

## **MANAGEMENT'S DISCUSSION & ANALYSIS**

### **For the three months ended March 31<sup>st</sup>, 2005.**

This report is dated May 25<sup>th</sup>, 2005

*The following Management's Discussion and Analysis ("MD&A") of the financial condition and results of our operations should be read in conjunction with the unaudited consolidated financial statements of Arawak Energy Corporation ("Arawak" or the "Company") and Notes relating thereto as at and for the three months ended March 31<sup>st</sup>, 2005 and the audited consolidated financial statements of Arawak as at and for the year ended December 31<sup>st</sup>, 2004. Our financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and presented in US dollars.*

*This MD&A contains certain "forward-looking statements". Forward-looking statements are not based on historical facts but rather on management's expectations regarding the Company's future growth, results of operations, production, future capital and other expenditures, competitive advantages, plans for and results of drilling activity, environmental matters, business prospects and opportunities. Forward-looking statements are based on the opinions and estimates of management at the date the statements are made, and are subject to a variety of risks and uncertainties and other factors that could cause actual events or results to differ materially from those projected in the forward-looking statements. These risks and uncertainties include, but are not limited to, risks associated with the oil and gas industry (for example operational risks in development, exploration and production; delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of reserve estimates; the uncertainty of estimates and projections in relation to production, costs and expenses and health, safety and environmental risks), the risk of commodity price and foreign exchange rate fluctuations, the uncertainty associated with negotiating with foreign governments and risk associated with international activity. Due to the risks, uncertainties and assumptions inherent in forward-looking statements, prospective investors in the Company's securities should not place undue reliance on these forward-looking statements.*

*This MD&A uses certain terms which are specific to the oil and gas industry. These are non-GAAP terms and are defined within our document. Except as otherwise required by the context, reference in this MD&A to "our", "we" or "us" refer to the combined business of Arawak and all of its subsidiaries.*

*All dollar amounts in this report are in US dollars unless otherwise indicated.*

*Additional information relating to the company is available on SEDAR at [www.sedar.com](http://www.sedar.com).*

## **OVERALL PERFORMANCE AND OPERATIONS REVIEW**

In the three months ended March 31<sup>st</sup>, 2005, the Company has passed two significant milestones in its continuing development.

The first of these, on January 7<sup>th</sup>, 2005, was the completion of the acquisitions of 100% of the issued share capital of Altius Energy Corporation ("Altius"), a company with operations in Kazakhstan, and 50% of the issued share capital of RF Energy Investments Limited ("RF Energy"), the holding company of ZAO PechoraNefteGas ("PNG"), a company operating in the Komi Republic of Russia.

The second milestone was the completion on March 18<sup>th</sup>, 2005, of a “bought deal” private placement whereby the Company issued 28 million new shares at a price of Cdn. \$2.10 per share. Net proceeds of Cdn. \$55.3 million after underwriting fees were exchanged into \$45.8 million.

Together these two events have materially improved the outlook and development potential of the Company, and transformed both the income statement and the balance sheet.

Prior to the acquisitions of Altius and RF Energy, the Company’s sole oil and gas investment was its 37.17% interest in Commonwealth Gobustan Limited (“CGL”). CGL continues to be treated for accounting purposes as an associated company of Arawak and incorporated into Arawak’s consolidated balance sheet by including Arawak’s share of CGL’s net assets. As a wholly-owned subsidiary, the income statement and balance sheet of Altius have been consolidated into Arawak’s own financial statements. For RF Energy, which is 50% owned by Arawak, the income statement and balance sheet have been “proportionately consolidated”. The results of each of these acquisitions have been included with effect from the date these transactions were completed. This MD&A discusses in detail only those assets which are controlled or jointly controlled, that is, Altius and RF Energy. A separate section is included at the end of this MD&A describing the key developments in the Company’s non-controlled associated company, CGL.

The private placement means that Arawak’s share of the 2005 capital budgets and operating budgets for all companies in the enlarged Arawak group are now fully funded. Surplus funds were used to repay a significant portion of borrowings in Altius and also a portion of the acquisition facility put in place to acquire the 50% shareholding in RF Energy (the “Acquisition Facility”). With our joint venture partners, we intend to put in place a borrowing facility in PNG that will allow the remainder of the Acquisition Facility to be repaid and potentially also the release of additional funds that may be utilised for future development of Arawak. There remain other opportunities for raising additional debt finance against increasing levels of production, should development opportunities arise.

