 43,992	\$ (871,098)	\$ (224,946)	\$ (1,512,495)
Cash flow provided by (used in) investing	\$ (3,347,284)	\$ (2,259,592)	\$ (755,612)	\$ (9,270)
Cash flow provided by (used in) financing	\$ (228,795)	\$ 3	\$ -	\$ -
Foreign exchange gain (loss) on cash held in foreign currencies	\$ (130,349)	\$ (423,174)	\$ 19,080	\$ (33,572)
Increase (decrease) in cash and cash equivalents in the fiscal period ended	\$ (3,662,436)	\$ (3,553,861)	\$ (961,478)	\$ (1,521,765)

(1) PetroKamchatka's IFRS transition date was June 1, 2010. Comparative quarterly information prior to this date has not been restated.

	For the three month periods ended			
	Subject to Restatement and Future Review		IFRS	
	February 28, 2011	May 31, 2011	August 31, 2011	November 30, 2011
Revenue	\$ -	\$ -	\$ -	\$ -
Expenses				
Equipment operating expense and other (recovery)	\$ 999,800	\$ 653,724	\$ 51,764	\$ (60,947)
General and administration	\$ 503,411	\$ 703,146	\$ 826,192	\$ 692,245
Share-based compensation	\$ 33,795	\$ 25,768	\$ 23,400	\$ 8,664
Depreciation	\$ 223,876	\$ 223,876	\$ 394,669	\$ 550,764
Impairments	\$ 17,013,932	\$ 75,044	\$ -	\$ 1,824,760
Other expenses	\$ -	\$ 795,451	\$ 137,640	\$ (18,632)
Total expenses	\$ -	\$ -	\$ 1,433,665	\$ 2,996,854
Net financing (income) expense	\$ -	\$ -	\$ (8,412)	\$ 39,015
Deferred income tax	\$ -	\$ -	\$ -	\$ (69,076)
Net loss for the period	\$ -	\$ -	\$ 1,425,253	\$ 2,966,793
Other comprehensive (income) loss				
Foreign exchange differences on translation of foreign operations	\$ -	\$ -	\$ 224,170	\$ 235,905
Revaluation of property and equipment	\$ -	\$ (1,580,763)	\$ -	\$ (1,684,878)
Changes in fair value of available-for-sale Assets	\$ -	\$ (296,950)	\$ -	\$ -
Net comprehensive (income) loss for the period	\$ -	\$ -	\$ 224,170	\$ (1,448,973)
Total comprehensive loss for the period	\$ -	\$ -	\$ 1,649,423	\$ 1,517,820
Loss attributable to:				
Shareholders of the Corporation	\$ -	\$ -	\$ 1,598,798	\$ 2,922,646
Non-controlling interest in subsidiary	\$ -	\$ -	\$ 50,625	\$ 44,147
Weighted average number of common shares outstanding – basic and diluted	490,345,076	490,396,137	490,396,137	490,396,137
Net loss per share – basic and diluted	\$ (0.04)	\$ (0.01)	\$ (0.00)	\$ (0.01)
Cash flow provided by (used in) operations	\$ (1,862,182)	\$ 953,036	\$ (1,047,945)	\$ (1,452,484)
Cash flow provided by (used in) investing	\$ (442,236)	\$ (10,287)	\$ -	\$ (30,915)
Cash flow provided by (used in) financing	\$ -	\$ -	\$ -	\$ -
Foreign exchange gain (loss) on cash held in foreign currencies	\$ 27,929	\$ (19,648)	\$ -	\$ (41,009)
Increase (decrease) in cash and cash equivalents in the fiscal period ended	\$ (2,276,489)	\$ 923,101	\$ (1,047,945)	\$ (1,483,399)

## SUMMARY OF GENERAL AND ADMINISTRATIVE EXPENSES BY QUARTER

	For the three month periods ended			
	Previous GAAP – note 1		IFRS	IFRS
	February 28, 2010	May 31, 2010	August 31, 2010	November 30, 2010
Employee salaries and benefits	\$ 243,486	\$ 87,788	\$ 75,901	\$ 179,622
Professional fees and consultants	\$ 140,611	\$ 1,103,110	\$ 395,299	\$ 192,571
Directors fees and expenses	\$ 108,019	\$ 82,515	\$ 43,741	\$ 120,626
Office administration and other	\$ 241,955	\$ (462,325)	\$ 82,114	\$ 48,107
<b>Total</b>	<b>\$ 734,071</b>	<b>\$ 811,088</b>	<b>\$ 597,055</b>	<b>\$ 540,926</b>
	For the three month periods ended			
	IFRS	IFRS	IFRS	IFRS
	February 28, 2011	May 31, 2011	August 31, 2011	November 30, 2011
Employee salaries and benefits	\$ 178,457	\$ 188,783	\$ 180,431	\$ 191,134
Professional fees and consultants	\$ 186,327	\$ 325,093	\$ 315,426	\$ 275,728
Directors fees and expenses	\$ 80,044	\$ 60,147	\$ 63,750	\$ 69,072
Office administration and other	\$ 58,583	\$ 129,123	\$ 266,585	\$ 156,311
<b>Total</b>	<b>\$ 503,411</b>	<b>\$ 703,146</b>	<b>\$ 826,192</b>	<b>\$ 692,245</b>

(1) PetroKamchatka's IFRS transition date was June 1, 2010. Comparative quarterly information prior to this date has not been restated. In the three months ended May 31, 2010, costs were reallocated between 'employee salaries and benefits'; 'professional fees' and 'office administration and other' categories to be consistent with allocations at the end of Fiscal 2010.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

PetroKamchatka is engaged in the exploration for petroleum and natural gas in the Kamchatka Peninsula of Russia but does not yet have reserves, production or revenue from operations. PetroKamchatka has historically funded its operations through equity financings.

The consolidated financial statements were prepared on the basis of accounting principles applicable to a 'going concern' which assumes that the Corporation will realize its assets and discharge its liabilities in the normal course of business. If the going concern assumption was not appropriate for the consolidated financial statements, then adjustments would be necessary to adjust the carrying value of assets and liabilities, reported expenses and to revise the balance sheet classifications used.

At November 30, 2011, the Corporation's working capital was \$2,608,441 (May 31, 2011 - \$1,991,870). Working capital at November 30, 2012 includes the reclassification of the Company's investment in a drilling rig of \$2,312,500 to current assets as that investment was made available for immediate sale. This amount is net of an fair value adjustment recorded in the second quarter of 2012 of \$2,121,710. The investment was previously recognized as non-current asset. Other components of working capital at November 30, 2011 included cash and cash equivalents of \$1,456,761, accounts receivable of \$355,959 and prepaid expenses of \$40,459 less accounts payable and accrued liabilities of \$1,089,794 and provisions of \$467,444. The fair value adjustment is the result of current market conditions, estimated maintenance costs required to return the drilling rig to safe operating conditions provided by rig manufacturers, and estimated transportation and storage costs.

The fair value is based on estimates and the actual sale proceeds from the drilling rig may differ materially from these estimates. The Corporation has no debt. There were no funds raised from equity issues in the six month periods ended November 30, 2011 or 2010.

The Corporation's capital expenditures on property and equipment in the six month periods ended November 30, 2011 and 2010 amounted to \$30,915 and \$764,882 respectively.

## **Capital management**

### **A major risk is whether or not the Corporation has sufficient capital to sustain itself.**

At November 30, 2011, the Corporation's consolidated working capital of \$2,608,441 and the fact the Corporation has no debt are positive factors supporting a 'going-concern' status. If the investment in drilling rig is excluded from current assets, the other components of the Corporation's working capital as at November 30, 2011, decreased by \$1,769,199 from the other working capital components at the May 31, 2011. The Corporation needs to realize its investment in the drilling rig. The Corporation's financial risk must be considered in more depth given the stage of its operations and funding limitations. Although management has undertaken significant cost reduction measures, the Corporation continues to incur equipment operating costs, general and administrative and other expenses. The Corporation has no cash inflow, nor is there any assurance that it can raise additional capital under current market conditions or sell its interest in the HighKelly drilling rig.

**The Corporation currently does not have sufficient capital to meet all of its commitments under the terms of its exploration licenses and will likely need additional funding, possibly from the sale of the HighKelly drilling rig and equity funding, to continue operations.** It could lose part or all of its remaining interests in the Russian exploration licenses if it fails to obtain additional funding. The exploration of the Corporation's properties depends on its ability to obtain equity financing, debt financing, strategic partnerships or other means. Management of the Corporation will monitor the Corporation's capital spending on its projects in Russia and its general and administrative expenses and will make modifications to its current plans as and when necessary.

The drilling of two dry holes in fiscal 2010 has negatively impacted the ability of the Corporation to raise additional capital. Whether or not the Corporation will realize its net interest in the HighKelly drilling rig is uncertain. Although the demand for drilling rigs has increased since June 1, 2010 and general market conditions have improved, the location of the HighKelly rig contributed to decreases in its fair value.

