



Gulf Keystone Petroleum Limited

Annual report and accounts 2005



**A solid platform
for growth**

Who We Are



Gulf Keystone is an oil and gas company focused on the exploration, development and production of oil and gas in the Republic of Algeria and elsewhere in North Africa and the Middle East.

Our focus is on exploration for oil and gas in proven hydrocarbon bearing basins, and on the appraisal and profitable exploitation of existing undeveloped discoveries.

To this end, we have acquired a substantial onshore acreage position in the Republic of Algeria, with some 27,400 sq km under licence. These interests are held under four separate Production Sharing Contracts with our partner SONATRACH – the Algerian National Oil Enterprise – and contain both significant exploration potential and a number of undeveloped oil and gas discoveries. Gulf Keystone is operator of all its licences.

Gulf Keystone is now looking to expand its activities in Algeria and elsewhere in North Africa and the Middle East.

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Chairman's Statement



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The year has been one of strong operational focus as we have continued with the drilling and testing of prospects and existing discoveries on Block 126a and have begun a comprehensive programme of technical and commercial studies on the major new acreage holdings acquired by Gulf Keystone Petroleum Limited ('the Company' or 'Gulf Keystone') in Algeria during 2005.

These varied activities have now confirmed that the Company has a portfolio of assets with very significant oil and gas potential. A recent independent assessment of the Company's reserves and resources carried out by RPS Energy Limited (RPS), and discussed further in the Chief Executive's statement, has confirmed that the Company's newly expanded portfolio of assets contains significant oil and gas exploration and development potential.

While the results of operational activities on Block 126a have been mixed, they have added immeasurably to our understanding of the significant hydrocarbon potential that exists in this geologically complex area. Commerciality has been formally declared on the two oil discoveries, GKN and GKS, and a third potential oil discovery has resulted from the drilling of well GRJ-2, which encountered three potentially hydrocarbon bearing intervals, and a test programme is being developed for this well.

Having fulfilled its work commitments on Block 126a, and following conclusion of the Second Exploration and Evaluation Period of the licence in April of this year, Gulf Keystone has decided to focus exclusively on bringing the GKS and GKN oil fields into production, and on unlocking the productive potential of the GRJ oil bearing structure. SONATRACH has notified the Company of its support for the extension to the Block 126a exploration licence, which is necessary to enable the Company to pursue further work on the GRJ field, however the extension to the contract still needs to be formally gazetted. The Company has relinquished the remaining exploration acreage on the block.

In April 2005, Gulf Keystone was a highly successful bidder in the 6th Algerian International Licencing Round, acquiring exploration and appraisal rights to six additional onshore blocks under two separate contracts. A third contract, covering the Ben Guecha Perimeter (Blocks 108 and 128b), also adjacent to the Company's other Constantine Basin interests, was secured as a result of direct negotiation with SONATRACH and the Algerian Ministry of Energy and Mines. This contract has been signed by all relevant parties and we now await the formal gazetting of this award.

200 sq km

6th bidding round success resulting in significant acreage additions during 2005.



Roger Parsons
Chairman

These awards have increased Gulf Keystone's acreage holdings from one block covering 5,830 sq km to nine blocks now covering some 27,400 sq km. The Company has been awarded Operatorship of all eight new blocks and holds 75% of the working interest with its partner SONATRACH holding the remaining 25% working interest. The Company has already commenced detailed technical and commercial studies on these new blocks with the intention of acquiring further 2D and 3D seismic data, and commencing appraisal and workover activities on discoveries already made on the licences, as soon as practicable.

I am delighted to report that Gulf Keystone has continued to strengthen radically its management team by recently recruiting individuals onto the Board and the Executive team with very significant international upstream experience in the financial, commercial and technical areas in particular. In this regard, Bill Guest took on the position of President of the Company in November 2005 while in March 2006 Jon Cooper joined as Finance Director for Gulf Keystone Petroleum Limited and Iain Patrick joined us as Director of Commercial and Legal Affairs for Gulf Keystone Petroleum (UK) Limited. We very much welcome them on board.

As the team expands and continues to build its reputation within Algeria as a skilled and technically competent Operator and Partner, Gulf Keystone is now increasingly well placed to concentrate on expanding its business development strategy. Such a strategy will inevitably be focused, first and foremost, on building its competitive position in Algeria. The Company is however, also beginning to focus actively, in parallel, on other selected areas within the North Africa and Middle East region where it considers that it has a competitive edge at the point of access as a result of its existing regional relationships.

Finally, I am delighted to acknowledge the strong and highly collaborative working relationship that the Company continues to enjoy in Algeria with its host, the Ministry of Energy and Mines, and partner SONATRACH and we look forward to building and developing these relationships further to our mutual benefit. I remain however acutely aware of the need for us to continue to be able to translate these excellent relationships into specific deliverables. We are also conscious of the need to demonstrate the viability of, and growth potential associated with the Company's strategy.

One of the key challenges that Gulf Keystone and other operators in Algeria have faced during 2005 has been the increasing cost of and access to goods and services. This obviously reflects the current state of the global service market particularly in Algeria and has for example hindered the Company from considering some of the more radical reservoir stimulation activities on Block 126a that it contemplated at the time of licence acquisition. The Company is however taking important steps to ensure that those services required in support of its future programme of activities within its expanded portfolio can be accessed on a timely and cost effective basis.

I would like to thank all those employed by the Company, whether in Bermuda, Algeria, London or elsewhere, for their significant efforts over the past year, and I now very much look forward to being able to report progress towards demonstrating the potential of, and crystallising the value from, the Company's diverse portfolio of assets.

Our Operational Focus

Operating in the oil sector in the Republic of Algeria, we have an in-depth knowledge of the country, it's local culture, and political and operating environments.



It's this understanding which has resulted in such an effective working relationship with SONATRACH, the Algerian National Oil Enterprise. It's an on-going partnership which reflects the complementary

