

# Building confidence in a growing market >>>

Eurasia Drilling Annual Report 2007

# Building confidence in a growing market >>>

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# Chairman's statement

On the back of strong performance and a successful IPO, we now have the opportunity to expedite and implement our expansion plans and leadership strategy.



**Lord Patrick James Gillford**  
Chairman

In our first year as a publicly traded company I am delighted to be able to report excellent results to you – a record year in terms of revenue, profit, cash flow and earnings per share, as well as outstanding operational figures. For example, our revenue increased by US \$405 million, or 37.2%, to US \$1,492 million for 2007 from US \$1,088 million in 2006. Net income increased by US \$78 million, or 85.7%, to US \$169 million in 2007 as compared to US \$91 million in 2006, and earnings per share increased from US \$0.76 in 2006 to US \$1.31 in 2007. However, the year 2007 will be remembered as a landmark year in EDC's history not only for its record performance, but also for a successful completion of an Initial Public Offering in November 2007 raising US \$783 million, of which US \$514 million (including US \$64 million from exercise of an overallotment, or 'greenshoe' option) was in the form of new shares issued. These superb results reflect the hard work of EDC's bright and innovative team. It is also the result of important strategic choices we made – choices that have put EDC in a strong position to continue to grow profitably, to strengthen our client relationships, and to seize the most attractive opportunities in a very dynamic global economy.

On the back of strong performance and a successful IPO, we now have the opportunity to expedite and implement our expansion plans and leadership strategy. We have already started to capitalize on the opportunities available by securing a future drilling rig fabrication facility in Kaliningrad, Russia through a partnership with LeTourneau Technologies Inc. This project will guarantee

EDC access to advanced, fast moving and custom-designed rigs at the lowest possible cost. It will also enhance our leadership position and meet the Company's expansion plans. For the first time crews will be commissioning 'fit for purpose rigs' as they arrive in the field. Simultaneously, we have increased the number of crews and drilling rigs, and as a result increased the number of meters drilled by 31% and the Company's overall onshore drilling market share in Russia from 20.3% in 2006 to 22.4% in 2007.

Our vision is to become the leading provider of drilling services in Russia. This goal is expected to be achieved through a combination of organic growth and acquisitions, including in particular expansion into new geographic markets serving new clients. We implemented this strategy in 2007 with the Company diversifying its customer base with non-LUKOIL business increasing from 18% (or 0.45 million meters drilled) in 2006 to 24% (or 0.80 million meters drilled) in 2007 and increasing the total number of drilling rigs to 195 at the end of 2007 from 178 at the end of 2006.

EDC continued to invest in expanding our current areas of operation and in the penetration of new markets, not only geographically but in rig types and business lines. In 2007 we expanded our business in East Siberia and Kazakhstan and strengthened our position as an offshore driller.

To increase high value services we provide to our clients, we continued to make substantial investments in the latest rig and equipment technology, as well as technology modernization by replacing old mud pumps, mud cleaning systems, and installing top drives on the high capacity rigs.

More than 1,700 people joined the Company in 2007.

# 1,700

All these actions heightened our performance during the year and, more importantly, strengthened our competitive position for the future.

With all the outstanding results we have achieved, we recognize that the secret to our success is not only our rigs, but the people who operate them. Highly qualified and experienced crews and a leading management team are essential to our ability to compete. In 2007, we continued to work hard to ensure that we attract and retain the people we need to grow our business, as well as to enhance our training and development programs. Importantly, we reduced employee attrition 5% compared to the previous two years. We also had a great year in terms of adding skilled team members to our ranks, with more than 1,700 people joining the Company in 2007.

We set goals for 2007 and I am delighted to report that we have achieved and exceeded them. The year's achievements have been reflected in our strong performance. EDC capitalized on the opportunities available to it this year and is strongly positioned to continue to take advantage of a favourable market and achieve top-tier performance in the years ahead. Insofar as 2007 was a landmark year for EDC, we expect that 2008 will be a year of further growth and I look forward to reporting on our progress.

In closing, I would like to thank Alexander Djaparidze for his leadership as our CEO. His knowledge of our industry, his leadership skills and contagious charisma are qualities that have been instrumental in driving the Company forward. I would also like to thank our Board of Directors for their vision, experience and confidence; our employees for their dedication, hard work and commitment to safety and integrity; our customers for the opportunity to earn their business; and our shareholders for their support of EDC.

**Lord Gillford**  
Chairman  
June 30, 2008

# Chief Executive Officer's statement

We have succeeded in delivering on our objectives and made good progress in shaping our business for the future.



**Alexander Yu. Djaparidze**  
Chief Executive Officer

The past year has been one of EDC's best years. We have succeeded in delivering on our objectives and made good progress in shaping our business for the future. Driving this performance through an exciting market are EDC's high-quality assets, innovation and application of new technology, strong customer relations, a solid balance sheet, increased demand for our services and, most importantly, our talented and dedicated employees who are the foundation of EDC. Some of the highlights for 2007 include:

- Increased revenues to a record US \$1,492 million, a 37.2% increase over 2006;
- Grew net income by US \$78 million, or 85.7%, to a record US \$169 million in 2007, as compared to US \$91 million in 2006;
- Improved earnings before interest, taxes, depreciation and amortization (EBITDA) by 77.8% to a record US \$295 million;
- Grew earnings per share from US \$0.76 in 2006 to US \$1.31 in 2007;
- Increased the Company's overall onshore drilling market share in Russia from 20.3% in 2006 to 22.4% in 2007;
- Invested US \$273 million in fleet enhancement and upgrades; and
- Increased total number of drilling rigs to 195 (from 178 in 2006).

As the search for oil reserves increasingly leads to remote operating environments and locations, demand is increasing for EDC's drilling solutions in diverse geographical areas in Russia.

## Financial results

In November 2007, EDC successfully completed an Initial Public Offering raising US \$783 million, of which US \$514 million (including US \$64 million from the exercise of an overallotment or 'greenshoe' option by the underwriters) was in the form of new shares issued.

In 2007, EDC increased its revenues by US \$405 million, or 37.2%, to US \$1,492 million from US \$1,088 million in 2006. The key component driving revenue growth was increased demand, with EDC having drilled 3,268,564 meters in 2007 compared to 2,495,405 meters in 2006. This increased demand was met by adding drilling crews, improving the productivity of our existing drilling crews and utilizing a greater number of drilling rigs.

Our operating profit increased 72.5% to US \$255 million, compared to US \$148 million in 2006. For the full year in 2007, the Company's net income increased by US \$86 million, or 85.7%, to US \$169 million, as compared to US \$91 million in 2006. EBITDA increased 77.8% to US \$295 million in 2007 (US \$166 million in 2006), with EBITDA margin increasing from 15.3% in 2006 to 19.8% in 2007. We also grew earnings per share from US \$0.76 in 2006 to US \$1.31 in 2007.

During the year we continued to enhance our financial flexibility by reducing our debt in proportion to total capitalization. In 2007, our equity ratio was 74.3%, as compared to 36.8% in 2006.

Increased revenues from US \$1,088 million in 2006 to US \$1,492 million.

# +37%

In 2007 our total capital expenditures were US \$273 million compared to US \$96 million in 2006 (excluding acquisitions and including advances for rigs under construction). EDC's business is capital intensive and expenditures are primarily required to (1) purchase new drilling rigs and equipment; (2) upgrade and modernize the existing drilling rigs and equipment; and (3) sustain existing equipment. In response to an extremely tight rig supply market and with a desire to enhance the quality and versatility of our assets, EDC in 2007 negotiated and signed an agreement with LeTourneau Technologies Inc, to produce drilling rigs custom designed for the Russian topography, climate and drilling environment at the assembly and fabrication plant in Kaliningrad. This facility is expected to provide for all of EDC's internal rig requirements from 2010 onwards. The first rig is due for delivery in the last quarter of 2008 and will be purpose built to EDC's specifications and drilling requirements utilising the manufacturing expertise of LeTourneau's engineers and supervisors.

### Operations

EDC has increased its overall onshore drilling services market share in Russia from 20.3% in 2006 to 22.4% in 2007, as measured by number of meters drilled, and expects 2008 to be an equally positive year.

Our business is currently organized within two main divisions, onshore and offshore drilling services. Our onshore drilling services include the construction of production, exploration and appraisal oil and gas and certain other types of wells, including vertical, deviated and horizontal wells, ranging from a depth of approximately 1,200 to more than 5,000 meters. In addition, through the onshore division we provide a wide range of workover services, including sidetracking. We provide our onshore drilling services in several major onshore oil and gas regions of the Russian Federation – Western Siberia, Timan-Pechora and Volga-Urals. In 2007, EDC continued to implement our strategy of increasing our presence and growing our business in key regions where the long-term growth potential is the highest and expanded our operations in Eastern Siberia and Kazakhstan. Our offshore division drills oil

and gas exploration and production wells in waters with depths of up to 45 meters. We provide our offshore drilling services with our Astra jack-up rig. In 2007, we drilled wells in the Russian, Kazakh and Turkmen sectors of the Caspian Sea.

In 2007, we increased the number of meters drilled by 31% to 3.3 million meters, as compared to 2.5 million meters in 2006. In addition, our operations resulted in efficiency gains, which included EDC drilling its first million meters in 125 days, as compared to 154 days in 2006.

During the past year, we have continued to diversify our customer base, with non-LUKOIL business increasing from 18% (or 0.45 million meters drilled) in 2006 to 24% (or 0.80 million meters drilled) in 2007. In addition to LUKOIL, our customers include a number of the major Russian and international oil and gas companies operating in Russia and the Caspian Sea, such as Rosneft, Gazpromneft, TNK-BP, Total, Shell and Naryanmarneftegas, a joint venture between LUKOIL and ConocoPhillips.

### Investing in technology

In 2007 EDC continued to invest in enhancing the quality and versatility of our assets. In addition to securing a rig assembly and fabrication facility in Kalinigrad, we have focused our efforts on acquiring new high-specification rigs that lend themselves to reconfiguration for new drilling applications and to the upgrades necessary to fully exploit advancements in technology. Over the last year we have expanded our fleet to 195 drilling rigs, as compared to 178 in 2006. We are also continuing to implement a fleet-wide program to increase individual rig power in order to drive higher capacity mud pumps and mud systems necessary to enable the implementation of better drilling fluids, more powerful down hole motors and new drill bit technologies (PDC). Top drives combined with modern directional drilling services enable EDC to capitalize on drilling the challenging wells precisely to the client's subsurface target. Collectively, these actions are reducing the time required to drill a well, creating the impetus to continue investing in corresponding reductions in rig-moving time to further shorten the drilling cycle.

Expansion of our drilling rigs to 195 from 178 in 2006.

# 195

### **Investing in people**

People make the difference at EDC. Our team is made up of highly-qualified professionals who bring the highest level of integrity to everything they do. We invest in retaining and training motivated specialists who share our high performance culture, producing results for our customers and creating value for our shareholders.

We have a proven track record in recruiting and developing new employees through co-operation with 18 universities and 13 colleges and offering competitive compensation and benefits. To meet the increased demand and take advantage of the new market opportunities in 2007, EDC grew its workforce by adding more than 1,700 employees. As a result, we increased the number of crews to 263, as compared to 216 in 2006. During the past year we have made a considerable investment in training and developing these new employees. In addition to expanded classroom training at state of the art training facilities, we introduced mentoring and on-the-job training programs, which integrate EDC's experience and knowledge of geology.

### **Outlook**

Most industry forecasts predict that global hydrocarbon demand will continue to increase as known oil and gas reserves decline. The demand for new fields and maximization of production from existing assets will increase. With these prospects in mind, we intend to fully exploit the growth opportunities before us. We anticipate that the 2008 financial year will demonstrate another year of growth in EDC's performance. We plan to increase the Company's revenue to US \$1.9 billion, based in part on our current backlog for 2008 (3.8 million meters).

To do so and to ensure our continuing success, we will be focusing our efforts on achieving operational excellence, particularly in seven crucial areas:

- Developing our existing employees and recruiting new talent, as well as continuing to improve the working environment and remuneration for employees; and

- Continuing to improve drilling efficiency with an existing resource base and adding new capacity; and
- Pursuing new projects and acquisitions to expand EDC's client base and geographic position; and
- Expanding offshore drilling and related services; and
- Investing in new drilling technologies to deliver more complex and high revenue wells; and
- Ramping up capacity at our Kaliningrad rig assembly and fabrication facility to meet future rig requirements; and
- Enhancing EDC's HS&E program.

All of us at EDC recognize that we have important responsibilities to our shareholders, customers and local communities. We strive to deliver superior returns to our shareholders with the most technologically advanced and versatile drilling rig fleet in Russia. Our goal is to deliver the most efficient drilling service to our customers, to have incident-free operations and have as little impact on the environment as possible. Our employees are committed to providing top quality services and have done an outstanding job in making EDC the leading independent drilling services provider in Russia.

In 2007 EDC achieved record revenues, while also earning its highest annual operating profit. We are pleased with the progress we have made in growing our business and developing the platform for long-term growth. I am proud of the EDC team for bringing us to this point and am grateful to you, our shareholders, for your support. Today, our direction is clear and EDC is well positioned to continue to take advantage of the growth of the oil industry in Russia, one of the premier oil and gas regions in the world. As we do, I hope and trust that you will be pleased with your investment in our Company.

### **Alexander Yu. Djaparidze**

Chief Executive Officer  
June 30, 2008

# Discussion and analysis of financial condition and results of operations

As of December 31, 2007, we estimate that our onshore drilling services market share in Russia reached 22.4%.

The following Discussion and Analysis of Financial Condition and Results of Operations is intended to help our shareholders understand the results of our operations and our financial condition. This information is provided as a supplement to, and should be read in conjunction with our Audited Consolidated Financial Statements and the accompanying notes, prepared in accordance with US GAAP and included elsewhere in this document. As used in this Discussion, 'Company', 'we,' 'us,' 'our' and 'EDC' means Eurasia Drilling Company Limited and, where the context requires, includes our subsidiaries.

## Nature of operations

According to Douglas-Westwood, we are the largest independent provider of onshore drilling services in Russia, as measured by the number of meters drilled, providing onshore integrated well construction services and workover services. In addition, we provide offshore drilling services in the Caspian Sea. We offer our onshore integrated well construction services and workover services to local and international oil and gas companies primarily in Russia and our offshore drilling services to Russian and international oil and gas companies in the Russian, Kazakh and Turkmen sectors of the Caspian Sea.

We entered the onshore drilling and workover services business in December 2004 by acquiring substantially all of the onshore drilling and certain related assets of LUKOIL. In 2006, we entered the offshore drilling business by acquiring the offshore drilling business of LUKOIL, which included 'Astra', a floating jack-up drilling rig located in the Caspian Sea. According to Douglas-Westwood, as at December 31, 2006, we had an estimated market share of approximately 20.3% of the onshore drilling services market in Russia, as measured by number of meters drilled. As of December 31, 2007, we estimate that our market share reached 22.4%.

Our business is currently organized within two main divisions, onshore and offshore drilling services. Our onshore drilling services include the construction of production, exploration and appraisal oil and gas wells and certain other types of wells, including vertical, deviated and horizontal wells, ranging from a depth of approximately 1,200 to more than 5,000 meters. In addition, through the onshore division we provide a wide range of workover services, including sidetracking. We provide our onshore drilling services in several major onshore oil and gas regions of the Russian Federation – Western Siberia, Timan-Pechora and Volga-Urals – and have recently begun to provide onshore drilling services in Kazakhstan on a limited basis. Our offshore division constructs oil and gas exploration and production wells in waters with depths of up to 45 meters. We provide our offshore drilling services with our jack-up rig, the Astra. In addition to LUKOIL, our customers include a number of the major Russian and international oil and gas companies operating in Russia and the Caspian Sea, such as Rosneft, Gazpromneft, TNK-BP, Total, Shell and Naryanmarneftegas, a joint venture between LUKOIL and ConocoPhillips.

## Overview

Our 2007 financial and operating results include:

- raising US \$783 million in an Initial Public Offering ('IPO') in November 2007, valuing the Company at approximately US \$2.4 billion;
- revenues increasing by 37.2% to US \$1,492 million;
- net income growing to a record US \$169 million;
- earnings before interest, taxes, depreciation and amortization (EBITDA) improving by 77.8% to a record US \$295 million;
- earnings per share increasing from US \$0.76 in 2006 to US \$1.31 in 2007;
- net cash provided by operating activities totaling a record US \$128 million;
- growth of the Company's overall onshore drilling market share in Russia from 20.3% in 2006 to 22.4% in 2007;
- an increase in total number of drilling rigs to 195 from 178;

- 
- announcement of a contract with LeTourneau Technologies Inc, to produce drilling rigs, custom designed for the Russian topography, climate and drilling environment, at an assembly and fabrication plant in Kaliningrad; and
  - a decrease in debt to approximately 25% of total capitalization at the end of 2007, from 63% at the end of 2006.

