# Georgian Oil and Gas Corporation JSC

## Consolidated Financial Statements
## for the year ended 31 December 2011

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**Independent Auditors' Report**

Board of Directors
Georgian Oil and Gas Corporation JSC

We have audited the accompanying consolidated financial statements of Georgian Oil and Gas Corporation JSC (the "Company") and its subsidiaries (the "Group"), which comprise the consolidated statement of financial position as at 31 December 2011, and the consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

*Management's Responsibility for the Consolidated Financial Statements*

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

*Auditors' Responsibility*

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

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

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

*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2011, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Tbilisi Branch of KPMG CIS Limited
10 April 2012

| '000 GEL | Note | 2011 | 2010 |
|---|---|---|---|
| **Assets** | | | |
| Property, plant and equipment | 14 | 271,606 | 224,839 |
| Intangible assets | | 222 | 784 |
| Prepayment for non-current assets | | 684 | - |
| Finance lease receivable | 15 | 43,074 | 40,445 |
| Deferred tax assets | 16 | - | 628 |
| **Non-current assets** | | **315,586** | **266,696** |
| | | | |
| Non-current assets held for distribution | 17 | 20,728 | 6,282 |
| Inventories | 18 | 735 | 12,345 |
| Current tax assets | | 756 | 2,642 |
| Value added tax recoverable | | - | 8,764 |
| Prepayments for current assets and expenses | | 23,290 | 25,797 |
| Trade and other receivables | 19 | 30,370 | 25,506 |
| Cash and cash equivalents | 20 | 35,079 | 57,589 |
| **Current assets** | | **110,958** | **138,925** |
| **Total assets** | | **426,544** | **405,621** |
| | | | |
| **Equity** | 21 | | |
| Share capital | | 478,772 | 495,532 |
| Additional paid in capital | | 71,718 | 74,570 |
| Fair value adjustment reserve for non-cash owner contributions | | (282,181) | (282,181) |
| Retained earnings | | 90,160 | 58,523 |
| **Total equity** | | **358,469** | **346,444** |
| | | | |
| **Liabilities** | | | |
| Loans and borrowings | 22 | 654 | 2,304 |
| Deferred tax liabilities | 16 | 10,635 | 7,938 |
| **Non-current liabilities** | | **11,289** | **10,242** |
| | | | |
| Restructured tax liabilities | | - | 17,027 |
| Loans and borrowings | 22 | 10,362 | 8,929 |
| Trade and other payables | | 2,685 | 2,932 |
| Dividend payable | 21 | 41,700 | - |
| Current tax liabilities | | - | 7,699 |
| Value added tax payable | | 1,623 | 11,867 |
| Other taxes payable | | 416 | 481 |
| **Current liabilities** | | **56,786** | **48,935** |
| **Total liabilities** | | **68,075** | **59,177** |
| **Total equity and liabilities** | | **426,544** | **405,621** |



The consolidated statement of financial position is to be read in conjunction with the notes to, and forming part of, the consolidated financial statements set out on pages 8 to 44.

| '000 GEL | Note | 2011 | 2010 |
|---|---|---|---|
| | | | Restated* |
| **Continuing operations** | | | |
| Revenue | 8 | 239,917 | 172,408 |
| Cost of gas and oil | 9 | (111,809) | (91,145) |
| Depreciation and amortization | | (19,778) | (17,793) |
| Personnel costs | | (7,906) | (7,244) |
| Taxes, other than on income | | (5,515) | (4,461) |
| Reversal of impairment loss of property, plant and equipment | 14 | 26,393 | 41,560 |
| Other expenses | 10 | (6,050) | (8,570) |
| Other income | 11 | 5,574 | 15,665 |
| **Results from operating activities** | | **120,826** | **100,420** |
| Finance income | 12 | 11,218 | 5,405 |
| Finance costs | 12 | (1,698) | (14,270) |
| **Net finance income/(costs)** | | **9,520** | **(8,865)** |
| **Profit before income tax** | | **130,346** | **91,555** |
| Income tax expense | 13 | (16,274) | (11,801) |
| **Profit from continuing operations** | | **114,072** | **79,754** |
| | | | |
| **Discontinued operation** | | | |
| Profit from discontinued operation (net of income tax) | 7 | 8,444 | 17,806 |
| **Profit and total comprehensive income for the year attributable to owners of the Company** | | **122,516** | **97,560** |

*See discontinued operations – note 7

These consolidated financial statements were approved by management on 10 April 2012 and were signed on its behalf by:

Zurab Janjgava
General Director

Alexander Sakandelidze
Financial Director



The consolidated statement of comprehensive income is to be read in conjunction with the notes to, and forming part of, the consolidated financial statements set out on pages 8 to 44.

| ’000 GEL | Share capital/ charter capital* | Fair value adjustment reserve for non-cash owner contributions | Additional paid-in capital | Retained earnings | Total |
|---|---|---|---|---|---|
| Balance at 1 January 2010 | **194,268** | **(31,168)** | **52,311** | **(29,937)** | **185,474** |
| **Total comprehensive income for the year** | | | | | |
| Profit for the year | - | - | - | 97,560 | 97,560 |
| **Contributions by and distributions to owners** | | | | | |
| Increase in additional paid in capital, net of tax of GEL 5,047 thousand (see note 21(b)) | - | - | 37,929 | - | 37,929 |
| Dividends to equity holders (see note 21(c)) | - | - | - | (9,100) | (9,100) |
| Distributions of non-cash assets (see note 14) | - | - | (15,670) | - | (15,670) |
| Increase in charter capital | 311,348 | - | - | - | 311,348 |
| Decrease in charter capital (see note 14) | (10,084) | - | - | - | (10,084) |
| Fair value adjustment of non-cash owner contributions | - | (20,943) | - | - | (20,943) |
| Fair value adjustment of non-cash owner contributions (see note 15) | - | (230,070) | - | - | (230,070) |
| **Balance at 31 December 2010** | **495,532** | **(282,181)** | **74,570** | **58,523** | **346,444** |
| | | | | | |
| Balance at 1 January 2011 | 495,532 | (282,181) | 74,570 | 58,523 | 346,444 |
| **Total comprehensive income for the year** | | | | | |
| Profit for the year | - | - | - | 122,516 | 122,516 |
| **Contributions by and distributions to owners** | | | | | |
| Dividends to equity holders (see note 21(c)) | - | - | - | (45,000) | (45,000) |
| Other cash distributions (see note 21(c)) | - | - | - | (4,200) | (4,200) |
| Distributions of non-cash assets net of tax of GEL 1,250 thousand (see note 21(c)) | - | - | - | (7,082) | (7,082) |
| Distributions of non-cash assets (see note 14) | - | - | (2,852) | - | (2,852) |
| Increase in share capital | 11,000 | - | - | - | 11,000 |
| Decrease in share capital (see note 27) | (26,723) | - | - | - | (26,723) |
| Transfer of subsidiary (see note 7) | (1,037) | - | - | (34,597) | (35,634) |
| **Balance at 31 December 2011** | **478,772** | **(282,181)** | **71,718** | **90,160** | **358,469** |

*In September 2011, the Company changed its legal form from a Limited Liability Company to a Joint Stock Company.



The consolidated statement of changes in equity is to be read in conjunction with the notes to, and forming part of, the consolidated financial statements set out on pages 8 to 44.

| '000 GEL | Note | 2011 | 2010 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Profit for the year | | 122,516 | 97,560 |
| *Adjustments for:* | | | |
| Depreciation and amortisation | | 20,842 | 19,130 |
| (Reversal of impairment loss)/impairment loss on trade and other receivables | | (926) | 5,076 |
| Reversal of impairment losses on property, plant and equipment | | (26,393) | (43,150) |
| Interest expense | | 1,031 | 12,163 |
| Amortization of government grant | | - | (2,119) |
| Unwind of discount for lease payments | | (2,629) | (1,216) |
| Other | | 115 | 847 |
| Income tax expense | | 18,214 | 17,735 |
| **Cash from operating activities before changes in working capital** | | **132,770** | **106,026** |
| Change in inventories | | 9,198 | 10,953 |
| Change in trade and other receivables | | (12,653) | (11,772) |
| Change in prepayments for current assets and expenses | | (21,921) | (5,087) |
| Change in value added tax recoverable | | 1,589 | (11,482) |
| Change in trade and other payables | | 16,223 | 459 |
| Change in VAT payable | | (10,244) | 9,646 |
| Change in other taxes payable | | (336) | (1,245) |
| Change in restructured tax liabilities | | (17,027) | (7,353) |
| **Cash flows from operations before income taxes and interest paid** | | **97,599** | **90,145** |
| Income tax paid | | (18,140) | (4,449) |
| Interest paid | | (669) | (4,705) |
| **Net cash from operating activities** | | **78,790** | **80,991** |
| | | | |
| **Cash flows from investing activities** | | | |
| Acquisition of property, plant and equipment | | (44,428) | (8,518) |
| Acquisition of intangible assets | | (95) | (58) |
| Acquisition of non-current assets held for distribution | | (20,728) | (6,282) |
| Investing in other companies | | (115) | (748) |
| **Net cash used in investing activities** | | **(65,366)** | **(15,606)** |
| | | | |
| **Cash flows from financing activities** | | | |
| Repayment of borrowings | | - | (6,876) |
| Cash distributed on the transfer of subsidiaries | | (26,623) | - |
| Cash distributed on the transfer of discontinued operation | 7 | (1,811) | - |
| Dividends paid | 21 | (7,500) | (9,100) |
| **Net cash used in financing activities** | | **(35,934)** | **(15,976)** |
| | | | |
| **Net (decrease)/increase in cash and cash equivalents** | | **(22,510)** | **49,409** |
| Cash and cash equivalents at 1 January | | 57,589 | 8,180 |
| **Cash and cash equivalents at 31 December** | 20 | **35,079** | **57,589** |



The consolidated statement of cash flows is to be read in conjunction with the notes to, and forming part of, the consolidated financial statements set out on pages 8 to 44.