In Russia, oil production in the first quarter averaged 5,590 barrels of oil per day (“bopd”) (2,795 bopd net to Arawak) and two new development wells were successfully brought on line. A further two development wells are currently being drilled and the final portion of 90 square kilometres of 3D seismic over the Sotchemyu and Talyu fields is being interpreted to provide a full 3D suite over the fields by the end of July 2005.

In Kazakhstan, production in the first quarter averaged 2,000 bopd. Seasonal weather factors in Akzhar and interruptions in the evacuation route for the Besbolek and Karataikyz fields have impaired production rates in the first quarter. However, a program of infrastructure upgrades is being initiated which is expected to improve production reliability.

In Azerbaijan, pilot oil production continued in the first quarter from the South West Gobustan fields and totalled approximately 6,500 barrels of oil (“bbls”). Together with crude oil inventory at the beginning of the period, two sales totalling approximately 8,900 bbls were made via SOCAR’s pipeline for export to Novorossiysk. A first appraisal well is being drilled in the Kyanizadag field in the Coastal block, with target depth of 3,800 metres and with natural gas and condensate as objectives. Results from this well should be available by the end of June 2005. The installation of gas processing facilities to service the existing gas wells in the Duvanny field is in progress, and first gas is expected on schedule in October 2005.

## RESULTS OF OPERATIONS

Due to the acquisition of the Kazakhstan and Russian operations on January 7<sup>th</sup>, 2005, the Company's financial and operating results have changed dramatically and only results for 2005 are presented. Comparison to the prior period is provided only for the items having significant balances for the three months ended March 31<sup>st</sup>, 2004.

### SUMMARY OF NETBACKS

#### For the three months ended March 31<sup>st</sup>, 2005

	US Dollars	Per Barrel
Revenue		
Crude oil sales	\$13,419	\$31.07
Interest and other income	\$220	\$0.51
Total revenue	\$13,639	\$31.58
Royalties and taxes	\$(3,053)	\$(7.07)
Production costs	\$(1,488)	\$(3.45)
Transportation and selling costs	\$(1,645)	\$(3.81)
Net operating income	\$7,453	\$17.25
General and administrative expenses	\$(1,902)	\$(4.40)
Realized foreign exchange loss	\$(127)	\$(0.29)
Realized interest expense	\$(846)	\$(1.96)
Current income tax expense	\$(1,347)	\$(3.12)
Cash flow from operations	\$3,231	\$7.48
Depletion, depreciation and amortization	\$(2,915)	\$(6.75)
Stock based compensation costs	\$(25)	\$(0.06)
Accretion expense	\$(49)	\$(0.11)
Unrealized foreign exchange gain	\$12	\$0.03
Future income tax recovery	\$640	\$1.48
Net income	\$894	\$2.07

### PRODUCTION

The Company's production from its Russian and Kazakhstan operations totalled 431,502 bbls for the three months ended March 31<sup>st</sup>, 2005, the equivalent of 4,795 bopd.

Production and sales	Kazakhstan	Russia	2005
Production - barrels	179,944	251,558	431,502
Production - barrels per day	2,000	2,795	4,795

## SALES

Sales in the first quarter totalled 431,840 barrels, the equivalent of 4,798 bopd. The average price received was \$31.07 per barrel.

<b>Sales and crude oil prices</b>	<b>Kazakhstan</b>	<b>Russia</b>	<b>2005</b>
Sales - barrels	191,352	240,488	431,840
Average daily sales - barrels	2,126	2,672	4,798
Average sales price per barrel	\$35.53	\$27.53	\$31.07

The Company sells oil to export, near abroad and domestic markets and the results for the first quarter are presented below:

<b>Export oil sales</b>	<b>Kazakhstan</b>	<b>Russia</b>	<b>2005</b>
Volume - barrels	156,686	94,086	250,772
Percentage of total sales	82%	39%	58%
Revenue ('000)	\$6,309	\$4,092	\$10,401
Average export price per barrel	\$40.26	\$43.50	\$41.48

### **Near-abroad oil sales**

Volume - barrels	-	32,124	32,124
Percentage of total sales	-	13%	7%
Revenue ('000)	-	\$654	\$654
Average near-abroad price per barrel	-	\$20.35	\$20.35

### **Domestic oil sales**

Volume - barrels	34,666	114,278	148,944
Percentage of total sales	18%	48%	35%
Revenue ('000)	\$489	\$1,875	\$2,364
Average domestic price per barrel	\$14.11	\$16.40	\$15.87

PNG export oil sales are exported by pipeline and sold as Urals Export Blend free on board ("FOB") Butinge, Lithuania. Altius crude is exported by pipeline and sold as Urals Export Blend, FOB Odessa, Ukraine. Near-abroad oil sales refers to sales by PNG to Belarus, which is party to customs union arrangements with Russia and exempted from export duty, while also being zero rated for VAT purposes. The basis of domestic sales is ex-field in Russia and delivered to the local refinery in Kazakhstan.