Demand for drilling services depends on a variety of factors, including worldwide demand for oil and gas, the ability of OPEC to set and maintain production levels and pricing, the level of production of non-OPEC countries and the policies of the various governments regarding exploration and development of their oil and gas reserves.

Our results of operations in particular depend on the levels of activity in Russia and countries of the Caspian Sea region, and the level of prices of crude oil and natural gas in Russia. While world prices for crude oil are characterized by significant fluctuations, determined by the global balance of supply and demand, Russian natural gas prices are regulated by the Russian government. While Russian natural gas prices have increased in recent years, and are expected to continue to rise to a level closer to parity with export netbacks, they are still significantly below world levels. The results of our workover operations tend to be less sensitive to the fluctuations in crude oil and natural gas prices, as our clients require such services to be performed with respect to their existing wells, which may require workover both during periods of high and low oil prices.

In 2007 our business continued to benefit from favorable market conditions resulting primarily from high commodity prices and increased demand. This increased demand was met by adding drilling crews, improving the productivity of our existing drilling crews and utilizing a greater number of drilling rigs.

We increased the number of crews to 263, as compared to 216 in 2006, and the number of drilling rigs to 195, as compared to 178 in 2006. As a result, we increased the number of meters drilled by 31.0% to 3.3 million meters, as compared to 2.5 million meters in 2006. In addition, our operations resulted in efficiency gains, which included EDC drilling its first million meters in 125 days, as compared to 154 days in 2006.

The productivity of our crews was improved due to the recent implementation and utilization of more advanced drilling technologies and the application of new standards to our drilling operations. The former include the use of Polycrystalline Diamond Compact drill bits in conjunction with modern drilling motors, drilling with real-time drilling navigation, the use of top-drives and four-step drilling mud cleaning systems. The latter include, for example, an increase in allowed deviations of vertical wells and the use of drilling mud that is more suitable for the geological conditions in which we operate.

During the past year, we have also continued to diversify our customer base, with non-LUKOIL business increasing from 18% (or 0.45 million meters drilled) in 2006 to 24% (or 0.80 million meters drilled) in 2007.

# Discussion and analysis of financial condition and results of operations continued

The company is focused on identifying growth opportunities and following a disciplined investment policy to capitalize on these opportunities.

At the same time, we continue to face cost pressure as a result of increases in labor costs, costs of services contracted to subcontractors, such as, for example, construction of well pads and access roads and petrophysical services, and prices for materials essential to our operations. Cost of services increased by US \$243 million, or 30.1%, to US \$1,050 million for 2007 (US \$807 million in 2006). However, cost of services as a percentage of total revenue decreased from 74.2% in 2006 to 70.4% in 2007. Thus, these labor and vendor cost increases, while meaningful, were acceptable given the overall increase in revenue in 2007. In 2007 EDC negotiated and signed an agreement with LeTourneau Technologies Inc, to produce drilling rigs custom-designed for the Russian topography, climate and drilling environment at an assembly and fabrication plant in Kaliningrad. This facility will provide EDC with guaranteed access to advanced, fast moving, heavy lift rigs at the lowest possible cost.

## Outlook

The price of oil remains at world record levels and shows few signs of retreating unless there is an unanticipated and precipitous reduction in demand.

Our long-standing business strategy continues to be the active expansion of our operations through acquisitions, expansion in offshore drilling and selective expansion in closely related services, upgrades and modifications and the deployment of our drilling assets in key geographic locations. In 2007 we continued the execution of our active expansion strategy by the following developments and activities:

- expansion of our onshore drilling operations in Kazakhstan and Eastern Siberia, where the oilfield services market is expected to grow at 50% CAGR by 2011 according to Douglas-Westwood;

- strengthening of our position as an offshore drilling services provider in the Russian and Turkmen sectors of the Caspian Sea;
- offering a wider range of higher margin drilling and workover services, including sidetracking and horizontal drilling;
- implementation of a fleet-wide modernization program to replace old mud pumps and mud cleaning systems, and to install top drives on the high capacity rigs; and
- securing a future drilling rig fabrication facility in Kaliningrad, Russia through a partnership with LeTourneau Technologies Inc. to guarantee EDC access to advanced, fast moving and custom-designed rigs at the lowest possible cost. This facility is expected to provide for all of EDC's internal rig requirements from 2010 onwards.

In 2007 our total capital expenditures and advances for fleet enhancement and upgrades were US \$273 million compared to US \$96 million in 2006 (excluding acquisitions) and including advances for rigs under construction.

In 2008 we will continue to make significant capital expenditures for the purpose of taking advantage of the growing demand for drilling services in our market. The company is focused on identifying growth opportunities and following a disciplined investment policy to capitalize on these opportunities. The Company remains committed to technology leadership and will continue to focus its investments, complemented with strategic acquisitions, on high-value, high-growth opportunities.

Also, we expect to continue to invest in a number of recruitment, retention and personnel development initiatives in connection with the manning of the crews and our efforts to mitigate expected personnel attrition.

We increased the number of meters drilled to 3.3 million compared to 2.5 million meters in 2006.

# +31%

We anticipate a continuation of favorable market conditions in 2008. As a result, we expect strong results in 2008 from our operations as we realize our expansion strategy.

### Results of operations

We made considerable progress implementing our strategies in 2007. These actions have resulted in solid financial performance with

strong and balanced contribution across all geographies and business lines. The strong performance reflects the extensive modernization and upgrade of our equipment, investment in training and development of our crews, continued improvement of our cost control initiatives and a disciplined approach to developing new business from existing accounts.

### Revenues

The following table sets forth a summary of our operating results for 2007 and 2006 (for additional information, please see the accompanying Consolidated Financial Statements):

#### Consolidated statements of income for the years ended December 31, 2007 and 2006 (All figures in thousands of US dollars, unless otherwise noted)

	2007	2006
<b>Revenues</b>		
Drilling and related services	1,468,047	1,048,209
Other sales and services	24,142	39,363
<b>Total revenues</b>	<b>1,492,189</b>	<b>1,087,572</b>
Cost of services	(1,049,762)	(806,881)
Selling, general and administrative expenses	(90,021)	(68,243)
Taxes other than income taxes	(56,574)	(41,250)
Depreciation	(40,423)	(23,722)
(Loss)/gain on disposal of property, plant and equipment	(610)	275
<b>Income from operating activities</b>	<b>254,799</b>	<b>147,751</b>
Interest expense	(29,880)	(19,392)
Interest income	4,546	1,343
Currency transaction gain	349	870
Other expenses	(363)	(6,350)
<b>Income before income taxes</b>	<b>229,451</b>	<b>124,222</b>
Income tax expense	(60,907)	(33,457)
<b>Net income</b>	<b>\$168,544</b>	<b>\$90,765</b>
<b>Basic earnings per share of common stock (US dollars)</b>	<b>1.31</b>	<b>0.76</b>

Total revenues increased by US \$405 million, or 37.2%, to US \$1,492 million for 2007 from US \$1,088 million in 2006. These results of operations for the 2007 were primarily influenced by an increase in the volume of drilling services provided by us and the annual increase in prices for our services that became effective in January 2007. For the past year, we increased the number of meters drilled by 31% to 3.3 million meters,

as compared to 2.5 million meters in 2006. This increase primarily resulted from an increase in the volume of drilling services provided to the companies of the LUKOIL group, as well as addition of new clients. The decrease in the revenues attributable to other sales and services, from US \$39.36 million to US \$24.14 million for 2007, primarily resulted from the sale of our workover operations in the Perm region in 2007.

## Discussion and analysis of financial condition and results of operations continued

Cost of services increased by 30.1% in 2007. However, as a percentage of total revenue this decreased from 74.2% in 2006 to 70.4% in 2007.

### Cost of services

Cost of services includes the following (in thousands of US \$):

	2007	2006
Materials	342,154	243,553
Services of subcontractors	336,615	318,766
Wages and salaries	233,323	151,743
Fuel and energy	57,888	47,467
Transportation of employees to drilling fields	27,714	23,085
Leasing and rent	11,331	8,504
Other	40,737	13,763
<b>Total cost of services</b>	<b>1,049,762</b>	<b>806,881</b>

Cost of services increased by US \$243 million, or 30.1%, to US \$1,050 million for 2007 from US \$807 million in 2006. As described more fully below, our cost of services for 2007 was primarily affected by an increase in the volume of drilling services provided by us. However, cost of services as a percentage of total revenue decreased from 74.2% in 2006 to 70.4% in 2007. In addition to an increase in revenue, we believe the margin improvement was primarily attributable to a concerted effort by management to improve the cost efficiency associated with our overall drilling process.

We generally subcontract with third parties to provide us with certain services in our onshore division in instances where we do not perform these services ourselves. In our onshore division, services contracted from third parties include the cost of subcontracting for technological transportation services; preparatory services; well facility services; construction of well pads and access roads; petrophysical services; well services; drilling motor and drilling navigation equipment repair services; cementing services; and drilling bit services. Services of subcontractors were the largest component of our cost of services for 2007 and 2006. Services of subcontractors for 2007 were US \$336.6 million, or 32% of total cost of services, as compared to US \$318.8 million, or 39.5% of total cost of services, for 2006. This increase was primarily a result of an increase in the volume of drilling services provided by us and the acquisition of our offshore division, which commenced operations on January 1, 2007.

Expenditures for materials have been primarily influenced by our customers' particular drilling programs and projects. Materials for our onshore and offshore drilling divisions primarily include tubular goods, chemicals and cement and drilling tools. Materials costs for 2007 were US \$342.2 million, or 32.6% of total cost of services as compared to US \$243.5 million, or 30.2% of total cost of services for 2006. This increase resulted primarily from an increase in the volume of drilling services provided by us and the acquisition of our offshore division on January 1, 2007, which resulted in extra costs of materials that were required in our offshore drilling operations.

Employee wages and salaries include costs of our personnel directly engaged in providing onshore and offshore drilling and other services. Employee costs include amounts we are required to pay to the Russian government in support of pension, social insurance and medical funds. The rate of contribution depends upon the amount of the salaries, wages and benefits accrued for our employees in the Russian Federation. Such expenses do not include contributions which we make to LUKOIL-GARANT, a private pension fund. Wages and salaries for 2007 were US \$233.3 million, or 22.2% of total cost of services as compared to US \$151.7 million, or 18.8% of total cost of services for 2006. The increase was primarily due to the additional crews hired to accommodate the increase in the volume of drilling services provided by us, acquisition of our offshore division and a number of company-wide salary increases.

Fuel and energy costs consist primarily of oil and lubricants. Fuel and energy costs for 2007 were US \$57.8 million, or 5.5% of total cost of services as compared to US \$47.5 million, or 5.9% of total cost of services for 2006. The increase in fuel and energy costs for 2007 was, in large part, due to an increase in fuel prices during this period. The decrease of fuel and energy costs as a percentage of our costs of services was partially attributable to a decrease in the use of diesel fuel powered drilling rigs during 2007.

Costs relating to the transportation of employees to drilling fields primarily include transportation services related to the mobilization and rotation of rig crews. Expenses relating to the transportation of employees to drilling fields for 2007 were US \$27.7 million, or 2.6% of total cost of services as compared to US \$23 million, or 2.9% of total cost of services for 2006. The decrease in the costs relating to the transportation of employees to drilling fields as a percentage of our costs of services for 2007 was primarily a result of optimization of transportation logistics, which included a change of the rotation schedule of our crews from a day rotation to a 21 day rotation and a change in the means of transportation from air to railroad travel.

Leasing and rent costs consist primarily of the cost of renting drilling equipment. Leasing and rent costs for 2007 were US \$11.3 million, or 1.08% of total cost of services as compared to US \$8.5 million, or 1.05% of total cost of services for 2006. The increase in leasing and rent costs for 2007 was primarily attributable to lease and rent price increases and an increase in the amount of equipment leased as a result of the company's business growth.

The remaining portion of our cost of services, which we categorize as 'other', includes current repair expenses for fixed assets; license fees; insurance expenses; safety and environmental expenses; and maintenance expenses. Other expenses amounted to US \$40.7 million or 3.9% of our total cost of services for 2007, as compared to US \$13.8 million or 1.7% of our total cost of services for 2006. The increase in the remaining portion of our cost of services for 2007 was primarily due to additional expenses related to our new comprehensive insurance program which became effective as of June 1, 2007 and crew facilities' maintenance expense.

#### **Selling, general and administrative expenses**

Selling, general and administrative expenses increased by US \$21.8 million to US \$90 million for 2007, as compared to US \$68.2 million for 2006. The increase in selling, general and administrative expenses was due primarily to the increase in the volume of business in the Naryanmar and Usinsk branches of BKE.

#### **Taxes other than income taxes**

Taxes other than income taxes increased by US \$15.3 million to US \$56.6 million for 2007 as compared to US \$41.3 million for 2006. The increase in taxes other than income taxes was primarily attributable to our asset base increase, business growth and an increase in the amount of social taxes payable by us resulting from an increase in the number of employees in 2007. Such taxes other than income tax attributable to business growth included various local taxes, such as property tax, education tax, police tax, animal protection tax and small nations tax.

#### **Depreciation**

Depreciation increased by US \$16.7 million to US \$40.4 million as compared to US \$23.7 million for 2006. The increase in depreciation was primarily the result of an increase in capital expenditures, particularly the acquisition of additional drilling equipment.

#### **Disposal of Property, Plant and Equipment**

Loss on the disposal of property, plant and equipment increased by US \$0.8 million to US \$0.6 million for 2007, as compared to a gain of US \$0.2 million for 2006. This loss was primarily due to the disposal of certain non-core assets in the Volga-Urals Region.

#### **Cash provided from operating activities**

Cash provided from operating activities increased by US \$107 million to US \$254.8 million for 2007, as compared to US \$147.8 million for 2006. The increase in cash provided from operating activities was primarily attributable to the increase in total revenues and cost optimization.

#### **Interest expense**

Interest expense increased by US \$10.6 million to US \$29.9 million for 2007, as compared to US \$19.4 million for 2006. The increase in interest expense was primarily attributable to additional borrowings to finance capital expenditures, such as acquisitions of new drilling rigs, and to maintain working capital.

# Discussion and analysis of financial condition and results of operations continued

Net income increased by US \$77.7 million to US \$168.5 million for 2007, as compared to US \$90.8 million for 2006.

## Income before income taxes

Income before income taxes increased by US \$105.3 million to US \$229.5 million for 2007, as compared to US \$124.2 million for 2006. The increase in income before income taxes was primarily attributable to the overall growth of our business.

## Income tax expense

Income tax expense increased by US \$27.4 million to US \$60.9 million for 2007, as compared to US \$33.5 million for 2006. The increase in income tax expense was primarily attributable to the increase in our income, our effective tax rate decreased slightly from 26.9% in 2006 to 26.5% in 2007 due to fewer disallowed expenses in 2007 on a percentage basis. In the near term, we expect our effective corporate income tax rate to be approximately 27%.

## Cash flows

The table below shows our net cash flows from operating, investing and financing activities for the years ended December 31, 2007 and 2006 (in thousands of US \$):

	2007	2006
Net cash provided by operating activities	<b>128,341</b>	49,705
Net cash used in investing activities	<b>(259,665)</b>	(131,789)
Net cash provided by financing activities	<b>449,753</b>	89,795

## Operating activities

Net cash provided by operating activities amounted to US \$128.3 million for the year ended December 31, 2007, as compared to US \$49.7 million for the year ended December 31, 2006. This increase in cash flows provided by operating activities principally reflects a higher net income of US \$168.5 million for 2007, as compared to US \$90.8 million for 2006.

## Investing activities

Net cash used in investing activities amounted to US \$259.7 million for the year

## Net income

As a result of the foregoing factors, net income increased by US \$77.7 million to US \$168.5 million for 2007, as compared to US \$90.8 million for 2006.

## Liquidity and capital resources

The Company's primary sources of liquidity are cash generated from operating activities and debt financing. The Company's plan going forward is to finance its capital expenditures, interest payments and dividends primarily out of operating cash flows as well as to finance a portion of its capital expenditures through current credit facilities, as well as by utilizing a portion of the proceeds from the offering of its shares which occurred in November 2007.

ended December 31, 2007, as compared to US \$131.8 million for the year ended December 31, 2006. This increase was primarily the result of payment for asset purchases.

## Financing activities

Net cash provided by financing activities amounted to US \$449.8 million for the year ended December 31, 2007, as compared to US \$89.8 million for the year ended December 31, 2006.