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# 1. Background

## (a) Organisation and operations

Georgian Oil and Gas Corporation JSC (the "Company"), formerly incorporated as a LLC, and its subsidiaries (the "Group") comprise Georgian Joint Stock and Limited Liability Companies as defined in the "Law of Georgia on Entrepreneurs". In September 2011 the Company changed its legal form from a Limited Liability Company to a Joint Stock Company. The Company was established as a 100% state-owned enterprise by the order of the Ministry of Economy of Georgia on 21 March 2006, on the basis of three Georgian state-owned companies: Georgian International Oil Corporation JSC, Georgian Gas International Corporation JSC and Teleti Oil Company JSC.

In 2006 and 2007, respectively, Georgian International Oil Corporation JSC and Georgian Gas International Corporation JSC ceased legal existence and the assets and liabilities were transferred to the Company. In November 2007 the shares in Teleti Oil Company JSC were taken over by the Government of Georgia. Related party transactions are detailed in note 26.

The Company's registered office is 21 Kakheti Highway, Tbilisi 0190, Georgia.

The Group's principal activities are the importation and sale of gas, the rental of gas pipelines and oil and gas exploration and extraction in the territory of Georgia. Before the transfer of the subsidiary (see note 7), the Group's principal activities also included operation of transitory gas pipelines in the territory of Georgia and transit of gas to the Republic of Armenia.

The Company has also been granted the status of "National Oil Company" in December 2006 by Presidential decree number 736 and it acts on behalf of the State of Georgia, receives and disposes of the State's share of extracted oil and gas produced by contractors in the territory of Georgia in accordance with the "Law of Georgia on Oil and Gas" and production sharing agreements signed between the State and the contractors. The Group has not recognized an intangible asset for this right as the Group does not control the right.

## (b) Business environment

### Georgian business environment

The Group's operations are primarily located in Georgia. Consequently, the Group is exposed to the economic and financial markets of Georgia which display characteristics of an emerging market. The legal, tax and regulatory frameworks continue development, but are subject to varying interpretations and frequent changes which together with other legal and fiscal impediments contribute to the challenges faced by entities operating in Georgia. The consolidated financial statements reflect management's assessment of the impact of the Georgian business environment on the operations and the financial position of the Group. The future business environment may differ from management's assessment.

# 2. Basis of preparation

## (a) Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRSs").

## (b) Basis of measurement

The consolidated financial statements are prepared on the historical cost basis.

## (c) Functional and presentation currency

The national currency of Georgia is the Georgian Lari ("GEL"), which is the Company's functional currency and the currency in which these consolidated financial statements are presented. All financial information presented in GEL has been rounded to the nearest thousand, except when otherwise indicated.

## (d) Use of estimates and judgments

The preparation of consolidated financial statements in conformity with IFRSs requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from those estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

Information about critical judgments in applying accounting policies that have the most significant effect on the amounts recognised in the consolidated financial statements is included in the following notes:

- Note 14 Property, plant and equipment – determination of the value in use of the gas transportation CGU;
- Note 15 Finance lease receivable – determination of whether the arrangement contains a lease and the fair value of the unguaranteed residual value;
- Note 16 Deferred tax assets and liabilities – determination of whether to recognise a temporary difference on initial recognition of the financial lease receivable.

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year is included in the following notes:

- Note 14 Property, plant and equipment – determination of reversal of impairment loss;
- Note 23 (b) Credit risk – impairment of trade and other receivables;
- Note 25 Contingencies – environmental matters and litigation.

# 3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by Group entities.

## (a) Basis of consolidation

### *(i) Subsidiaries*

Subsidiaries are entities controlled by the Group. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the Group.

### *(ii) Loss of control*

Upon the loss of control, the Group derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss. If the Group retains any interest in the previous subsidiary, then such interest is measured at fair value at the date that control is lost. Subsequently it is accounted for as an equity-accounted investee or as an available-for-sale financial asset depending on the level of influence retained.

### *(iii) Jointly controlled operations*

A jointly controlled operation is a joint venture carried on by each venturer using its own assets in pursuit of the joint operations. The consolidated financial statements include the assets that the Group controls and the liabilities that it incurs in the course of pursuing the joint operation, and the expenses that the Group incurs and its share of the income that it earns from the joint operation.

### *(iv) Transactions eliminated on consolidation*

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with equity-accounted investees are eliminated against the investment to the extent of the Group's interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

## (b) Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortised cost in foreign currency translated at the exchange rate at the end of the reporting period.

Non-monetary items in a foreign currency that are measured based on historical cost are translated using the exchange rate at the date of the transaction.

Foreign currency differences arising in retranslation are recognised in profit or loss.

**(c) Financial instruments**

Financial instruments comprise investments in trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables.

***(i) Non-derivative financial assets***

The Group initially recognizes loans and receivables and deposits on the date that they are originated.

The Group derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Group is recognized as a separate asset or liability.

Financial assets and liabilities are offset and the net amount presented in the statement if financial position when, and only when, the Group has a legal right to offset the amounts and intends either to settle on a net basis or to realise the asset and liability simultaneously.

The Group classifies non-derivative financial assets into the loans and receivables category.

Loans and receivables are a category of financial assets with fixed or determinable payments that are not quoted in an active market.

Loans and receivables are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition loans and receivables are measured at amortised cost using the effective interest method, less any impairment losses.

Loans and receivables category comprise trade and other receivables and cash and cash equivalents.

Cash and cash equivalents comprise cash balances and call deposits with maturities of three months or less.

***(ii) Non-derivative financial liabilities***

The Group initially recognises debt securities issued on the date that they are originated. All other financial liabilities are recognized initially on the trade date at which the Group becomes a party to the contractual provisions of the instrument.

The Group derecognizes a financial liability when its contractual obligations are discharged or cancelled or expire.

The Group classifies non-derivative financial liabilities into the other financial liability category. Other financial liabilities comprise loans and borrowings and trade and other payables.

Such financial liabilities are recognized initially at fair value less any directly attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortised cost using the effective interest method.

### (d) Share capital

*Ordinary shares*

Ordinary shares are classified as equity. Incremental costs directly attributable to issue of ordinary shares and share options are recognised as a deduction from equity, net of any tax effects.

*Reduction of share capital*

Share capital reductions and non-cash distributions are recognized at the carrying amount of the assets distributed. Non-cash distributions of the Company are out of scope of IFRIC 17 *Distributions of Non-cash Assets to Owners* since the ultimate controlling party controls the assets before and after the distribution.

*Increase of share capital*

Share capital increase is effected through issuance of new shares. When share capital is increased, any difference between the registered amount of share capital and the fair value of the assets contributed is recognized as a separate component of equity as fair value adjustment reserve for non-cash owner contributions.

### (e) Property, plant and equipment

#### *(i) Recognition and measurement*

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Property, plant and equipment contributed by the shareholder are initially measured at fair value. The cost of property, plant and equipment at the date of adopting IFRS, 1 January 2008, was determined by reference to its fair value at that date ("deemed cost").

Cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for their intended use, the costs of dismantling and removing the items and restoring the site on which they are located, and borrowing costs on qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment.

The gain or loss on disposal of an item of property, plant and equipment is determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment, and is recognized net within other income/other expenses in profit or loss.

#### *(ii) Subsequent costs*

The cost of replacing a component of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the component will flow to the Group, and its cost can be measured reliably. The carrying amount of the replaced component is derecognised. The costs of the day-to-day servicing of property, plant and equipment are recognised in profit or loss as incurred.

### *(iii) Depreciation*

Items of property, plant and equipment are depreciated from the date that they are installed and are ready for use, or in respect of internally constructed assets, from the date that the asset is completed and ready for use. Depreciation is based on the cost of an asset less its residual value. Significant components of individual assets are assessed and if a component has a useful life that is different from the remainder of that asset, that component is depreciated separately.

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Group will obtain ownership by the end of the lease term. Land is not depreciated.

The estimated useful lives of significant items of property, plant and equipment for the current and comparative periods are as follows:

- gas and oil pipelines 30-35 years
- buildings 50 years
- oil wells 4-9 years
- plant and equipment 2-14 years
- other 1-6 years

Depreciation methods, useful lives and residual values are reviewed at each financial year end and adjusted if appropriate.