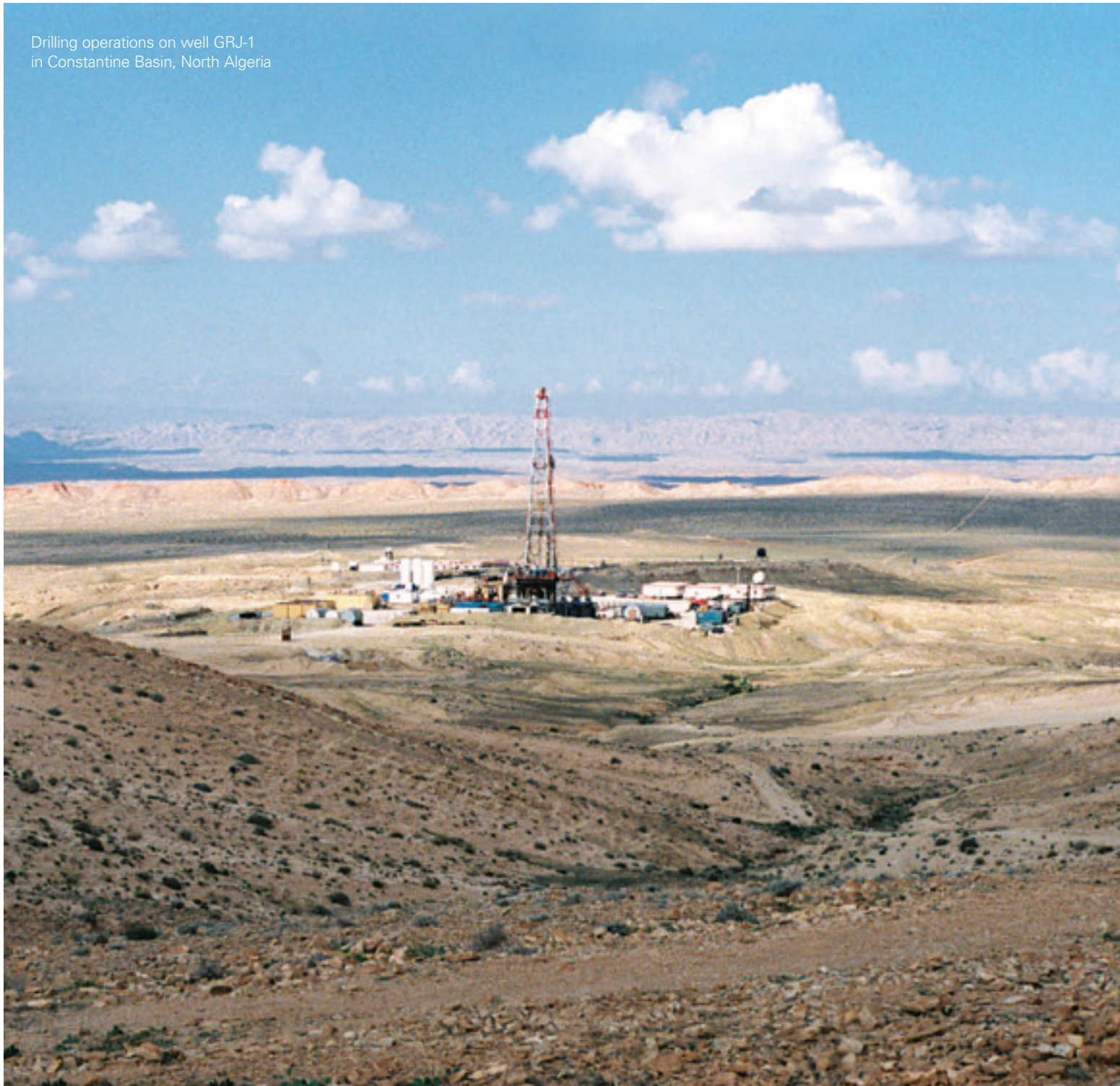
strengths of both SONATRACH professionals and Gulf Keystone's Board and Senior Management, and one on which we intend to build in the years ahead.



Realising the Potential

In April 2005, the company was highly successful in the 6th Algerian International Licencing Round, acquiring exploration and appraisal rights to six additional blocks.

Drilling operations on well GRJ-1
in Constantine Basin, North Algeria



Two further blocks were acquired through direct negotiation. The new holdings offer great potential, in terms of both pre-existing oil and gas discoveries and exploration opportunities,

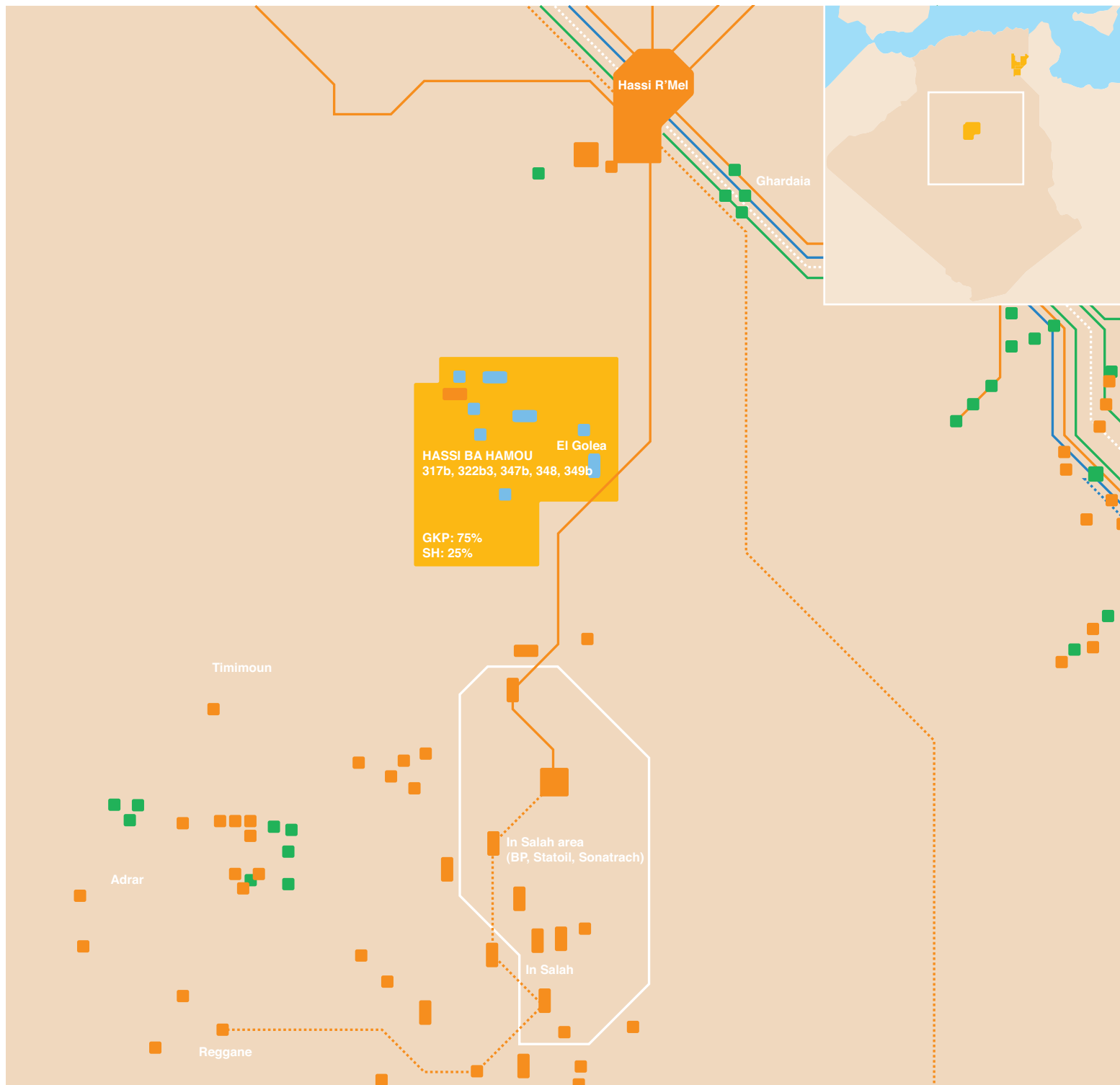
and a full technical and commercial review of these assets has now been completed. Plans for the further exploration and appraisal of these interests are well advanced.