## INTEREST EXPENSE

Interest expense includes interest amounts payable in respect of the loan facility put in place to fund the acquisition of RF Energy and also in respect of the prepayment facility which Altius utilized during the period. An arrangement fee of \$175,000 was paid at inception of the loan and included within interest expense for the quarter.

## DEPLETION, DEPRECIATION AND AMORTIZATION EXPENSE

Depletion, depreciation and amortization expense for the three months ended March 31<sup>st</sup>, 2005 has increased to \$2.9 million from \$1,493 for the three months ended March 31<sup>st</sup>, 2004 as a result of the acquisitions of operations in Kazakhstan and Russia.

Depletion expense has been calculated in accordance with the Company's accounting policies set out herein. The base for the country-by-country depletion calculations include amounts resulting from the respective acquisition purchase price allocations.

Future development costs and proved reserve estimates are derived from the respective independent reserve reports for Kazakhstan and Russia. Future development costs on proved undeveloped reserves of \$39 million for Kazakhstan and \$14.5 million for Russia (total of \$53.5 million) are included in the depletion calculation.

## CAPITAL EXPENDITURES

The major investments made by the Company during the first quarter of 2005 were the acquisition of a 50% share in RF Energy and 100% of Altius. Significant development programs are under way in both Russia and Kazakhstan and capital expenditures from the date of acquisition to March 31<sup>st</sup>, 2005 were \$1.6 million and \$2.4 million respectively.

## SHARE CAPITAL

As of March 31<sup>st</sup>, 2005 the Company had the following outstanding shares:

Common Shares	165,125,921
Exchangeable Shares of Arawak Acquisition Inc.	7,249,277
Stock Options	6,375,000

On January 7<sup>th</sup>, 2005, the Company completed a business acquisition, resulting in the issuance of 37,374,480 common shares of Arawak and the issuance by Arawak Acquisition Inc. (a wholly-owned subsidiary of Arawak) of 13,873,971 exchangeable shares. The exchangeable shares are exchangeable for Arawak common shares on a one-for-one basis on or before January 7<sup>th</sup>, 2007.

On March 11<sup>th</sup>, 2005, the Company completed a "bought deal" private placement, whereby a total of 28 million common shares were issued at Cdn. \$2.10 per share.

During the three months ended March 31<sup>st</sup>, 2005, pursuant to the terms of the Company's stock option plan, the Company granted 5,425,000 stock options, each such option entitling the holder to purchase one common share in the Company at a price of Cdn. \$2.10 in a period of five years. A total of 6,375,000 stock options were outstanding as at March 31<sup>st</sup>, 2005 and as of the date of this MD&A, of which 950,000 were vested and fully exercisable.

## LIQUIDITY AND CAPITAL RESOURCES

The levels of cash, current assets and current liabilities as at March 31<sup>st</sup>, 2005 and December 31<sup>st</sup>, 2004 are as set out below:

(In thousands of US dollars)	March 31 <sup>st</sup> 2005	Dec. 31 <sup>st</sup> 2004
Cash and cash equivalents	18,269	1,345
Total current assets	30,734	1,393
Total current liabilities	9,318	1,616

The Company had working capital of \$21.4 million at March 31<sup>st</sup>, 2005 and negative working capital of \$0.2 million at December 31<sup>st</sup> 2004.

The Company's cash deposits are held principally in US dollars and are managed centrally; surplus funds are placed on time deposit. Limited funds are kept in the Azerbaijan Republic or, subsequent to the acquisitions of RF Energy and Altius, in Russia or Kazakhstan respectively.