## (f) Leased assets

Leases in terms of which the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a finance lease and a receivable equal to the net investment in the lease is recognized and presented within loans and receivables. Subsequently the recognition of finance income is based on a pattern reflecting a constant periodic rate of return on the Group's net investment in the finance lease.

Other leases are operating leases and the leased assets are not recognised on the Group's statement of financial position.

## (g) Inventories

Inventories are measured at the lower of cost and net realisable value. The cost of inventories is based on the first-in first-out principle, and includes expenditure incurred in acquiring the inventories, production or conversion costs and other costs incurred in bringing them to their existing location and condition. In the case of manufactured inventories and work in progress, cost includes an appropriate share of production overheads based on normal operating capacity.

Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

## (h) Impairment

### *(i) Financial assets*

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is impaired if objective evidence indicates that a loss event has occurred after the initial recognition of the asset, and that the loss event had a negative effect on the estimated future cash flows of that asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include default or delinquency by a debtor, restructuring of an amount due to the Group on terms that the Group would not consider otherwise, indications that a debtor or issuer will enter bankruptcy, adverse changes in the payment status of borrowers or issuers in the Group, economic conditions that correlate with defaults or the disappearance of an active market for a security.

The Group considers evidence of impairment for loans and receivables at both a specific asset and collective level. All individually significant loans and receivables are assessed for specific impairment. All individually significant loans and receivables found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified. Loans and receivables that are not individually significant are collectively assessed for impairment by grouping together loans and receivables with similar risk characteristics.

In assessing collective impairment the Group uses historical trends of the probability of default, timing of recoveries and the amount of loss incurred, adjusted for management's judgement as to whether current economic and credit conditions are such that the actual losses are likely to be greater or less than suggested by historical trends.

An impairment loss in respect of a financial asset measured at amortised cost is calculated as the difference between its carrying amount, and the present value of the estimated future cash flows discounted at the asset's original effective interest rate. Losses are recognized in profit or loss and reflected in an allowance account against receivables. Interest on the impaired asset continues to be recognized through the unwinding of the discount. When a subsequent event causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

### *(ii) Non-financial assets*

The carrying amounts of the Group's non-financial assets, other than inventories and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. An impairment loss is recognized if the carrying amount of an asset or its related cash-generating unit (CGU) exceeds its estimated recoverable amount.

The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or CGU. For the purpose of impairment testing, assets that cannot be tested individually are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or CGU.

Impairment losses are recognized in profit or loss. Impairment losses recognized in respect of CGUs are allocated to carrying amounts of the assets in the CGU (group of CGUs) on a pro rata basis.

Impairment losses recognized in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognized.

### (i) Employee benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee, and the obligation can be estimated reliably.

### (j) Provisions

A provision is recognised if, as a result of a past event, the Group has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognised as finance cost.

### (k) Non-current assets held for sale or distribution

Non-current assets, or disposal groups comprising assets and liabilities, that are expected to be recovered primarily through sale or distribution rather than through continuing use, are classified as held for sale or distribution. Immediately before classification as held for sale, the assets, or components of a disposal group, are remeasured in accordance with the Group's accounting policies. Thereafter generally the assets, or disposal group, are measured at the lower of their carrying amount and fair value less cost to sell. Any impairment loss on a disposal group is allocated to assets and liabilities on pro rata basis, except that no loss is allocated to inventories, financial assets, deferred tax assets or employee benefit assets, which continue to be measured in accordance with the Group's accounting policies. Impairment losses on initial classification as held for sale or distribution and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

Intangible assets and property, plant and equipment once classified as held for sale or distribution are not amortised or depreciated. In addition, equity accounting of equity-accounted investees ceases once classified as held for sale or distribution.

### (l) Revenue

#### *(i) Sale of gas and oil*

Revenue from the sale of gas and oil in the course of ordinary activities is measured at the fair value of the consideration received or receivable, net of returns, trade discounts and volume rebates.

Revenue is recognized when persuasive evidence exists, usually in the form of an executed sales agreement, that the significant risks and rewards of ownership have been transferred to the customer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably, there is no continuing management involvement with the goods,

and the amount of revenue can be measured reliably. If it is probable that discounts will be granted and the amount can be measured reliably, then the discount is recognized as a reduction of revenue as the sales are recognized.

The timing of the transfers of risks and rewards varies depending on the individual terms of the sales agreement. For sales of gas, the sale is recognized on the basis of metered usage of gas by customers. For sales of oil, transfer occurs upon loading the product onto the relevant carriers, inspection by an independent inspector and sealing of carriers based on FCA (Incoterms 2000) at Vaziani or Supsa stations (Georgia) terms. The seller is responsible for delivery of goods to the named points, uploading goods to the buyer's wagons and customs registration.

***(ii) Rent of pipelines***

Revenue from rent of gas pipelines is recognized in profit or loss on the basis of the metered gas transferred through the pipelines at the contract rate.

***(iii) Services***

Revenue from services rendered is recognized in profit or loss in proportion to the stage of completion of the transaction at the reporting date. The stage of completion is assessed by reference to surveys of work performed.

Gas and oil transportation fees received in cash are recognized on the basis of the metered gas and oil transferred through the pipelines at the contract rate for cubic meters of gas and barrels of oil. Gas transportation fees received in the form of gas are measured at the fair value of gas received. The fair value of gas received is determined by reference to the unregulated market price of gas sold in the Georgian market.

**(m) Finance income and costs**

Finance income comprises interest income on funds invested and unwinding of discount on finance lease receivable. Interest income is recognised as it accrues in profit or loss, using the effective interest method.

Finance costs comprise interest expense on borrowings and impairment losses recognised on financial assets.

Borrowing costs that are not directly attributable to the acquisition, construction or production of a qualifying asset are recognised in profit or loss using the effective interest method.

Foreign currency gains and losses are reported on a net basis as either finance income or finance cost depending on whether foreign currency movements are in a net gain or net loss position.

**(n) Income tax**

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Current tax payable also includes any tax liability arising from the declaration of dividends.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized for temporary differences on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss; and related to investments in subsidiaries and jointly controlled entities to the extent that it is probable that they will not reverse in the foreseeable future.

Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax assets and liabilities, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

### (o) Discontinued operations

A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of or is held for sale, or is a subsidiary acquired exclusively with a view to resale. Classification as a discontinued operation occurs upon disposal or when the operation meets the criteria to be classified as held for sale, if earlier. When an operation is classified as a discontinued operation, the comparative statement of comprehensive income is re-presented as if the operation had been discontinued from the start of the comparative period.

### (p) Segment reporting

An operating segment is a component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. All operating segments' operating results are reviewed regularly by the General Director to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

Segment results that are reported to the General Director include items directly attributable to a segment.

# 4. New standards and interpretations not yet adopted

A number of new Standards, amendments to Standards and Interpretations are not yet effective as at 31 December 2011, and have not been applied in preparing these consolidated financial statements. Of these pronouncements, potentially the following will have an impact on the Group's operations. The Group plans to adopt these pronouncements when they become effective.

- IAS 28 (2011*) Investments in Associates and Joint Ventures* combines the requirements in IAS 28 (2008) and IAS 31 that were carried forward but not incorporated into IFRS 11 and IFRS 12. The amended standard will become effective for annual periods beginning of or after 1 January 2013 with retrospective application required. Early adoption of IAS 28 (2011) is permitted provided the entity also early-adopts IFRS 10, IFRS 11, IFRS 12 and IAS 27 (2011). The new Standard will not have any impact on the Group's financial position or performance.

- IFRS 9 *Financial Instruments* will be effective for annual periods beginning on or after 1 January 2015. The new standard is to be issued in phases and is intended ultimately to replace International Financial Reporting Standard IAS 39 *Financial Instruments: Recognition and Measurement*. The first phase of IFRS 9 was issued in November 2009 and relates to the classification and measurement of financial assets. The second phase regarding classification and measurement of financial liabilities was published in October 2010. The remaining parts of the standard are expected to be issued during 2012. The Group recognises that the new standard introduces many changes to the accounting for financial instruments and is likely to have a significant impact on Group's consolidated financial statements. The impact of these changes will be analysed during the course of the project as further phases of the standard are issued. The Group does not intend to adopt this standard early.

- IFRS 11 *Joint Arrangements* will be effective for annual periods beginning on or after 1 January 2013 with retrospective application required. The new standard supersedes IAS 31 *Interests in Joint Ventures*. The main change introduced by IFRS 11 is that all joint arrangements are classified either as joint operations, which are consolidated on a proportionate basis, or as joint ventures, for which the equity method is applied. The type of arrangement is determined based on the rights and obligations of the parties to the arrangement arising from joint arrangement's structure, legal form, contractual arrangement and other facts and circumstances. When the adoption of IFRS 11 results a change in the accounting model, the change is accounted for retrospectively from the beginning of the earliest period presented. Under the new standard all parties to a joint arrangement are within the scope of IFRS 11 even if all parties do not participate in the joint control. Early adoption of IFRS 11 is permitted provided the entity also early-adopts IFRS 10, IFRS 12, IAS 27 (2011) and IAS 28 (2011). The Group has not yet analyzed the likely impact of the new Standard on its financial position or performance.