In May, 2011, the Corporation announced it had signed a non-binding Letter of Intent whereby the Corporation would issue common shares in exchange for the outstanding shares of Advastor Services Ltd. ("Advastor"). Advastor owns 100% of four Russian entities which in turn hold six exploration licenses in northern European Russia, an established oil and gas producing region close to existing production and transportation infrastructure. The transaction is subject to due diligence and for the Corporation to complete a financing of a minimum of \$30 million. As at January 27, 2012, a definitive binding agreement has not been reached with Advastor. Therefore, PetroKamchatka continues to review additional opportunities to enter other oil-producing basins in Russia, typically involving privately-held acreage with post-exploration risk hydrocarbons that require access to the capital markets to be further developed.

## Capital expenditures

The following table indicates the Corporation's net share of capital expenditures and recoveries, excluding additions of \$260,000 acquired through the issuance of the Corporation's common shares in Q2, 2010.

	For the three month periods ended			
	February 28, 2010	May 31, 2010	August 31, 2010	November 30, 2010
Russia petroleum and natural gas properties	\$ 3,239,957	\$ 2,827,912	\$ 794,827	\$ 9,270
Less VAT recoveries	\$ (1,013,494)	\$ (1,553,409)	\$ (39,215)	\$ -
	\$ 2,226,463	\$ 1,274,503	\$ 755,612	\$ 9,270
Canada petroleum and natural gas properties	\$ -	\$ 165,850	\$ -	\$ -
Joint interest drilling rig	\$ -	\$ 198,296	\$ -	\$ -
Property and equipment	\$ -	\$ -	\$ -	\$ -
Other equipment – Russia	\$ -	\$ (286,017)	\$ -	\$ -
Office furniture and equipment	\$ 8,477	\$ (44,488)	\$ -	\$ -
<b>Total capital expenditures</b>	<b>\$ 2,234,940</b>	<b>\$ 1,308,143</b>	<b>\$ 755,612</b>	<b>\$ 9,270</b>
	For the three month periods ended			
	February 28, 2011	May 31, 2011	August 31, 2011	August 31, 2011
Russia petroleum and natural gas properties	\$ 18,888	\$ 10,497	\$ -	\$ -
Less VAT recoveries	\$ -	\$ -	\$ -	\$ -
	\$ 18,888	\$ 10,497	\$ -	\$ -
Canada petroleum and natural gas properties	\$ -	\$ -	\$ -	\$ -
Joint interest drilling rig	\$ -	\$ -	\$ -	\$ -
Property and equipment	\$ -	\$ -	\$ -	\$ 30,915
Other equipment - Russia	\$ -	\$ -	\$ -	\$ -
Office furniture and equipment	\$ -	\$ -	\$ -	\$ -
<b>Total capital expenditures</b>	<b>\$ 18,888</b>	<b>\$ 10,497</b>	<b>\$ -</b>	<b>\$ 30,915</b>

During the three month period ended November 30, 2011, PetroKamchatka capital expenditures on its Russian oil and gas properties and equipment were \$30,915 compared to \$9,270 in the three month period ended November 30, 2010. It was determined subsequent to November 30, 2010 that the mapped prospects on the Icha license were non-commercial on a fully risked basis. In the third quarter of fiscal 2011, the Corporation recorded a writedown of \$17,013,932 representing its capitalized carrying costs under Previous GAAP in the Icha license.

PetroKamchatka's future capital requirements will focus on the resource evaluation of its Tigilskaya exploration license and its work commitments under those Russian exploration licenses together with any additional interests in Russian licenses the Corporation may acquire. In early 2012 the Corporation decided to seek early relinquishment of the Ichinskaya and Vorovskaya exploration licenses back to the MNFR. The 2012 work program and budgets are subject to approval by the Board of Directors and upon the ability of the Corporation to obtain adequate financing.

## Equity

As at November 30, 2011, PetroKamchatka had 490,396,137 common shares, 19,516,940 warrants and 16,581,000 options outstanding. The option exercise prices were out-of-the-money at November 30, 2011 and January 27, 2012. The exercise prices of the 19,516,940 warrants were out-of-the-money on November

30, 2011 and expired unexercised on December 10, 2011.

## CONTRACTUAL OBLIGATIONS

Under the terms and conditions of its Russian exploration licenses, the Corporation is committed to the completion of seismic work programs and the drilling of exploration wells by certain dates in order to maintain the licenses in good standing. Requests for extensions have been granted in the past and were based on discretion at the time of the request but do not assure that such extensions would be granted in the future. Although an early surrender of an exploration license has been accepted in the past, there is no assurance that this would be accepted in the future.

### Russian Licenses

At November 30, 2011, the Corporation held 100% interests in the Ichinskaya and Vorovskaya exploration licenses, which were acquired in September 2009. The licenses, valid until September 2014, each require minimum seismic, drilling and completion programs in the first two to three years of the license term. The Corporation has determined that it currently does not have sufficient capital to complete its minimum commitments under the terms of the Ichinskaya and Vorovskaya licenses. Effective May 31, 2011, the Corporation recorded a write down of its carrying value relating to these licenses of \$75,044.

The Corporation estimates aggregate expenditures of approximately \$49 million will be required to meet the seismic and drilling work commitments of the Ichinskaya and Vorovskaya exploration licenses over the five year term of the licenses. In January, 2012 the Corporation decided to seek early relinquishment of the Ichinskaya and Vorovskaya exploration licenses back to the Russian Federal Ministry of Natural Resources ("MNR").

On September 10, 2011, a wholly-owned Russian subsidiary of the Corporation received a new 5 year exploration license granted by the Russian Federal Agency for Subsoil Use, Kamchatka. This license, named 'Tigilskaya', is effectively the previously held Tigil License but with additional acreage to the east. In total, the license covers 416,400 net hectares. It was granted on the basis of a work commitment to acquire 500 km of 2-D seismic prior to September 10, 2014 of which 200 km must be acquired prior to September 10, 2013. The work commitment also requires the drilling of two exploration wells, one by September 10, 2015 and second by September 10, 2016. The Corporation estimates expenditures of approximately \$51 million will be required to meet the minimum seismic and drilling work commitments of the Tigilskaya license over the five year term of the licenses.

The Corporation is seeking partners to farm-in on its aggregate Kamchatka acreage.

### Provisions

In 2008, the Corporation entered into two non-cancellable leases for office space in Canada. Due to changes in its activities, the Corporation has ceased to completely use this office space as at the Reporting Date. The leases expire on June 30, 2013. Management estimates that 75% of the office space is surplus to its needs. The obligation for 75% of the discounted future payments has been provided for as 'onerous contract' net of an estimate of sublease income that might be realizable. The total provision at November 30, 2011 of \$119,008 is comprised of a current portion of \$75,366 and a non-current portion of \$43,642. The undiscounted future net minimum lease payments for these leases before recoveries, if any, by fiscal year are as follows:

Fiscal year 2012 remaining	\$ 132,000
Fiscal year 2013	264,000
Fiscal year 2014	<u>22,000</u>
Total	<u>\$ 418,000</u>

When the exploration licenses in Tigil and Icha terminated, there were no future operations in these entities and the operating agreements with KKPL relating to Tigil and Icha expired. At May 31, 2011, the Corporation recognized a provision of \$795,451 as its estimated share of future costs to wind-up the joint venture. A substantial portion of this provision results from employee severance payments required under Russian law. There are no future operating benefits to be derived from the joint venture after the expiry of the exploration licenses. During the six months ended November 30, 2011 the provision was reduced by \$403,373,

consisting of revisions to future costs and actual costs incurred during the period, resulting in a remaining provision of \$392,078 at November 30, 2011.

## **RELATED PARTY TRANSACTIONS**

At November 30, 2011, there were no amounts due from directors or officers.

At November 30, 2011, there was \$160,229 (May 31, 2011 - \$127,800) owing to directors and officers for services performed in the normal course of operations.

## **OFF-BALANCE SHEET ARRANGEMENTS**

As at November 30, 2011 and May 31, 2011, the Corporation did not have any off-balance sheet arrangements, other than the Corporation's lease commitments and work commitments as described previously.

## **FINANCIAL INSTRUMENTS**

The fair value of the Corporation's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximated their carrying values as at November 30, 2011 and May 31, 2011 and June 1, 2010, the Transition Date to IFRS.

The Corporation is exposed to various risks associated with its financial instruments. These risks are categorized as market risk, credit risk and liquidity risk.

Market risk is the risk that changes in market conditions, such as commodity prices, exchange rates and interest rates, will affect the Corporation's net earnings or the value of its financial instruments. The objective of market risk management is to manage and control exposures within acceptable limits, while maximizing returns.

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Significant changes in commodity prices can also reduce the Corporation's ability to raise capital. Commodity prices for crude oil are impacted by world economic events that dictate the levels of supply and demand. In the future, the Corporation may attempt to mitigate commodity price risk through the use of financial derivatives. The Corporation did not have any oil or gas production and did not have any risk management contracts in place as at November 30, 2011 and May 31, 2011 or for the reporting periods then ended or thereafter.

The Corporation is exposed to foreign currency fluctuations as it holds cash and incurs expenses and property and equipment expenditures in foreign currencies. The Corporation incurs expenditures and expenses in Russian roubles, Pounds sterling, Euros and Canadian dollars and is exposed to fluctuations in exchange rates in these currencies. There were no forward foreign exchange rate contracts in place as at November 30, 2011 and May 31, 2011 or for the reporting periods then ended or thereafter.