Todd Kozel (CEO) and Boumediène Belkacem, Vice President Amont of SONATRACH signing contract for Hassi Ba Hamou

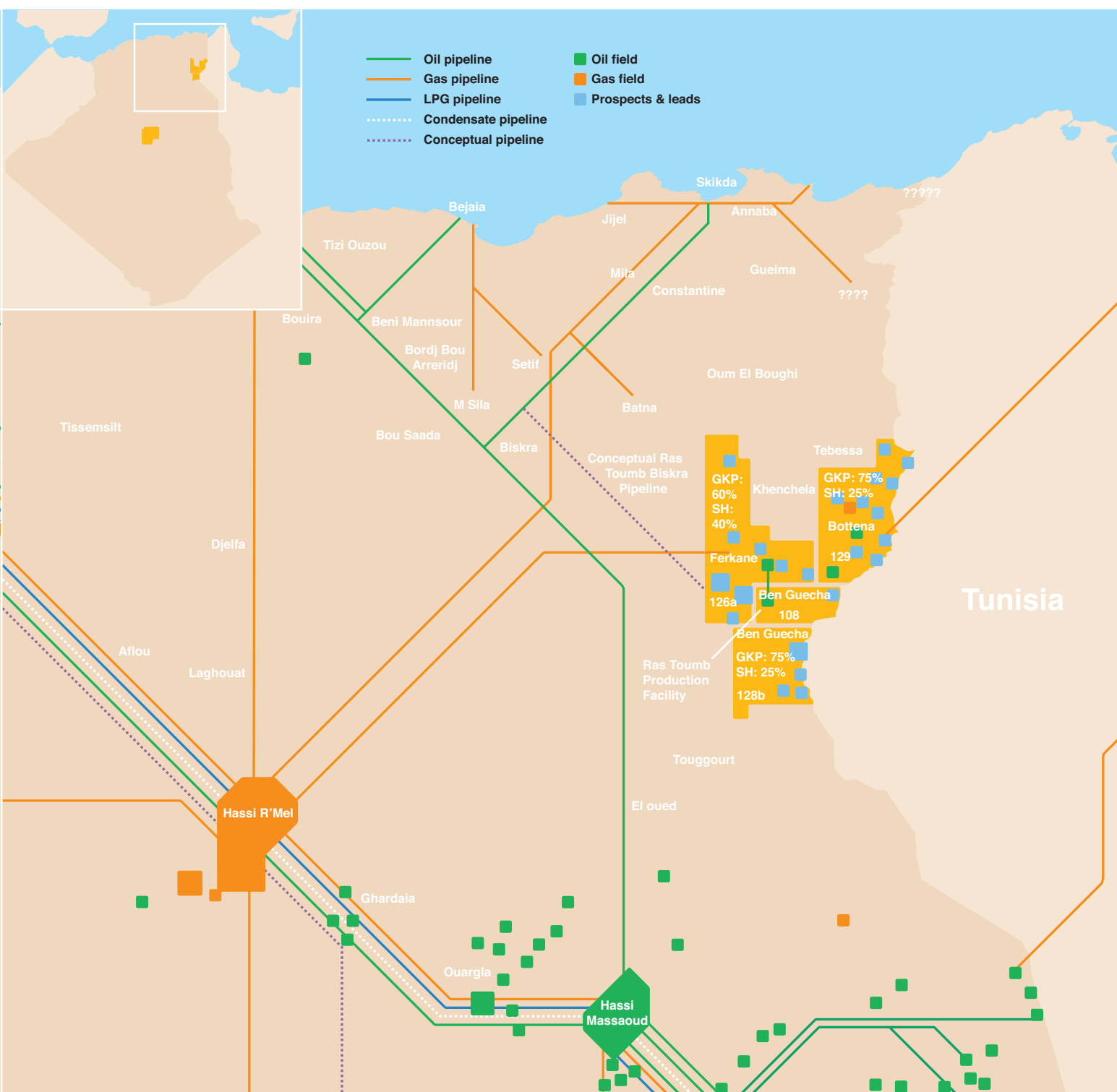


Our licences

Two key operational areas: The Constantine basin in North Eastern Algeria and the Hassi Ba Hamou Perimeter in the Allal Dome area of Central Algeria.



Gulf Keystone currently holds interests in nine blocks in Algeria, four in the Oil prone Constantine basin in North Eastern Algeria, and five in the gas prone Allal dome area of Central Algeria.



Chief Executive Officer's Statement





The key challenges for Gulf Keystone are very clearly to secure early production of cashflow from Block 126a and to radically advance the exploration and appraisal of its newly acquired licences.

I am pleased to be able to report on the activities of Gulf Keystone over the past year.

On the operational side, significant focus has been placed on the drilling and testing of prospects and existing discoveries on Block 126a and on the maturation and finalisation of development plans for the GKS and GKN oil discoveries. In parallel, a major technical and commercial effort has been undertaken to increase our understanding of the hydrocarbon resource potential, and economic potential, of the three further contract areas awarded in 2005, and to progress plans for the further exploration and appraisal of these areas.

The Block 126a 2005 drilling campaign consisted of the drilling of two wells, exploration well RTBW-1 and appraisal well GRJ-2, and the drilling of a sidetrack to an existing well, GKS-3. The well workover campaign consisted of the re-entry and stimulation of wells GKS-2 and GRJ-1. The results, which are discussed in more detail below, were mixed but have enabled the Company to progress its plans for the commercialisation of oil discoveries on Block 126a and have added immeasurably to our understanding of this geologically complex area. The above programme marks the completion of all work obligations on Block 126a.

One of the key achievements of 2005 was the award of three additional contract areas in Algeria. The areas awarded to Gulf Keystone include the Hassi Ba Hamou (HBH) Perimeter, containing 5 blocks and located in the Eastern Timimoun Basin to the north of BP's In Salah field, and Blocks 108, 128b and 129, located in the Constantine Basin. Preparation of exploration and appraisal plans for these licences are well underway.

Moving ahead...

Chief Executive Officer's Statement

The company is now in a position to focus heavily on further development of its business within Algeria and beyond and the management and expansion of its portfolio of assets.