- IFRS 12 *Disclosure of Interests in Other Entities* will be effective for annual periods beginning on or after 1 January 2013. The new standard contains disclosure requirements for entities that have interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. Interests are widely defined as contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. The expanded and new disclosure requirements aim to provide information to enable the users to evaluate the nature of risks associated with an entity's interests in other entities and the effects of those interests on the entity's financial position, financial performance and cash flows. Entities may early present some of the IFRS 12 disclosures early without a need to early-adopt the other new and amended standards. However, if IFRS 12 is early-adopted in full, then IFRS 10, IFRS 11, IAS 27 (2011) and IAS 28 (2011) must also be early-adopted. The new Standard will not have any impact on the Group's financial position or performance.

- IFRS 13 *Fair Value Measurement* will be effective for annual periods beginning on or after 1 January 2013. The new standard replaces the fair value measurement guidance contained in individual IFRSs with a single source of fair value measurement guidance. It provides a revised definition of fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair value measurements. IFRS 13 does not introduce new requirements to measure assets or liabilities at fair value, nor does it eliminate the practicability exceptions to fair value measurement that currently exist in certain standards. The standard is applied prospectively with early adoption permitted. Comparative disclosure information is not required for periods before the date of initial application. The new Standard is not expected to have a significant effect on the consolidated financial statements of the Group.

- Amendment to IAS 1 *Presentation of Financial Statements: Presentation of Items of Other Comprehensive Income.* The amendment requires that an entity present separately items of other comprehensive income that may be reclassified to profit or loss in the future from those that will never be reclassified to profit or loss. Additionally, the amendment changes the title of the statement of comprehensive income to statement of profit or loss and other comprehensive income. However, the use of other titles is permitted. The amendment shall be applied retrospectively from 1 July 2012 and early adoption is permitted. The amendment will not have any impact on the Group's financial position or performance.

- Various *Improvements to IFRSs* have been dealt with on a standard-by-standard basis. All amendments, which result in accounting changes for presentation, recognition or measurement purposes, will come into effect for annual periods beginning after 1 January 2011. The Group has not yet analysed the likely impact of the improvements on its financial position or performance.

## 5. Determination of fair values

A number of the Group's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and for disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

### (a) Property, plant and equipment

The fair value of property, plant and equipment contributed by the shareholder is based on market values. The market value of property is the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably and willingly. The fair value of items of plant, equipment, fixtures and fittings is based on market approach and cost approaches using quoted market prices for similar items when available.

When no quoted market prices are available, the fair value of property, plant and equipment is primarily determined using depreciated replacement cost. This method considers the cost to reproduce or replace the property, plant and equipment, adjusted for physical, functional or economical depreciation, and obsolescence.

### (b) Trade and other receivables

The fair value of trade and other receivables is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. This fair value is determined for disclosure purposes.

### (c) Financial liabilities

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date.

## 6. Operating segments

As at 31 December 2011 and 2010, the Group has four reportable segments, as described below, which are the Group's strategic business units. The strategic business units offer different products and services, and are managed separately. For each of the strategic business units, the Company's General Director reviews internal management reports on at least a quarterly basis. The following summary describes the operations in each of the Group's reportable segments:

*Continuing operations*

- *Gas Supply*. Includes purchase and sale of gas.
- *Pipeline rental*. Includes rental income earned by the Company from the lease of gas pipelines to Georgian Gas Transportation Company LLC. As a consequence of the spin off of Georgian Gas Transportation Company LLC to the shareholder in August 2011 (see note 7), the rental income is presented as external revenue and became a separately monitored segment.
- *Upstream activities*. Includes sale of oil from production sharing arrangements.
- *Oil transportation*. Includes transportation of oil through the territory of Georgia.

*Discontinued operations*

- *Gas transportation*. This segment previously included revenues earned from transportation of gas within the territory of Georgia and transit to Armenia. This segment was discontinued in August 2011 (see note 7).

Information regarding the results of each reportable segment is included below. Performance is measured based on segment profit before infrastructure costs, central over heads, interest and income tax, as included in the internal management reports that are reviewed by the Company's General Director. Segment profit is used to measure performance as management believes that such information is the most relevant in evaluating the results of certain segments relative to other entities that operate within these industries. The Company's General Director does not monitor segment assets or liabilities.

### *(i) Information about reportable segments*

| | Gas supply | | Pipeline rental | | Upstream activities | | Oil transportation | | Gas transportation (discontinued) | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **'000 GEL** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** |
| External revenues | 199,365 | 138,115 | 11,048 | - | 14,291 | 15,087 | 10,970 | 12,118 | 31,695 | 47,521 | 267,369 | 212,841 |
| Inter-segment revenues | - | - | 16,144 | 24,481 | - | - | - | - | - | - | 16,144 | 24,481 |
| Cost of gas and oil | (123,535) | (92,833) | - | - | (361) | (3,167) | - | - | - | - | (123,896) | (96,000) |
| Other expenses | - | - | - | - | - | - | - | - | (21,773) | (33,563) | (21,773) | (33,563) |
| Reportable segment profit before unallocated costs, net finance cost and income tax | 75,830 | 45,282 | 27,192 | 24,641 | 13,930 | 11,920 | 10,970 | 12,118 | 9,922 | 13,958 | 137,844 | 107,759 |

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| **Revenues** | | |
| Total revenue for reportable segments | 283,513 | 237,322 |
| Adjustment to bring transportation revenue in the form of gas to the fair value of gas received | 23,176 | 33,013 |
| Other revenue | 987 | 783 |
| Presentation of continuing nature of transactions between continuing and discontinued operations | 28,666 | 32,956 |
| Reclassification of discontinued operations | (96,425) | (131,666) |
| Consolidated revenue | **239,917** | **172,408** |
| | | |
| **Profit or loss** | | |
| Total profit or loss for reportable segments | 137,844 | 107,759 |
| Reversal of impairment loss of property, plant and equipment | 26,393 | 43,150 |
| Unallocated personnel expenses | (7,906) | (7,244) |
| Unallocated depreciation expenses | (19,778) | (17,793) |
| Net finance income/(costs) | 10,722 | (11,639) |
| Other net unallocated (costs)/income | (6,545) | 1,062 |
| Reclassification of discontinued operations | (10,384) | (23,740) |
| Consolidated profit from continuing operations before income tax | **130,346** | **91,555** |

The reconciliation adjustment of GEL 28,666 thousand (2010: GEL 32,796 thousand) represents revenue from sales transactions between Georgian Gas Transportation Company LLC and the Company which are expected to continue after the transfer of the subsidiary to the shareholder. The discontinued operations are presented in the consolidated statement of comprehensive income so as to reflect the continuance of the relationship (see note 7).

### *(ii) Reconciliation of revenues from discontinued operations*

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| **Revenues** | | |
| Total revenue for discontinued segment | 31,695 | 47,521 |
| Adjustment to bring transportation revenue in the form of gas to the fair value of gas received | 23,176 | 33,013 |
| Other revenue | 987 | 783 |
| Sale of gas to Georgian Oil and Gas Corporation JSC | 28,666 | 32,956 |
| Sale of gas to other parties included in Gas Supply segment | 11,901 | 17,393 |
| Revenue from discontinued operations (note 7 and 8) | **96,425** | **131,666** |

### *(iii) Geographical information*

Substantially all of the Group's revenue is from and the non-current assets of the Group are located in Georgia, except for gas transportation revenue received in the form of gas which was received from the Russian Federation until the the transfer of Georgian Gas Transportation Company LLC to the shareholder in August 2011.

### *(iv) Major customer*

In 2011, one customer of the Group's gas supply segment represented approximately 82% of the Group's total revenue (GEL 197,913 thousand). In 2010, one customer of the Group's gas supply segment represented approximately 70% of the Group's total revenue (GEL 119,874 thousand).

## 7. Discontinued operation

On 31 August 2011 the Group transferred its wholly owned subsidiary, Georgian Gas Transportation Company LLC, to the Ministry of Energy and Natural Resources of Georgia. The subsidiary was transferred for the purpose of separation of supply and transportation in the Georgian Energy Market. As the subsidiary was not presented as a discontinued operation or classified as held for sale or distribution as at 31 December 2010, the comparative statement of comprehensive income has been re-presented to present the discontinued operation separately from continuing operations.

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| **Results of discontinued operation** | | |
| Revenue | 96,425 | 131,666 |
| Cost of gas and oil | (65,471) | (70,824) |
| Depreciation and amortization | (1,064) | (1,337) |
| Personnel costs | (3,225) | (5,059) |
| Taxes, other than on profit | (58) | (60) |
| Reversal of impairment of property, plant and equipment | - | 1,590 |
| Rent of gas pipelines | (16,144) | (24,641) |
| Other expenses | (1,771) | (7,286) |
| Other income | 490 | 2,465 |
| **Results from operating activities** | **9,182** | **26,514** |
| Finance income | 1,202 | 959 |
| Finance costs | - | (3,733) |
| **Net finance income/(costs)** | **1,202** | **(2,774)** |
| **Profit before income tax** | **10,384** | **23,740** |
| Income tax expense | (1,940) | (5,934) |
| **Profit for the year** | **8,444** | **17,806** |

The transactions between continuing and discontinued operations are expected to continue after the transfer of the subsidiary to the shareholder. The discontinued operations are presented so as to reflect the continuance of the relationship.