Financial instruments that potentially subject the Corporation to concentration of credit risk consist of accounts receivable. There is low credit risk on accounts receivable. Accounts receivable consists of Russian VAT, recoverable goods and services tax in Canada and net (non-consolidated portion of) accounts receivable from the Corporation's joint interest entities. All accounts receivable are current and considered collectible.

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. The Corporation's financial liabilities consist of accounts payable and accrued liabilities and provisions for an onerous lease relating to office space in Canada. Accounts payable consist primarily of invoices payable to trade suppliers or professionals for services rendered.

## RECENT CHANGES IN ACCOUNTING POLICIES

The Corporation prepares its financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants (“CICA Handbook”). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards (“IFRS”) and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Corporation commenced reporting on this basis in these interim condensed consolidated financial statements. In the condensed consolidated financial statements, the term “Canadian GAAP” or “Previous GAAP” refers to “Canadian GAAP” before the adoption of IFRS.

These interim condensed consolidated financial statements have been prepared in accordance with International Accounting Standards (“IAS”) 34 - “*Interim Financial Reporting*”. Subject to certain transition elections and mandatory exemptions disclosed in note 15, the Corporation has consistently applied the same accounting policies in its opening IFRS statement of financial position at June 1, 2010 (the “Transition Date”) and throughout the periods presented, as if these policies had always been in effect. These are the Corporation’s first interim condensed consolidated financial statements for part of the period covered by the first IFRS annual financial statements and *IFRS 1 - “First-time Adoption of International Financial Reporting Standards”* has been applied. Note 15 discloses the impact of the transition to IFRS on the Corporation’s reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Corporation’s Previous Canadian GAAP financial statements. The policies adopted in these interim consolidated financial statements are based on IFRS issued and outstanding as at the date the Corporation’s Board of Directors approved the interim unaudited condensed consolidated financial statements. Any subsequent changes to IFRS that are given effect in the Corporation’s annual consolidated financial statements for the reporting period ending May 31, 2012 could result in a restatement of these interim consolidated financial statements, including the transition adjustments recognized on the initial adoption of IFRS.

The unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the Corporation’s reporting period ended May 31, 2011 and for the three month period ended August 31, 2011.

The following discussion explains the significant differences between IFRS and Previous GAAP followed by the Corporation:

### Property, plant and equipment

IFRS standards generally require that a corporation choose to report its petroleum and natural gas assets either at the amount which would have been recorded had the Corporation always followed current IFRS standards or at a fair value on the date of adoption of IFRS where fair value is the greater of ‘fair value less costs to sell’ or ‘value-in-use’.

*IFRS-1, “First-Time Adoption of International Financial Reporting Standards”* (“IFRS-1”), provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions to the general requirement for full retrospective application of IFRS.

For Canadian GAAP purposes, the Corporation followed the full cost method of accounting as prescribed by Accounting Guideline 16 (“AcG16”). At the Transition Date, the Corporation elected, as a ‘*First Time Adopter of IFRS*’ to measure the carrying amount of its capitalized E&E assets at the amount capitalized in its full cost pool of capitalized costs under Previous GAAP, subject to an impairment test at the Transition Date. At the Transition Date, the E&E assets were tested for impairment in accordance with IFRS 6 “*Exploration for and Evaluation of Mineral Resources*” and/or International Accounting Standard (“IAS”) 36. No impairment charge was required. The Corporation recognizes CGUs based on exploration licenses granted by the Russian Federal Ministry of Natural Resources (“MNR”). The Corporation’s CGUs at the Transition Date included: ‘Icha’; ‘Ichinskaya’; and ‘Vorovskaya’. Each of these is located in the Kamchatka, Russia.

Otherwise, there are significant differences in accounting for property, plant and equipment under IFRS including:

- Pre-license costs or costs incurred before the legal right to explore must be expensed under IFRS. Under full cost accounting, these costs are capitalized and included in the country cost centre;
- Under IFRS, petroleum and natural gas assets are divided into exploration and evaluation assets (“E&E assets”) and development assets. E&E assets encompass expenditures incurred by a corporation in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. The Corporation capitalizes and reports these costs as E&E assets on the statement of financial position under IFRS. Once technical feasibility and commercial viability of reserves is established for a CGU, the costs are tested for impairment and transferred to property and equipment (“P&E”). If technical feasibility and commercial viable reserves is not established for a new area, the costs are expensed. Development assets include those expenditures that are incurred to bring reserves to commercial production including drilling, completion and equipping costs. Under full cost accounting, E&E costs are currently disclosed as P&E but withheld from depletion. Costs were transferred to depletable assets when proved and probable reserves are assigned or when it was determined that the costs were impaired;
- Under full cost accounting, P&E is depleted on a country cost centre basis. IFRS requires depletion of individual components at a CGU level, which may be at a level lower than a country cost centre. At this time, the Corporation does not have reserves or cash generating units. As the Corporation is a pure exploration entity and has made no discoveries to date, it follows that it has no reserves, development, production or revenue at the date of this MD&A.
- Both exploration assets and development assets, if any, are assessed to determine whether impairment losses exist under IFRS at the transition date. These impairment tests are conducted at a CGU level (the lowest level at which cash inflows can be separately identified). Under IFRS, the impairment test compares the carrying value of the assets to the greater of the fair value of the assets less costs to sell and the value-in-use of the assets, which is measured on the basis of the discounted cash flows. Future impairment tests are required when management determines that indicators of impairment exist. Should impairment losses be recorded in accordance with IFRS, certain losses can be reversed in the future if facts and circumstances change. Under full cost accounting, impairment was a two step test conducted at the country cost centre level and there were no reversals of impairments.
- Both Canadian GAAP and IFRS require a company to provide for a liability related to decommissioning property, plant and equipment. Both methodologies are similar. There is no impact on PetroKamchatka because it has no reserves, production or development assets that would give rise to decommissioning liabilities. Canadian GAAP requires the decommissioning liability to be discounted at a credit-adjusted risk-free rate while IFRS requires the decommissioning liability to be discounted at an appropriate rate with either the cash flows or rate adjusted for risks. On transition to IFRS, the change in the asset retirement obligation (“ARO”) liability on P&E for which the full cost exemption is applied must be recorded in retained earnings.
- In accordance with IFRS transition provisions, the Corporation elected to use fair value equipment presented in the Corporation’s statement of financial position at the Transition Date. Fair value is based on independent appraisals of fair value. The adjustment to fair value under IFRS of \$4,447,941 at the Transition Date required a reduction of \$2,495,456 in the carrying value of equipment from that measured under Previous GAAP.
- Under IFRS, depreciation expense is recorded for all periods including those periods when the equipment is idle. The only time depreciation is not recorded is when equipment is held-for sale. Instead of depreciation based on historical costs, the depreciation under IFRS is calculated on the basis of the amount of fair value.

## **Stock-based Compensation**

Under Canadian GAAP, the Corporation recognized an expense related to its share-based payments on a straight-line basis through the date of full vesting and did not incorporate a forfeiture multiple. Under IFRS, each tranche in an award is considered a separate grant with a different vesting date and fair value. Each grant is accounted for separately using the applicable assumptions for those specific dates and different fair values. IFRS 2 has not been applied to equity instruments which vested before the Transition Date to IFRS.

### **Income Tax Accounting**

Although both Canadian GAAP and IFRS follow the liability method of accounting for income taxes, where tax liabilities and assets are recognized on temporary differences, there are some exceptions to the treatment of temporary differences under IFRS that could lead to an adjustment to an entity's future tax liability under IFRS. In addition, an entity's future tax liability will be impacted by the tax effects of changes to comply with IFRS for other changes in accounting treatments.

### **Foreign Exchange Accounting**

In accordance with IFRS transitional provisions, the Corporation elected to reset the cumulative translation adjustment account, which includes gains and losses from the translation of foreign operations, to \$nil. This reclassification resulted in a reduction of the Corporation's deficit as at the Transition Date of \$1,018,864.

### **Functional Currency**

Under IFRS, each legal entity must look to primary and secondary indicators to determine the functional currency for the legal entity. There is no such thing as a 'group' functional currency. The Corporation has determined the functional currency for each legal entity in the following countries as follows:

Jersey	- USD
Cyprus	- USD
Russia	- RUR
Canada	- CAD

The assets and liabilities of foreign operations are translated to USD at exchange rates at the Reporting Date. The income and expenses of foreign operations are translated to USD at exchange rates at the dates of the transactions. Foreign currency differences are recognized in 'other comprehensive income' and presented in the foreign currency translation reserve in equity. If the operation is a non-wholly-owned subsidiary, then the relevant proportionate share of the translation difference is allocated to the non-controlling interest. When a foreign operation is disposed of such that control, significant influence or joint control is lost, the cumulative amount in the translation reserve related to that foreign operation is reclassified to profit or loss as part of the gain or loss on disposal. When the Corporation disposes of only part of its interest in a subsidiary that includes a foreign operation while retaining control, the relevant proportion of the cumulative amount is re-attributed to non-controlling interests. When the Corporation disposes of only part of its investment in an associate or joint venture that includes a foreign operation, while retaining significant influence or joint control, the relevant proportion of the cumulative amount is reclassified to profit or loss. When the settlement of a monetary item receivable from or payable to a foreign operation is neither planned nor likely in the foreseeable future, foreign exchange gains and losses arising from such a monetary item are considered to form part of the net investment in a foreign operation and are recognized in other comprehensive income and presented in the translation reserve in equity.