A share placement of 28 million shares at Cdn. \$2.10 per share was announced on February 28<sup>th</sup>, 2005 and completed on March 18<sup>th</sup>, 2005, resulting in net proceeds after underwriters' fees of \$45,777,704 (Cdn. \$55,272,000). From this amount, \$29,000,000 has been used to temporarily reduce indebtedness of the group and the balance has been retained to fund, in part, the 2005 capital expenditure program, of which the Company's share is expected to be \$32 million in total (\$18.2 million in Kazakhstan, \$7.3 million in Russia and \$6.5 million in Azerbaijan). The balance of the 2005 capital expenditure program is expected to be funded from operating cash flow.

Subsequent to the repayments described above, group indebtedness at March 31<sup>st</sup>, 2005 was \$20,500,000 of which \$666,667 is repayable during the remainder of 2005. The Company intends to refinance a portion of or the full amount of the loan (which has been borrowed from parties related to the major shareholder, Rosco S.A.) from new debt facilities to be raised from commercial lenders.

In addition, the Company continues to seek additional business opportunities in Kazakhstan, Russia, and Azerbaijan and potentially elsewhere in the Former Soviet Union. Funding of any such further transactions will be considered on a case-by-case basis, depending on materiality and the expected cash flow profile of the opportunity.

## SUMMARY OF QUARTERLY RESULTS

The following financial data is derived from the Company's consolidated financial statements for each of the eight most recently completed quarters.

Quarter ended	Total Revenues	Income (loss) before extraordinary items	Net income (loss)	Net Income (loss) Per Common Share	
				Basic	Fully Diluted
<b>2005 March 31<sup>st</sup></b>	<b>13,419</b>	<b>894</b>	<b>894</b>	<b>0.006</b>	<b>0.006</b>
2004 December 31 <sup>st</sup>	-	(198)	(198)	(0.002)	(0.002)
September 30 <sup>th</sup>	-	(596)	(596)	(0.006)	(0.006)
June 30 <sup>th</sup>	-	(328)	(328)	(0.004)	(0.004)
March 31 <sup>st</sup>	-	(363)	(363)	(0.004)	(0.004)
2003 December 31 <sup>st</sup>	-	667	667	0.007	0.007
September 30 <sup>th</sup>	-	(472)	(472)	(0.006)	(0.006)
June 30 <sup>th</sup>	-	(331)	(331)	(0.005)	(0.004)

The profit attributable to the fourth quarter of 2003 includes \$804,841 in respect of the Company's interest in associated companies, \$86,954 in respect of interest on the loan to CGL, and \$171,015 in respect of rights offering expenses reclassified from the previous quarter. Similarly, some professional fees expensed in the third quarter of 2004 related to the business transactions and were reclassified in the fourth quarter of 2004.

## **RELATED PARTY TRANSACTIONS**

### **BUSINESS TRANSACTIONS**

On January 7<sup>th</sup>, 2005, the Company completed two business transactions which are related party transactions within the meaning of OSC Rule 61-501.

The first of these was the acquisition of 50 percent of the shares of RF Energy, the holding company of PNG. The 50 percent stake was acquired from an affiliate of Rosco S.A. (the Company's largest shareholder). The consideration paid by Arawak was \$40.8 million in cash. The consideration and transaction costs were satisfied by drawing down an amount of \$41.5 million from a loan facility put in place for this purpose with Vitol Holding B.V. (also an affiliate of Rosco S.A.).

The second transaction completed on January 7<sup>th</sup>, 2005 was the acquisition of all of the outstanding shares of Altius in consideration for the issuance by Arawak of 37,374,480 common shares and the issuance by Arawak Acquisition Inc. (a wholly-owned subsidiary of Arawak incorporated for the purposes of the Altius transaction) of 13,873,971 exchangeable shares. These exchangeable shares are exchangeable for Arawak common shares on a one-for-one basis on or before January 7<sup>th</sup>, 2007. The Altius transaction will therefore result in the issuance by Arawak of an aggregate of 51,248,451 common shares, including 27,555,986 common shares issued to Rosco S.A.

### **LOAN FROM VITOL HOLDING B.V. - TRANCHE A**

Interest expense for the three months ended March 31<sup>st</sup>, 2005 includes \$0.1 million related to Tranche A of the loan provided by Vitol Holding B.V., entered into on January 7<sup>th</sup>, 2005. The loan balance at March 31<sup>st</sup>, 2005 was \$14 million. Related interest expense included in accounts payable and accrued liabilities outstanding at March 31<sup>st</sup>, 2005 was \$0.15 million. An arrangement fee of \$0.18 million was paid at the inception of this loan and \$0.06 million was allocated to Tranche A and included within interest expense for the period.