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| **Cash flows (used in)/from discontinued operation** | | |
| Net cash used in operating activities | (12,956) | 14,460 |
| **Net cash flows for the year** | **(12,956)** | **14,460** |

## Effect of disposal on the financial position of the Group

| **'000 GEL** | **2011** |
|---|---|
| Property, plant and equipment | (6,425) |
| Intangible assets | (2) |
| Deferred tax assets | (628) |
| Inventories | (5,166) |
| Prepayments for current assets and expenses | (24,428) |
| Value added tax recoverable | (7,175) |
| Trade and other receivables | (8,715) |
| Cash and cash equivalents | (1,811) |
| Trade and other payables | 16,470 |
| Current tax liabilities | 1,940 |
| Other taxes payable | 306 |
| **Net assets and liabilities** | **(35,634)** |
| | |
| Cash and cash equivalents disposed of | (1,811) |
| **Net cash outflow** | **(1,811)** |

# 8. Revenue

| | Continuing operations | | Discontinued operation (see note 7) | |
|---|---|---|---|---|
| **'000 GEL** | **2011** | **2010** | **2011** | **2010** |
| Sales of gas | 187,438 | 120,715 | 40,567 | 50,349 |
| Rent of gas pipelines | 27,218 | 24,488 | - | - |
| Income from crude oil | 14,291 | 15,087 | - | - |
| Oil transportation fee | 10,970 | 12,118 | - | - |
| Gas transportation fee – receivable in the form of gas | - | - | 42,003 | 66,027 |
| Gas transportation fee – receivable in cash | - | - | 12,868 | 14,507 |
| Other | - | - | 987 | 783 |
| **Total revenues** | **239,917** | **172,408** | **96,425** | **131,666** |

The Company rents its gas pipeline to Georgian Gas Transportation Company LLC (former subsidiary, see note 7). The contract is valid until 1 January 2020. The lease payments are contingent on the volume of gas transported through the leased gas pipeline.

# 9. Cost of gas and oil

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| Cost of gas | 111,448 | 87,978 |
| Cost of crude oil | 361 | 3,167 |
| | **111,809** | **91,145** |

# 10. Other expenses

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| Banking, consulting and other professional services | 766 | 2,310 |
| Representative and business trip expenses | 558 | 535 |
| Transportation, materials and repair and maintenance | 398 | 796 |
| Office and related equipment maintenance | 395 | 533 |
| Communication expenses | 161 | 171 |
| Impairment of investment in other companies | 115 | 836 |
| Penalties | - | 130 |
| Other | 3,657 | 3,259 |
| | **6,050** | **8,570** |

# 11. Other income

| ’000 GEL | 2011 | 2010 |
|---|---|---|
| Customer penalties for late payment | 3,673 | 8,947 |
| Oil processing | 1,094 | 1,080 |
| Income from provided services | - | 807 |
| Other | 807 | 4,831 |
| | **5,574** | **15,665** |

# 12. Finance income and finance costs

| ’000 GEL | 2011 | 2010 |
|---|---|---|
| **Recognised in profit or loss** | | |
| Interest income on bank deposits | 7,663 | 2,930 |
| Unwinding of discount on finance lease receivable | 2,629 | 1,216 |
| Reversal of impairment on trade and other receivables | 926 | - |
| Net foreign exchange gain | - | 1,259 |
| **Finance income** | **11,218** | **5,405** |
| | | |
| Interest expense on bank loans | (731) | (776) |
| Net foreign exchange loss | (667) | - |
| Interest expense on loans from the Government of Georgia | (300) | (7,654) |
| Impairment loss on trade and other receivables | - | (5,840) |
| **Finance costs** | **(1,698)** | **(14,270)** |
| **Net finance costs recognised in profit or loss** | **9,520** | **(8,865)** |

# 13. Income tax expense

The Group's applicable tax rate is the income tax rate of 15% for Georgian companies.

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| **Current tax expense** | | |
| Current year | 13,577 | 4,291 |
| | | |
| **Deferred tax expense** | | |
| Origination and reversal of temporary differences | 2,697 | 7,510 |
| | **16,274** | **11,801** |

In 2011 current tax of GEL 1,250 thousand relating to the distribution of non-cash assets (2010: GEL 6,403 thousand relating to the settlement of loans issued by the Government of Georgia) was recognised directly in equity.

**Reconciliation of effective tax rate:**

| | **2011** | | **2010** | |
|---|---|---|---|---|
| | **'000 GEL** | **%** | **'000 GEL** | **%** |
| Profit before income tax | 130,346 | 100 | 91,555 | 100 |
| Income tax at applicable tax rate | 19,552 | 15 | 13,733 | 15 |
| (Non-taxable income) /Non-deductible expenses | (668) | (1) | 884 | 1 |
| Change in unrecognised temporary differences on finance lease receivable (note 16) | (2,610) | (2) | (2,816) | (3) |
| | 16,274 | 12 | **11,801** | **13** |

# 14. Property, plant and equipment

| '000 GEL | Gas and oil pipelines | Land and buildings | Oil wells | Plant and equipment | Other | Construction in progress and construction materials | Total |
|---|---|---|---|---|---|---|---|
| *Cost* | | | | | | | |
| Balance at 1 January 2010 | 211,910 | 30,800 | 29,834 | 7,142 | 8,349 | 31,244 | 319,279 |
| Additions | 8,480 | 12,428 | - | 1,838 | 2,139 | 7,499 | 32,384 |
| Disposals | (940) | (11,918) | - | (76) | (360) | (15,862) | (29,156) |
| Transfers | 11,168 | - | - | - | - | (11,168) | - |
| **Balance at 31 December 2010** | **230,618** | **31,310** | **29,834** | **8,904** | **10,128** | **11,713** | **322,507** |
| Balance at 1 January 2011 | 230,618 | 31,310 | 29,834 | 8,904 | 10,128 | 11,713 | 322,507 |
| Additions | 1,256 | 449 | - | 333 | 1,633 | 49,675 | 53,346 |
| Disposals | (27) | (1,702) | - | (3,742) | (7,232) | (4,269) | (16,972) |
| **Balance at 31 December 2011** | **231,847** | **30,057** | **29,834** | **5,495** | **4,529** | **57,119** | **358,881** |
| ***Depreciation and impairment losses*** | | | | | | | |
| Balance at 1 January 2010 | 95,814 | 6,987 | 10,094 | 4,252 | 4,413 | 1,246 | 122,806 |
| Depreciation for the year | 12,300 | 810 | 2,892 | 1,506 | 1,494 | - | 19,002 |
| Disposals | (535) | (28) | - | (55) | (372) | - | (990) |
| Impairment loss reversal | (39,071) | (1,151) | - | (647) | (1,223) | (1,058) | (43,150) |
| **Balance at 31 December 2010** | **68,508** | **6,618** | **12,986** | **5,056** | **4,312** | **188** | **97,668** |
| Balance at 1 January 2011 | 68,508 | 6,618 | 12,986 | 5,056 | 4,312 | 188 | 97,668 |
| Depreciation for the year | 14,887 | 741 | 2,892 | 995 | 1,306 | - | 20,821 |
| Disposals | - | (158) | - | (1,565) | (3,034) | (64) | (4,821) |
| Impairment loss reversal | (21,983) | (3,988) | - | - | (298) | (124) | (26,393) |
| **Balance at 31 December 2011** | **61,412** | **3,213** | **15,878** | **4,486** | **2,286** | **-** | **87,275** |
| *Carrying amounts* | | | | | | | |
| **At 1 January 2010** | 116,096 | 23,813 | 19,740 | 2,890 | 3,936 | 29,998 | 196,473 |
| **At 31 December 2010** | 162,110 | 24,692 | 16,848 | 3,848 | 5,816 | 11,525 | 224,839 |
| **At 31 December 2011** | **170,435** | **26,844** | **13,956** | **1,009** | **2,243** | **57,119** | **271,606** |

During 2011 the Government of Georgia contributed certain property, plant and equipment in the form of an increase in share capital. The share capital has been increased by the nominal amount of these assets of GEL 10,900 thousand which approximates the fair value of these assets (2010: nominal value of GEL 39,708 thousand and fair value of GEL 18,765 thousand), which are included in total additions of GEL 53,346 thousand (2010: GEL 32,384 thousand).

Included in disposals with a carrying amount of GEL 12,151 thousand (2010: GEL 28,166 thousand) are assets with a carrying amount of GEL 9,277 thousand (2010: GEL 25,754 thousand) which have been withdrawn by the Government of Georgia. The amount represents a transfer of non-cash assets at amount of GEL 2,852 thousand deducted from additional paid in capital (2010: GEL 15,670 thousand deducted from additional paid in capital and GEL 10,084 thousand decrease in share capital) and decrease of GEL 6,425 thousand due to transfer of 100% shares of Georgian Gas Transportation Company LLC.