### **Provisions**

A provision is recognized if, as a result of a past event, the Corporation has a present obligation (legal or constructive) that can be estimated reliably, and it is probable that an outflow of economic resources will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

The Corporation's activities could give rise to decommissioning obligations for dismantling, decommissioning and site restoration activities. Provision would be made, if applicable, for the estimated cost and capitalized in the relevant asset category unless it arises from the normal course of production activities in which case it is recognized in net income.

Provision for decommissioning obligations would be measured at the present value of management's best estimate of the expenditure required to settle the present obligation at the Reporting Date using a risk-free discount rate. Subsequent to the initial measurement, the obligation would be adjusted at the end of each reporting period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The increase in the provision due to the passage of time would be recognized as 'finance costs'; whereas, increases or decreased due to changes in the estimated future cash flows would be capitalized. Actual costs incurred upon settlement of the decommissioning obligations would be charged against the provision to the extent the provision is established.

Contingent liabilities are possible obligations whose existence will only be confirmed by future events not wholly within the control of the Corporation, or present obligations where it is not probable that an outflow of resources will be required or the amount of the obligation cannot be measured with sufficient reliability. Contingent liabilities are not recognized in the financial statements but are disclosed unless the possibility of an outflow of economic resources is remote.

A provision for onerous contracts is recognized when the expected benefits to be derived by the Corporation from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

### **Warrants recognized as a financial liability at fair value**

Under Previous Canadian GAAP, the fair value of share purchase warrants was calculated upon initial recognition which fair value was not subsequently re-measured. The full amount was classified in equity. Under IFRS, the warrants can be classified as 'equity instruments' or 'financial liabilities' depending upon certain factors. Under IFRS, warrants issued to purchase common shares for a fixed price, stated in a currency other than the Corporation's functional currency are considered 'derivative financial liabilities' when such warrants were not offered to all shareholders. If warrants are issued in the Corporation's functional currency or if warrants with exercise prices in other currencies are offered to all shareholders, such are treated as 'equity instruments'. The Corporation has warrants with exercise prices in both USD and non-USD (£ and CAD). Fair values of those accounted for as derivative financial liabilities are re-measured at each Reporting Date. All outstanding warrants expire in November 2011 or December 2011 and the exercise prices are materially out-of-the-money. As such, the fair value of the warrants treated as current (at November 30, 2011 and May 31, 2011) or non-current (June 1, 2010 Transition Date) is immaterial or nominal. At November 30, 2011, the warrants treated as liabilities are considered to be fairly measured at '\$nil'.

### **Non-controlling interest in subsidiary**

Subsidiaries are entities controlled by the Corporation. The financial statements of subsidiaries are included in the consolidated financial statements for the date that control commences until the date that control ceases. Losses applicable to the non-controlling interest in a subsidiary are allocated to the non-controlling interest even if doing so causes the non-controlling interest to have a deficit balance.

### **Business Combinations**

With respect to business combinations entered into prior to June 1, 2010, entities are allowed to adopt an 'IFRS-1' election to not restate business combinations. Under Canadian GAAP, the Corporation, for purposes of its internal reorganization accounted for the exchange of its shares to acquire PKR using the 'continuity of interest basis of accounting'. In addition, it accounted for its arrangement with Bluerock Acquisition Corp. as a capital transaction. The Corporation has not made any business acquisitions that are affected by the elections to the Transition Date or in the reporting periods ended May 31, 2011 and November 30, 2011.

## Other

The following pronouncements from the IASB will become effective for financial reporting periods beginning on or after January 1, 2013. All of these new or revised standards permit early adoption with transitional arrangements depending upon the date of initial application:

- IFRS 9 – *Financial Instruments* - addresses the classification and measurement of financial assets.
- IFRS 10 – *Consolidated Financial Statements* - builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company.
- IFRS 11 – *Joint Arrangements* – establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled.
- IFRS 12 – *Disclosure of Interest in Other Entities* – provides the disclosure requirements for interests held in other entities including joint arrangements, associates, special purpose entities and off balance sheet entities.
- IFRS 13 – *Fair Value Measurement* – defines fair value, requires disclosure about fair value measurements and provides a framework for measuring fair value when it is required or permitted within the IFRS standards.
- IAS 19 – *Employee Benefits* – revises the existing standard to eliminate options to defer the recognition of gains and losses in defined benefit plans, requires remeasurement of a defined benefit plan's assets and liabilities to be presented in other comprehensive income and increases disclosure.
- IAS 27 – *Separate Financial Statements* – revised the existing standard which addresses the presentation of parent company financial statements that are not consolidated financial statements.
- IAS 28 – *Investments in associate and Joint Ventures* – revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

Management is assessing the impact that these new standards will have on the consolidated financial statements.

## **DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Under National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings ("NI 52-109"), venture issuers can file a Venture Issuer Basic Certificate (the "Basic Certificate") as defined by NI 52-109. The Basic Certificate does not include representations relating to the establishment and maintenance of disclosure controls and procedures ("DC&P") and internal control over financial reporting ("ICFR"), as defined in NI 52-109. For interim filings, the Basic Certificate requires that the venture issuer's certifying officers certify that:

- They have reviewed the interim consolidated financial statements and interim MD&A (the "interim filings") of the Corporation;
- Based on their knowledge, having exercised reasonable diligence, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
- Based on their knowledge, having exercised reasonable diligence, the interim consolidated financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date of and for the periods presented in the interim filings.

PetroKamchatka is currently listed on the TSXV, and the Corporation's CEO and CFO file the Basic Certificate. They do not make any representations relating to the establishment and maintenance of:

- Controls and other procedures designed to provide reasonable assurance that information required to be disclosed by the issuer in its annual filings, interim filings or other reports filed or submitted under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation; and
- A process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP.

Investors should be aware that, due to the limited resources and 'few' number of staff of the Corporation, and the fact that the Corporation's activities are carried out in Jersey, Cyprus, Russia and Canada, inherent limitations exist relative to the Corporation's ability to design and implement, on a cost effective basis, DC&P and ICFR as defined in NI 52-109. Also, the Corporation does not have in-house expertise sufficient to deal with all of the complex and diverse taxation, legal and regulatory matters in all of these jurisdictions, without the assistance of external firms and consultants to assist and to advise on the reporting implications related to such matters. These circumstances may result in additional risks to the quality, reliability, transparency and timeliness of interim and annual filings and other reports provided under securities legislation.

The CEO and CFO are however responsible for ensuring that processes are in place to provide them with sufficient knowledge to support the representations they are making in the Basic Certificate. They employ advisors and consultants and review financial materials and processes to mitigate the risk of material misstatements in financial reporting.

## **BUSINESS CONDITIONS AND RISKS**

An investment in PetroKamchatka should be considered highly speculative due to the early stage of development of PetroKamchatka's Russian properties. PetroKamchatka is in the exploration phase. It has no proven reserves or production or production revenues and has drilled two unsuccessful wells to date. There is no assurance that any future wells that may be drilled will be successful. There is no assurance that any discoveries that may occur will provide commercial quantities of oil or natural gas. The following information describes certain significant risks and uncertainties inherent in PetroKamchatka's business. Prospective investors should take these risks into account in evaluating PetroKamchatka and in deciding whether to make an investment in PetroKamchatka. This section does not describe all risks applicable to the Company, its industry or its business, and it is intended only as a summary of certain material risks. Prospective investors should carefully consider such risks and uncertainties together with other information contained in this MD&A. If any of such risks or uncertainties actually occurs, the Company's business, financial condition or operating results could be harmed substantially and could differ materially from the plans and other forward-looking statements discussed elsewhere in this MD&A.

### **Risks Associated with Oil and Natural Gas Exploration**

There can be no assurance that commercial quantities of hydrocarbons will be recovered by PetroKamchatka in the future. Petroleum and natural gas exploration involves a high degree of risk. There is no assurance that expenditures made on future exploration by PetroKamchatka will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of exploration drilling programs due to many inherent uncertainties including: drilling in unknown formations; drilling in unknown conditions; the impact of changing drilling plans and locations as results from wells drilled become known or additional seismic data and interpretations thereof become available; and the risk that potential hazards may result during drilling such as unusual or unexpected formations, pressures or other conditions which may affect the costs of drilling and operating wells. PetroKamchatka does not have sufficient historical costs to rely upon in making estimates of its future exploration and development expenditures.

Management will continue to evaluate prospects and leads on an ongoing basis in a manner consistent with industry standards and past practices. The long term commercial success of PetroKamchatka depends on its ability to find or acquire, develop and commercially produce, transport and market oil and natural gas reserves. No assurance can be given that PetroKamchatka will be able to achieve this.