Gulf Keystone is Operator of, and holds 100% of the interest available to foreign partners in, all of its Algerian licence interests. Given the rapid expansion of its portfolio during the year, and ahead of the next round of exploration and appraisal activity, the Company's recent focus has been firstly on the full technical review and inventorisation of its portfolio of discoveries, prospects and leads, secondly the potential introduction of strategic partners to complement and accelerate its exploration and appraisal efforts, and thirdly the expansion of its management team. I'm pleased to be able to report good progress on a number of fronts.

With regard to the technical review of the portfolio, and of the newly awarded licences in particular, RPS Energy Limited recently and independently estimated that for the HBH Perimeter and Block 129 alone, gross recoverable hydrocarbon volumes for the licences total 201.7 million barrels of oil equivalent ("Best Estimate" or Mean case). These resources include a significant gas discovery in the HBH licence and certain oil discoveries in Block 129. Under the new AIM guidelines, these volumes are categorised as "Contingent Resources" (being existing discoveries of oil and gas that require further technical or commercial evaluation).

In addition RPS confirm in these two contract areas, and in the retained area of Block 126a, the presence of 23 undrilled prospects and leads which, at the "Best Estimate" (Mean) unrisks level, contain potential gross recoverable reserves for the licences ("Prospective Resources") of 473.1 million barrels of oil equivalent. On a risked basis, this equates to 70.8 mmbob. Further discoveries and prospectivity have been recognised by SONATRACH and Gulf Keystone in Blocks 108 and 128b and these are currently under review.

Block 126a GKN/GKS development

Operational activity on the GKN and GKS discoveries included the workover of well GKS-2 and the drilling of a sidetrack on well GKS-3. Well GKS-2, was re-entered and stimulated. Production testing of the well resulted in a measured flow rate of 4,586bopd and 4.61 million cubic feet of gas per day.

Well GKS-3 was originally drilled in 2003 and completed with a perforated liner. The GKS-3 sidetrack, drilled in 2005, allowed further testing and acid stimulation of the Ras Toubm and Cenomanian intervals. These intervals proved to be tight and non-productive. The well was suspended pending evaluation of further stimulation techniques.

Gulf Keystone has submitted a "Final Discovery Report" with a development plan for the GKN field and has made an "Early Production Licence" application for the GKS field. These discoveries are located in a geologically complex area, hence the development of reserves will be phased – data from each phase being utilised to optimise, and confirm the economic viability of, the subsequent phase. The GKN field is already linked by a pipeline

to production facilities at Ras Toubm, and the GKS discovery well, GKS-2, is situated within 2.4km of this pipeline. Gulf Keystone is proposing to tie GKS-2 into the GKN pipeline, following a capacity upgrade, and carry out extended well testing in order to assess the ultimate recovery of the well and provide insight to the optimum mechanism for accessing the remaining GKS field reserves. The oil recovered during the extended well test will be marketed with the GKN production. The drilling of a second development well on the GKN discovery, GKN-4, is planned as part of the first phase of the GKN development, following receipt of a production licence as is the acquisition of a small (c. 150sq km) 3D seismic survey. Approval for the GKN/GKS development project was temporarily delayed due to the recent introduction of legislation limiting the flaring of gas. However, the Company has now submitted to SONATRACH a viable plan to utilise the associated gas produced with the oil from both fields, which is presently under active review. The Company believes that development approval and a production licence will be granted shortly.

Chief Executive Officer's Statement



GRJ Oil Discovery

Well GRJ-1, drilled in 2003, was re-entered and tested during 2005. However only small quantities of oil were recovered under test with no sustainable production being achieved. This further illustrates the challenges that have been experienced in Block 126a where widespread oil has been encountered but sufficient connectivity between the wellbore and fractures within the reservoir has not always been achievable from initial operations. The well was suspended pending evaluation of various options for stimulating the reservoir and achieving the necessary connectivity.

Data from well GRJ-2, drilled in 2005, which was analysed by third party consultants, indicated that there are three separate potential reservoir intervals which may have the potential to contain hydrocarbons. Given the poor productivity of some previous wells, it was decided to defer testing of this well until the optimal test programme could be designed and agreed between SONATRACH and Gulf Keystone and suitable equipment could be made available in Algeria. Progress is being made towards finalising a testing strategy.

The Company has applied for an eight month licence extension from Algerian authorities in respect of the GRJ discovery in order to complete the testing of well GRJ-2 which, in the case of success, the Company expects would be the subject of a production licence application.

Hassi Ba Hamou Perimeter (Blocks 317b, 322b, 347b, 348, 349b)

The HBH Perimeter, covering an area of 18,380 sq km, contains one existing gas field, HBH, confirmed by the drilling of three wells by SONATRACH and a number of undrilled leads and prospects.

The initial seismic and well data set acquired by the Company in connection with the licence award included data relating to the HBH-1 discovery well and a portion of the 4,069 km of 2D seismic data previously acquired by SONATRACH. Since then, the Company has acquired from SONATRACH a substantially enhanced data set, including important log and well test data from a successful appraisal well HBH-3 and a substantial quantity of additional seismic data.

This has enabled the Company to carry out a full technical and economic review of the contract area and identify a potential gas resource base which is materially larger than was identifiable at the time of licence award. RPS, as part of their recent independent review of Gulf Keystone's reserves and resources, estimate that the HBH Field contains recoverable gas reserves of 995 bcf. (These are classified as "Contingent Resources", pending commercialisation of gas, and represent the "Best Estimate" or Mean case). RPS also confirmed a minimum of four undrilled leads and prospects containing a further potential 1,935 bcf in place (Mean unrisked case). The Company's ongoing technical analysis of the HBH Perimeter is continuing to identify significant additional hydrocarbon prospectively.

Gulf Keystone intends to appraise the existing HBH discovery and drill two exploration wells during the first three year phase of the contract. It had, in addition, intended to acquire 100 sq km of 3D seismic and 400 km of 2D seismic as part of this initial programme. However, given the significantly enhanced prospectivity of the HBH Perimeter, a potential increase in that programme to some 2,000km of 2D seismic and 500 sq km of 3D seismic during this initial phase, is under consideration.



Todd Kozel
Chief Executive Officer

Ben Guecha (Blocks 108/128b)

The primary focus of SONATRACH and Gulf Keystone (the 'JV Partners') on the Ben Guecha permit will be the further development of the existing Ras Toubm oil field and the exploration for additional oil and gas reserves. SONATRACH's interpretation of its previously acquired 4,457 km of 2D seismic on the permit identified seven additional prospects and leads, one of which, OSD, SONATRACH completed the drilling and logging of an exploration well and temporarily abandoned the well awaiting testing equipment. The JV partners committed to drill two wells on the permit during the initial three year phase of the licence, as a minimum work program.