### **LOAN FROM VITOL HOLDING B.V. - TRANCHE B**

Interest expense for the three months ended March 31<sup>st</sup>, 2005 includes \$0.4 million related to Tranche B of the loan provided by Vitol Holding B.V. entered into on January 7<sup>th</sup>, 2005. The loan balance at March 31<sup>st</sup>, 2005 was \$6 million. Related interest expense included in accounts payable and accrued liabilities outstanding at March 31<sup>st</sup>, 2005 was \$0.10 million. An arrangement fee of \$0.18 million was paid at the inception of this loan and an amount of \$0.12 million was allocated to Tranche B and included within interest expense for the period.

### **CRUDE OIL SALES**

Revenues from Russian and Kazakhstan export crude oil sales during the three months ended March 31<sup>st</sup>, 2005 of \$10.4 million were received from Vitol S.A, an affiliate of Rosco S.A. Accounts receivable at March 31<sup>st</sup>, 2005 includes revenues from export crude oil sales to Vitol S.A. of \$5.1 million.

### **CRUDE OIL SALES PREPAYMENT FACILITY**

The crude oil sales prepayment facility provided by Vitol S.A. had an outstanding balance at March 31<sup>st</sup>, 2005 of \$0.5 million. Related interest expense for the three months ended March 31<sup>st</sup>, 2005 is \$0.1 million and there are no related accounts payable and accrued liabilities outstanding at March 31<sup>st</sup>, 2005.

## **PRICE INSURANCE**

Put options were purchased from Vitol S.A. for \$0.12 million during the three months ended March 31<sup>st</sup>, 2005 for price insurance for the period from March through to December 2005. Prepaid expenses at March 31<sup>st</sup>, 2005 includes \$0.108 million related to the put options.

## **LEGAL FEES**

During the three months ended March 31<sup>st</sup>, 2005, the Company incurred legal fees totalling \$0.3 million (three months ended March 31<sup>st</sup>, 2004: \$0.01 million) from a legal firm of which a director of the Company is a partner. Legal fees included in accounts payable and accrued liabilities are \$0.3 million as at March 31<sup>st</sup>, 2005 and \$0.2 million as at December 31<sup>st</sup>, 2004.

## **LOAN ONE TO ASSOCIATE**

Interest revenue on Loan One to CGL, during the three months ended March 31<sup>st</sup>, 2005 was \$0.023 million (three months ended March 31<sup>st</sup>, 2004: \$0.028 million). CGL repaid \$0.058 million during the three months ended March 31<sup>st</sup> 2005 (three months ended March 31<sup>st</sup>, 2004: nil).

## **LOAN TWO TO ASSOCIATE**

Interest revenue on Loan Two to CGL, during the three months ended March 31<sup>st</sup>, 2005 was \$0.075 million (three months ended March 31<sup>st</sup>, 2004: nil).

## **TRANSACTIONS WITH SHAREHOLDER**

During the three months ended March 31<sup>st</sup>, 2005, the Company reimbursed the Vitol group, of which Rosco S.A. is an affiliate, for transactions with a value of \$0.066 million (March 31<sup>st</sup>, 2004: \$80,604) which were all charged at cost. The balance owed to the Vitol group at March 31<sup>st</sup>, 2005 was \$0.3 million (December 31<sup>st</sup>, 2004: \$0.076 million).

These transactions were, to the knowledge of management, at terms and rates no more and no less favorable than those with unrelated parties.

## **MINORITY INTEREST INVESTMENT IN AZERBAIJAN**

During the three months ended March 31<sup>st</sup>, 2005, pilot oil production continued from the South West Gobustan fields, and together with crude oil inventory at the beginning of the first quarter, two sales totalling approximately 8,900 barrels were made via SOCAR's pipeline for export to Novorossiysk.

During the first quarter of 2005, CGL recommenced drilling in the Coastal block in the South West Gobustan fields. The first appraisal well is being drilled in the Kyanizadag field in the Coastal block, with target depth of 3,800 metres and with natural gas and condensate as objectives. Results from this well should be available by the end of June 2005.

During 2004, CGL established potential gas deliverability of approximately 12 million cubic feet of gas per day. The installation of gas processing facilities to service the existing gas wells in the Duvanny field is in progress, and first gas is expected on schedule in October 2005.

The Company provided funding to CGL during the first quarter of 2005 of \$2.8 million.