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### Liquidity

The table below shows our cash and cash equivalents for the years ended December 31, 2007 and 2006 (in thousands of US \$):

	2007	2006
Short-term deposit – US dollars	216,857	–
Short-term deposit – Russian rubles	61,254	–
Cash held in banks – Russian rubles	50,880	3,524
Cash held in banks – US dollars	14,098	25,772
<b>Total cash and cash equivalents</b>	<b>343,089</b>	<b>29,296</b>

Our cash flow in the short term can be negatively affected by the level of expenditures we are required to make in the fourth and first quarter of each year to mobilize our rigs, crews and equipment to drilling sites.

### Capital expenditures

Our business is capital intensive and expenditures are primarily required to (i) purchase new drilling rigs and other equipment and (ii) upgrade and modernize the technical characteristics of our existing drilling rigs and equipment. For each of the years ended December 31, 2007 and 2006 advances given for property, plant and equipment amounted to the following (in thousands of US \$):

	2007	2006
Advances given for property, plant and equipment	64,506	50,961

The amounts represent cash advances for property, plant and equipment not yet received.

The table below presents the amounts invested in construction, which is still in progress (in thousands of US \$):

	2007	2006
Construction in progress	133,652	6,704

### Capital resources

For each of the years ended December 31, 2007 and 2006 our short-term and long-term debt amounted to the following (in thousands of US \$) (please see our Audited Consolidated Financial Statements and the accompanying notes for more detail):

	2007	2006
Short-term debt and current portion of long-term debt	118,911	77,557
Long-term debt	165,494	200,196

We believe we have sufficient working capital to meet our requirements for at least the next 12 months. We also expect to meet our contractual obligation payment requirements with cash flows from our operations and other financing arrangements.

# Discussion and analysis of financial condition and results of operations continued

Increase in earnings per share from US \$0.76 in 2006 to US \$1.31 in 2007.

# US \$ 1.31

## Other

### Off-balance sheet arrangements

The Company does not have off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on its financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

### Related party transactions

#### PetroAlliance

In 2007, EDC purchased well construction and related services and equipment from PetroAlliance Services Company Limited ('PAS'), of which a significant stockholder of EDC is the Chairman of the Board of Directors, in the amount of approximately US \$23.9 million and US \$18.3 million, respectively (in 2006: US \$20.6 million and nil, respectively). Amounts payable to PAS were US \$4.2 million and US \$5.1 million as of December 31, 2007 and 2006, respectively. During 2007, EDC provided drilling services to PAS of US \$ 3.1 million (nil in 2006). Amounts receivable from PAS were US \$0.8 million and nil as of December 31, 2007 and 2006 respectively.

#### Shareholder loans

In the period from November 2006 through March 2007, the Company entered into loan agreements with our shareholders to partially fund the investment program of our onshore drilling services division and the purchase of our offshore drilling services business. The

aggregate principal amount of such loans was US \$70.0 million. The loans mature on December 31, 2011 and incur interest at the rate of 8.6% per annum. Interest expense of US \$5.8 million and US \$0.3 million was recognized and paid on these loans during 2007 and 2006, respectively.

#### Acquisition of OOO BKE Shelf

Pursuant to a participating interest sale and purchase agreement, dated May 18, 2007, between AstraOrient Limited and Medjid Zulpukarov, we acquired a 100% interest in OOO 'BKE Shelf' for a purchase price of RUR 10,000. Mr. Zulpukarov had held the interest as a nominee for the Company.

#### Capital lease obligations

During 2006, we received property, plant and equipment under a capital lease from an associated company and a company in which a substantial stockholder has a controlling interest, OAO LK Leasing, with a carrying amount of US \$11.7 million. In 2007, we acquired US \$19.2 million of additional drilling equipment from this entity. Amounts payable to LK Leasing for this equipment were US \$1.5 million as of December 31, 2007.

#### Earnings per share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the reporting period.

The calculation of earnings per share for these years was as follows:

	2007	2006
Net income available for common stockholders	168,544	90,765
Weighted-average number of outstanding shares (post split)	128,341,261	118,682,500
Basic earnings per share of common stock (US dollars)	1.31	0.76

There is no potential dilution in earnings available to common stockholders and as such diluted earnings per share are not disclosed.

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## **Certain factors affecting our results of operations**

### **Changes in crude oil and natural gas prices**

The prices of crude oil and natural gas in Russia can have a significant impact on our results of operations. World prices for crude oil are characterized by significant fluctuations that are determined by many factors, including the global balance of supply and demand. However, Russian natural gas prices are regulated by the Russian government. While Russian natural gas prices have increased in recent years, and are expected to continue to rise to a level closer to parity with export netbacks, they are still significantly below world levels. A substantial or an extended decline in crude oil and natural gas prices could result in lower capital expenditures by our customers, and consequently, a reduction in the number of wells to be drilled by oil and gas companies. The results of our workover operations tend to be less sensitive to the fluctuations in crude oil and natural gas prices, as our clients require such services to be performed with respect to their existing wells, which may require workovers both during periods of high and low oil prices.

### **Productivity**

Our results of operations are affected by the productivity of our crews, as measured by the number of meters drilled per active drilling crew. For the year ended December 31, 2007, each of our active drilling crews drilled on average approximately 30,893 meters. We expect this measure of our efficiency to improve due to the recent implementation and utilization of more advanced drilling technologies and the application of new standards to our drilling operations. The former include the use of Polycrystalline Diamond Compact drill bits in conjunction with modern drilling motors, drilling with real-time drilling navigation, the use of top-drives and four-step drilling mud cleaning systems. The latter include, for example, an increase in allowed deviations of vertical wells and the use of drilling mud that is more suitable for the geological conditions in which we operate.

### **Operating capacity**

Our revenue growth can be negatively affected by the number of drilling rigs and drilling crews available to us. Our ability to grow our onshore business or maintain it at its current level depends on our ability to procure sufficient numbers of new drilling rigs and modernize our existing drilling rigs. As such, as of December 31, 2007, we have contractually committed to purchase 13 new drilling rigs, of which we expect 4 to be delivered during the first half of 2008. Furthermore, we expect to enter into contractual commitments to purchase 11 additional drilling rigs. However, the global demand for new drilling rigs and rig modernization services currently substantially exceeds their supply. Moreover, any new drilling rigs which we purchase will require an increase in the number of engineers, equipment operators and other technical and management personnel. We believe any such increase in personnel will result in an increase in the wages and salaries category of our cost of services.

### **Seasonality**

Our revenue from onshore and offshore drilling services can be negatively affected by severe winter weather conditions in certain regions of Russia that make oil and gas operations difficult during that season. For example, during January and February 2006, Russia experienced severely cold temperatures of approximately -45 degrees Celsius in certain regions where we operate and the lost drilling time during such period amounted to approximately 90 days, which was equivalent to the loss of use of three drilling crews for one calendar month, which contributed to delays in the mobilization of our equipment and service commencement dates. Our revenue from onshore drilling services may also be negatively affected by winter thawing because drilling rigs, equipment and materials situated in certain regions can only be transported during winter when the ground is sufficiently frozen to create access roads. As a result, a portion of our business activity in the fourth and first quarter of each year is devoted to transportation of drilling rigs, equipment and materials and we experience a decrease in revenues while continuing to incur costs.

# Discussion and analysis of financial condition and results of operations continued

Eastern Siberia, the area where we expect to pursue opportunities to provide exploration drilling services, is expected to grow at 50% CAGR during five year period.

If we fail to complete a drilling contract on time or are unable to move our equipment due to adverse weather conditions, our ability to timely commence drilling at another site may be impeded. However, the effect of severe weather conditions on our operations depends on the specific type of service being provided. For instance, our onshore exploration drilling services are most affected by adverse weather conditions, as our drilling rigs, equipment, materials and crews that are required for such services are mobilized to remote locations accessible only by winter roads or helicopters. On the other hand, our onshore production drilling services tend to be less affected by adverse weather conditions due to the cluster drilling method utilized by us, which involves drilling multiple wells from a single drilling pad. With respect to such drilling method, our operations may be temporarily disrupted by adverse weather conditions in the event we are unable to operate our rigs or mobilize required supplies to rig sites. With respect to our offshore division, we are generally unable to perform drilling services in the Russian Sector of the Caspian Sea during winter months due to the presence of ice.

## Market trends

According to Douglas-Westwood, for the year ended December 31, 2006, the Russian oilfield services market (excluding equipment manufacturing and formation evaluation services, but including services performed by in-house oil field services providers) is estimated to be worth approximately US \$10.7 billion and is forecast to rise to approximately US \$27.4 billion by 2011, representing a CAGR of approximately 21%. While all regions show growth, based on current price levels, during this five-year period, the oilfield services market in Western Siberia is expected to grow at 13% CAGR compared to 21% for Timan Pechora and 13% for Volga Urals. Eastern Siberia,

the area where we expect to pursue opportunities to provide exploration drilling services, is expected to grow at 50% CAGR during the same period.

## Change in mix of services

Because margins can vary significantly amongst the services we provide, our results of operations are affected by changes in the mix of onshore and offshore drilling services we provide to our customers. The services we provide in our onshore division have expanded from offering primarily conventional production and exploration drilling services in January 2005 to offering a wider range of higher margin drilling and workover services, including sidetracking and horizontal drilling.

For example, for the year ended December 31, 2005, we drilled 46,208 meters utilizing the horizontal drilling technique, while for the year ended December 31, 2006, our horizontal drilling operations increased to 146,718 meters and for the year ended December 31, 2007 we drilled 302,134 meters utilizing the horizontal drilling technique. We expect the scope of our horizontal drilling to continue to grow as we expect our clients to increasingly demand such services in order to access additional producing horizons in the oil and gas fields they operate.

Also by way of example, the number of side-tracks we performed in the past has fluctuated. For the year ended December 31, 2005, we drilled 37 side-tracks, while for the year ended December 31, 2006, we drilled 42 sidetracks. For the year ended December 31, 2007, we drilled 53 side-tracks. As a result of the higher margins achieved through sidetracking, we intend to continue to expand these services. Although we currently have incurred minimal capital expenditures with respect to sidetracking, we expect to significantly increase these expenditures in the near future.

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**Price optimization**

Our revenue growth depends on our ability to charge clients market prices for our onshore and offshore drilling and other services. The LUKOIL Framework Agreement established a pricing adjustment formula applicable to the onshore drilling services we provide to LUKOIL. Such pricing formula effectively limits our ability to adjust the prices related to our onshore drilling services for LUKOIL in order to reflect fluctuations in the market prices occurring prior to the following annual price adjustment. However, we consider that the current prices at which we provide services pursuant to the LUKOIL Framework Agreement are acceptable given the volume of services provided. In addition, we believe that the contracts we enter into with our other customers, and the companies of the LUKOIL group outside of the scope of the LUKOIL Framework Agreement, provide us with greater flexibility to adjust such contract prices to better conform with current market levels.

**Quantitative and qualitative disclosure about market risk**

Fluctuations in the foreign currency exchange rates of the Russian ruble, as compared to the US dollar, may negatively impact our results of operations.

We are exposed to foreign currency exchange rate risks. The currency giving rise to these risks is primarily the Russian ruble. We use the Russian ruble for the majority of our operations, while the US dollar is our reporting currency. Foreign exchange gains and losses result from converting monetary assets and liabilities denominated in the Russian ruble into US dollar amounts at each balance sheet date. This includes any borrowings in a foreign currency. As of December 31, 2007, we had US \$214 million of a total of US \$284 million of our long and short-term debt denominated in the Russian ruble. In addition, the results

of our operations are impacted by transactions entered into in currencies other than the Russian ruble, and a fluctuation in exchange rates will result in a change in the recognized revenues and expenses associated with such transactions. Furthermore, while the majority of our revenues are denominated in the Russian ruble, some of our costs, including those associated with purchases of foreign manufactured land rigs, are denominated in the US dollar and other currencies. Any significant foreign currency exchange rate fluctuations (both short- and long-term) could have a material adverse effect on our business, financial condition and results of operations.

**Interest rate risk**

We are exposed to changes in interest rates, primarily associated with our variable rate short-term and long-term borrowings.

**Critical accounting policies**

Our Consolidated Financial Statements are impacted by the accounting policies used by management during their preparation. The detailed discussion of our critical accounting policies is provided in Note 2 of the Consolidated Financial Statements.

The Company recognizes the importance of, and is committed to, high standards of corporate governance. Since the Company is incorporated in the Cayman Islands, it is not subject to UK corporate governance requirements. However, the Company intends to comply with established best practice, wherever possible and where it is in the Company's best interests. This report describes how the Company has applied the Principles of Good Governance as set out in the Combined Code on Corporate Governance, issued by the Financial Reporting Council in June 2006 (the 'Combined Code'), except where indicated within this report.

## The Board

The Board of Directors is responsible for the management and oversight of the Company, and meets on a regular basis. The Board consists of seven Directors and the role of Chairman and Chief Executive are clearly defined and separate. Six out of the seven members of the Company's Board of Directors serve in a non-executive capacity. The Board considers four of these six non-executive Directors (Lord Gillford, who also serves as Chairman, Mr. Huck, Mr. Gremillion and Mr. Vladimirov) to be independent for purposes of the Combined Code. One non-executive director, Mr. Shokhin, is not strictly independent for the purposes of the Combined Code, since he is also a member of the board of directors of a customer of the Company, LUKOIL.

Nevertheless, the Board does not consider that this fact undermines his independence. In fact, the Board considers that, as a result of his service on this other board, he brings particular expertise to the Company's Board of Directors, since he has a greater industry specific knowledge. The Board will continue to consider its composition from time to time and may choose to deviate from the strict requirements of the Combined Code in relation to Board composition on a case-by-case basis if it is considered in the best interests of the Company or consistent with industry practice generally or required by applicable Cayman Islands law, provided that any such deviation is consistent with the Directors' general fiduciary duties and applicable policies of the Company.

In accordance with the Articles of Association, each Director holds his office until he is disqualified or removed from the office by an ordinary resolution of a general meeting of shareholders. Thus, the Company does not comply completely with the provisions of the Combined Code, which require that all non-executive directors should be appointed for a specific term and be subject to re-election.

Brief biographies of the executive and non-executive directors are set out below. The biographies illustrate that the Directors have a range of business and financial experience that is important and relevant to the management of the Company.

Name	Age	Position
Lord Gillford	46	Chairman of the Board of Directors
Alexander Yu. Djaparidze	52	Director
L. Todd Gremillion	60	Director
Martin E. Hansen	66	Director
Rene Huck	60	Director
Albert I. Vladimirov	68	Director
Alexander Shokhin	56	Director

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Except as otherwise noted, each member of the Board of Directors was appointed to the Board on October 15, 2007.

**Lord Gillford.** Lord Gillford has been a member of the board of directors of OJSC Polyus Gold since March 2006. Lord Gillford founded and is currently a director of The Policy Partnership Limited. Since 1997, Lord Gillford has served as a member of the board of directors of the Benevolent Society of St. Patrick, and since 2005, he has served on the Advisory Council of the Ukrainian British City Club. Lord Gillford was a director of Ballot Box Limited from 2000 to 2003, and chairman of the board of directors (without executive powers) of Cleveland Bridge UK Ltd from 2000 to 2004. Lord Gillford is a graduate of Eton College.

**Alexander Yu. Djaparidze.** Mr. Djaparidze has been a member of the board of directors of BKE since 2005 where he served as the Chairman from 2005 until present. From June 1995 to February 2007, Mr. Djaparidze served as President of PetroAlliance, where he currently serves as Executive Chairman of the board of directors. Prior to joining PetroAlliance, he held various executive positions at CGE, and served as Managing Director of MD SEIS. Mr. Djaparidze holds a degree in Mining Engineering and Geophysics from the Gubkin Russian State University of Oil and Gas. Mr. Djaparidze is a Candidate of Technical Science from the Gubkin Moscow Institute of Oil and Gas. Mr. Djaparidze was awarded the Russian Federation Government prize for special achievements in science and technology.

**L. Todd Gremillion.** Mr. Gremillion has been a member of the board of directors of BKE since 2005, where he is also a member of BKE's Strategic Planning Committee. From May 1991 to April 2006, he was a partner of Akin, Gump, Strauss, Hauer & Feld, an international law firm where he specialized in matters involving the oil and gas industry. Mr. Gremillion received his bachelor and law degrees from Louisiana University.

**Martin E. Hansen.** Mr. Hansen served as our Chief Financial Officer from May 1, 2004 until November 17, 2007 and has served since January 1, 2005. He was formerly a member of the board of directors of BKE from 2005 to 2007. From 1999 to 2002, Mr. Hansen was Chief Financial Officer of PetroAlliance. Mr. Hansen holds a bachelor of business administration degree from the University of Iowa.