Future oil and natural gas exploration may involve unprofitable efforts, not only from drilling unsuccessful wells but possibly from wells that are productive but do not produce sufficient net revenues to provide a reasonable rate of return on capital invested, after drilling, operating and other costs are considered. PetroKamchatka is unable to predict whether any portion of the resources will be discovered or, if discovered, be commercially viable to produce any portion of the resources. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the risk and cost of operations and various field operating conditions may adversely affect the production from successful wells. In addition, delays in obtaining governmental approvals or consents, insufficient storage or transportation capacity or other geological and mechanical conditions may negatively impact PetroKamchatka's future success.

While close well supervision and effective maintenance can contribute to maximizing production rates, the risks of production delays or declines cannot be eliminated. These may have a negative impact on future net revenue and cash flows. In addition, commodity prices may decline in future periods. Oil and natural gas operations are subject to many risks during the exploration, development and production phases of the oil and natural gas properties. These risks may include but are not necessarily limited to encountering unexpected formations or pressures; premature declines of reservoirs; blow-outs; cratering; sour gas releases; fires; and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition of PetroKamchatka.

The marketability of any oil and natural gas discovered or acquired will be affected by numerous factors beyond the control of PetroKamchatka. These factors include: market fluctuations; proximity and capacity of oil and natural gas pipelines and processing facilities; and government regulations including laws or regulations dealing with royalties, allowable production quantities, importing and exporting of oil and natural gas, and environmental protection.

## **Financial Risks**

### **Additional financing will be required to fund the cost of PetroKamchatka's future exploration and development activities.**

PetroKamchatka does not presently have sufficient cash to pay for exploration and development programs in fiscal 2012 and beyond. The exploration and development of PetroKamchatka's properties in 2012 and beyond depends, therefore, on PetroKamchatka's ability to obtain additional financing through equity financing or other means. Failure to obtain any financing necessary to fund PetroKamchatka's future capital expenditure plans may result in a delay in the exploration, development or production from PetroKamchatka's properties.

As a result of the weakened global economic situation, PetroKamchatka, along with all other oil and gas entities, may have restricted access to equity or debt capital. There may be increases in borrowing costs. Although PetroKamchatka's asset base may not have changed, the lending capacity of all financial institutions has diminished and risk premiums have increased. As future capital expenditures will be financed out of funds generated from operations, borrowings and possible future equity sales, PetroKamchatka's ability to raise capital is dependent on, among other factors, the overall state of capital markets and investor appetite for investments in the energy industry and PetroKamchatka's securities in particular.

There can be no assurance that PetroKamchatka will obtain necessary additional financing or that any joint venture partner will obtain financing under the terms of any joint venture agreement into which it enters with PetroKamchatka. The failure of PetroKamchatka to obtain additional financing on a timely basis or on terms favourable to PetroKamchatka could result in the loss or substantial dilution of PetroKamchatka's interests in its properties. The failure of any joint venture partner to obtain required financing could adversely affect PetroKamchatka's ability to complete the exploration or development of any such joint venture project on a timely basis, if at all.

Should PetroKamchatka elect to satisfy its cash commitments through the issuance of securities, by way of either private placement or public offering, there can be no assurance that PetroKamchatka's efforts to raise such funding will be successful, or achieved on terms favourable to PetroKamchatka or its existing shareholders.

## History of Losses

PetroKamchatka has incurred substantial losses in all of its fiscal years including the most recent fiscal period ended November 30, 2011. PetroKamchatka's total comprehensive loss during the six month period ended November 30, 2011 was \$3,167,243. Cash flow used in operating activities during the same period was approximately \$2,500,429. As at November 30, 2011, PetroKamchatka had a deficit of approximately \$90.1 million. PetroKamchatka has significant work commitments that need to be funded if PetroKamchatka is to maintain its interest in its exploration licenses in Kamchatka. To become profitable, PetroKamchatka must identify and establish reserves at its properties, and then either develop its properties or locate and enter into agreements with third party operators on favourable economic terms. PetroKamchatka may suffer significant additional losses in the future and may never be profitable. Even if PetroKamchatka does achieve profitability, it may not be able to sustain or increase profitability on a quarterly or annual basis. PetroKamchatka expects to incur losses unless and until such time as one or more of its properties enters into commercial production and generates sufficient net revenue to fund continuing operations.

## Limited Operating History and No Record of Earnings

PetroKamchatka only recently commenced operations in Russia and has no earnings history. Accordingly, PetroKamchatka has limited operating history in the oil and natural gas industry in Russia (or elsewhere) and has no meaningful, historical financial information or record of performance. Any future profitability from PetroKamchatka's business will be dependent upon the successful development of PetroKamchatka's lands, and there can be no assurance that PetroKamchatka will achieve profitability in the future. There are no known quantities of oil or natural gas reserves on PetroKamchatka's properties. Revenues may not occur for some time, if at all. The timing and extent of these influences is variable and uncertain and accordingly PetroKamchatka is unable to predict when, if at all, profitability will be achieved. An investment in the PetroKamchatka shares is highly speculative and should only be made by persons who can afford a significant or total loss of their investment.

## Substantial Capital Requirements

PetroKamchatka's business plan requires significant expenditures, particularly near-term capital expenditures, in its exploration and development phases, assuming there may be a development phase. PetroKamchatka may be unable to finance its needs on acceptable terms, or at all, which may have a material adverse effect on PetroKamchatka's operations. PetroKamchatka's future growth depends on its ability to make large capital expenditures for the exploration and development of petroleum and natural gas properties. Future cash flows and the availability of equity or debt financing will be subject to a number of variables including, but not necessarily limited to: (i) the success of PetroKamchatka's prospects in Kamchatka; (ii) success in finding and commercially producing reserves; and (iii) prices of oil and natural gas.

Debt financing, if any, could lead to: (i) a substantial portion of operating cash flow being dedicated to the payment of principal and interest; (ii) PetroKamchatka being more vulnerable to competitive pressures and economic downturns; and (iii) restrictions on PetroKamchatka's operations.

PetroKamchatka might not be able to obtain necessary financing on acceptable terms, or at all. If sufficient capital resources are not available, PetroKamchatka might be forced to curtail exploration and/or development drilling and other activities or may be forced to sell some or all of its assets on an untimely or unfavourable basis, which would have a material adverse effect on PetroKamchatka's business, financial condition and results of operations.

If PetroKamchatka's future net revenues or resources decline, it may have limited ability to expend capital necessary to undertake or complete future drilling programs. There can be no assurance that equity or debt financing or cash generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if equity or debt financing is available, that it will be on terms acceptable to PetroKamchatka.

The inability of PetroKamchatka to access sufficient capital for its operations could have a material adverse effect on PetroKamchatka's financial condition, results of operations or prospects.

## Political and Government Risk

Beyond the risks inherent in the oil and natural gas industry, PetroKamchatka is subject to additional risks resulting from doing business in Russia. Russia has been undergoing a substantial political transformation from a centrally-planned economy under communist rule to a pluralist, market-oriented democracy. A significant number of changes have been undertaken during recent years, but there can be no assurance that the political and economic reforms necessary to complete such a transformation will continue. The Russian political system is vulnerable to the population's dissatisfaction with reforms, social and ethnical unrest and changes in governmental policies. PetroKamchatka is unable to foresee all the changes possible on the political scene of the Russian Federation that might impact upon the binding provisions of laws, the regulations and their interpretation or enforcement as well as the consequences of such changes upon PetroKamchatka's assets and operations.

These risks can involve matters arising out of evolving laws and policies of Russia, the imposition of special taxes or similar charges, oil export or pipeline restrictions, foreign exchange fluctuations and currency controls, the unenforceability of contractual rights or the taking of property without fair compensation, restrictions on the use of expatriates in operations and other matters.

There can be no assurance that the license agreements under the licenses granted by MNFR and others are enforceable or binding in accordance with PetroKamchatka's understanding of the terms; or that if breached, PetroKamchatka would be able to find a remedy. PetroKamchatka bears the risk that a change of government could occur and a new government may terminate or void the licenses, laws and regulations that PetroKamchatka is relying upon. Operations in Kamchatka, Russia are subject to risks due to the harsh climate, difficult topography and the potential for social, political, economic, legal and financial instability.

PetroKamchatka's core focus for exploration has been fully directed in the Kamchatka Peninsula of Russia with varying degrees of political or government risk including:

- the risk of changes in government, policy, regulation, or fiscal terms;
- the risk of changes in conditions under which exploration licenses are awarded, including related work commitments;
- the risks of required government approvals being delayed or withheld or cancelled;
- risks associated with the cost or access to government-owned pipeline systems or other such infrastructure needed to transport oil and natural gas to markets; and
- risks associated with government policy that forces PetroKamchatka and its partners to cede an interest in the project to government-owned or controlled oil and natural gas companies.

PetroKamchatka's recent announcement that it may pursue other areas of interest in Russia may increase the exposure to these political and government risks. Changes in any government policy or regulation are beyond PetroKamchatka's control and may significantly affect the viability or profitability of its operations, or its ability to obtain future licenses.