### (a) Impairment loss and subsequent reversal

As at 31 December 2009, following a decline in gas prices, the economic slowdown in the Republic of Armenia and Georgia and the related significant decline in the gas consumption of both countries in 2009, the Group determined that there is an indication of impairment of its property, plant and equipment of the gas transportation business. The Group estimated the recoverable amount of the property, plant and equipment based on its value in use. Based on the assessment, the carrying amount of the property, plant and equipment was determined to be GEL 75,909 thousand higher than its recoverable amount, and an impairment loss of GEL 75,909 thousand was recognized as at 31 December 2009.

In 2010, following certain increase in gas prices and economic activity in Georgia, as well as a change in the Group's contractual arrangements, the Group reassessed its estimate of the recoverable amount of the property, plant and equipment of the gas transportation business and GEL 43,150 thousand of the initially recognized impairment was reversed as at 31 December 2010.

In 2011, following the transfer of shares of Georgian Gas Transportation Company LLC (see note 7), the Group's business model for the gas transportation business has changed significantly.

As a result of this change in the business model, when making investment decisions in relation to the gas pipelines, management also considers the cash flows generated from the sale and purchase of gas from Azerbaijan, which was previously considered a separate cash generating unit.

Management has reassessed the recoverable amount of the pipeline network based on the new cash generating unit and, as a consequence, the previously recognized impairment loss has been fully reversed as at 31 December 2011.

The impairment loss and its subsequent reversal were allocated _pro rata_ to property, plant and equipment constituting the gas transportation business.

The following key assumptions were used in performing the impairment testing of assets in the gas transportation business as at 31 December 2011:

- Cash flows were projected based on actual operating results and the eight-year business plan because the Group has fixed contractual arrangements with the lessee for eight years.
- Sales prices of gas were based on the prices set in the amended sales agreements of the Group and the forecasted gas prices in the European market.
- A pre-tax discount rate of 16.7% was applied in determining the recoverable amount of the Group's assets in the gas transportation business.

The values assigned to the key assumptions represent management's assessment of future trends in the business and are based on both external sources and internal sources (historical data).

An increase of three percentage points in the discount rate used or a decrease of sales prices of gas by 10% would not have triggered impairment.

## 15. Finance lease receivable

In 1996 the Government of Georgia entered into a 30 year arrangement with a consortium of oil companies that undertook construction and development of a pipeline system from the border with Azerbaijan to the Supsa oil terminal on the Georgian Black Sea coast. The arrangement granted the oil companies the right to transport of oil across the territory of Georgia through that pipeline system. The pipeline infrastructure on Georgian territory became the property of the Government of Georgia and ownership of this infrastructure was transferred to the Company in June-July 2010 through a contribution to the charter capital of the Company with a nominal value of GEL 269,299 thousand. In exchange for the oil companies use of the pipeline, the Group receives a transit fee for each barrel of oil transported through the pipeline. Management has determined that the initial arrangement contained a finance lease at inception.

The Group has recognized a lease receivable of GEL 39,229 thousand at the date that title was transferred to the Company. The lease receivable is the present value of the net investment in the lease comprising the present value of the assets' unguaranteed residual value at the end of the lease term. The difference of GEL 230,070 thousand between the nominal amount and the present value of the net investment in the lease has been recognized in equity as fair value adjustment for non-cash owner contributions.

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| Balance at beginning of the year/date of title transfer | 40,445 | 39,229 |
| Unwinding of discount on finance lease receivable | 2,629 | 1,216 |
| Balance at end of the year | **43,074** | **40,445** |

Contingent rents related to oil transportation recognized in the consolidated statement of comprehensive income during 2011 amounted to GEL 10,970 thousand (2010 GEL 5,020 thousand).

# 16. Deferred tax assets and liabilities

## (a) Unrecognised deferred tax assets

No deferred tax asset has been recognized for the temporary difference between the tax and accounting base of the finance lease receivable that was contributed during 2010 (see note 15). Management has not recognized deferred tax on this temporary difference as the initial recognition of the financial lease affected neither accounting nor taxable profit or loss.

The unrecognised deferred tax asset on the above transaction as at 31 December 2011 is GEL 29,084 thousand (2010: GEL 31,694 thousand).

## (b) Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

| | **Assets** | | **Liabilities** | | **Net** | |
|---|---|---|---|---|---|---|
| **'000 GEL** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** |
| Property, plant and equipment | - | - | (11,059) | (8,879) | (11,059) | (8,879) |
| Inventories | 240 | 521 | - | - | 240 | 521 |
| Loans and borrowings | - | 1,119 | (32) | - | (32) | 1,119 |
| Trade and other receivables | 216 | - | - | (71) | 216 | (71) |
| Tax (assets)/liabilities | 456 | 1,640 | (11,091) | (8,950) | (10,635) | (7,310) |
| Set off of tax | (456) | (1,012) | 456 | 1,012 | - | - |
| Net tax (assets)/liabilities | **-** | **628** | **(10,635)** | **(7,938)** | **(10,635)** | **(7,310)** |

## (c) Movement in temporary differences during the year

| **'000 GEL** | **1 January 2011** | **Recognised in profit or loss** | **Disposed off** | **31 December 2011** |
|---|---|---|---|---|
| Property, plant and equipment | (8,879) | (2,836) | 656 | (11,059) |
| Inventories | 521 | 240 | (521) | 240 |
| Trade and other receivables | 1,119 | (140) | (763) | 216 |
| Loans and borrowings | (71) | 39 | - | (32) |
| | **(7,310)** | **(2,697)** | **(628)** | **(10,635)** |

| **'000 GEL** | **1 January 2010** | **Recognised in profit or loss** | **Recognised directly in equity** | **31 December 2010** |
|---|---|---|---|---|
| Property, plant and equipment | (1,378) | (7,501) | - | (8,879) |
| Inventories | 934 | (413) | - | 521 |
| Trade and other receivables | 9,284 | (3,606) | (4,559) | 1,119 |
| Loans and borrowings | (6,697) | 710 | 5,916 | (71) |
| Prepayments for current assets and expenses | 188 | (188) | - | - |
| | **2,331** | **(10,998)** | **1,357** | **(7,310)** |

## 17. Non-current assets held for distribution

Non-current assets held for distribution as at 31 December 2011 represent construction in progress of GEL 12,307 thousand and prepayments given of GEL 8,421 thousand for the construction of electric lines and substations. Management has a firm intention to distribute these assets to the shareholder in 2012.

## 18. Inventories

| **’000 GEL** | **2011** | **2010** |
|---|---|---|
| Crude oil | 575 | 664 |
| Gas receivable | - | 6,309 |
| Gas | - | 3,183 |
| Other | 160 | 2,189 |
| | **735** | **12,345** |

## 19. Trade and other receivables

| **’000 GEL** | **2011** | **2010** |
|---|---|---|
| Trade receivables | 30,357 | 25,493 |
| Other receivables | 13 | 13 |
| | **30,370** | **25,506** |

The Group’s exposure to credit and currency risks and impairment losses related to trade and other receivables are disclosed in note 23.

## 20. Cash and cash equivalents

| **’000 GEL** | **2011** | **2010** |
|---|---|---|
| Petty cash | - | 1 |
| Bank balances | 35,079 | 57,588 |
| **Cash and cash equivalents in the consolidated statement of cash flows and in the consolidated statement of financial position** | **35,079** | **57,589** |

The Group’s exposure to interest rate risk and a sensitivity analysis for financial assets and liabilities are disclosed in note 23.

# 21. Equity

## (a) Share capital

In September 2011 the Company changed its legal form from a Limited Liability Company to a Joint Stock Company.

| | **2011** |
|---|---|
| Balance at 1 January 2011 | **495,532** |
| Increase in charter capital through non-cash assets contributed by the shareholder | 10,553 |
| Issue of new shares for non-cash assets | 447 |
| Total increase in share capital | **11,000** |
| Decrease in charter capital on transfer of subsidiaries (note 27) | (27,760) |
| Balance at 31 December 2011 | **478,772** |

Upon the change in legal form, the charter capital of GEL 478,325 thousand was converted into 23,916,265 shares with a par value of GEL 20.

| | **Ordinary shares** |
|---|---|
| *Number of shares unless otherwise stated* | **2011** |
| Par value | GEL 20 |
| On issue at 1 September 2011 | 23,916,265 |
| Issued for non-cash assets | 22,345 |
| On issue at 31 December 2011 | 23,938,610 |

### Ordinary shares

The holders of ordinary shares are entitled to receive dividends as declared from time to time, and are entitled to one vote per share at meetings of the Company.