**Rene Huck.** Mr. Huck is recently retired from Schlumberger where he has held a variety of senior positions over the last 15 years, most recently as Vice-President QHSE and Industry Affairs. Before joining Schlumberger, Mr. Huck was CEO of the drilling contractor Techfor – Cosifor. Prior to that, he worked for 16 years as an engineer and operations manager at TOTAL. Mr. Huck has also served on the board of directors of PetroAlliance 2004-2007. Mr. Huck is a Mechanical Engineer from Ecole Centrale in Nantes, France and a Petroleum Engineer from the French Petroleum Institute in Paris, France.

**Albert I. Vladimirov.** Mr. Vladimirov has been a member of the board of directors of BKE since 2005, where he is also a member of BKE's Strategic Planning Committee. Mr. Vladimirov is a Professor and Rector of the Gubkin Russian State University of Oil and Gas since 1993. Mr. Vladimirov has been a full member of the Russian Engineering Academy since 1995 and a full member of the Russian Academy of Natural Sciences since 1996. Mr. Vladimirov holds a degree in Equipment for Chemical Industry from the Gubkin State University of Oil and Gas. Mr. Vladimirov is a Candidate of Technical Science.

**Alexander Shokhin.** Mr. Shokhin has been a member of the board of directors of LUKOIL and Chairman of its Personnel and Remuneration Committee since January 2005. Mr. Shokhin has been the President of the State University-Higher School of Economics since 1995. He also has been President of the Russian Union of Industrialists and Entrepreneurs since 2005. Mr. Shokhin was Chairman of the

Supervisory Council of Renaissance Capital Investment Group from 2002 until 2005. From 1994 until 2002 he was a Deputy of the State Duma, where his last position was the Head of the Duma Committee on Credit Institutions and Capital Markets. Mr. Shokhin holds a degree in Economics from Moscow State University. Mr. Shokhin is a Doctor of Economic Science, Professor and Member of the Russian Academy of Natural Sciences.

The Company is controlled through its Board. The Board's main roles are to manage the Company with the objective of maximising shareholder value, set the general business strategy of the Company and to oversee the decision-making and risk management processes within the Company. The Board is governed by its Charter, which is posted on the Company's web site.

The Board reserves to itself certain key matters to approve or monitor, such as the Company's business plans, annual budget, significant capital expenditures, as well as the Company's operating and financial performance. The Directors are provided with regular information on the Company's performance and activities and meet on a regular basis. Meetings include a formal schedule of matters specifically reserved for the Board's decision and additional meetings may be arranged as necessary.

As required by the Combined Code, all Directors have access to the advice and services of the Company Secretary, and any Director wishing to do so in furtherance of his duties may take independent professional advice at the Company's expense. In the year ended 31 December 2007, no Director sought independent professional advice. In order to discharge their duties, Directors are provided with access to papers prior to Board meetings and Directors are free to seek any further information they consider necessary. In addition, between Board meetings, Directors have access to the Company's officers and employees in order to progress the Company's business. In order to facilitate the Directors' fulfillment of their responsibilities regarding continuing

education and to enhance each Director's knowledge of the Company, the Company's business operations and the latest developments in corporate governance, the management provides Directors with the following:

- Access to, or notice of, continuing educational programs that are designed to keep Directors abreast of the latest developments in corporate governance matters and critical issues relating to the operation of public company boards.
- Material that contains information pertaining to (i) the Company's industry and (ii) comparisons of the Company with its major competitors.
- Periodic visits to operating units, drilling rigs and laboratories, normally as part of regularly scheduled Board meetings.
- A legal review for the Board, at least annually, of (i) the status of major litigation, (ii) compliance with significant regulatory requirements affecting the Company and (iii) corporate governance matters.

In accordance with provision A1.5 of the Combined Code, the Company has in place Directors' and Officers' Insurance in respect of the Directors' duties as directors.

### **Board Committees**

The principal committees of the Board are the Audit and Finance, Remuneration and Nomination and Corporate Governance Committees. All committees of the Board are governed by Terms of Reference, which are posted on the Company's web site. We believe that our Audit and Finance Committee serves the same function as the audit committee recommended by the Combined Code and that our Remuneration and Nomination Committee serves the same function as the remuneration committee and the nominations committee recommended by the Combined Code. We are not currently able to comply with the requirements of the Combined Code in relation to the composition of the audit committee and the remuneration committee. Our Audit Committee is comprised of two members, one being Mr. Hansen, our former Chief Financial Officer, and the other being Mr. Shokhin, who, although a non-executive director, is not strictly independent for purposes

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of the Combined Code. Our Remuneration and Nomination Committee is comprised of three members, Mr. Djaparidze, our Chief Executive Officer, Mr. Vladimirov, a non-executive director who is independent for purposes of the Combined Code, and Mr. Huck, a non-executive director who is independent for purposes of the Combined Code. We will seek to modify the composition of our Audit Committee and our Remuneration and Nomination Committee over time as further appointments are made to our Board of Directors.

The Board delegates specific responsibilities to Committees as described below.

#### **Audit and Finance Committee**

The Company's Audit and Finance Committee consists of two members: Mr. Shokhin and Mr. Hansen. The committee is chaired by Mr. Shokhin. The Audit and Finance Committee is authorized to carry out the following functions relating to the control of the Company's financial and business operations:

- coordinate with the Company's independent auditors and prepare recommendations for its Board of Directors in connection with the election and removal of the independent auditors and on the fee and scope of services to be provided by the independent auditors;
- assess the independent auditors' reports;
- review the Company's standards and internal controls procedures and make appropriate reports and recommendations to the Company's Board of Directors;
- assess the Company's financial reports;
- review and approve budgets and business plans, as well as the process for developing budgets and business plans;
- review and approve intra-company financings; and
- review and approve any financing transactions with a value in excess of US \$50 million.

The Committee met prior to the Board Meeting on May 26, 2008, at which it reviewed, discussed with the management and the external auditor, and approved the Company's audited Consolidated Financial Statements (prepared in accordance with US GAAP) as of December 31, 2007 and 2006 and for each of the years in the two year period ended December 31, 2007.

#### **Remuneration and Nomination Committee**

The Company's Remuneration and Nomination Committee consists of three members: Mr. Huck, Mr. Vladimirov and Mr. Djaparidze. The Committee is responsible for establishing and implementing a policy for the compensation of directors, consultants and members of senior management, which may take the form of cash, stock options granted pursuant to stock option plans and other benefits.

On March 18, 2008, the Remuneration and Nomination Committee of the Company's Board of Directors approved a schedule of performance awards in connection with the Company's 2007 Incentive Compensation Plan, which schedule is described in more detail in the Remuneration Report.

#### **Corporate Governance Committee**

Our Corporate Governance Committee consists of two members: Lord Gillford and Mr. Gremillion. The Committee is chaired by Lord Gillford. The Corporate Governance Committee is responsible for assisting and advising our Board of Directors with respect to matters relating to the general operation of the Board of Directors, our corporate governance and the performance of the Board of Directors and individual directors. To ensure compliance with the Company's obligations under the Listing Rules (including the obligations under the Disclosure and Transparency Rules) of the United Kingdom Listing Authority (UKLA), to preserve the Company's reputation for integrity and ethical conduct and to avoid improper conduct by anyone associated with the Company, the Company introduced a Corporate Disclosure Policy and a Share Dealing Policy.

## Relationship with Shareholders

The Company continues to increase its communication with shareholders, investors and brokers. Presentations are made to analysts, the press and institutional investors at the time of the announcement of the full year and half-year results. The Company, principally through the Chief Executive Officer and Chief Financial Officer, maintains a regular dialogue with institutional Shareholders and financial analysts, particularly following the interim and preliminary results announcements. The Company has an internet web site [www.eurasiadrilling.com](http://www.eurasiadrilling.com) on which it publishes its press releases, Stock Exchange announcements, announcements of conference calls with shareholders and other information concerning the Company's business. The Company also publishes its annual and interim results on the web site.

Shareholders are and will also be sent copies of Annual and Interim Reports and, where appropriate, are sent circulars and prospectuses.

## Internal Controls

The Board is responsible for the Company's system of internal controls and for reviewing its effectiveness. However, such a system can only manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, but not absolute, assurance against material misstatement or loss.

The Board maintains full control over strategic, financial, operational and compliance issues. Within the overall objectives set by the Board, the

management of the Company is delegated to the Chief Executive Officer, who is assisted by the Company's management. The responsibilities of the Company's management include:

- the development and recommendation of strategic plans for consideration and approval by the Board that reflect the longer-term objectives and priorities established by the Board;
- implementation of the strategies and policies of the Company as determined by the Board;
- monitoring of the operating and financial results against the plans and budgets;
- prioritising the allocation of technical and human resources;
- developing and implementing risk management systems; and
- managing and monitoring health, safety and environmental matters.

## Statement of Compliance with the Combined Code

The Directors believe the Company has complied with the provisions set out the Combined Code, except as set out above in this report. The Directors are of the opinion that these areas of noncompliance do not prejudice shareholders' interests and are justifiable given the specific circumstances of the Company.

## Going concern

The Directors are satisfied that the Company has adequate resources to continue to operate for the foreseeable future and have adopted the going concern basis in preparing the financial statements.

This Report is submitted for the year ended December 31, 2007.

### **Activities, profits and dividends**

The activities of the Company, including profits and dividends are discussed in the Discussion and Analysis of Financial Condition and Results of Operations (at pages 6-17), the Corporate Governance Report (at pages 18-22), and the Directors' Remuneration Report (at pages 26-29), which are incorporated into this Directors' Report as if set forth herein.

### **Share Capital and Major Shareholders**

The Company's Share Capital and Major Shareholders are set forth in the Company's Prospectus, dated November 2, 2007 at pages 86-87.

### **Company Policies**

The Directors have adopted several policies applicable to the Directors, officers and employees of the Company including:

#### **Corporate Disclosure Policy Summary**

The Company has adopted a Corporate Disclosure Policy, a copy of which is available on the Company's web site.

The Corporate Disclosure Policy regulates the disclosure of information about the Company to the public. The purpose of the Policy is to raise awareness of the Company's approach to disclosure among the Board of Directors, senior management and employees of the Company. This Corporate Disclosure Policy does not derogate from the Company's existing policies and practices regarding confidential information.

A disclosure committee (the 'Disclosure Committee') has been established with responsibility for overseeing the Company's disclosure practices and consists of the Chief Executive Officer, Chief Financial Officer and General Counsel of EDC. Confidential information about or related to the Company must not be disclosed to third parties except in accordance with the Corporate Disclosure Policy. The Corporate Disclosure Policy provides examples of what may constitute confidential information, which depending upon the circumstances may include, but are not limited to the following: (i) changes in corporate structure; (ii) changes in capital structure; (iii) changes in financial results; (iv) changes in business operations; (v) acquisitions and dispositions; and (vi) changes in credit arrangements.

#### **Share Dealing Policy Summary**

The Company has adopted a Share Dealing Policy, a copy of which is available on the Company's web site.

The Share Dealing Policy forbids dealing in the Company's shares based on material non-public information, i.e. insider trading and similar offenses. The purpose of the Share Dealing Policy is to ensure compliance with the law, to preserve the Company's reputation for integrity and ethical conduct and to avoid improper conduct by anyone associated with the Company. The Share Dealing Policy makes the Company's directors, officers and employee aware that they are all personally responsible for ensuring the Company's strict compliance with this Policy and that any breach of it will be treated as a disciplinary offence with the severest consequences. The Policy establishes certain procedures and requires all persons to consult with the General Counsel of the Company before taking any action that may be covered by the Policy.

## **Policy and Practice on Payment of Suppliers**

As a result of the nature of the Company's business, its contractual relationships with suppliers of goods and services and with sub-contractors vary according to circumstances. It is the Company's policy to enter into an appropriate form of contractual agreement on payment terms and to pay according to those terms. The Company does not follow any particular code or practice for the payment of creditors. In practice, the Company makes every effort to pay accordingly when it can be confirmed that the supplier has provided the goods or services in accordance with the relevant terms of the contract.

## **Significant Agreements**

The Directors are not aware of any significant agreements to which the Company and/or any of its subsidiaries or associates is a party that take effect, alter or terminate upon a change of control of the Company following a takeover bid, save that a subsidiary that ceased to be a subsidiary of the Company would cease to benefit from the Company's financing arrangements.

## **Annual General Meeting**

The Directors have scheduled an Annual General Meeting of the Members of the Company for September 9, 2008 in Limassol, Cyprus.

## **Amendments to the Articles of Association**

As adopted by Special Resolution dated June 31, 2007, the Company amended and restated its Memorandum of Association as follows:

- "1. The name of the Company is Eurasia Drilling Company Limited (the 'Company')."*
- 2. The registered office of the Company will be situated at the offices of Paget-Brown Trust Company Ltd., Boundary Hall, Cricket Square, PO Box 1111, Grand Cayman KY1-1102, Cayman Islands or at such other location as the Directors may from time to time determine.*
- 3. The objects for which the Company is established are unrestricted and the Company shall have full power and authority to carry out any object not prohibited by any law as provided by Section 7(4) of the Companies Law*

*of the Cayman Islands (as amended) (the 'Law')."*

- 4. The Company shall have and be capable of exercising all the functions of a natural person of full capacity irrespective of any question of corporate benefit as provided by Section 27(2) of the Law.*
- 5. The Company will not trade in the Cayman Islands with any person, firm or corporation except in furtherance of the business of the Company carried on outside the Cayman Islands; provided that nothing in this section shall be construed as to prevent the Company effecting and concluding contracts in the Cayman Islands, and exercising in the Cayman Islands all of its powers necessary for the carrying on of its business outside the Cayman Islands.*
- 6. The liability of the shareholders of the Company limited to the amount, if any, unpaid on the shares respectively held by them.*
- 7. The capital of the Company is US \$2,500,000.00 divided into 250,000,000 shares of a nominal or par value of US \$0.01 each provided always that subject to the Law and the Articles of Association the Company shall have power to redeem or purchase any of its shares and to subdivide or consolidate the said shares or any of them and to issue all or any part of its capital whether original, redeemed, increased or reduced with or without any preference, priority, special privilege or other rights or subject to any postponement of rights or to any conditions or restrictions whatsoever and so that unless the conditions of issue shall otherwise expressly provide every issue of shares whether stated to be ordinary, preference or otherwise shall be subject to the powers on the part of the Company hereinbefore provided.*
- 8. The Company may exercise the power contained in Section 226 of the Law to deregister in the Cayman Islands and be registered by way of continuation in some other jurisdiction."*

# Statement of Directors' responsibilities in respect of the Annual Report and the Financial Statements

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The Directors are responsible for preparing the Annual Report and the Company financial statements in accordance with applicable law and regulations.

Our corporate affairs are governed by our amended and restated memorandum of association (the 'Memorandum of Association'), the amended and restated articles of association (the 'Articles of Association') and by the Companies Law (2004 Revision) (the 'Companies Law') and the common law of the Cayman Islands. As noted in the Corporate Governance Report, because the Company is incorporated in the Cayman Islands, it is not subject to UK corporate governance requirements. Because the Company intends to comply with established best practice, wherever possible and where it is in the Company's interests, the Company has applied the Principles of Good Governance as set out in the Combined Code, except where indicated within this report.

The Company's Audited Consolidated Financial Statements and the accompanying notes, have been prepared in accordance with US GAAP.

In preparing the Company's financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with US GAAP; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that its financial statements comply with the US GAAP. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's web site. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other applicable or controlling jurisdictions.

To the best of the Directors' knowledge:

- (a) The Financial Statements prepared in accordance with US GAAP give a true and fair view of the assets, liabilities, financial position and profit-loss of the Company and its consolidated undertakings; and
- (b) The Annual Report includes a fair review of the development and performance of the Company's business and the position of the Company and its consolidated undertakings as a whole, together with a description of the principal risks and uncertainties they face.

This Remuneration Report for the year ending December 31, 2007 sets out how the principles of the UK Combined Code of Corporate Governance (the 'Combined Code') relating to Directors' and senior management remuneration are applied. The Board believes that the Company was generally compliant with the provisions of the Combined Code relating to management remuneration throughout the period, except where indicated within this Report.

### **Remuneration Committee**

The Board has delegated to the Remuneration and Nomination Committee, through Terms of Reference, consideration of executive remuneration issues generally, including the use of share incentive plans. The Remuneration and Nomination Committee comprises of three members: Rene Huck (Chairman), a non-executive director whom the Company deems independent, Albert Vladimirov, a non-executive director whom the Company deems independent, and Alexander Djaparidze, a director who is also the Company's Chief Executive Officer. The Committee met on March 18, 2008 to approve an award plan under the Company's 2007 Incentive Compensation Plan. The terms of reference permit the Remuneration Committee to obtain its own external advice on any matter at the Company's expense.