The Company acquired 156 sq km of 3D data over the greater Ras Toubm area in 2005 and this, together with an enhanced seismic and well data base since received from SONATRACH, has formed the basis of an ongoing full technical review of the contract area, the initial results of which have confirmed the prospectivity of the area.

Further to the signing of the Production Sharing contract in 2005, these licences are yet to be ratified by being published in the Algerian official gazette. While the Company has already commenced a comprehensive work programme on the licence, the first official three year phase of the licence will not commence until the contract is ratified.

Bottena Perimeter (Block 129)

Covering an area of 4,368 sq km, the Bottena Perimeter is in the South Constantine Basin, adjacent to Block 126a and extending towards the Tunisian border. The licence area contains the Hassi El Kerma (HEK) oil discovery and Djebel Foua gas discovery. SONATRACH recently drilled two additional structures on the permit area, Djebel Darmoun (DDN) (2000) and Hanchir Baaziz (HCZ) (2002) both of which confirmed the presence of oil.

Gulf Keystone currently intends to appraise the discoveries HEK and DDN, drill one exploration well and acquire additional 2D and 3D seismic data on the Bottena Perimeter. In addition Gulf Keystone is considering processing and interpreting the 412 sq km 3D seismic survey that was acquired by SONATRACH over the DDN discovery in July 2005. It is presently undertaking a full technical review of the licence to firm up the prospectivity.

Financial Results

The Company reports a loss after taxation of \$40.8 million (2004: \$2.4 million) for the period. This loss is after an impairment charge for Block 126a of \$35.1 million. The impairment under IFRS 6 was triggered for the Block 126a's group of cash generating units by the transfer of \$24.8 million relating to the GKN and GKS fields from intangible fixed assets to tangible fixed assets, and reflects the decision of the Company not to apply for an extension to the Block 126a licence area outside of GKN, GKS and GRJ-2.

Capital Expenditure on exploration and evaluation activities was \$47 million. At the end of the year the Company had \$51.4 million in cash of which \$34.7 million was pledged against the issue of bank guarantees to SONATRACH.

Outlook

The key challenges for Gulf Keystone during 2006 are very clearly to secure production and cash flow from Block 126a and to radically advance the exploration and appraisal of its newly acquired licences. The Company is now in position to focus efforts on the further development of its business and the expansion of its portfolio, exploiting what it considers to be its particular competitive edge at the point of access for new opportunities in both Algeria and other selected areas of the Middle East and North Africa. We approach this next phase in the Company's development with considerable optimism.

Todd Kozel
Chief Executive Officer

Board of Directors and Management



01 Roger Wentworth Parsons
Non-Executive Chairman (64)

From 1988 to 1999, Mr. Parsons was Chief Executive of Rea Brothers Group Plc., a publicly quoted banking and financial services company. He retired from full-time employment at the end of 1999, when Rea Brothers was sold to Close Brothers Company Plc. Prior to Rea Brothers, he spent 25 years in international banking, first with Citibank and subsequently with Grindlays Bank Plc, where he was a Managing Director. He has acted as a Director for both public and private companies in the UK, United States and Greece and in 2004 retired from the Board of American Standard Companies, Inc. (an S&P 500 company) where he had been a non-executive Director for ten years. He is currently a Director of Høegh Capital Partners Advisors Limited, an investment advisory company.



02 Todd Francis Kozel
Chief Executive Officer (39)

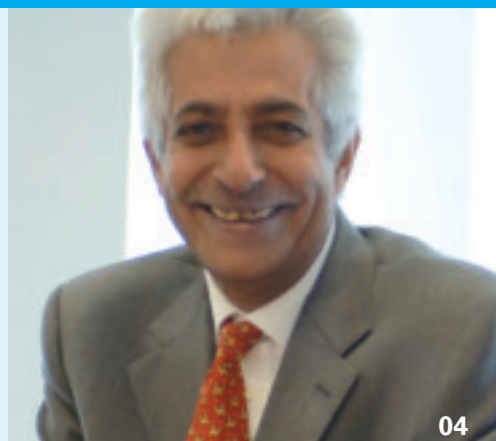
Mr. Kozel co-founded Gulf UAE in 2000 where he serves as a Director. In 1988, Mr. Kozel founded Texas Keystone, Inc., an independent oil and gas exploration, development and production company, headquartered in Pittsburgh, USA. Mr. Kozel served as Texas Keystone's President from 1995 to 2004 and has served as a Director since 1988. Mr. Kozel also co-founded Falcon Drilling Company, LLC, an American independent drilling and oilfield services company, in 2001 and serves on its Board of Directors.

03 Jon Cooper
Finance Director (37)

Jon joined Gulf Keystone as Finance Director in March 2006. Jon is an experienced finance professional with advisory experience in the oil and gas industry. Prior to joining Gulf Keystone, Jon spent 9 years at Dresdner Kleinwort Wasserstein, where he worked as a Director in the Oil & Gas Corporate Finance Team most recently covering Russia and Central & Eastern Europe. During this time Jon worked on mergers & acquisitions, public offerings and as strategic adviser to a wide range of companies including Gazprom, Lukoil, OMV, PKN Orlen, Unocal, Petronas and Harvest Natural Resources. Jon qualified as a Chartered Accountant with KPMG in 1996 and has a B.Eng in Mechanical Engineering and PhD in Biomedical Engineering.



Team



04 Sheikh Sultan Bin Saqr Al-Qassimi
Non-Executive Director (51)

Sheikh Sultan Al-Qassimi started his professional career in 1976 as co-founder of GIBCA, an industrial, construction and investment group in the United Arab Emirates. In addition to his role as Managing Director of GIBCA, Sheikh Sultan has served as a Director of several public joint stock companies, amongst which are Dubai Investment (PJSC) and Union Insurance (PJSC) and is currently a vice-chairman and chairman of the Executive Committee of the United Arab Bank (PJSC). Amongst his achievements are the establishment, along with others, of the United Arab Emirates' The Banks Association and The National Contractors Association. He was awarded the title "Gulf Chief Executive Officer of 1993", (which includes The Kingdom of Saudi Arabia and Kuwait) and is an active member of, and often represents his country in, its economic delegations.



05 James William Guest
President (52)

Mr Guest, a geologist by background, has 30 years of experience in the international oil and gas industry. He joined Shell in 1975 and held a variety of exploration, production and commercial positions in the Far East, W. Africa and Europe before joining the Board of Monument Oil and Gas Plc ("Monument") in 1990. During the 1990's, Monument developed into one of the UK's largest independent exploration and production companies. Mr Guest held the position of Technical Director and latterly Business Development Director up to the time of Monument's sale in 1999. Since then he has held a variety of independent advisory and senior management roles in the upstream sector, joining the board of Gulf Keystone as a non-executive in May 2004.