## Government Regulation

The oil and natural gas industry (exploration, production, pricing, marketing and transportation) is subject to extensive controls and regulations imposed by various levels of government. The Russian Government may regulate or intervene with respect to price, taxes, royalties and the exportation of oil and natural gas. Such regulations may be changed from time to time in response to economic or political conditions. The implementation of new regulations or the modification of existing regulations affecting the oil and natural gas industry could reduce demand for natural gas and crude oil and increase PetroKamchatka's costs, any of which may have a material adverse effect on PetroKamchatka's intended business, financial condition and results of operations. PetroKamchatka's operations require licenses and permits from various governmental authorities. There can be no assurance that PetroKamchatka will be able to obtain all necessary licenses and permits that may be required to carry out exploration and development on its properties. It is not expected that any of these controls or regulations will affect the operations of PetroKamchatka in a manner materially different than they

would affect other oil and natural gas companies of similar size. All current legislation is a matter of public record and PetroKamchatka is unable to predict what additional legislation or amendments may be enacted.

### **Limitations on Foreign Investments**

The Russian Law on Foreign Investments provides for control and restrictions regarding foreign investments in strategic industries of federal significance. Under the 2008 amendments to the Subsoil Law, subsoil plots containing recoverable oil reserves in excess of 70 million tons and gas reserves above 50 billion cubic metres (as evidenced by the Russian State Register of Reserves, as of January 1, 2006) are characterized as being of federal significance. Based on information available to PetroKamchatka as at this date, PetroKamchatka does not believe that any of its properties will be classified as significant based on the above criteria.

If in the process of a geological survey, a foreign investor, such as PetroKamchatka, discovers oil or gas reserves that are significant (as identified above); the Russian Government may refuse to grant the foreign investor the right for exploration and production in respect of such property. If the resources were discovered in the course of a geological survey, on the basis of a combined license (for geological survey, exploration and production), the Russian Government may decide to terminate the right to use this property. The Subsoil Law provides for compensation of expenditures related to prospecting and appraisal, and repayment of a one-time payment for the grant of rights. Moreover, such entities may be entitled to a premium payable by the Russian State. The legislation does not provide for clear terms of payment of the above compensation, and it may take a long time for the subsoil user to receive those funds from the Russian Government. The Russian Government may impose additional limitations on Russian legal entities with the participation of foreign investors on their participation in tenders and auctions for the right to use such significant properties.

### **Dependence on KKPL**

KKPL has been a strategic partner of PetroKamchatka in the Tigil and Icha jointly controlled companies. The Tigil exploration license expired on December 31, 2010, and on April 29, 2011, the MNFR approved the early relinquishment of the Icha license effective March 28, 2011. PetroKamchatka is dependent upon KKPL to pay its share of the dissolution costs upon wind-up of the Tigil and Icha joint venture companies.

### **Legal and Regulatory Risks**

Risks associated with the Russian legal system include, among others: (i) the untested nature of the independence of the judiciary and its immunity from economic and political influences; (ii) inconsistencies between laws, Presidential decrees, and government and ministerial orders and resolutions; (iii) the lack of judicial or administrative guidance on interpreting applicable laws; (iv) a high degree of discretion on the part of governmental authorities; (v) the relative inexperience of judges and courts in interpreting new legal norms; (vi) substantial gaps in many areas of Russian law; (vii) the unpredictability of enforcement of foreign judgments and uneven record of enforcement of foreign arbitral awards; (viii) relatively frequent changes to existing Russian law as currently in effect; and (ix) unclear authority of regulatory agencies or relevant officers to complete certain actions.

The recent nature of much Russian legislation, the lack of consensus about the scope, content and pace of economic and political reform, and the rapid evolution of the Russian legal system in ways that may not always coincide with market developments, may result in ambiguities, inconsistencies and anomalies, the enactment of laws and regulations without a clear constitutional or legislative basis, and ultimately in investment risks that do not exist in more developed legal systems. All of these weaknesses could affect PetroKamchatka's ability to enforce its rights or to defend itself against claims by others.

These uncertainties also extend to property rights. During Russia's transformation from a centrally planned economy to a market economy, legislation has been enacted to protect private property against expropriation and nationalisation. However, it is possible that due to a lack of experience in enforcing these provisions and the possibility of potential political changes, these protections would not be enforced in the event of an attempted expropriation or nationalisation. Expropriation or nationalisation of any substantial assets of PetroKamchatka, potentially without adequate compensation, would have a material adverse effect on PetroKamchatka.

Many Russian laws are structured in a way that provides for significant administrative discretion in interpretation, application and enforcement. Consequently, good relations with central and regional governmental authorities are essential to ensure that PetroKamchatka is able to run its business efficiently. Reliable texts of laws and regulations at the regional and local levels may not be available, and are not usually updated or catalogued. As a result, the applicable law is sometimes difficult to ascertain and apply, even after reasonable effort. In addition, the laws are subject to different and changing interpretations and administrative applications. As a result of these factors, even the best efforts of PetroKamchatka to comply with the laws may not always result in full compliance.

Russian laws often provide general statements of principles rather than a specific guide to implementation, and government officials may be delegated or exercise broad authority to determine matters of significance. Such authority may be exercised in an unpredictable way and effective appeal processes may not be available. In addition, breaches of Russian law may involve severe penalties and consequences that could be considered as disproportionate to the violation committed.

The independence of the judicial system and its immunity from economic and political influences in Russia remains largely untested. The court system is understaffed and under-funded. Judges and courts are generally inexperienced in the areas of business and corporate law. Russia is a civil law jurisdiction and judicial precedents generally have no binding effect on subsequent decisions. Not all Russian legislation and court decisions are readily available to the public or organised in a manner that facilitates understanding. The Russian judicial system can be slow. All of these factors make judicial decisions in Russia difficult to predict and effective redress uncertain. Additionally, court claims are often used to further political aims, and court decisions are not always enforced or followed by law enforcement agencies. There is no guarantee that the proposed judicial reform aimed at balancing the rights of private parties and governmental authorities in courts and reducing grounds for re-litigation of decided cases will be implemented and succeed in building a reliable and independent judicial system.

### **Limited Duration of Licenses**

The rights of the Corporation's Russian subsidiaries and joint interest companies under Geological Licenses are limited in time as each license is issued for a five-year term. The term of an exploration license can be extended upon the license holder's request if necessary to finalize exploration provided that the license holder did not violate the terms of its license. In such case, no tender or auction is conducted. The Subsoil Law does not include detailed regulations on the procedure for extending a subsoil license. As a matter of practice, license holders often reach agreement with the authorities on such extension. However there is no guarantee that a license extension will be granted.

### **Termination, Suspension or Revocation of Exploration (Geological), Combined and Production Licenses**

The licensing regime in Russia for the exploration, development and production of oil and natural gas is governed primarily by the Subsoil Law and regulations issued there under. Most licenses provide that they may be terminated if licensees fail to comply with license requirements; if licensees do not make timely payments of levies and taxes for the use of the subsoil, if licensees systematically fail to provide information; or if licensees fail to fulfil any capital expenditure and/or work commitments.

PetroKamchatka may not be able to, or may voluntarily decide not to, comply with license requirements for some or all of its license areas. On April 29, 2011, the Corporation and its joint venture partner received approval for early relinquishment of the Icha license effective March 28, 2011. The Icha license was to expire on December 30, 2011. If it fails to fulfil the specific terms of any of its licenses or if it operates in the license areas in a manner that violates Russian law, government regulators may impose fines on the Russian Companies or suspend or terminate their licenses. Any suspension or termination of one or more of the subsoil licenses could have a material adverse effect on PetroKamchatka's operations and the value of its assets.

The rights of any subsoil user may also be challenged on the basis of defects in the process of issuing its subsoil licenses. Vague and inconsistent requirements of the Subsoil Law and the regulations there under can make it difficult to conclude that any given subsoil license has been issued in full compliance with applicable law.

## **Environmental**

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and natural gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material, as well as suspension of the operations of the subsoil user. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to governments and third parties and may require PetroKamchatka to incur costs to remedy such discharge. Although PetroKamchatka believes that it is in material compliance with current applicable environmental regulations, no assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect PetroKamchatka's financial condition, results of operations or prospects.

## **Prices, Markets and Marketing**

The marketability and price of oil and natural gas will be affected by numerous factors beyond PetroKamchatka's control. The ability to market natural gas may depend upon PetroKamchatka's ability to acquire space on pipelines that deliver natural gas to commercial markets. PetroKamchatka may also be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities, and related to operational problems with such pipelines and facilities as well as extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and many other aspects of the oil and natural gas business.

PetroKamchatka's revenues, profitability and future growth and the carrying value of its properties are substantially dependent on prevailing prices of oil and natural gas. PetroKamchatka's ability to borrow and to obtain additional capital on attractive terms is also substantially dependent upon oil and natural gas prices. Prices for oil and natural gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and natural gas, market uncertainty and a variety of additional factors beyond the control of PetroKamchatka. These factors include economic conditions, the actions of the Organization of Petroleum Exporting Countries, governmental regulation, political stability in the Middle East and elsewhere, the foreign supply of oil and natural gas, the price of foreign imports and the availability of alternative fuel sources. Any substantial and extended decline in the price of oil and natural gas would have an adverse effect on PetroKamchatka's carrying value of its resources or future proved reserves (if any), borrowing capacity, revenues, profitability and cash flows from operations. No assurance can be given that prices for oil or natural gas will be sustained at levels that will enable PetroKamchatka to operate profitably.