### **Remuneration Policy for Senior Management**

The objective of the Company's remuneration policy are to ensure that members of the senior management of the Company are provided with appropriate incentives to encourage enhanced performance and are, in a fair and responsible manner, rewarded for their individual contributions to the success of the Company. The Committee aims to provide a competitive remuneration package to attract, retain and motivate senior management with the experience needed to shape and execute the Company's strategy and deliver shareholder value. The Committee takes account of external market data supplied by independent professional advisers and is sensitive

to the wider scene, including pay and employment conditions elsewhere in the Company, especially when determining annual salary increases.

The Committee's policy is for a significant proportion of executive reward to be variable and dependent upon the Company's performance. Variable reward components provide an opportunity for higher levels of remuneration where this remuneration is supported by exceptional performance, whether at an individual level or in relation to the Company's short-term and longer-term business priorities. Variable rewards will continue to be provided through a balanced mix of performance-related elements. The annual bonus scheme supports operational objectives over the financial year, whilst the Company's schedule of awards under its 2007 Incentive Compensation Plan will reward superior performance over a longer period.

The remuneration of senior management consists of:

- Basic salary – which forms the major element of remuneration and is based on comparable positions in leading businesses of similar size and complexity.
- Annual discretionary bonus – which is based on achievement of Company profit targets, as well as other financial and non-financial measures and personal targets. The maximum bonus payout is fifty percent (50%) of salary.
- 2007 Incentive Plan – under which the senior management may receive awards in an aggregate value of up to fifteen times (15x) each such person's annual salary and bonus, depending upon the increase in the price of the Company's GDRs over five years.

Further details of each element of the senior management's remuneration package, together with details of interests in shares, are set out below in this Report. For purposes of this Report, the senior management of the Company was as follows:

Senior Management	Position
Alexander Djaparidze	Chief Executive Officer
Martin Hansen	Chief Financial Officer (until November 17, 2007)
Ronald Harris	Chief Financial Officer (from November 17, 2007)
Murray Vasilev	Senior Vice President – Business Development
Doug Stinemetz	General Counsel and Secretary

In addition, senior management for purposes of this Report includes the following persons who are officers of OOO Burovaya Kompaniya Evrasia ('BKE'), which is the Company's principal Russian operating subsidiary:

Alexander Bogachev	President, BKE
Talekh Aleskerov	Senior Vice President Finance, BKE

### Management Remuneration

#### (a) Basic salary and benefits

The Company structures remuneration packages which are appropriate to the particular function and level of responsibility of each individual member of senior management and which are designed to attract, retain and motivate such persons. It takes into account the remuneration structures and levels at other companies, in particular in the Russian oilfield services sector. Eligible members of senior management are also provided with insurance and other health benefits in accordance with market standards.

Senior management compensation for the period January 1, 2007 through December 31, 2007 in the aggregate was approximately US \$1,120,000.

#### (b) Annual Discretionary Bonus Scheme

The Company operates an annual discretionary bonus scheme under which eligible members of management are able to earn a discretionary bonus up to a maximum of fifty percent (50%) of salary, dependent upon performance conditions being met. The bonus is payable in cash.

Senior management discretionary bonuses for the period January 1, 2007 through December 31, 2007 in the aggregate was approximately US \$2 million.

#### (c) Share Incentive Plan

It is the Remuneration and Nomination Committee's policy that senior management should participate in the Company's Incentive Compensation Plans as this scheme aligns their interests with those of our shareholders by linking the reward available to participants with increase in the overall price of the Company's GDRs. Details of the share incentive awards are set out below.

#### 2007 Incentive Compensation Plan

In July 2007, the Board of Directors considered and approved the 2007 Incentive Compensation Plan (the 'Plan'). The Plan was adopted by the Board of Directors to reward certain corporate officers, directors and key employees of the Company and certain independent consultants by enabling them to acquire ordinary shares of the Company and/or other awards as the Remuneration and Nomination Committee of the Board of Directors deems appropriate. The Plan was designed to attract and retain key employees of the Company and its subsidiaries, to attract and retain qualified directors of the Company, to attract and retain consultants and other independent contractors and to stimulate the active interest of such persons in the development and financial success of the Company and its subsidiaries. The Plan allowed the Company to issue ordinary shares in the Company up to five percent (5%) of the total ordinary shares issued and outstanding on such terms and conditions as are, in the best judgment of the Board of Directors, necessary, appropriate, advisable or convenient in connection with the foregoing.

In March 2008, the Remuneration and Nomination Committee approved a schedule of awards under the Plan, similar to a phantom stock plan payable in cash. Under this schedule of awards, eligible members of senior management are granted an opportunity during the period beginning January 1, 2008 and ending December 31, 2012 (the 'Performance Period') to earn incentive compensation awards (individually an 'Award' and collectively – 'Awards') in an aggregate value of up to fifteen times (15x) each such participant's annual compensation, meaning each participant's annual salary and bonus, calculated for each calendar year beginning January 1 and ending December 31 ('Award Year') within the Performance Period based on the participant's current salary and bonus at the Starting Date for such Award Year ('Annual Compensation'). Starting Date means the date one year prior to the last trading day on the London Stock Exchange prior to the end of the applicable Award Year (the 'Target Date'). Each Award Year, the Award is an amount equal to the participant's respective Annual Compensation times fifteen (x 15) multiplied by the applicable Annual Available Award Percentage for the Award Year and then multiplied by the applicable Annual Award Percentage Reached for the Award Year. Annual Available Award Percentage means a percentage set forth in the table below, indicating how much Annual Compensation is available for an Award each Award Year

if a Target Price Increase (i.e. percentages listed below for target increases in the Company's GDR price each Award Year) is realized. Annual Award Percentage Reached means the percentages set forth below, indicating what percentage of the available Annual Compensation shall be granted as an Award each Award Year if an applicable Target Price Increase is realized.

Pursuant to the Incentive Plan, the terms and conditions of each Award are to be set forth in an award agreement between the participant and the Company, incorporating the terms of the Incentive Plan and its Exhibits. Awards may be earned by the participants each Award Year upon the Company's GDR price reaching certain Target Price Increases. No such Award is to be made if such Target Price Increases are not achieved. The Target Price Increase achieved in any Award Year will be calculated based on the percentage increase of (i) the average sale price per GDR, quoted by the LSE, for the twenty (20) trading days preceding the Target Date over (ii) the Starting Price.

Column A of the table below sets out five (5) possible Target Price Increases for each Award Year of the Performance Period. Column B states the Annual Award Percentage Reached upon achievement of the applicable Target Price Increase for such Award Year.

Column A	Column B
<b>Target price Increase</b>	<b>Annual Award Percentage Reached</b>
Below 5% increase in the Starting Price	0%
From 5% up to 10% increase in the Starting Price	25%
From 10% up to 15% increase in the Starting Price	50%
From 15% up to 20% increase in the Starting Price	75%
From 20% or more increase in the Starting Price	100%

The Award will be made in un-equal installments each Award year during the Performance Period in accordance with the table below, in which (i) Column C represents the applicable Award Year and (ii) Column D represents the Annual Available Award Percentage of Annual Compensation available to calculate the Award in such Award Year.

Column C	Column D
<b>Award Year</b>	<b>Annual Available Award Percentage</b>
2008	12%
2009	15%
2010	18%
2011	25%
2012	30%
<b>TOTAL:</b>	<b>100%</b>

Each participant's right to such Award vests on the earliest of (i) the calendar day which is immediately after the applicable Target Date, provided that the participant on that date is still employed or otherwise in good standing with the Company and/or its affiliates. The Company will pay the participant such Award within thirty (30) days of the date it vests, if paid in cash (the 'Payment Date'). Each participant has the right to elect to receive such Award in GDRs rather than cash.

If a participant's employment with the Company or its affiliates is terminated on or prior to a Target Date or such participant is deemed not in good standing as may be determined by the Company from time to time in its sole discretion on or prior to a Target Date, such participant will forfeit any Award and shall have no right to receive any Award arising on such Target Date.

No Awards under the schedule of awards set forth above have been earned or vested in 2007.

**Non-executive Directors  
(a) Remuneration Policy for non-executive Directors**

Non-executive Directors receive an annual fee up to \$112,500, subject to attendance at Board and Committee meetings, and are reimbursed for expenses incurred in performing their duties. Non-executive Directors do not receive any performance-

related bonuses, pensions, share options or other forms of benefit. The Board may grant extra remuneration to any Director who performs special services at the request of the Company.

**(b) Appointment of non-executive Directors**

Non-executive directors are appointed for an indefinite term. Notwithstanding the above, the Company may terminate their appointment with immediate effect if such non-executive director has:

- committed any serious or repeated breach or non-observance of obligations to the Company (which include an obligation not to breach fiduciary duties); or
- been guilty of any fraud or dishonesty or acted in any manner which, in the opinion of the Company, brings or is likely to bring the Company into disrepute or is materially adverse to the interests of the Company; or
- been declared bankrupt or has made an arrangement with or for the benefit of creditors; or
- been otherwise disqualified from acting as a director.

**Interests of Directors and Senior Management in the Company**

As of December 31, 2007, the Directors and senior management of the Company, to the Company's best knowledge, had the following interests in shares of the Company:

Directors and Senior Management	Shares (including GDRs)	Percentage of Shares
Alexander Djaparidze <sup>1</sup>	62,397,819	42.49%
Todd Gremillion <sup>2</sup>	903,500	0.62%
Martin Hansen <sup>3</sup>	521,250	0.35%
Doug Stinemetz <sup>4</sup>	395,000	0.27%

<sup>1</sup> Alexander Djaparidze is a Director, as well as our Chief Executive Officer. Alexander Djaparidze was the beneficial owner of an aggregate of 62,397,819 shares. Alexander Djaparidze owned directly 27,635,479 shares. Alexander Djaparidze was a beneficial owner of 33,192,340 shares through his beneficial ownership of Cloudburst Orange Limited. A familial trust of Alexander Djaparidze was a beneficial owner of 1,570,000 shares through its ownership of Margin Finance Company Limited.

<sup>2</sup> Todd Gremillion is a Director and was a beneficial owner of 903,500 shares through his ownership of Goldrust LLP.

<sup>3</sup> Martin Hansen was our Chief Financial Officer until November 17, 2007, as well as a Director.

<sup>4</sup> S. Douglas Stinemetz, our General Counsel and Secretary, was a beneficial owner of 395,000 shares through his ownership of Eagle Eye Holdings, Inc.

As of December 31, 2007, no other Directors or members of senior management of the Company, to the Company's best knowledge, had interests in shares in the Company. As of December 31, 2007, there were no options or other commitments to issue additional shares in the Company.

# Independent auditors' report

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## **The Board of Directors of Eurasia Drilling Company Limited:**

We have audited the accompanying consolidated balance sheets of Eurasia Drilling Company Limited and its subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity and comprehensive income, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the management of Eurasia Drilling Company Limited. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eurasia Drilling Company Limited and its subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

**ZAO KPMG**  
May 22, 2008

# Consolidated balance sheets

as of December 31, 2007 and 2006

(all amounts in thousands of US dollars, unless otherwise noted)

	Note	2007	2006
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents	3	343,089	29,296
Accounts receivable, net	4	230,888	151,371
Inventories	5	208,284	141,302
Taxes receivable	11	46,127	29,252
Deferred income tax assets	11	8,775	7,358
Other current assets		8,481	4,128
<b>Total current assets</b>		<b>845,644</b>	<b>362,707</b>
Property, plant and equipment	6	496,670	237,631
Long-term accounts receivable	7	6,542	15,099
Deferred income tax assets	11	4,198	10,114
Other non-current assets		6,749	3,507
<b>Total assets</b>		<b>1,359,803</b>	<b>629,058</b>
<b>Liabilities and stockholders' equity</b>			
<b>Current liabilities</b>			
Accounts payable and accrued liabilities		210,337	140,979
Advances received		3,339	6,054
Short-term debt and current portion of long-term debt	9	118,911	77,557
Taxes payable	11	32,444	30,511
<b>Total current liabilities</b>		<b>365,031</b>	<b>255,101</b>
Long-term debt	10	165,494	200,196
Accrued pension liability	12	4,860	6,311
Long-term VAT payable		1,012	2,588
Long-term deferred income tax liabilities	11	1,510	1,235
Other non-current liabilities		-	1,638
<b>Total liabilities</b>		<b>537,907</b>	<b>467,069</b>
<b>Stockholders' equity</b>			
Common stock	15	1,469	50
Additional paid-in capital		514,180	35,460
Retained earnings		277,855	119,311
Accumulated other comprehensive income		28,392	7,168
<b>Total stockholders' equity</b>		<b>821,896</b>	<b>161,989</b>
<b>Total liabilities and stockholders' equity</b>		<b>1,359,803</b>	<b>629,058</b>

Ronald A. Harris  
Chief Financial Officer  
May 22, 2008

The accompanying notes are an integral part of these consolidated financial statements

# Consolidated statements of income

for the years ended December 31, 2007 and 2006

(all amounts in thousands of US dollars, unless otherwise noted)

	Note	2007	2006
<b>Revenues</b>			
Drilling and related services		1,468,047	1,048,209
Other sales and services		24,142	39,363
<b>Total revenues</b>		1,492,189	1,087,572
Cost of services	14	(1,049,762)	(806,881)
Selling, general and administrative expenses		(90,021)	(68,243)
Taxes other than income taxes		(56,574)	(41,250)
Depreciation		(40,423)	(23,722)
(Loss)/gain on disposal of property, plant and equipment		(610)	275
<b>Income from operating activities</b>		254,799	147,751
Interest expense		(29,880)	(19,392)
Interest income		4,546	1,343
Currency transaction gain		349	870
Other expenses		(363)	(6,350)
<b>Income before income taxes</b>		229,451	124,222
Income tax expense	11	(60,907)	(33,457)
<b>Net income</b>		168,544	90,765
Basic earnings per share of common stock (US dollars)	15	1.31	0.76

The accompanying notes are an integral part of these consolidated financial statements

# Consolidated statements of changes in stockholders' equity and comprehensive income

for the years ended December 31, 2007 and 2006  
(all amounts in thousands of US dollars, unless otherwise noted)

	Common stock	Treasury stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income/ (expense), net of tax	Total stockholders' equity
<b>Balance as of January 1, 2006</b>	<b>50</b>	<b>(500)</b>	<b>35,460</b>	<b>31,546</b>	<b>(2,870)</b>	<b>63,686</b>
Comprehensive income:						
Net income	–	–	–	90,765	–	<b>90,765</b>
Other comprehensive income:						
Foreign currency translation gain	–	–	–	–	10,381	<b>10,381</b>
Comprehensive income:						<b>101,146</b>
Sale of treasury stock	–	500	–	–	–	<b>500</b>
Effect of initial adoption of SFAS No. 158	–	–	–	–	(343)	<b>(343)</b>
Dividends declared	–	–	–	(3,000)	–	<b>(3,000)</b>
<b>Balance as of December 31, 2006</b>	<b>50</b>	<b>–</b>	<b>35,460</b>	<b>119,311</b>	<b>7,168</b>	<b>161,989</b>
Comprehensive income:						
Net income	–	–	–	168,544	–	<b>168,544</b>
Other comprehensive income:						
Foreign currency translation gain	–	–	–	–	20,188	<b>20,188</b>
Pension benefits:						
Actuarial gain	–	–	–	–	1,036	<b>1,036</b>
Comprehensive income:						<b>189,768</b>
Stock split	1,200	–	(1,200)	–	–	<b>–</b>
Sale of common stock	219	–	479,920	–	–	<b>480,139</b>
Dividends declared	–	–	–	(10,000)	–	<b>(10,000)</b>
<b>Balance as of December 31, 2007</b>	<b>1,469</b>	<b>–</b>	<b>514,180</b>	<b>277,855</b>	<b>28,392</b>	<b>821,896</b>

The accompanying notes are an integral part of these consolidated financial statements

# Consolidated statements of cash flows

for the years ended December 31, 2007 and 2006

(all amounts in thousands of US dollars, unless otherwise noted)

	Note	2007	2006
<b>Cash flows from operating activities</b>			
<b>Net income</b>		<b>168,544</b>	90,765
Adjustments for non-cash items:			
Depreciation		40,423	23,722
Accrued interest expense		5,084	2,680
Deferred income taxes		5,332	(265)
Loss/(gain) on disposal of property, plant and equipment		610	(275)
Increase in allowance for doubtful accounts receivable		1,045	968
All other items – net		222	(247)
Changes in operating assets and liabilities:			
Accounts receivable		(69,374)	(44,862)
Inventories		(55,179)	(32,201)
Taxes receivable		(14,263)	(2,793)
Other current assets		(3,904)	(1,880)
Accounts payable and accrued liabilities		55,708	41,239
Advances received		(2,961)	(29,627)
Taxes payable		(1,748)	2,158
Other current liabilities		(1,198)	323
<b>Net cash provided by operating activities</b>		<b>128,341</b>	49,705
<b>Cash flows from investing activities</b>			
Purchases of property, plant and equipment		(273,254)	(96,102)
Proceeds from sale of property, plant and equipment		13,589	1,827
Acquisition of subsidiary, net of cash acquired		–	(37,514)
<b>Net cash used in investing activities</b>		<b>(259,665)</b>	(131,789)
<b>Cash flows from financing activities</b>			
Proceeds from issuance of short-term debt		242,500	285,995
Principal repayments of short-term debt		(224,362)	(289,141)
Proceeds from issuance of long-term debt		63,894	109,429
Principal repayments of long-term debt		(91,153)	(6,961)
Repayment of capital lease obligations		(11,265)	(5,677)
Dividends paid		(10,000)	(4,350)
Proceeds from sale of treasury stock		–	500
Proceeds from sale of common stock		480,139	–
<b>Net cash provided by financing activities</b>		<b>449,753</b>	89,795
Effect of exchange rate changes on cash		(4,636)	(187)
<b>Net increase in cash and cash equivalents</b>		<b>313,793</b>	7,524
Cash and cash equivalents at beginning of period		29,296	21,772
<b>Cash and cash equivalents at end of period</b>	3	<b>343,089</b>	29,296
<b>Supplemental disclosures of cash flow information</b>			
Interest paid		24,796	16,712
Income tax paid		63,027	31,704

The accompanying notes are an integral part of these consolidated financial statements

# Notes to consolidated financial statements

(all amounts in thousands of US dollars, unless otherwise noted)

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## Note 1. Organization and environment

The primary activities of Eurasia Drilling Company Limited (the 'Company') and its subsidiaries (together, the 'Group') include providing exploratory and developmental drilling and oil and gas field services to companies operating within the Russian Federation, Kazakhstan, and Caspian Sea region.