Board of Directors and Management



06 Christopher Howard Garrett

Managing Director, Gulf Keystone Petroleum (UK) Ltd (53)

Mr. Garrett joined Gulf Keystone in November 2004 as Managing Director of the UK entity and Operations Manager for Algeria. Previously he worked for Randall & Dewey and Baker Hughes in a number of roles ranging from international exploration and operations management through to property and prospect evaluation. Mr. Garrett's background is in geology and geophysics and he spent 12 years overseas working in the USA and Middle East. He brings to Gulf Keystone over 29 years of oilfield experience gained with Core Laboratories and Western Geophysical and latterly with Baker Hughes and Randall & Dewey. Mr. Garrett is an AAPG Certified Petroleum Geologist and Fellow of the Geological Society



07 Ibrahim A. Al-Khaldi

Chief Operating Officer (42)

Mr Al-Khaldi has been employed by the Company since inception. Mr Al-Khaldi co-founded Gulf UAE in 2000, where he has served as its Chief Operating Officer since March 2001. Prior to joining Gulf UAE, Mr Al-Khaldi served as Business Development Manager for the Middle East and North Africa for Baker Atlas, a subsidiary of Baker Hughes Inc., one of the world's largest oil services companies. Prior to joining Baker Atlas, Mr Al-Khaldi served as a general field engineer for Western Atlas International Inc., an oil services company and a predecessor company to Baker Atlas, and was responsible for assignments to Europe, Africa, the Middle East, the Far East, South America and North America.



Team



09

08 Ali A. Al-Qabandi (CPA, ICPA)

Vice-President Business Development (54)

Mr Al-Qabandi (CPA, ICPA) is the Vice-President Business Development of the Company. Mr Al-Qabandi co-founded Gulf UAE and served as its Chief Financial Officer between October 2001 and May 2005. Prior to joining Gulf UAE, Mr Al-Qabandi held numerous executive positions and committee chairmanships for the Kuwait Oil Company, which he joined in 1979. Most recently, Mr Al-Qabandi served as the Executive Assistant Managing Director of Planning and Finance for the Kuwait Oil Company ("KOC") and a Director of the Kuwait National Petroleum Company. Mr Al-Qabandi also served as a board member of Kuwait Oil Company (KGOC), a Kuwait Petroleum subsidiary and a board member of United Oil projects Chairman of the Corporate Information Implementation Project, Chairman of the KOC Profit Center Committee and was a Member of the Strategic Planning Steering Committee, the Review of KOC Organization Committee, the Cost Optimization Steering Committee and Field Development Steering Committee. Mr Al-Qabandi is a Certified Public Accountant and International Certified Public Accountant.

09 Iain Patrick

Director of Commercial & Legal, Gulf Keystone (UK) Ltd (48)

Iain has 25 years experience in the international oil and gas industry. After qualifying as a lawyer in 1980, Iain worked in legal and commercial positions for several oil companies in the UK and the Netherlands before joining Monument Oil and Gas plc in 1988 where he was Commercial Director until the sale of the company in 1999. In this role Iain was responsible for acquisitions and disposals of assets in over twenty countries, including Algeria. Iain then co-founded PWX Limited, a consultancy providing business development support to a number of oil and gas companies, prior to joining Gulf Keystone in March 2006.

Directors’ report

for the year ended 31 December 2005

The Directors submit their report and the consolidated financial statements of Gulf Keystone Petroleum Limited (the ‘Group’) for the year ended 31 December 2005.

Gulf Keystone Petroleum Limited is a public company, incorporated in Bermuda, and quoted on the Alternative Investment Market of the London Stock Exchange.

Principal activities

The principal activity of the Group during the year was that of an oil and gas exploration Group operating in the Republic of Algeria.

Results and dividends

The Group trading loss for the year after taxation was \$40.8 million (2004: \$2.4 million).

The Directors do not recommend a dividend for the year.

Review of the business and future developments

A review of the business is given on pages 2 to 15 of this document.

Post balance sheet event

On 9 June 2006 the Group signed loan agreements with GIBCA Limited and Falcon Partners Trust, both related parties, to provide an unsecured debt facility in aggregate of \$5 million at an interest rate of 7% and for a term of 12 months.

Directors

The following Directors have held office during the year.

- RW Parsons – Chairman ⁽¹⁾
- TF Kozel – CEO
- Sheikh Sultan Bin Saqr Al-Qassimi – Non-Executive Director⁽¹⁾
- JW Guest – President (moved from a non-executive position to an executive position 11 November 2005)
- CA Brown – CFO (appointed 11 May 2005, resigned 6 April 2006)
- JR Cooper – Finance Director (appointed 6 April 2006)

(1) Members of the audit committee, appointments committee and Directors’ remuneration committee.

Directors’ interests in shares and options

Directors’ interests in the shares of the company, including family interests, were as follows:

	At 31 December 2005 Number of Common Shares	At 1 January 2005 Number of Common Shares
TF Kozel	20,050,000	20,000,000
RW Parsons	300,000	200,000
JW Guest	20,000	—
Sheikh Sultan Bin Saqr Al-Qassimi	—	—
Caroline Brown	10,000	—

In addition to the above interests:

1. TF Kozel is a shareholder in Gulf Keystone Petroleum Company LLC (“Gulf UAE”) which is interested in 40,000,000 Common Shares.
2. Sheikh Sultan Bin Saqr Al-Qassimi is a shareholder in GIBCA Limited which is interested in 20,000,000 Common Shares. GIBCA Limited is also a shareholder in Gulf UAE which as stated above is interested in 40,000,000 Common Shares.

Directors’ interests in share options of the company, including family interests, as at 31 December 2005 are disclosed on page 24.

Substantial shareholdings

Other than the Directors' interests shown above, the company has been notified of the following substantial interests as at 31 May 2006:

	Number of Common Shares	Percentage of issued share capital
Goldman Sachs Securities (Nominees) Ltd	12,990,146	5.12
Chase Nominees Ltd	11,000,000	4.34
Pershing Keen Nominees Ltd	10,467,940	4.13
Evolution Securities Nominees Ltd	9,180,000	3.62
Nortrust Nominees Ltd	8,030,957	3.17
HSBC Global Custody Nominees (UK) Ltd	8,021,250	3.16

Auditors

A resolution to reappoint Baker Tilly as auditors will be put to the members at the annual general meeting.

AGM 2006

The resolutions to be proposed at the AGM to be held on 15 July 2006 are set out in the notice of the AGM.

By order of the board

Todd Kozel

Director
13 June 2006

Corporate Governance Statement

for the year ended 31 December 2005

Principles of Corporate Governance

The policy of the Board is to manage the affairs of the Group in accordance with the principles underlying the Combined Code on Corporate Governance.

The Board

The Group is led and controlled by a Board comprising a chief executive officer, one non-executive chairman, one non-executive Director and two executive Directors.