### (b) Additional paid in capital

Additional paid in capital represents benefits provided to the Group by the Government of Georgia acting in its role of the shareholder and non-cash assets transferred by the Group to the Government of Georgia as follows:

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| Balance at 1 January | **74,570** | **52,311** |
| Transfer of non-cash assets to the Government of Georgia | (2,852) | (15,670) |
| **Decrease in additional paid in capital** | **(2,852)** | **(15,670)** |
| Increase due to settlement of loans from Government of Georgia, net of tax | - | 28,231 |
| Increase due to restructuring of tax liabilities, net of tax | - | 7,071 |
| Increase due to non-cash assets transferred to the Government of Georgia at an amount higher than the carrying value, net of tax | - | 2,627 |
| **Increase in additional paid in capital** | **-** | **37,929** |
| **Net (decrease)/ increase in additional paid in capital** | **(2,852)** | **22,259** |
| **Balance at 31 December** | **71,718** | **74,570** |

### (c) Dividends

In 2011 dividends of GEL 45,000 thousand were declared and GEL 5,500 thousand paid (2010: GEL 9,100 thousand declared and paid).

In 2011, upon request of the shareholder, the Company agreed to pay GEL 4,200 thousand to a State-owned fund out of which GEL 2,000 thousand was paid during 2011.

In 2011 non-cash assets with a carrying amount of GEL 8,332 thousand were transferred to the shareholder.

# 22. Loans and borrowings

This note provides information about the contractual terms of the Group's interest-bearing loans and borrowings, which are measured at amortised cost. For more information about the Group's exposure to interest rate, foreign currency and liquidity risk, see note 23.

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| ***Non-current liabilities*** | | |
| Loans issued by the Government of Georgia | 654 | 2,304 |
| | **654** | **2,304** |
| ***Current liabilities*** | | |
| Current portion of loans issued by the Government of Georgia | 1,950 | - |
| Bank overdraft | 8,412 | 8,929 |
| | **10,362** | **8,929** |

### Terms and debt repayment schedule

Terms and conditions of outstanding loans were as follows:

| | | | | **31 December 2011** | | **31 December 2010** | |
|---|---|---|---|---|---|---|---|
| **'000 GEL** | **Currency** | **Nominal interest rate** | **Year of maturity** | **Face value** | **Carrying amount** | **Face value** | **Carrying amount** |
| Loans issued by the Government of Georgia | GEL | 7% | 2012 | 1,620 | 1,578 | 1,620 | 1,396 |
| Loans issued by the Government of Georgia | GEL | 0.5% | 2012-2013 | 1,162 | 1,026 | 1,162 | 908 |
| Bank overdraft | USD | 9% | 2012 | 8,412 | 8,412 | 8,929 | 8,929 |
| **Total interest-bearing liabilities** | | | | **11,194** | **11,016** | **11,711** | **11,233** |

# 23. Financial instruments and risk management

## (a) Overview

The Group has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk

This note presents information about the Group's exposure to each of the above risks, the Group's objectives, policies and processes for measuring and managing risk, and the Group's management of capital. Further quantitative disclosures are included throughout these consolidated financial statements.

The Executive Directors have overall responsibility for the establishment and oversight of the Group's risk management framework.

The Group's risk management policies are established to identify and analyse the risks faced by the Group, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Group's activities.

## (b) Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Group's receivables from customers and cash and cash equivalents.

### *(i) Exposure to credit risk*

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was as follows:

| | **Carrying amount** | |
|---|---|---|
| **'000 GEL** | **2011** | **2010** |
| Trade and other receivables | 30,370 | 25,506 |
| Bank balances | 35,079 | 57,588 |
| | **65,449** | **83,094** |

As at 31 December 2011 the Group had placements with 1 bank whose balances exceeded 10% of total bank balances (31 December 2010: 1 bank). The carrying value of these balances as of 31 December 2011 was GEL 35,042 thousand (31 December 2010: GEL 57,484 thousand) and the long-term credit rating of the Bank according to Standard & Poors as at 31 December 2011 was BB-.

### *(ii) Trade and other receivables*

Credit risk is managed by requesting prepayments from customers or assessing their creditworthiness prior to extending credit. No collateral in respect of trade and other receivables is generally required.

The Group establishes an allowance for impairment that represents its estimate of incurred losses in respect of trade and other receivables. The main components of this allowance are a specific loss component that relates to individually significant exposures, and a collective loss component established for groups of similar assets in respect of losses that have been incurred but not yet identified. The collective loss allowance is determined based on historical data of payment statistics for similar financial assets.

The maximum exposure to credit risk for trade receivables at the reporting date by geographic region was:

| | **Carrying amount** | |
|---|---|---|
| **'000 GEL** | **2011** | **2010** |
| Domestic | 26,021 | 24,920 |
| Euro-zone countries | 3,668 | - |
| CIS countries | 668 | 573 |
| | **30,357** | **25,493** |

The maximum exposure to credit risk for trade receivables at the reporting date by type of customer was:

| | Carrying amount | |
|---|---|---|
| **’000 GEL** | **2011** | **2010** |
| Gas distributors | 25,675 | 22,066 |
| Others | 4,682 | 3,427 |
| | **30,357** | **25,493** |

As at 31 December 2011 the Group had two customers whose balances exceeded 10% of total trade receivables (31 December 2010: two customers). The carrying value of these balances as of 31 December 2011 was GEL 27,986 thousand (31 December 2010: GEL 18,090 thousand).

## Impairment losses

The aging of trade and other receivables at the reporting date was:

| **’000 GEL** | **Gross 2011** | **Impairment 2011** | **Gross 2010** | **Impairment 2010** |
|---|---|---|---|---|
| Not past due | 15,778 | - | 22,146 | - |
| Past due 0- 30 days | 14,324 | - | 313 | - |
| Past due 31-120 days | 195 | - | 9 | - |
| Past due 121-365 days | - | - | 44 | - |
| Past due more than one year | 1,517 | 1,444 | 10,491 | 7,497 |
| | **31,814** | **1,444** | **33,003** | **7,497** |

The movement in the allowance for impairment in respect of trade and other receivables during the year was as follows:

| **’000 GEL** | **2011** | **2010** |
|---|---|---|
| Balance at beginning of the year | 7,497 | 61,860 |
| Increase during the year | - | 7,638 |
| Disposed of as a result of transfer of subsidiary | (5,084) | - |
| Amounts written off against receivables | (43) | (21,797) |
| Amounts transferred with related receivables to settle loans | - | (37,642) |
| Decrease due to reversal | (926) | (2,562) |
| Balance at end of the year | **1,444** | **7,497** |

## (c) Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in meeting the obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. The Group's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation.

Typically the Group ensures that it has sufficient cash on demand to meet expected operational expenses for a period of 60 days, including the servicing of financial obligations; this excludes the potential impact of extreme circumstances that cannot reasonably be predicted, such as natural disasters. In addition, the Group maintains a USD 8,400 thousand overdraft facility that is unsecured. Interest on this facility is payable at the rate of 9%. USD 5,000 thousand has been drawn down under this facility as at 31 December 2011.

The Group has contractual commitments for construction and purchase of pipes (see note 24).

The following are the contractual maturities of financial liabilities, including estimated interest payments and excluding the impact of netting agreements.

**2011**

| '000 GEL | Carrying amount | Contractual cash flows | 0-6 mths | 6-12 mths | 1-2 yrs | 2-3 yrs | 3-5 yrs | Over 5 yrs |
|---|---|---|---|---|---|---|---|---|
| **Non-derivative financial liabilities** | | | | | | | | |
| Loans issued by the Government of Georgia | 2,604 | 2,782 | 1,620 | 330 | 832 | - | - | - |
| Bank overdraft | 8,412 | 8,412 | 8,412 | - | - | - | - | - |
| Trade and other payables | 2,685 | 2,685 | 2,685 | - | - | - | - | - |
| | **13,701** | **13,879** | **12,717** | **330** | **832** | **-** | **-** | **-** |

**2010**

| '000 GEL | Carrying amount | Contractual cash flows | 0-6 mths | 6-12 mths | 1-2 yrs | 2-3 yrs | 3-5 yrs | Over 5 yrs |
|---|---|---|---|---|---|---|---|---|
| **Non-derivative financial liabilities** | | | | | | | | |
| Loans issued by the Government of Georgia | 2,304 | 2,782 | - | - | 1,950 | 832 | - | - |
| Bank overdraft | 8,929 | 8,929 | 8,929 | - | - | - | - | - |
| Trade and other payables | 2,932 | 2,932 | 2,932 | - | - | - | - | - |
| Restructured tax liabilities | 17,027 | 17,027 | 17,027 | - | - | - | - | - |
| | **31,192** | **31,670** | **28,888** | - | **1,950** | **832** | - | - |

It is not expected that the cash flows included in the maturity analysis could occur significantly earlier, or at significantly different amounts.

## (d) Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, interest rates and equity prices will affect the Group's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

### *(i) Currency risk*

The Group is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than the respective functional currencies of Group entities. The currency in which these transactions primarily are denominated is U.S. Dollars (USD). The Company generally does not hedge its exposure to foreign currency risk.