Revenue from test production for the three months ended March 31<sup>st</sup>, 2005 of \$0.15 million (three months ended March 31<sup>st</sup>, 2004: nil) has been offset against capitalized costs and not recognized as turnover.

## **CRITICAL ACCOUNTING ESTIMATES AND ADOPTION OF NEW ACCOUNTING POLICIES**

### **PRINCIPLES OF CONSOLIDATION**

The Company's unaudited consolidated financial statements have been prepared in US dollars following Canadian generally accepted accounting principles and include the financial statements of Arawak and its wholly owned subsidiaries, which are registered under the laws of Anguilla (British West Indies), the Netherlands, Kazakhstan, British Columbia, Alberta & Ontario (Canada) and England & Wales.

Operations in Russia are conducted through a joint venture and accordingly, these financial statements reflect only the Company's proportionate interest.

The Company's operations in Azerbaijan are recognized as an equity investment and accordingly, these financial statements reflect the Arawak share of the net results and net assets.

### **FOREIGN CURRENCY TRANSLATION**

In Kazakhstan, operations are financially and operationally integrated and the functional currency is the US dollar. Arawak translates foreign currency denominated transactions using the temporal method whereby monetary assets and liabilities are translated at year-end rates; non-monetary assets and liabilities are translated at rates in effect on the date of the transactions; revenue and expenses are translated at rates in effect on the date of the transaction with the exception of depreciation and amortization, which are translated at historic rates; and foreign exchange gains and losses are included in earnings.

The functional currency of the Russian operations is the Russian rouble as it reflects the economic substance of the underlying events and circumstances of the Russian activities. Transactions and amounts are translated using the current rate method whereby assets and liabilities are translated at the rate in effect on the balance sheet date; revenues and expenses are translated at the rate in effect on the transaction date; and exchange gains or losses are recorded directly as a separate component in shareholders' equity.

### **CASH AND CASH EQUIVALENTS**

Cash and cash equivalents include cash on account and highly liquid investments with a term to maturity of three months or less at the date of purchase.

### **INVENTORY**

Crude oil inventory consists of amounts produced and in storage tanks and is recorded at the lower of cost, determined on a weighted average basis, and net realizable value. Supplies inventory is recorded at the lower of cost, determined on a weighted average basis, and net replacement cost.

### **OTHER CURRENT ASSETS**

Other current assets include refundable value added tax, refundable goods and services tax, prepaid expenses and advances to employees.

## **OIL AND GAS PROPERTIES**

Arawak follows the full cost method of accounting, whereby all costs incurred in exploring for and developing oil and gas reserves are capitalized. Such costs include land acquisition, geological and geophysical, drilling of both productive and unproductive wells, plant and equipment and administration costs reasonably allocable to these activities. Proceeds from disposals are recorded as a reduction of the related expenditures without recognition of a gain or loss unless the disposal would result in a change of 20 percent or more in the depletion rate.

Capitalized costs are accumulated on a country by country basis and are depreciated and depleted using the unit of production method based upon estimated proved reserves. The carrying values of unproved properties are excluded from the depreciation and depletion calculation.

The Company applies a ceiling test to capitalized costs to ensure that such costs do not exceed estimated future net revenues from production of proved reserves using forecasted sales prices less expected future capital, production, royalties and asset retirement obligation, together with the value of unproved properties at the lower of cost and net realizable value. An impairment loss is recognized when the carrying amount is not recoverable and exceeds its fair value. The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected from the proved reserves.

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of commitments and contingent liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting periods. Amounts recorded for the depletion of oil and gas properties and asset retirement obligations are based on estimates of proved reserves and future development costs. The ceiling test is based on estimates of proved reserves, production rates, oil and gas prices and future costs. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be material.

## **ASSET RETIREMENT OBLIGATION**

The Company recognizes a liability for the fair value of legal obligations associated with the retirement of long-lived tangible assets in the period incurred with a corresponding increase in the carrying amount of the related asset, which is depleted on a unit-of-production basis over the life of the proved reserves. The liability is adjusted each reporting period to reflect revisions to the estimated future cash flows and for the passage of time. The liability accretes until the date of expected settlement of the retirement obligations. The related accretion expense is charged to earnings. Actual expenditures incurred for site reclamation and abandonment are charged against the liability to the extent it exists on the balance sheet with the difference recognized as a gain or loss in the period in which settlement occurs.

## **REVENUE RECOGNITION**

Sales of crude oil are recorded in the period in which title transfers to the customer.