Volatile oil and natural gas prices make it difficult to estimate the value of producing properties for acquisition and often cause disruption in the market for oil and natural gas producing properties, as buyers and sellers have difficulty agreeing on such value. Price volatility also makes it difficult to budget for and project the return on acquisitions and development of exploration projects.

## **Third Party Risk**

In the normal course of its business, PetroKamchatka enters into contractual arrangements with third parties which subject PetroKamchatka to the risk that such parties may default on their obligations. PetroKamchatka may be exposed to third party credit risk through its contractual arrangements with its current or future joint venture partners, suppliers and other parties. In the event such entities fail to meet their contractual obligations to PetroKamchatka, such failures could have a material adverse effect on PetroKamchatka and its future cash flow from operations.

## **Dependence on Key Personnel**

The success of PetroKamchatka will be largely dependent upon the quality of its management and personnel, including in particular, Graeme Phipps, the Chief Executive Officer and a director, and key Russian personnel. Loss of the services of such persons, or the inability to attract personnel of equal ability, could materially adversely affect PetroKamchatka's business operations and prospects. PetroKamchatka has not purchased "key man" insurance on any of its directors, officers or key employees, and has no current plans to do so.

## **Availability of Drilling Equipment, Access and Infrastructure**

Any development of the properties will require the construction of significant infrastructure, possibly including among other things roads, pipelines, power generation facilities and a coastal terminal and offshore loading system, and also the drilling of multiple wells. The cost of completing and operating such infrastructure and drilling such wells is very uncertain, and overruns in budgeted expenditures are common risks that can make a particular project uneconomical.

Factors that can delay or prevent drilling operations, include unexpected drilling conditions, pressure or irregularities in formations, equipment failures or accidents, shortages or delays in the availability of drilling rigs or the delivery of equipment, the inability to hire personnel or engage other third parties for drilling and completion services, compliance with government regulations, adverse weather, delays or increased costs in developing the necessary infrastructure required to support the drilling operations, the cost of diesel to power the operations and the remote location of the assets.

PetroKamchatka does not currently have contractual commitments that ensure it will have adequate supply of equipment or crews to achieve possible future development plans. The ability to implement any development plans is dependent upon the ability to recruit and train an appropriate labour force and there is no assurance that this will be possible. Future development plans could require the deployment of significant amounts of equipment. Constraints in the availability of, or higher than anticipated costs for drilling rigs, equipment, supplies or personnel could delay or adversely affect PetroKamchatka's future exploration and development of its properties. This could have a material effect on the financial condition and results of operations. If the Company cannot complete the planned developments on time or on budget, the financial performance may be adversely affected, and could have a material adverse effect on the value of an investment in PetroKamchatka.

## **Access to Kamchatka Properties**

Unlike most Russian oil production, which is delivered to markets by pipelines from landlocked oil fields or oil production such as from Sakhalin Island, which is pumped to the mainland by pipeline in winter months when Sakhalin Island becomes inaccessible to shipping vessels due to ice, the exploration license areas in Kamchatka are normally accessible to pack ice breaking vessels even in the harshest of winter months. PetroKamchatka expects that, with investment in suitable infrastructure, any commercially recoverable oil that may be found in the exploration license areas in Kamchatka and subsequently produced pursuant to production licenses will be capable of direct export to world markets.

## **Risks May Not be Insurable**

PetroKamchatka's operations are subject to the risks normally experienced in the operation and development of oil and natural gas properties and the drilling of oil and natural gas wells, including encountering unexpected formations or pressures, blow-outs and fires, all of which could result in personal injuries, loss of life and damage to property of PetroKamchatka and others. In accordance with customary industry practice, PetroKamchatka may not be fully insured against all of these risks, nor are all such risks insurable. Environmental regulation is becoming increasingly stringent and costs and expenses of regulatory compliance are increasing.

## **Management of Growth**

PetroKamchatka may be subject to growth-related risks including capacity constraints and pressure on its internal systems and controls. The ability of PetroKamchatka to manage growth effectively will require it to continue to implement and improve its operational and financial systems and to expand, train and manage its

employee base. The inability of PetroKamchatka to deal with this growth could have a material adverse impact on its business, operations and prospects.

### **Licenses, Permits, Approvals or Agreements**

There are numerous permits, approvals, and agreements with third parties, which will be necessary in order to enable PetroKamchatka to proceed with PetroKamchatka's development plans and otherwise accomplish PetroKamchatka's objectives. The Russian Government has discretion in interpreting various laws, regulations, and policies governing operations under the licenses. The state authorities have broad discretion to interpret requirements for the issuance of various licenses and permits necessary for subsoil use operations. PetroKamchatka's inability to meet any of these requirements could have a material adverse effect on PetroKamchatka's exploration or development activities, and may even result in the termination of the subsoil use licenses.

PetroKamchatka's properties are held indirectly in the form of licenses and ownership working interests in Russian project companies holding the licenses. If PetroKamchatka or the holder of the license fails to meet the specific requirement of a license, the license may terminate or expire. There can be no assurance that any of the obligations required to retain each license will be met. The termination or expiration of PetroKamchatka's licenses or the beneficial interests relating to a license may have a material adverse effect on PetroKamchatka's results of operation and business. Extensions have been granted in the past in respect of both the Tigil and Icha Blocks. Where an extension may be required but is not granted, PetroKamchatka will be in default of its obligations under the terms of the exploration license and the exploration license will be forfeited.

### **HighKelly Rig**

PetroKamchatka, together with KKPL, entered into a restated rig purchase agreement with HighKelly Industries Limited to acquire the HighKelly rig for \$16 million. Pursuant to this agreement and the Settlement Agreement, PetroKamchatka withdrew as a direct purchaser of the HighKelly rig and KKPL agreed to purchase the rig and grant to PetroKamchatka a 46.25% interest therein. PetroKamchatka repaid its loan with KKPL on June 8, 2008 and paid its share of the final rig payments on November 12, 2008. PetroKamchatka's obligations under the Settlement Agreement have been met and KKPL has provided formal recognition of PetroKamchatka's 46.25% interest in the HighKelly rig in accordance with the provisions of the Settlement Agreement. On August 18, 2009, KKPL initiated an arbitration proceeding in The International Court of Arbitration against HighKelly, the manufacturer of the HighKelly rig, in respect of an alleged claim by KKPL that HighKelly failed to comply with certain of its contractual obligations to manufacture and deliver a customized rig to KKPL in compliance with specific contracted requirements. KKPL is seeking to recover damages for the alleged breach of contract by HighKelly. PetroKamchatka is not involved in these proceedings and is not able to predict the outcome of such proceedings. It was determined that the HighKelly rig is unsuited for PetroKamchatka's operations in Kamchatka and should be sold. KKPL has agreed to suspend arbitration proceedings against HighKelly until June 30, 2012 in order for the Corporation and KKPL to work towards a sale of the HighKelly rig. There is no certainty as to the price that may be realized on sale or that a sale of the rig may be realized on terms acceptable to PetroKamchatka and KKPL.

### **Land Use Rights**

Conducting operations which include exploration and production works requires the holding of respective rights to real property (land) on which such work is to be carried out. In certain cases, it may be necessary to reclassify the land prior to commencement of any work, which is often a time-consuming and costly procedure. Lack of the relevant title to land or loss thereof may impact on the works timetable and could have a negative impact on the cost of operations, results, financial condition or development prospects of PetroKamchatka.

### **No Reserves or Production**

PetroKamchatka does not have any proven reserves or production and may never have any reserves or production. The future performance of PetroKamchatka's business will depend upon the ability to identify, acquire or successfully discover and develop oil and natural gas reserves that are economically recoverable. Without successful exploration activities, PetroKamchatka will not be able to develop oil and natural gas reserves or generate revenues. There are no assurances that oil and natural gas reserves will be discovered

in sufficient quantities to enable PetroKamchatka to recover PetroKamchatka's exploration and development costs or sustain PetroKamchatka's business. No assurance can be given that PetroKamchatka's exploration and development activities will result in the discovery of any reserves. Operations may be curtailed, delayed or cancelled as a result of lack of adequate capital and other factors, such as lack of availability of rigs and other equipment, title problems, weather, compliance with governmental regulations or price controls, mechanical difficulties, or unusual or unexpected formations, pressures and or work interruptions. In addition, the costs of future exploration and development may materially exceed initial estimates.

## **Resource Estimates**

There are numerous uncertainties inherent in estimating quantities of prospective resources, including many factors beyond PetroKamchatka's control. Estimates with respect to resources that may be developed and produced in the future are often based upon volumetric calculations, probabilistic methods and upon analogy to similar types of resources, rather than upon actual production history. Estimates based on these methods generally are less reliable than those based on actual production history. Subsequent evaluation of the same reserves based upon production history will result in variations, which may be material, from the estimated resources.

Resource estimates may require revision based on actual production experience. Such figures are typically determined based upon assumed commodity prices and operating costs. Fluctuations in crude oil prices and costs may render uneconomic the recovery of such oil.

References to "resources" and "prospective resources" in this MD&A do not constitute, and should be distinguished from, references to "reserves". Reserves are estimated remaining quantities of oil and natural gas and related substances anticipated to be recoverable from known accumulations, as of a given date, based on the analysis of drilling, geological, geophysical, and engineering data; the use of established technology; and specified economic conditions, which are generally accepted as being reasonable.