#### Exposure to currency risk

The Group's exposure to foreign currency risk was as follows based on notional amounts:

| **'000 GEL** | **USD-denominated** | **USD-denominated** |
|---|---|---|
| | **2011** | **2010** |
| Trade and other receivables | 4,753 | 9,207 |
| Cash and cash equivalents | 52 | 5,477 |
| Trade and other payables | (29) | (96) |
| Loans and borrowings | (8,412) | (8,929) |
| **Net exposure** | **(3,636)** | **5,659** |

The following significant exchange rates applied during the year:

| **in GEL** | **Average rate** | | **Reporting date spot rate** | |
|---|---|---|---|---|
| | **2011** | **2010** | **2011** | **2010** |
| USD 1 | 1.6703 | 1.7831 | 1.6860 | 1.7728 |

#### Sensitivity analysis

A 10% strengthening of the GEL, as indicated below, against USD at 31 December would have increased/(decreased) profit or loss for the year by the amounts shown below. This analysis is based on foreign currency exchange rate variances that the Group considered to be reasonably possible at the end of the reporting period. The analysis assumes that all other variables, in particular interest rates, remain constant. The analysis is performed on the same basis for 2010.

| **'000 GEL** | **Profit or loss** |
|---|---|
| 31 December 2011 | 309 |
| 31 December 2010 | (481) |

A weakening of the GEL against USD at 31 December would have had the equal but opposite effect to the amounts shown above, on the basis that all other variables remain constant. There would be no impact directly in equity as a result of foreign currency fluctuations.

### *(ii) Interest rate risk*

Changes in interest rates impact primarily loans and borrowings by changing either their fair value (fixed rate debt) or their future cash flows (variable rate debt). Management does not have a formal policy of determining how much of the Group's exposure should be to fixed or variable rates. However, at the time of raising new loans or borrowings management uses its judgment to decide whether it believes that a fixed or variable rate would be more favourable to the Group over the expected period until maturity.

#### Profile

At the reporting date the interest rate profile of the Group's interest-bearing financial instruments was:

| | Carrying amount | |
|---|---|---|
| **'000 GEL** | **2011** | **2010** |
| **Fixed rate instruments** | | |
| Loans and borrowings | 11,016 | 11,233 |
| | **11,016** | **11,233** |

#### Fair value sensitivity analysis for fixed rate instruments

The Group does not account for any fixed rate financial instruments as fair value through profit or loss or as available-for-sale. Therefore a change in interest rates at the reporting date would not have an effect in profit or loss or in equity.

#### Fair values versus carrying amounts

Management believes that the fair value of the Group's financial assets and liabilities approximates their carrying amounts. The basis for determining fair values is disclosed in note 5.

The interest rates used to discount estimated cash flows, where applicable, are based on the government yield curve at the reporting date plus an adequate credit spread, and were as follows:

| | **2011** | **2010** |
|---|---|---|
| Loans and borrowings | 9% - 13% | 9% - 13% |

### (e) Capital management

The Group has no formal policy for capital management but management seeks to maintain a sufficient capital base for meeting the Group's operational and strategic needs, and to maintain confidence of market participants. This is achieved with efficient cash management, constant monitoring of Group's revenues and profit, and long-term investment plans mainly financed by the Group's operating cash flows. With these measures the Group aims for steady profits growth.

There were no changes in the Group's approach to capital management during the year.

Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

# 24. Capital commitments

During the year ended 31 December 2011 the Group entered into contracts for construction and purchase of pipes for GEL 27,455 thousand (2010: GEL 23,732 thousand).

# 25. Contingencies

## (a) Insurance

The insurance industry in the Georgia is in a developing state and many forms of insurance protection common in other parts of the world are not yet generally available. The Group does not have full coverage for its plant facilities, business interruption, or third party liability in respect of property or environmental damage arising from accidents on Group property or relating to Group operations. Until the Group obtains adequate insurance coverage, there is a risk that the loss or destruction of certain assets could have a material adverse effect on the Group's operations and financial position.

## (b) Litigation

The Group is defending a claim brought to the courts in 2010 by a foreign company that is seeking contractual payments and interest accrued for non-payment as well as other damages and lost profits from non-performance of a contract concluded in 2003 to 2004 by the Company. In 2010, the Group hired legal advisors to represent the Group in the dispute. The Group disputes the validity of the claim. Management assesses the likelihood that the Group will be required to make a contractual payment of USD 5 million to the foreign company as possible. Management assesses the probability that the Group will also be required to pay accrued interest as well as other damages and lost profits as remote.

## (c) Taxation contingencies

The taxation system in Georgia is relatively new and is characterised by frequent changes in legislation, official pronouncements and court decisions, which are sometimes unclear, contradictory and subject to varying interpretation. In the event of a breach of tax legislation, no liabilities for additional taxes, fines or penalties may be imposed by the tax authorities after six years have passed since the end of the year in which the breach occurred.

These circumstances may create tax risks in Georgia that are more significant than in other countries. Management believes that it has provided adequately for tax liabilities based on its interpretations of applicable Georgian tax legislation, 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.

## (d) Environmental matters

The enforcement of environmental regulation in Georgia is evolving and the enforcement posture of government authorities is continually being reconsidered. The Company periodically evaluates its obligations under environmental regulations. As obligations are determined, they are recognized immediately. Potential liabilities, which might arise as a result of changes in existing regulations, civil litigation or legislation, cannot be estimated but could be material. In the current enforcement climate under existing legislation, management believes that there are no significant liabilities for environmental damage.

# 26. Related party transactions

## (a) Control relationships

The Company's was wholly owned by the state of Georgia represented by the Ministry of Economic Development of Georgia as at 31 December 2010. In November 2011, a 24% interest in Georgian Oil and Gas Corporation was transferred to Partnership Fund, a wholly state owned entity. As at 31 December 2011, the ultimate controlling party is the Ministry of Economic Development of Georgia which holds 76% of the issued shares. The Partnership Fund holds 24% of the issued shares of the Company. The Company does not have a parent company.

## (b) Transactions with key management personnel

### *(i) Key management remuneration*

Key management received the following remuneration during the year, which is included in personnel costs:

| **'000 GEL** | **2011** | **2010** |
|---|---|---|
| Salaries and bonuses | **935** | **860** |

## (c) Other related party transactions

The Group's other related party transactions are disclosed below. The transactions with Georgian Gas Transportation Company (see note 7) are presented from the date it was transferred to the Ministry of Energy and Natural Resources of Georgia. Transactions with the shareholder are disclosed in notes 14, 15, 17 and 21 of these consolidated financial statements.

### *(i) Revenue*

| | **Transaction value for the year ended 31 December** | | **Outstanding balance as at 31 December** | |
|---|---|---|---|---|
| **'000 GEL** | **2011** | **2010** | **2011** | **2010** |
| State controlled entities: | | | | |
| Rent of pipelines | 11,049 | - | - | - |
| Sale of gas and gas transportation: | 27 | 814 | 61 | 36 |
| | **11,076** | **814** | **61** | **36** |

All outstanding balances with related parties are to be settled in cash within six months of the reporting date. None of the balances are secured.

### *(ii) Expenses*

| | **Transaction value for the year ended 31 December** | | **Outstanding balance as at 31 December** | |
|---|---|---|---|---|
| **'000 GEL** | **2011** | **2010** | **2011** | **2010** |
| State controlled entities: | | | | |
| Purchase of Gas | 5,472 | - | 1,402 | - |
| | **5,472** | **-** | **1,402** | **-** |

***(iii) Loans***

| **'000 GEL** | **Interest expense** | | **Outstanding balance** | |
|---|---|---|---|---|
| | **2011** | **2010** | **2011** | **2010** |
| State controlled entities: | | | | |
| Loans received | **300** | **7,654** | **2,604** | **2,304** |

## 27. Significant subsidiaries

In April 2011 the Group created a new subsidiary, Georgian Green Energy Development Company, which later in the year was transferred to the Ministry of Energy and Natural Resources resulting in a decrease in the share capital. The net assets of the subsidiary at the date of the transfer were GEL 10,000 thousand.

In June 2011 a new subsidiary, Georgian Energy Development Fund JSC, was created with charter capital of GEL 100 thousand which was transferred to the Ministry of Energy and Natural Resources in August 2011 resulting in a decrease in the share capital. The net assets of the subsidiary at the date of the transfer were GEL 16,723 thousand.

In June 2011 Board of Directors of Georgian Oil and Gas Corporation decided to liquidate Ioris Valley Oil and Gas LLC, dormant subsidiary.

On 30 September 2011, the Group's wholly owned subsidiary, Georgian Gas Transportation Company LLC, was transferred to the Ministry of Energy and Natural Resources (see note 7).

At 31 December 2011, the Company did not have any significant subsidiaries.

## 28. Events subsequent to the reporting date

In January 2012 a new subsidiary, JSC Namakhvan Hes Cascade, was created with charter capital of GEL 20,000 thousand. The subsidiary will be used to commence construction of Namakhvani Hydro Power Plant.

In March 2012 dividends of GEL 20 million were declared by the Company.

In March 2012 the Government of Georgia issued a decree according to which the Company may not declare or pay any dividends to its shareholders in excess of 35% of the Company's net profit for any financial year commencing from 2012 through to and including 2017.