There are no matters specifically reserved to the Board for its decision, although board meetings are held on a regular basis and effectively no decision of any consequence is made other than by the Directors. All Directors participate in the key areas of decision-making, including the appointment of new Directors, through the appointments committee.

The Board is responsible to shareholders for the proper management of the Group. A statement of Directors' responsibilities in respect of the financial statements is set out on page 24. The Non-Executive Directors have a particular responsibility to ensure that the strategies proposed by the Executive Directors are fully considered.

To enable the Board to discharge its duties, all Directors have full and timely access to all relevant information.

There is no agreed formal procedure for the Directors to take independent professional advice at the Group's expense.

All Directors submit themselves for re-election at the Annual General Meeting at regular intervals. There are no specific terms of appointment for non-executive Directors.

During 2005 six scheduled board meetings were held. Three took place in Zurich, two in Algiers and one in Dubai.

Board Committees

The following committees, which have written terms of reference, deal with specific aspects of the Group's affairs.

1. The Remuneration and Appointments Committee

The Remuneration and Appointments Committee is responsible for making recommendations to the Board on the Company's framework of Executive remuneration and its cost. The Committee determines the contract terms, remuneration and other benefits for each of the Executive Directors and for other senior members of management. The Board itself determines the remuneration of the Non-Executive Directors. The committee comprises the Non-Executive Directors subject to the note that William Guest moved from a non-executive to executive position on 11 November 2005. It is chaired by the Chairman and is advised by a leading firm of recruitment consultants. Details of the Directors' remuneration are set out on page 23.

2. The Audit Committee

The Audit Committee comprises the two Non-Executive Directors and is chaired by Roger Parsons. Its prime tasks are to review the half-yearly and annual accounts before they are presented to the Board, focusing in particular on accounting policies and areas of management judgement and estimation. The committee is responsible for monitoring the controls which are in force to ensure the integrity of the information reported to the shareholders. The committee acts as a forum for discussion of internal control issues and contributes to the Board's review of the effectiveness of the Group's internal control and risk management systems and processes. It advises the Board on the appointment of external auditors and on their remuneration for both audit and non-audit work, and discusses the nature

and scope of the audit with the external auditors. The committee assesses the performance of the external auditors as well as their independence and objectivity. The external auditors confirm their independence each year in writing to the Committee.

The committee, which meets at least three times per year, provides a forum for reporting by the Group's external auditors. Meetings are also attended, by invitation, by the Chief Executive Officer and Chief Finance Officer.

Internal Control

The Board acknowledges its responsibility for establishing and monitoring the Group's systems of internal control. Although no system of internal control can provide absolute assurance against material misstatement or loss, the Group's systems are designed to provide the Directors with reasonable assurance that problems are identified on a timely basis and dealt with appropriately.

The key procedures that have been established and which are designed to provide effective control are as follows:

Management Structure – The Board meets regularly to discuss all issues affecting the Group.

Investment Appraisal – The Group has a clearly defined framework for investment appraisal and approval is required by the Board where appropriate.

The Board regularly reviews the effectiveness of the systems of internal control and considers the major business risks and the control environment. No significant control deficiencies have come to light during the year and no weakness in internal financial control has resulted in any material losses, contingencies or uncertainties which would require disclosure as recommended by the guidance for Directors on reporting on internal financial control.

The Board considers that in light of the control environment described above, there is no current requirement for a separate internal audit function.

Relations with Shareholders

The President, Chief Executive Officer and Finance Director are the Company's principal spokespeople with investors, fund managers, the press and other interested parties. Each of the non-executive Directors is available to attend meetings with major shareholders (without the executive Directors present), if requested by such major shareholders. At the Annual General Meeting, private investors are given the opportunity to question the Board.

This year's Annual General Meeting will be held on 15 July 2006. The notice of the Annual General Meeting may be found on page 48.

Going Concern

The Directors have considered the factors relevant to support a statement on going concern. They have a reasonable expectation that the Group will continue in operational existence for the foreseeable future and have therefore used the going concern basis in preparing the financial statements. In common with many exploration companies, the Group raises finance for its exploration and appraisal activities in discrete tranches to finance its activities for limited periods. Further funding is raised as and when required. When any of the projects move to development, specific financing may be required to enable development to take place

Remuneration and Appointments

31 December 2005

Report of the Remuneration and Appointments Committee

The company has established a Remuneration and Appointments Committee. For the majority of the year the members of the committee were Messrs Parsons and Guest, who were non-executive Directors and the committee was chaired by Roger Parsons. However, on 11 November 2005 William Guest moved from a non-executive to an executive position and was replaced by Sheikh Sultan Bin Saqr Al-Qassimi at that date.

In determining certain Directors' remuneration for the year, the committee consulted the Chief Executive, Todd Kozel about the committee's proposals. The committee was provided with information supplied by the Curzon Group, a specialist recruitment company, with regard to structuring Directors' remuneration packages and search for suitable candidates; the Curzon Group did not provide any other services to the Group.

Details of the remuneration of each Director are set out below.

Remuneration Policy

The policy of the committee is to reward executive Directors in line with the current remuneration of Directors in comparable businesses taking into consideration the advice of independent benefit consultants in order to recruit, motivate and retain high quality executives within a competitive market place.

There are two main elements of the remuneration packages for executive Directors and senior management:

- Basic annual salary (including Directors' fees) and benefits;
- Share option incentives

There are no pension arrangements in the Group.

The Directors have share options granted to them under the terms of the Share Option Scheme which is open to other qualifying employees. The exercise of options under the Scheme is based upon the satisfaction of conditions relating to the share price. The conditions vary from grant to grant.

Directors' contracts

It is the Company's policy that executive Directors should have contracts with an indefinite term providing for a maximum of one year's notice. In the event of early termination, the Directors' contracts provide for compensation up to a maximum of basic salary for the notice period.

Todd Kozel, William Guest and Caroline Brown have service contracts with the Company. These can be terminated by either side on twelve months' notice. Caroline Brown's contract terminated on 6 April 2006.

Non-executive Directors

The fees of non-executive Directors are determined by the board as a whole having regard to the commitment of time required and the level of fees in similar companies.