Eurasia Drilling Company Limited was registered on November 25, 2002 under the Law of Cayman Islands. The Company was established for the purpose of acquiring OOO LUKOIL Burenie and its subsidiaries.

In November 2004 Eurasia Drilling Company Limited entered into a purchase agreement with OAO NK LUKOIL to acquire OOO LUKOIL Burenie and its subsidiaries. The acquisition was completed on December 30, 2004. Prior to the acquisition, the Company had no operating activity.

OOO LUKOIL Burenie, now OOO Eurasia Drilling Company, was established in accordance with the decision of the Board of Directors of OAO NK LUKOIL as of February 13, 1995 and registered by the resolution of the Head of Kogalym Administration \_ 216 as of May 17, 1995. It was formed from the West Siberian drilling subdivisions of OAO NK LUKOIL.

As of December 31, 2006 and 2007 OOO Eurasia Drilling Company had on-shore operating branches in Kogalym, Perm, Usinsk, Naryan-Mar and Zhirnovsk (Volgograd Region) in the Russian Federation and in 2007 the Group established a subsidiary in Kazakhstan, TOO BKE Kazakhstan Burenie, to provide on-shore drilling services.

In December 2006, Eurasia Drilling Company Group acquired 100% interests in LUKOIL Shelf Limited and LUKOIL Overseas Orient who provide off-shore drilling services in the Caspian Sea to various oil and gas companies in the Russian Federation, Kazakhstan and Turkmenistan (refer to note 16). In 2007 these companies were renamed EDC Shelf Limited and AstraOrient Limited, respectively. In 2007, the Company established a Russian subsidiary, OOO BKE Shelf, to operate its off-shore drilling services segment. It is planned to transfer all operations from EDC Shelf Limited to OOO BKE Shelf.

The majority of the Group's revenues are currently derived from services provided to OAO NK LUKOIL and its affiliated entities (the 'LUKOIL Group') and as such, OOO Eurasia Drilling Company is economically dependent upon its contractual agreements with the LUKOIL Group (refer to note 20).

## Business and economic environment

The Russian Federation, Kazakhstan, and Turkmenistan have been experiencing political and economic change that has affected, and may continue to affect, the activities of enterprises operating in this environment. Consequently, operations in these countries involve risks that typically do not exist in other markets.

The accompanying financial statements reflect management's assessment of the impact of the business environment in the countries in which the Group operates on the operations and financial position of the Group. The future business environment may differ from management's assessment.

## Basis of preparation

The consolidated financial statements have been prepared by the Group in accordance with accounting principles generally accepted in the United States of America ('US GAAP').

## Note 2. Summary of significant accounting policies

The following significant accounting policies have been applied in the preparation of the consolidated financial statements.

### Principles of consolidation

These consolidated financial statements include the financial position and results of the Company and controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority interest shareholders have substantive participating rights. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in other companies are recorded at cost. Equity investments and investments in other companies are included in 'Other non-current assets' in the consolidated balance sheet.

### Use of estimates

The preparation of the consolidated financial statements requires management of the Group to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Significant items subject to such estimates and assumptions include the carrying amount of property, plant and equipment, accounts receivable, inventories, deferred income taxes, long-term debt and accrued pension liability. Actual results could differ from those estimates.

# Notes to consolidated financial statements continued

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## Note 2. Summary of significant accounting policies continued

### Acquisitions

Assets acquired and liabilities assumed in business combinations are recorded on the Company's consolidated balance sheet as of the respective acquisition dates based upon their fair values at such dates. The results of operations of the businesses acquired by the Company begin to be included in the Company's consolidated statement of income upon the respective acquisition dates.

### Functional and reporting currency

The functional currency of the Group, except for OOO Eurasia Drilling Company, OOO BKE Shelf and TOO BKE Kazakhstan Burenie, is the US dollar. The functional currency of OOO Eurasia Drilling Company and OOO BKE Shelf is the Russian ruble and the functional currency of TOO BKE Kazakhstan Burenie is Kazakh Tenge because these are the currencies of the primary economic environments, in which they operate and in which cash is generated and expended. The Group's reporting currency is the US dollar.

Translation from the functional currency to the US dollar was conducted as follows:

- All assets and liabilities were translated from the functional to the reporting currency at the exchange rate effective at the reporting date;
- Equity items were translated from the functional to the reporting currency at the historical exchange rate;
- Items in the statement of income and cash flows were translated from the functional currency to the reporting currency at rates, which approximate rates at the date of transaction.

Translation differences resulting from the use of these exchange rates are included as a separate component of accumulated other comprehensive income.

The closing exchange rate as of December 31, 2007 and 2006 was 24.5462 and 26.3311 Russian rubles to one US dollar, respectively.

The Russian ruble and other currencies of republics of the former Soviet Union are not readily convertible outside of their countries. Accordingly, the translation of amounts recorded in these currencies into US dollars should not be construed as a representation that such currency amounts have been, could be or will in the future be converted into US dollars at the exchange rate shown or at any other exchange rate.

### Cash and cash equivalents

Cash and cash equivalents include all highly liquid investments with an original maturity of three months or less.

### Accounts receivable

Accounts receivable are recorded at their transaction amounts less allowance for doubtful accounts. Allowance for doubtful accounts receivable is recorded to the extent that there is a likelihood that any of the amounts due will not be obtained. Non-current receivables are discounted to the present value of expected cash flows in future periods using the original discount rate.

### Inventories

Inventories, consisting primarily of materials and tools used for drilling are stated at the lower of cost or market value. The cost of inventories is determined using an 'average cost' method.

### Property, plant and equipment

Property, plant, and equipment are stated at cost, net of depreciation. Depreciation is calculated on a straight-line method over the useful lives of the assets, estimated to be in the following ranges:

Buildings	15 – 30 years
Machinery and equipment	2 – 20 years
Vehicles	5 – 10 years

The cost of maintenance, repairs and replacement of minor items of property, plant and equipment is expensed as incurred. Major renewals and improvements of assets are capitalized.

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**Note 2. Summary of significant accounting policies continued****Impairment of long-lived assets**

Long-lived assets and certain intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future net cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future net cash flows, an impairment charge is recognized by writing down the carrying value to the estimated fair value of the asset group. Assets to be disposed of are reported at lower of the carrying amount or fair value less costs to dispose and are no longer depreciated.

**Leased assets**

Leases under which the Group assumes substantially all the risks and rewards of ownership are classified as capital leases. Leased property, plant and equipment meeting certain capital lease criteria are capitalized and the present value of the related lease payments is recorded as a liability. Amortization of capitalized lease assets is computed on the straight-line method over the shorter of the estimated useful life or the initial lease term.

Payments for operating leases, under which the Group does not assume all the risks and rewards of ownership are expensed in the period they are incurred.

**Deferred income taxes**

Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purpose of consolidated financial statements and their respective tax bases and operating loss and tax credit carry forwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

The ultimate realization of deferred income tax assets is dependent upon generation of future taxable income in the reporting periods in which the originating expenditures become deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

**Interest-bearing borrowings**

Interest-bearing borrowings are recognized initially at cost. Any transaction costs are recorded as 'Other current assets' and amortized. Subsequent to initial recognition, long-term borrowings are stated at amortized cost with any difference between cost and redemption value being recognized in the consolidated statement of operations over the period of the borrowings.

**Pension benefits**

The expected costs in respect of pension obligations of the Group are determined by an independent actuary. The net periodic costs are recognized as employees render the services necessary to earn the post retirement benefits.

**Environmental expenditures**

Group companies accrue for losses associated with environmental remediation obligations, not within the scope of SFAS No. 143, 'Accounting for asset retirement obligations', when such losses are probable and reasonably estimable. Such accruals are adjusted as further information becomes available or circumstances change.

**Revenue recognition****Drilling and related services**

Drilling and related services are generally sold based upon contracts with our customers that do not include significant post-delivery obligations. Service revenue is recognized when the services are rendered and collectibility is reasonably assured. Rates for services are typically priced on a per day, per meter, per man-hour, or similar basis. Claims and change orders that are in the process of being negotiated with customers for extra work or changes in the scope of work are included in revenue when collection is deemed probable.

The Group presents as work in progress gross amounts due from customers for services under contracts in progress where costs incurred plus recognized profits (less recognized losses) exceeds progress billings. The Group presents as advances received from customers gross amounts due to customers for services under contracts in progress where progress billings exceed costs incurred plus recognized profits (less recognized losses).

The revenue is recognized only when it is probable that the economic benefits associated with the transaction will flow to the Group.

# Notes to consolidated financial statements continued

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## Note 2. Summary of significant accounting policies continued

### Revenue recognition continued

#### Other sales and services

Revenues for other sales and services are recognized when the significant risks and rewards of ownership have passed to the buyer, when it is probable that economic benefits will flow to the Group and when these economic benefits can be reliably measured.

All sales are shown net of VAT.

#### Treasury stock

Purchases by Group companies of the Company's outstanding stock are recorded at cost and classified as treasury stock within Stockholders' equity. Stock shown as Authorized and Issued include treasury stock. Stock shown as Outstanding does not include treasury stock.

#### Earnings per share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the reporting period. A calculation is carried out to establish if there is potential dilution in earnings per share if convertible securities were to be converted into shares of common stock or contracts to issue shares of common stock were to be exercised. If there is such dilution, diluted earnings per share are presented.

#### Commitments and contingencies

Certain conditions may exist as of balance sheet date, which may result in losses to the Group but the impact of which will only be resolved when one or more future events occur or fail to occur.

If the Group's assessment of contingencies indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If a probable material loss is within the range and there is no amount within the range which is a better estimate than any other amount, the minimum amount in the range is accrued. If the assessment indicates that a potential material loss is not probable, but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, is disclosed in the notes to the consolidated financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed.

#### Comparative amounts

Certain prior period amounts have been reclassified to conform with current period presentation.

#### Recent accounting pronouncements

In March 2008, the FASB issued SFAS No. 161, '*Disclosures about Derivative Instruments and Hedging Activities*'. This Statement improves financial reporting about derivative instruments and hedging activities by enhanced disclosures of their effects on entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements for fiscal years and interim periods beginning after November 15, 2008, early application is encouraged. The Group is required to adopt the provisions of SFAS No. 161 in the first quarter 2009 and does not expect any material impact on its results of operations, financial position or cash flows upon adoption.

In December 2007, the FASB issued SFAS No. 141 (Revised), '*Business combinations*.' This Statement will apply to all transactions in which an entity obtains control of one or more businesses. SFAS No. 141 (Revised) requires an entity to recognize the fair value of assets acquired and liabilities assumed in a business combination; to recognize and measure the goodwill acquired in the business combination or gain from a bargain purchase and modifies the disclosure requirements. The Group is required to prospectively adopt the provisions of SFAS No. 141 (Revised) for business combinations for which the acquisition date is on or after January 1, 2009. Early adoption of SFAS No. 141 (Revised) is prohibited.

In December 2007, the FASB issued SFAS No. 160, '*Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*.' This Statement will apply to all entities that prepare consolidated financial statements (except not-for-profit organizations) and will affect those which have an outstanding noncontrolling interest (or minority interest) in their subsidiaries or which have to deconsolidate a subsidiary. This Statement changes the classification of a non-controlling interest; establishing a single method of accounting for changes in the parent company's ownership interest that does not result in deconsolidation and requires a parent company to recognize a gain or loss when a subsidiary is deconsolidated. The Group is required to prospectively adopt the provisions of SFAS No. 160 in the first quarter 2009, except for the presentation and disclosure requirements which shall be applied retrospectively. Early adoption of SFAS No. 160 is prohibited.

In February 2007, FASB issued SFAS No. 159, '*The Fair Value Option for Financial Assets and Financial Liabilities*'. This Statement expands the possibility of using fair value measurements and permits enterprises to choose to measure certain financial assets and financial liabilities at fair value. Enterprises shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent period. The Group is required to adopt the provisions of SFAS No. 159 in the first quarter 2008 and does not expect any material impact on its financial statements upon adoption.

## Note 2. Summary of significant accounting policies continued

### Recent accounting pronouncements continued

In September 2006, the FASB issued SFAS No. 158, 'Employers' Accounting for Defined Benefit Pension and Other post retirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)'. This Statement requires an employer that sponsors one or more single-employer defined benefit plans to: (a) Recognize the funded status of a benefit plan in its statement of financial position; (b) Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost; (c) Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions); (d) Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of this Statement are effective December 31, 2006, except for the requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end, which is effective December 31, 2008. The adoption of the provisions of SFAS No. 158 did not have a material impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, 'Fair Value Measurements,' which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. This Statement does not require any new fair value measurements but is expected to increase the consistency of those measurements. The Group elected to adopt the provisions of SFAS No. 157 with the one-year deferral permitted by FASB Staff Position ('FSP') 157-2 for non-financial assets and non-financial liabilities measured at fair value, except those that are recognized or disclosed on a recurring basis, until January 1, 2009. The deferral applies to non-financial assets and liabilities measured at fair value in a business combination and impaired property, plant and equipment for which we use fair value. The Group does not expect any material impact on its financial statements upon adoption.

In June 2006, the FASB issued FASB Interpretation No. 48, 'Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109' (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, 'Accounting for Income Taxes'. The Group adopted the provisions of FIN 48 in the first quarter 2007. The adoption of the provisions of Interpretation No. 48 did not have a material impact on the Group's results of operations, financial position or cash flows.

In June 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-3, 'How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)'. The consensus requires disclosure of either the gross or net presentation, and any such taxes reported on a gross basis should be disclosed in the interim and annual financial statements. The Group adopted the provisions of EITF Issue No. 06-3 in 2006. The adoption of the Issue did not have a material impact on the Group's financial statements.