## **OFFICE EQUIPMENT AND RELATED AMORTIZATION**

Office equipment is amortized on a straight line basis over its estimated useful life of 3 to 6 years.

## **ROYALTIES AND TAXES**

Royalty rates in Kazakhstan are graduated, increase with cumulative annual production and are based on net sales prices. Russian royalties are based on world oil prices.

The Company also pays over-riding royalties at two of the three oil fields in Kazakhstan. The royalty rates are fixed and paid based on sales volumes.

## **INCOME TAX**

The Company follows the liability method of accounting for income taxes. Under this method, income tax assets and liabilities are recognized based on the estimated tax effects of temporary differences in the carrying values of assets and liabilities in the financial statements and their respective tax bases, using income tax rates enacted on the balance sheet date. The effect of a change in income tax rates on the future income tax assets and liabilities is recognized in income in the period of the change.

## **STOCK BASED COMPENSATION COSTS**

Compensation expense is based on the fair value at the grant date and recognized in income over the vesting periods of the respective options for options granted on or after January 1, 2003 with a corresponding increase to contributed surplus. Any consideration received upon exercise of the options, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital.

## **FINANCIAL INSTRUMENTS AND FINANCIAL RISK**

The fair value of cash, accounts receivable, other current assets, accounts payable and accrued liabilities and the crude oil prepayment facility approximate their carrying values due to the short term nature of these instruments. The fair value of loans to associates approximates their carrying amounts as interest rates approximate market interest rates. The other long-term liabilities are non-interest bearing and therefore, do not approximate fair-value, however, the fair value cannot be practically estimated.

The Company uses various financial instruments to manage its crude oil price exposure. The instruments are not used for trading purposes. The Company hedges its exposure to petroleum commodity prices by entering into crude oil options when deemed appropriate. These derivative contracts are not accounted for as hedges and are recorded at fair value on the balance sheet with changes in fair value recognized in earnings. Premiums paid are deferred and amortized to earnings over the term of the contract.

## **BUSINESS RISKS**

As a junior oil and gas exploration, development and production company, Arawak is subject to risks and uncertainties inherent to the oil and gas industry and to risks inherent to a company of its size and at its stage of development. Due to the international nature of the Company's operations, it is subject to additional risks, including currency fluctuations, political risk, price controls and varying forms of fiscal regimes.

## **OIL AND GAS INDUSTRY RISKS**

Risks in the oil and gas industry include price fluctuations for commodity prices, operational risks and environmental concerns. Oil and natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors. Arawak manages its operations in order to keep exposure to these risks to reasonable levels, including the use of hedging instruments and forward sale, fixed price contracts to hedge its exposure.

Operational risks in the oil and gas industry include exploration and reserve estimate risks, costs and availability of services and materials, premature reservoir declines, blowouts, well bore collapse, equipment failure and other accidents and adverse weather conditions. Arawak attempts to mitigate these risks by employing experienced field personnel, consultants and contractors.

The oil and gas industry is subject to extensive environmental and other regulation imposed by governmental authorities. Arawak has existing policies and practices that ensure its operations conform to the standards and government regulations required for each jurisdiction in which it operates.

## **POLITICAL AND ECONOMIC CONDITIONS IN RUSSIA AND KAZAKHSTAN**

Whilst there have been improvements in the economic situation in Russia and Kazakhstan in recent years, their economies continue to display some characteristics of emerging markets. These characteristics include, but are not limited to, the existence of currencies that are not freely convertible outside of the respective countries, a low level of liquidity of debt and equity securities in the markets and relatively high inflation.

Additionally, the oil and gas sectors in Russia and Kazakhstan are impacted by political, legislative, fiscal and regulatory developments. The prospects for future economic stability are largely dependent upon the effectiveness of economic measures undertaken by the Governments, together with legal, regulatory and political developments, which are beyond the Company's control.

The financial condition and future operations of the Company may be adversely affected by continued economic difficulties. Management is unable to predict the extent and duration of the economic difficulties, nor quantify the impact, if any, on these financial statements.

## **NEED FOR CAPITAL**

Arawak must rely on access to debt and capital markets to supplement internally generated cash flow to fund its capital commitments and to finance its growth plans. There can be no assurance that Arawak will be successful in obtaining the funds required to meet its capital needs on a timely basis or, if it is successful, that the terms on which such funds are obtained will be advantageous to Arawak.