Prospective resources are those quantities of petroleum estimated, as of a given date, to be potentially recoverable from undiscovered accumulations by application of future development projects. Prospective resources have both an associated chance of discovery and a chance of development. Not all exploration projects will result in discoveries. The chance that an exploration project will result in the discovery of petroleum is referred to as the "chance of discovery." Thus, for an undiscovered accumulation the chance of commerciality is the product of two risk components - the chance of discovery and the chance of development.

## **Seasonality**

The level of oil and natural gas exploration and development activity in the Kamchatka Peninsula is influenced by seasonal weather patterns. Wet weather and spring thaw may make the ground unstable, with associated restrictions on the movement of rigs and other heavy equipment, thereby reducing activity levels. Also, certain oil and natural gas producing areas are located in areas that are inaccessible other than during the winter months because the ground surrounding the sites in these areas consists of swampy terrain. Seasonal factors and unexpected weather patterns may lead to declines in exploration and production activity and potential declines in production of oil and natural gas of PetroKamchatka. Supplies are shipped via water in the summer during the shipping season from May to September. In winter months there is possible access by way of winter roads.

## **Competition**

Oil and natural gas exploration is intensely competitive in all its phases and involves a high degree of risk. PetroKamchatka competes with numerous other participants in the search for oil and natural gas properties. PetroKamchatka's competitors include oil and natural gas companies that have substantially greater financial resources, staff and facilities than those of PetroKamchatka. PetroKamchatka's ability to establish and increase reserves in the future will depend not only on its ability to explore and develop its present properties, but also on its ability to select and acquire suitable producing properties or prospects for exploratory drilling. In addition, competitive factors will affect the distribution, marketing and prices realized from future oil and natural gas sales and will be affected by methods and reliability of delivery. Competition may also be presented by alternate fuels and other sources of energy.

## **Conflicts of Interest**

Certain directors of the Corporation and its subsidiaries are associated with other reporting issuers or other corporations, which may give rise to conflicts of interest. Some of these corporations may, from time to time, be involved in business transactions which may create situations in which conflicts may arise. Ultimately, conflicts of interest declarations by the individuals will be subject to and governed by the procedures and remedies set forth in Jersey Law, if necessary.

## **Issuance of Debt**

PetroKamchatka requires significant financial resources to conduct its exploration plans and to develop its properties. These activities may be financed partially or wholly with debt, which may increase PetroKamchatka's debt levels above industry standards. Depending on future exploration and development plans, if any, PetroKamchatka may require additional equity and/or debt financing that may not be available or, if available, may not be available on favourable terms. The level of PetroKamchatka's indebtedness from time to time could impair PetroKamchatka's ability to obtain additional financing in the future on a timely basis to take advantage of business opportunities that may arise. At November 30, 2011 and May 31, 2011, and the date of the MD&A, the Corporation had no debt.

## **Variations in Exchange Rates**

PetroKamchatka is exposed to foreign currency fluctuations as it holds cash and incurs capital expenditures and expenses in Russian roubles, Euros, Pounds Sterling and Canadian Dollars and is exposed to fluctuations in exchange rates of these currencies relative to the US dollar. There were no forward foreign exchange rate contracts in place as at November 30, 2011 and May 31, 2011 or at any time during the periods then ended May 31, 2011 or thereafter.

## **Hedging**

PetroKamchatka does not currently engage in any hedging activities.

## **Fluctuations in the price of the PetroKamchatka Plc Shares**

In recent years, the stock market has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market price of securities issued by many companies for reasons unrelated to the operating performance of these companies. The market price of the Corporation's common shares could be subject to wide fluctuations in response to a number of factors, most of which PetroKamchatka cannot control, including:

- changes in securities analysts' recommendations and their estimates of PetroKamchatka's financial performance;
- fluctuations in broader stock market prices and volumes, particularly among securities of oil and natural gas services companies;
- changes in market valuations of similar companies;
- investor perception of PetroKamchatka's industry or its prospects;
- additions or departures of key personnel;
- commencement of or involvement in litigation;
- changes in environmental and other governmental regulations;
- announcements by PetroKamchatka or its competitors of strategic alliances, significant contracts, new technologies, acquisitions, commercial relationships, joint ventures or capital commitments;
- variations in PetroKamchatka's quarterly results of operations or cash flows or those of other oil and natural gas companies;

- revenues and operating results failing to meet the expectations of securities analysts or investors in a particular quarter;
- future issuances and sales of the Corporation's shares or other securities;
- demand for and trading volume of the Corporation's shares;
- domestic and worldwide supplies and prices of and demand for oil and natural gas; and
- changes in general conditions in the domestic and worldwide economies, financial markets or the oil and natural gas industry.

The realization of any of these risks and other factors beyond PetroKamchatka's control could cause the market price of the Corporation's shares to decline significantly. In particular, the market price of the Corporation's shares may be influenced by variations in oil and natural gas commodity prices, because demand for PetroKamchatka's services is closely related to the prices of these commodities. This may cause the Corporation's share price to fluctuate with these underlying commodity prices, which are highly volatile.

#### **Risk associated with non-compliance with specific, formal requirements of Russian law**

Pursuant to some provisions of Russian law, a court may order the liquidation of a Russian company due to non-satisfaction of formal requirements by such company, associated with the incorporation, reorganization or operations of a company. There have been cases in the past where formal infringements in the course of establishing a Russian company or the failure to satisfy the requirements of Russian law have been used by Russian courts as grounds for the liquidation of the company. For instance, under Russian commercial company law, a negative value of net assets, computed in compliance with Russian accounting standards as at the end of the second or subsequent year of a company's operations, may serve as grounds for the court to issue an order to liquidate the company upon a motion submitted by State administration authorities. Numerous Russian companies have a negative value of net assets, caused by very low, historical level of total assets indicated in the balance sheet drawn in compliance with Russian accounting standards, however, this has no negative impact on the solvency of such companies, i.e., ability to cover current debts. When taking the decision on issuing an order on the liquidation of a company, some Russian courts have been guided not only by the fact that the given company failed to satisfy the binding requirements of the law, but also by other factors, such as i.e., the financial condition of the company and its ability to meet tax requirements, as well as the business and economic consequences of its liquidation. Such risk is present in relation to some of the Russian subsidiaries and affiliates. In July 2011, OJSC LukinCholot, CJSC Tigil Exploration and CJSC Icha exploration received information letters from the regional inspection tax service of Kamchatka advising the entities of the negative net asset balance in each entity. In case of refusal from voluntary liquidation or action by the shareholders of these entities to eliminate the negative asset balance, the regional tax service could assume measures to liquidate the companies by judicial means.

In case of liquidation, PetroKamchatka may be forced to reorganize the current operations carried out by such subsidiaries. One of the consequences of liquidation is the automatic loss of all the rights resulting from Geological Licenses. Such liquidation may result in additional costs, which in consequence may have an adverse effect upon the operations, results, financial condition or development prospects of PetroKamchatka.

#### **Risk associated with the obligations of stockholders, ensuing from the provisions of Russian law**

Under Russian law, a stockholder of a Russian joint-stock company bears no liability for the company's obligations and only bears the risk of losing the invested capital. This principle, however, is subject to an exemption in situations where: (i) the company is declared bankrupt due to any actions or omissions on the part of a stockholder or a shareholder; and (ii) the value of the company's assets is not sufficient to pay its obligations. Moreover, a stockholder in a Russian joint-stock company who has control over the company and has the right to issue binding instructions to the company, is jointly and severally liable with the company for any obligations resulting from transactions entered into or action taken upon instructions of such stockholder or shareholder.

Pursuant to the above, PetroKamchatka may in some cases be held liable for the liabilities of its Russian subsidiaries or affiliates, which may have material adverse effects on the operations, results, financial condition or development prospects of PetroKamchatka.

### **PetroKamchatka may be unable to recover funds from Russian subsidiaries**

From time to time, PetroKamchatka may transfer funds to its Russian subsidiaries or affiliates in the form of loans, advances or equity contributions. There is no assurance that PetroKamchatka's subsidiaries or affiliates will be able to pay principal or interest on loans or advances or distribute dividends without incurring costs, expenses, fees or charges, due to Russian currency control regulation, limitations on the payment of dividends, taxation of such payments and other Russian law restrictions. Such costs, expenses, fees or charges may have material adverse effects on the value of the Corporation's shares.

### **Risk associated with access to oil and natural gas storage, transmission and transport infrastructure**

There is a risk associated with restricted access to the transmission and transportation infrastructure, which could limit the possibilities for oil and natural gas sales outside the Russian Federation. Access of third parties to the transmission capacities and exporting potential is highly dependent on the discretionary decisions of the Russian Government and the existing syndicates of companies, controlling the transmission infrastructure. In the case of commercial discoveries, PetroKamchatka will have to incur investment outlays for the transmission and storage infrastructure. There is no guarantee that any of the Russian Subsidiaries' access to transmission and transport infrastructure will not be hampered, or that the future costs for the storage and transmission infrastructure will not be significant and may have a material adverse effect on the operations, results, financial condition or development prospects of PetroKamchatka.