### Note 3. Cash and cash equivalents

Cash and cash equivalents include the following:

	As of December 31, 2007	As of December 31, 2006
Short-term deposit – US dollars	216,857	–
Short-term deposit – Russian rubles	61,254	–
Cash held in banks – Russian rubles	50,880	3,524
Cash held in banks – US dollars	14,098	25,772
<b>Total cash and cash equivalents</b>	<b>343,089</b>	<b>29,296</b>

### Note 4. Accounts receivable, net

Accounts receivable include the following:

	As of December 31, 2007	As of December 31, 2006
Trade accounts receivable	226,807	141,293
Advances given	8,695	13,366
	235,502	154,659
Allowance for doubtful accounts	(4,614)	(3,288)
<b>Total accounts receivable, net</b>	<b>230,888</b>	<b>151,371</b>

## Notes to consolidated financial statements continued

### Note 5. Inventories

Inventories include the following:

	As of December 31, 2007	As of December 31, 2006
Materials for drilling and workover	189,252	123,919
Work in progress	14,789	14,202
Other consumables	4,243	3,181
<b>Total inventories</b>	<b>208,284</b>	<b>141,302</b>

### Note 6. Property, plant and equipment

Property, plant and equipment include the following:

	As of December 31, 2007	As of December 31, 2006
Machinery and equipment	334,481	179,952
Buildings	24,802	23,276
Vehicles	10,730	12,904
	<b>370,013</b>	216,132
Less: accumulated depreciation	<b>(71,501)</b>	(36,166)
Construction in progress	<b>133,652</b>	6,704
Advances given for property, plant and equipment	<b>64,506</b>	50,961
<b>Total property, plant and equipment</b>	<b>496,670</b>	<b>237,631</b>

### Note 7. Long-term accounts receivable

The Company's long-term accounts receivable were as follows:

	Stated interest rates	As of December 31, 2007	As of December 31, 2006
Long-term accounts receivables denominated in US dollars	6.00%	6,214	14,121
Long-term accounts receivables denominated in Russian rubles	0%	328	978
<b>Total long-term accounts receivable</b>		<b>6,542</b>	<b>15,099</b>

Long-term accounts receivable denominated in US dollars represent amounts receivable from the sale of property, plant and equipment in November 2005 with a carrying value of US \$10 million to companies related to a former member of management of the Company. The Group recognized a gain of US \$5 million on this transaction. These receivables are secured by a pledge over the assets sold.

As these interest rates were below market rates at the date of origination these long-term accounts receivable have been recorded on the balance sheet by discounting the initial amount over the period it is to be repaid using market interest rates of 12.24% and 9.91% for Russian ruble and US dollar loans, respectively, estimated by management to be the rate applicable to the Group for borrowings of a similar nature.

**Note 8. Obligations under capital leases**

The Group leases drilling equipment and vehicles under agreements with an option to purchase the leased equipment at the end of the lease term. These assets are accounted for as capital leases.

Included in machinery and equipment and vehicles is US \$25.1 million of assets under capital lease as of December 31, 2007 (2006: US \$26.9 million).

Property, plant and equipment includes assets under capital lease as follows:

	As of December 31, 2007	As of December 31, 2006
At cost	33,248	30,003
Less: accumulated depreciation	(8,186)	(3,105)
<b>Net property, plant and equipment</b>	<b>25,062</b>	<b>26,898</b>

Future minimum lease payments for the assets under capital lease are as follows:

	As of December 31, 2007
2008	10,890
2009	5,635
2010	1,375
2011	657
2012-2019	3,941
<b>Total minimum lease payments</b>	<b>22,498</b>
Less: amount representing interest	(3,946)
Present value of minimum lease payments	18,552
Less: current portion (note 9)	(9,292)
<b>Long-term obligations under capital leases (note 10)</b>	<b>9,260</b>

**Note 9. Short-term debt and current portion of long-term debt**

Short-term debt and current portion of long-term debt includes the following:

	As of December 31, 2007	As of December 31, 2006
Short-term debt	84,337	44,433
Current portion of long-term debt (note 10)	25,282	25,012
Short-term capital lease obligations (note 8)	9,292	8,112
<b>Total short-term debt and current portion of long-term debt</b>	<b>118,911</b>	<b>77,557</b>

Short-term debt represents the following:

	Currency	Maturity	Stated interest	As of December 31, 2007
OAo AKB Sbergatelny Bank	Russian rubles	September 12, 2008	8.00%	36,666
OAo AKB Sbergatelny Bank	Russian rubles	July 10, 2008	7.40%	20,225
OAo AKB Sbergatelny Bank	Russian rubles	April 18, 2008	7.40%	15,705
OAo AKB Sbergatelny Bank	Russian rubles	August 26, 2008	7.40%	11,130
ZAO UniCredit Bank	Russian rubles	May 09, 2008	7.35%	611
<b>Total short-term debt</b>				<b>84,337</b>

## Notes to consolidated financial statements continued

### Note 10. Long-term debt

Long-term debt includes the following:

Lender	Final maturity date	As of December 31, 2007	As of December 31, 2006
<i>Debt of the Company</i>			
Loans from stockholders	2011	<b>70,000</b>	60,000
OAO NK LUKOIL	2009	–	32,030
<i>Debt of the Company's subsidiaries</i>			
ZAO UniCredit Bank	2012	<b>37,888</b>	–
ZAO UniCredit Bank	2009	<b>33,814</b>	16,805
AK Sbergatelny Bank of the Russian Federation (OAO) – Zapadno-Uralskiy Bank	2010	–	50,402
ZAO UniCredit Bank	2008	–	5,534
Loans from LUKOIL Group companies			
OAO NK LUKOIL	2018	<b>34,826</b>	44,511
OOO Lukoil Nizhnevolzhskneft	2010	<b>2,096</b>	–
OOO LUKOIL-Perm	2041	<b>1,348</b>	1,137
OAO Komineft	2008	<b>873</b>	633
OAO Tebukneft	2014	<b>521</b>	447
OAO Uhtaneft	2015	<b>142</b>	122
OOO LUKOIL-Komi	2010	<b>8</b>	14
<b>Total long-term debt</b>		<b>181,516</b>	211,635
Current portion of long-term debt (note 9)		<b>(25,282)</b>	(25,012)
Long-term capital lease obligation (note 8)		<b>9,260</b>	13,573
<b>Total non-current long-term debt</b>		<b>165,494</b>	200,196

### Stockholders

Long-term loans from stockholders represent loans denominated in US dollars which bear interest at 8.60% and mature on December 31, 2011. These loans were received for the purpose of financing the purchases of property, plant and equipment.

### OAO NK LUKOIL

The Company's long-term debt with OAO NK LUKOIL was denominated in US dollars and was payable in installments of US \$11.5 million in December 2007 and 2008 and US \$11.3 million in 2009. This long-term debt bore interest at a rate of 6.00% per annum. The debt represented financing of 50% of the purchase price of OOO Eurasia Drilling Company. This debt was repaid in November 2007.

### Debt of the Company's subsidiaries

#### ZAO UniCredit Bank (formerly ZAO International Moscow Bank)

Long-term debts with ZAO UniCredit Bank with outstanding balances of US \$33.8 million and US \$37.9 million are denominated in Russian rubles and bear interest at 8.75% and 8.95% per annum, respectively.

OOO Eurasia Drilling Company has unused credit facilities with ZAO UniCredit Bank of US \$6.1 million denominated in Euro expiring on February 5, 2008, at an interest rate of EURIBOR plus 2.55% and of US \$16.3 million denominated in Rubles expiring on July 20, 2008, at an interest rate of MosPrime plus 2.6%.

#### AK Sbergatelny Bank of the Russian Federation (OAO) – Zapadno-Uralskiy Bank

Long-term debts with AK Sbergatelny Bank of the Russian Federation (OAO) – Zapadno-Uralskiy Bank with outstanding balances of US \$23.3 million and US \$27.1 million as of December 31, 2006 were denominated in Russian rubles and bear interest at 11.00% and 11.30% per annum, respectively. These debts were repaid in November 2007.

**Note 10. Long-term debt** continued**Debt of the Company's subsidiaries** continued

## LUKOIL Group companies

Long-term debt of subsidiaries, denominated in Russian rubles, represent various borrowings from LUKOIL Group Companies. This long-term debt has been recorded at fair value based on effective interest rates estimated by management to be applicable to the Company at the acquisition date, which on average was 12.66% per annum.

Long-term debt of subsidiaries is secured by property, plant and equipment with a carrying amount of US \$60.9 million.

Annual maturities of long-term debts outstanding at December 31, 2007 are as follows:

	2008	2009	2010	2011	2012	2013 and thereafter
	25,282	42,128	19,739	84,825	1,994	7,548

**Note 11. Taxes****Income taxes**

The Group is taxable in a number of jurisdictions within and outside of the Russian Federation and, as a result, is subject to a variety of taxes as established under the statutory provisions of each jurisdiction.

The maximum combined statutory tax rate in the Russian Federation is 24%.

The Groups operations outside the Russian Federation are subject to the following rates of income tax:

Kazakhstan	40%
Turkmenistan	20%
Cyprus	10%
Cayman Islands, British Virgin Islands and the Netherlands	0%

The majority of the Group's earnings in 2007 and 2006 were taxed in the Russian Federation.

As of January 1, 2007, and for the 12 months period ended December 31, 2007, the Group does not have any unrecognized tax benefits and thus, no interest and penalties related to unrecognized tax benefits were accrued. The Group's policy is to record interest and penalties related to unrecognized tax benefits as components of income tax expense. In addition, the Group does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

The Company and its subsidiaries file standalone income tax returns in each country in which they operate. Income tax returns are open for inspection by the tax authorities in Russia for tax years 2005-2007 and in Turkmenistan, Kazakhstan and Cyprus for 2007 only.

There are not currently, and have not been during the two years ended December 31, 2007, any provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits in a Group company by offsetting tax losses in another Group company against such profits. Tax losses of a Group company in the Russian Federation may, however, be used fully or partially to offset taxable profits in the same company in any of the ten years following the year of loss.

	Year ended December 31, 2007	Year ended December 31, 2006
Current income tax expense	55,575	33,722
Deferred income tax expense/(benefit)	5,332	(265)
<b>Total income tax expense</b>	<b>60,907</b>	<b>33,457</b>

Deferred income taxes are included in the consolidated balance sheets as follows:

	As of December 31, 2007	As of December 31, 2006
Deferred income tax assets – current	8,775	7,358
Deferred income tax assets – non-current	4,198	10,114
Deferred income tax liabilities – non-current	(1,510)	(1,235)
<b>Net deferred income tax asset</b>	<b>11,463</b>	<b>16,237</b>

## Notes to consolidated financial statements continued

### Note 11. Taxes continued

#### Income taxes continued

The following table sets out the tax effects of each type of temporary differences which give rise to deferred income tax assets and liabilities:

	As of December 31, 2007	As of December 31, 2006
Accounts payable and accrued liabilities	7,784	6,834
Property, plant and equipment	3,112	8,505
Inventories	2,542	1,691
Accrued pension liability	1,166	1,515
Other current assets	398	–
Long-term accounts receivable	321	1,953
Accounts receivable	–	24
<b>Deferred income tax assets</b>	<b>15,323</b>	<b>20,522</b>
Property, plant and equipment	(1,510)	(1,235)
Accounts receivable	(1,370)	–
Other current liabilities	(579)	(1,089)
Long-term debt	(283)	(1,769)
Investments	(118)	(90)
Inventories	–	(102)
<b>Deferred income tax liabilities</b>	<b>(3,860)</b>	<b>(4,285)</b>
<b>Net deferred income tax asset</b>	<b>11,463</b>	<b>16,237</b>

Based upon the level of historical taxable income and expectations for future taxable income over future periods, in which the deferred income tax assets are deductible, management believes it is more likely than not the Group will realize the benefits of these deductible temporary differences as of December 31, 2007 and 2006.

The Company has not recognized deferred income taxes on US \$391 million of undistributed earnings of its Russian subsidiaries, since such earnings are considered to be reinvested indefinitely. If the earnings were distributed in the form of dividends, the Company would be subject to foreign withholding taxes. The amount of unrecognized deferred income tax liability is US \$20 million.

The following table is a reconciliation of the amount of income tax expense that would result from applying the Russian combined statutory income tax rate to income before income taxes to total income taxes:

	As of December 31, 2007	As of December 31, 2006
Income before income taxes	229,451	124,222
Notional income tax at Russian statutory rate	55,068	29,813
Increase in income tax due to non-deductible items, net	5,839	3,644
<b>Total income tax expense</b>	<b>60,907</b>	<b>33,457</b>

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**Note 11. Taxes continued****Income taxes** continued

Taxes receivable include the following:

	As of December 31, 2007	As of December 31, 2006
VAT recoverable	20,426	16,614
Prepaid VAT	13,727	1,856
Prepaid profit taxes	11,228	9,422
Other taxes	746	1,360
<b>Total taxes receivable</b>	<b>46,127</b>	<b>29,252</b>

Taxes payable include the following:

	As of December 31, 2007	As of December 31, 2006
VAT	12,759	8,882
Social taxes and contributions	9,198	8,048
Personal income tax	5,602	3,157
Profit taxes payable	1,734	7,380
Property tax	1,526	2,004
Road tax	86	284
Other taxes	1,539	756
<b>Total taxes payable</b>	<b>32,444</b>	<b>30,511</b>

**Note 12. Pension benefits**

The Company sponsors a post employment and post retirement benefits program. The primary component of the post employment and post retirement benefits program is a defined benefit pension plan that covers the majority of the Company's employees. This plan is administered by a non-state pension fund, LUKOIL-GARANT, and provides pension benefits. The Company also provides several long-term employee benefits such as death-in-service benefit and lump-sum payments upon retirement of a defined benefit nature and other defined benefits to certain old age and disabled pensioners who have not vested any pensions under the pension plan.

The post employment and post retirement benefits program was inherited by the Company from the LUKOIL Group as of the date of acquisition.

The Company's pension plan primarily consists of a defined benefit plan enabling employees to contribute a portion of their salary to the plan and at retirement to receive a lump sum amount from the Company equal to all past contributions made by the employee up to 3.5% of their annual salary. Employees also have the right to receive upon retirement the benefits accumulated under the previous pension plan when OOO Eurasia Drilling Company was a subsidiary of the LUKOIL Group. This plan was replaced in December 2003. These benefits have been fixed and included in the benefit obligation as of December 31, 2007 and 2006. The amount was determined primarily based on a formula including past pensionable service and relative salaries as of December 31, 2003.

On December 31, 2006, the Group adopted the provisions of SFAS No. 158, 'Employers' Accounting for Defined Benefit Pension and Other post retirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R)'. This Statement requires employers to recognize the funded status of all post retirement defined benefit plans in the statement of financial position with corresponding adjustments to accumulated other comprehensive income. The adjustment to accumulated other comprehensive income at adoption represents the net unrecognized actuarial gains and unrecognized prior service costs, both of which were previously netted against the plan's funded status in the statement of financial position. These amounts will be subsequently recognized as net periodic benefit cost. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods will be recognized as a component of other comprehensive income. These amounts will be subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in accumulated other comprehensive income at adoption of SFAS No. 158.

The Company uses December 31 as the measurement date for its post employment and post retirement benefits program. An independent actuary has assessed the benefit obligations as of December 31, 2007 and 2006.

LUKOIL-GARANT is a multiemployer pension plan in which OOO Eurasia Drilling Company employees participate. The information that follows represents the obligations and assets attributable to OOO Eurasia Drilling Company employees participating in this pension plan.

## Notes to consolidated financial statements continued

### Note 12. Pension benefits continued

The following table provides information about the benefit obligations and plan assets as of December 31, 2007 and 2006. The benefit obligations below represent the projected benefit obligation of the pension plan.

	2007	2006
<b>Benefit obligations</b>		
Benefit obligations as of January 1	12,519	11,660
Effect of exchange rate changes	868	1,081
Service cost	581	655
Interest cost	825	840
Actuarial gain	(1,494)	(237)
Benefits paid	(914)	(701)
Curtailment gain	-	(779)
<b>Benefit obligations as of December 31</b>	<b>12,385</b>	<b>12,519</b>
<b>Plan assets</b>		
Fair value of plan assets as of January 1	6,208	5,995
Effect of exchange rate changes	486	547
Return on plan assets	288	302
Interest income on individual pension accounts	217	267
Other changes in fair value of individual pension accounts	(125)	(849)
Employer contributions	1,365	879
Benefits paid	(914)	(933)
<b>Fair value of plan assets as of December 31</b>	<b>7,525</b>	<b>6,208</b>
Funded status	(4,860)	(6,311)
<b>Amounts recognized in the consolidated balance sheet as of December 31, 2007 and 2006</b>		
Accrued pension liability	(4,860)	(6,311)

Weighted average assumptions used to determine benefit obligations as of December 31, 2007 and 2006:

	2007	2006
Discount rate	6.40%	6.60%

Weighted average assumptions used to determine net periodic benefit costs for the year ended December 31, 2007 and 2006:

	2007	2006
Discount rate	6.60%	7.00%
Expected return on plan assets	9.34%	8.81%

Included in accumulated other comprehensive loss as of December 31, 2007 and 2006, are the following before-tax amounts that have not yet been recognized in net periodic benefit cost:

	2007	2006
Unrecognized actuarial (gain) loss	(912)	451

Amounts recognized in other comprehensive income during the years ended December 31, 2007 and 2006:

	2007	2006
Additional (gain) loss arising during the period	(1,363)	451
Re-classified gain amortization	-	-
<b>Net amount recognized in other comprehensive income for the period</b>	<b>(1,363)</b>	<b>451</b>

The real expected rates of return on bonds and equities are based on what is observed in the international markets over extended periods of time. In the calculation of the expected return on assets no use is made of the historical returns LUKOIL-GARANT has achieved.

In addition to the plan assets, LUKOIL-GARANT holds assets in the form of an insurance reserve. The purpose of this insurance reserve is to satisfy pension obligations should the plan assets not be sufficient to meet pension obligations. The Group's contributions to the pension plan are determined without considering the assets in the insurance reserve.

## Note 12. Pension benefits continued

The plans are funded on a discretionary basis through a solidarity account, which is held in trust with LUKOIL-GARANT. LUKOIL-GARANT does not allocate separately identifiable assets to the Group or its other third party clients. All funds of plan assets and other individual pension accounts are managed as a pool of investments.

The asset allocation of the investment portfolio maintained by LUKOIL-GARANT for the Group and its clients was as follows:

Type of assets	As of December 31, 2007	As of December 31, 2006
Russian corporate bonds	33%	23%
Equity securities of Russian issuers	22%	21%
Shares in investment funds	17%	8%
Bank deposits	8%	9%
Promissory notes of Russian issuers	6%	24%
Shares of OAO NK LUKOIL	3%	8%
Russian governmental bonds	2%	2%
Russian municipal bonds	–	1%
Other assets	9%	4%
	<b>100%</b>	<b>100%</b>

The investment strategy employed by LUKOIL-GARANT includes an overall goal to attain a maximum investment return, while guaranteeing the principal amount invested. The strategy is to invest with a medium-term perspective while maintaining a level of liquidity through proper allocation of investment assets. Investment policies include rules and limitations to avoid concentrations of investments.

The investment portfolio is primarily comprised of two types of investments: securities with fixed yield and equity securities. The securities with fixed yield include mainly high yield corporate bonds. Maturities range from one to three years.

Components of net periodic benefit cost were as follows:

	Year ended December 31, 2007	Year ended December 31, 2006
Service cost	581	655
Interest cost	825	840
Less expected return on plan assets	(535)	(490)
Curtailement loss	–	8
<b>Total net periodic benefit cost</b>	<b>871</b>	<b>1,013</b>

Total employer contributions for 2008 are expected to be approximately US \$1 million.

Accumulated benefit obligations were US \$11.6 million and US \$11.4 million as of December 31, 2007 and December 31, 2006, respectively.

The following benefit payments, which reflect expected future services, as appropriate, are expected to be paid:

	2008	2009	2010	2011	2012	5-year period 2008-2012	5-year period 2013-2017
Pension benefits	1,416	749	756	784	768	4,473	3,238
Lump sum payments upon retirement, death and disability	1,141	755	776	763	791	4,226	3,814
<b>Total expected benefits to be paid</b>	<b>2,557</b>	<b>1,504</b>	<b>1,532</b>	<b>1,547</b>	<b>1,559</b>	<b>8,699</b>	<b>7,052</b>

## Note 13. Fair value of financial instruments

The fair values of all financial instruments are approximately equal to their carrying values as disclosed in the consolidated financial statements. Fair values were determined based on discounted cash flows using estimated market interest rates for similar financial arrangements.

## Notes to consolidated financial statements continued

### Note 14. Cost of services

Cost of services includes the following:

	Year ended December 31, 2007	Year ended December 31, 2006
Materials	342,154	243,553
Services of subcontractors	336,615	318,766
Wages and salaries	233,323	151,743
Fuel and energy	57,888	47,467
Transportation of employees to drilling fields	27,714	23,085
Leasing and rent	11,331	8,504
Other	40,737	13,763
<b>Total cost of services</b>	<b>1,049,762</b>	<b>806,881</b>

### Note 15. Stockholders' equity

#### Common stock

##### Authorized

The Company's authorized common shares consisted of 50,000 shares with a par value of US \$1 per share as of December 31, 2006.

On July 31, 2007 the Stockholders declared a 2,500-to-1 stock split. In connection with the stock split, the Stockholders have approved an amendment to the articles of association to increase the number of authorized common stock from 50,000 to 125 million and to decrease the par value of each share of outstanding common stock from US \$1 per share to US \$0.01 per share. As a result, the Company transferred US \$1.2 million from additional paid-in capital to common stock, representing the par value of additional stock issued to the Stockholders. Earnings per share amounts shown in these consolidated financial statements for all periods reflect this stock split.

On July 31, 2007 the Stockholders approved an amendment to the articles of association to increase the number of authorized common stock from 125 million to 250 million.

##### Issued and outstanding

The Company's issued and outstanding common shares consisted of 50,000 shares with a par value of US \$1 per share as of December 31, 2006. As a result of stock split mentioned above, the number of issued and outstanding common stock comprised of 125 million as of July 31, 2007.

In connection with the Company's Initial Public Offering, the Company issued an additional 19,148,936 common shares on November 1, 2007 and 2,716,307 common shares on December 5, 2007.

The number of issued and outstanding common stock was 146,865,243 shares with a par value of US \$0.01 per share as of December 31, 2007.

##### Treasury stock

As of January 1, 2006 the Company had 5,000 shares of common stock held as treasury stock recorded at cost. In July 2006 the Company issued this treasury stock to existing stockholders at cost.

##### Dividends and dividends limitations

Profits available for distribution from the Company's Russian subsidiaries to the Company in respect of any reporting period are primarily determined by reference to the statutory financial statements of these subsidiaries prepared in accordance with the laws of the Russian Federation and denominated in Russian rubles. Under Russian Law, dividends are limited to the retained earnings as set out in the statutory financial statements of the Company's Russian subsidiaries. These laws and other legislative acts governing the rights of stockholders to receive dividends are subject to various interpretations.

Retained earnings of the Company's Russian subsidiaries were RUR 9.6 billion and RUR 5.8 billion, respectively as of December 31, 2007 and 2006, pursuant to the statutory financial statements, which at the US dollar exchange rates as of December 31, 2007 and 2006 amount to US \$391 million and US \$220 million, respectively.

The Stockholders declared dividends of US \$200 per pre split common share for 2007 on July 16, 2007 totaling US \$10 million.

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**Note 15. Stockholders' equity continued****Earnings per share**

The calculation of earnings per share for these years was as follows:

	Year ended December 31, 2007	Year ended December 31, 2006
Net income available for common stockholders	168,544	90,765
Weighted average number of outstanding shares (post split)	128,341,261	118,682,500
Basic earnings per share of common stock (US dollars)	1.31	0.76

There is no potential dilution in earnings available to common stockholders and as such diluted earnings per share are not disclosed.

**Note 16. Business combinations**

In December 2006, the Group company acquired 100% of the outstanding common shares of LUKOIL Overseas Orient Limited and LUKOIL Shelf Limited from the LUKOIL Group for US \$40.3 million paid in cash. LUKOIL Shelf Limited is operating the Astra drilling rig owned by LUKOIL Overseas Orient Limited in the Caspian sea.

The companies are providing offshore well drilling services in the Caspian sea to various oil and gas companies in the Russian Federation, Kazakhstan and Turkmenistan. The purpose of the acquisition was to initiate the offshore drilling operations of the Group in the Caspian region.

The values of certain liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Changes to the carrying value of the liabilities may result in adjustments to the carrying value of property, plant and equipment acquired.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

Current assets	19,590
Property, plant and equipment	27,298
Other non-current assets	11
Total assets acquired	46,899
Current liabilities	(5,364)
Non-current deferred tax liabilities	(1,235)
Total liabilities assumed	(6,599)
Net assets acquired	40,300

**Note 17. Commitments and contingencies****Commitments****Commitments for provision of drilling services**

Under the terms of sale and purchase agreement between Eurasia Drilling Company Limited and OAO NK LUKOIL, the Group has committed to rendering future drilling services to LUKOIL Group Companies.

Under this agreement the Group will provide drilling services to the LUKOIL Group and precise terms of rendering of such services will be set by signing annual well construction contracts with the LUKOIL Group starting from January 1, 2005 through December 31, 2009. The estimated level of drilling to be performed by the Group during this five-year period was agreed at a minimum of 6.5 million meters. The estimated revenues for the developmental drilling services set out in the contract at the date of acquisition were RUR 73.19 billion (US \$2.6 billion). The prices for drilling services under these contracts are reviewed on an annual basis based on market prices.

Under the terms of the contract, drilling services of US \$1,211 million and US \$753 million will be provided by the Group during 2008 and 2009, respectively.

In the event of any agreed change in the scope of work or any failure to provide or fulfill the agreed scope of work by either party, Eurasia Drilling Company Limited or OAO NK LUKOIL, during the years 2005 to 2009, as well as in the event of any consequences arising out of such party's failure to fulfill its obligations, the defaulting party shall compensate to the other party any reasonable losses. Such compensation may be equal to the share of the reduced revenues, in the form of the provision or fulfillment of other types of contracted work, as well as any penalties applicable under the contract.

# Notes to consolidated financial statements continued

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## Note 17. Commitments and contingencies continued

### Commitments continued

#### Insurance

The insurance industry in the Russian Federation and certain other areas where the Group has operations is in the course of development. Management believes that the Group has adequate property damage coverage for its main production assets. In respect of third party liability for property and environmental damage arising from accidents on Group property or relating to Group operations, the Group has insurance coverage that is generally higher than insurance limits set by the local legal requirements. Management believes that the Group has adequate insurance coverage of the risks, which could have a material effect on the Group's operations and financial position.

#### Litigation

The Group is involved in various claims and legal actions arising in the normal course of business. It is the opinion of management that the ultimate disposition of these matters will not have a material adverse effect on the Group's consolidated financial position, results of operations, or liquidity.

#### Environmental obligations

Group companies have operated in the Russian Federation, Kazakhstan and Turkmenistan for several years. Environmental regulations are currently under consideration in these countries. Group companies routinely assess and evaluate their obligations in response to new and changing legislation.

As liabilities in respect of the Group's environmental obligations are able to be determined, they are charged against income over the estimated remaining lives of the related assets or recognized immediately depending on their nature. The likelihood and amount of liabilities relating to environmental obligations under proposed or any future legislation cannot be reasonably estimated at present and could become material. Under existing legislation, however, management believes that there are no significant unrecorded liabilities or contingencies, which could have a materially adverse effect on the operating results or financial position of the Group.

#### Taxation

The taxation system in the Russian Federation, Kazakhstan and Turkmenistan is relatively new and is characterized by frequent changes in legislation, official pronouncements and court decisions, which are often unclear, contradictory and subject to varying interpretation by different tax authorities. Taxes are subject to review and investigation by a number of authorities, which have the authority to impose severe fines, penalties and interest charges. A tax year remains open for review by the tax authorities during the three subsequent calendar years; however, under certain circumstances a tax year may remain open longer. Recent events within the Russian Federation suggest that the tax authorities are taking a more assertive position in their interpretation and enforcement of tax legislation.

These circumstances may create tax risks that are substantially more significant than in other countries. Management believes that it has provided adequately for tax liabilities based on its interpretations of applicable tax legislations, official pronouncements and court decisions. However, the interpretations of the relevant authorities could differ and the effect on these consolidated financial statements, if the authorities were successful in enforcing their interpretations, could be significant.

## Note 18. Related party transactions

In 2007, the Group purchased well construction and related services and equipment from an affiliated company, PetroAlliance Services Company Limited ("PAS"), of US \$23.9 million and US \$18.3 million, respectively (2006: US \$20.6 million and nil, respectively). Amounts payable to PAS were US \$4.2 million and US \$5.1 million as of December 31, 2007 and 2006, respectively. During 2007, the Group provided drilling services to PAS of US \$3.1 million (2006: nil). Amounts receivable from PAS were US \$0.8 million and nil as of December 31, 2007 and 2006, respectively. A stockholder of Eurasia Drilling Company Limited is the chairman of the Board of Directors of PAS.

In 2006 the Company received property, plant and equipment under capital lease from an associated company OAO LK Leasing – a company in which a substantial stockholder of Eurasia Drilling Company has a controlling interest, with a carrying value of US \$11.7 million. Capital lease obligations were US \$13.8 million (2006: US \$20.7 million).

In 2007 the Company purchased drilling equipment from OAO LK Leasing with a carrying value of US \$19.2 million. Amounts payable to LK Leasing for these equipment were US \$1.5 million as of December 31, 2007.

In 2007 and 2006, the Company received long-term loans of US \$10 million and US \$60 million from its stockholders, respectively (refer note 10). Interest expense of US \$5.8 million and US \$0.3 million was recognized and paid during 2007 and 2006, respectively.

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**Note 19. Segment information**

Presented below is information about the Group's operating and geographical segments for the periods ended December 31, 2007 and 2006, in accordance with SFAS No. 131, 'Disclosures about Segments of an Enterprise and Related Information'.

The Group has two operating and geographical segments: on-shore drilling conducted in the CIS and off-shore drilling conducted in the Caspian Sea. These segments are based upon the Group's organizational structure, the way in which these operations are managed, the availability of separate financial results, and materiality considerations. Management, on a regular basis, assess the performance of these operating segments. The operations of the off-shore drilling services segment commenced on December 20, 2006 upon the acquisition of EDC Shelf Limited (formerly LUKOIL Shelf Limited) and AstraOrient Limited (formerly LUKOIL Overseas Orient Limited). In 2007, the Company established a Russian subsidiary, OOO BKE Shelf, to operate its off-shore drilling services segment. It is planned to transfer all operations from EDC Shelf Limited to OOO BKE Shelf.

Geographical segments have been determined based on the area of operations and include two segments. They are CIS and the Caspian Sea.

Segment detailed information is summarized as follows:

	On-shore drilling services (CIS)	Off-shore drilling services (Caspian Sea)	Consolidated
<b>For the year ended December 31, 2007</b>			
Total revenues	1,451,421	40,768	1,492,189
Net income	162,252	6,292	168,544
Total assets	1,303,042	56,761	1,359,803
<hr/>			
	On-shore drilling services (CIS)	Off-shore drilling services (Caspian Sea)	Consolidated
<b>For the year ended December 31, 2006</b>			
Total revenues	1,087,572	–	1,087,572
Net income	90,765	–	90,765
Total assets	582,160	46,898	629,058

**Note 20. Concentration of credit risk and sales**

A significant proportion of the Group's operations are with LUKOIL Group companies and as such the Group has significant concentrations of credit risk with the LUKOIL Group.

Included in the Group's sales and accounts receivables are the following transactions and balances with LUKOIL Group companies.

	2007	2006
Sales for the year ended December 31	<b>1,188,929</b>	956,759
Accounts receivable as of December 31	<b>176,350</b>	116,027

# Corporate information

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## Directors

### Lord Patrick James Gillford

Chairman of the Board of Directors  
Eurasia Drilling Company Ltd.  
Principal, Policy Partnership Ltd.

### Alexander Yu. Djaparidze

Chief Executive Officer,  
Eurasia Drilling Company Ltd.

### L. Todd Gremillion

Former Partner, Akin, Gump, Strauss,  
Hauer & Feld

### Martin E. Hansen

Former Chief Financial Officer,  
Eurasia Drilling Company Ltd.

### Rene Huck

Former Vice-President, Schlumberger

### Albert I. Vladimirov

Professor and Rector,  
Gubkin Russian State University  
of Oil and Gas

### Alexander Shokhin

Member, Board of Directors, LUKOIL

## Officers

### Alexander Yu. Djaparidze

Chief Executive Officer

### Murray L. Vasilev

Senior Vice President Business  
Development

### Ronald A. Harris

CFO, Senior VP Investor Relations

### S. Douglas Stinemetz

General Counsel and Secretary

### Kim L. Kruschwitz

Vice President, Marketing and Investor  
Relations

## Subsidiary Officers

Alexander N. Bogachev  
President, OOO Burovaya  
Kompaniya Eurasia

### Taleh M. Aleskerov

Senior VP Finance and CFO, OOO  
Burovaya Kompaniya Eurasia

### Medjid M. Zulpukarov

General Director, BKE Shelf Ltd.

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## Principle Administrative Offices

No. 53, Mykonos Court  
Aristide Charalambous 2  
1077 Nicosia  
Cyprus

## Annual General Meeting

The Annual General Meeting of Members  
of Eurasia Drilling Company Limited will  
be held on Tuesday, September 9th, 2008  
in Limassol, Cyprus.

## Investor Relations Contact

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