Directors' Emoluments

	Salary \$	Fees \$	2005 Total \$	2004 Total \$
Roger Parsons	–	81,000	81,000	47,250
Todd Kozel	675,000	–	675,000	483,750
Sheikh Sultan Bin Saqr Al Qassimi	–	45,000	45,000	26,250
William Guest	60,518	39,206	99,724	26,250
Caroline Brown	186,823	–	186,823	–
	922,341	165,206	1,087,547	583,500

Remuneration and Appointments

for the year ended 31 December 2005

Directors' Interests in Options

Directors' interests in share options of the company, including family interests, as at 31 December 2005 were as follows:

	Date of grant	Number of options over Common shares	Exercise Price (British Pence)	Option exercise period
TF Kozel	20 August 2004	2,650,000	48p	20 August 2004 – 19 August 2014
RW Parsons	20 August 2004	50,000	48p	20 August 2004 – 19 August 2014
JW Guest	20 August 2004	50,000	48p	20 August 2004 – 19 August 2014
Sheikh Sultan Bin Saqr Al-Qassimi	20 August 2004	500,000	48p	20 August 2004 – 19 August 2014
CA Brown	11 May 2005	1,200,000	60.5p	14 May 2005 – 13 May 2015

The above options were all held as at 31 December 2004 except for those of CA Brown which was granted in the year.

The exercise of an option is subject to be following conditions being satisfied:

- (a) on or after the share price of Common Shares reaching 96p, an option shall be exercisable in respect of one-third of total shares under option;
- (b) on or after the price of the Common Shares reaching 144p, an option shall be exercisable in respect of further third of total shares under option; and
- (c) on or after the price of the Common Shares reaching 192p, an option may be exercisable in respect of 100 per cent. of the shares under option.

There were no share options exercised or waived during the year.

On 5 January 2006, J W Guest was awarded the right to subscribe for a further 2,100,000 Common shares with an exercise price of 66p and an exercise period between 5 January 2006 and 30 December 2015. The options are exercisable in two tranches of 1,050,000. The first vesting date is 31 December 2008 and the second 31 December 2009.

Caroline Brown's exercisable share options reduced to 400,000 on 6 April 2006. Her resignation on that date resulted in the lapse of 800,000 unexercisable options. There have been no other charges in Directors' interests.

The market price of the shares at 31 December 2004 and 31 December 2005 was 54.5p and 70.25p respectively and the range during the period was 45.75p to 94.5p.

Approval

R.W. Parsons

Chairman of the Remuneration and Appointments Committee
13 June 2006

Directors' Responsibilities

for the year ended 31 December 2005

These are the Group's first full year consolidated financial statements under International Financial Reporting Standards.

The Directors prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period. In preparing those financial statements, the Directors have:

- a. selected suitable accounting policies and then applied them consistently;
- b. made judgements and estimates that are reasonable and prudent;
- c. stated whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements;

- d. prepared the financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and the Group and to enable them to ensure that the financial statements comply with the applicable laws and are in accordance with International Financial Reporting Standards. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Legislation in Bermuda governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Independent Auditors' Report

31 December 2005

We have audited the Group financial statements on pages 26 to 47.

This report is made solely to the company's members, as a body. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the accounting policies as set out on page 30. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the Report of the Remuneration and Appointments committee, the Chairman's Statement, the Chief Executive Officer's Statement and the Corporate Governance Statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the Group financial statements give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2005 and of its loss for the year then ended and the financial statements have been properly prepared in accordance with the accounting policies set out on page 30.

Baker Tilly

Registered Auditor
Chartered Accountants
2 Bloomsbury Street
London WC1B 3ST
13 June 2006

Consolidated Income Statement

for the year ended 31 December 2005

	NOTES	2005 \$'000	Restated 2004 \$'000
Continuing Operations			
Revenue		–	–
Impairment provision	9	(35,145)	–
General and administrative expenses		(7,325)	(4,197)
Share option expense	22	(394)	(108)
Loss from operations	3	(42,864)	(4,305)
Investment income	5	2,213	1,928
Loss before tax		(40,651)	(2,377)
Tax expense	6	(135)	–
Loss after tax for the year	17	(40,786)	(2,377)
Loss per share (cents)			
Basic and diluted	7	(16.08)	(1.72)

Consolidated Balance Sheet

as at 31 December 2005

	NOTES	2005 \$'000	Restated 2004 \$'000
Non-current assets			
Property, plant and equipment	8	25,594	83
Intangible assets	9	28,651	41,708
		54,245	41,791
Current assets			
Inventories	11	3,472	2,485
Trade and other receivables	12	3,386	425
Cash and cash equivalents	12	51,439	89,882
		58,297	92,792
Total assets		112,542	134,583
Current liabilities			
Trade and other payables	13	20,291	4,068
Tax liabilities	6	135	–
Provisions	14	2,050	–
Total liabilities		22,476	4,068
Net assets		90,066	130,515
Equity			
Share capital	15	1,638	1,626
Share premium account	15	135,349	135,349
Convertible warrants	16	–	12
Share option charge reserve	16	502	108
Exchange translation reserve	16	(57)	–
Accumulated losses	17	(47,366)	(6,580)
Total equity		90,066	130,515

The financial statements on pages 26 to 47 were approved by the board of Directors and authorised for issue on 13 June 2006 and are signed on its behalf by:



Roger Parsons
Chairman



Todd Kozel
Chief Executive Office

Statement of Changes in Equity

Consolidated Statement of Changes in Equity

for the year ended 31 December 2005

	Attributable to equity holders of the group					Cumulative Translation Reserve	Total Equity
	Share Capital \$'000	Share premium \$'000	Share option reserve \$'000	Convertible warrants \$'000	Accumulated Deficit \$'000	\$'000	\$'000
Balance at 1 January 2004	24,493	–	–	–	(5,578)	–	18,915
- Prior year adjustment re overheads capitalised (see note 26)	–	–	–	–	1,375	–	1,375
- as restated	24,493	–	–	–	(4,203)	–	20,290
Preferred shares private placement	13,072	–	–	–	–	–	13,072
Share conversion and issue	(35,939)	135,349	–	–	–	–	99,410
Warrants subscribed	–	–	–	12	–	–	12
Net loss for the year	–	–	–	–	(2,377)	–	(2,377)
Balance at 1 January 2005	1,626	135,349	–	12	(7,837)	–	129,151
- Prior year adjustment re overheads capitalised (see note 26)	–	–	–	–	1,363	–	1,363
- Prior period adjustment re share option expense	–	–	108	–	(108)	–	–
- as restated	1,626	135,349	108	12	(6,580)	–	130,515
Employee share option expense	–	–	394	–	–	–	394
Exchange differences arising on translation of overseas operations	–	–	–	–	–	(57)	(57)
Exercise of warrants	12	–	–	(12)	–	–	–
Net loss for the year	–	–	–	–	(40,786)	–	(40,786)
Balance at 31 December 2005	1,638	135,349	502	–	(47,366)	(57)	90,066

The exchange rate used in the currency revaluation at year end was British Pound = 1.7361 US Dollar.

Consolidated Cash Flow Statement

for the year ended 31 December 2005

	NOTES	2005 £'000	Restated 2004 £'000
Operating activities			
Cash used in operations	18	(2,132)	(5,852)
Interest received		2,213	1,928
Net cash generated/(used) in operating activities		81	(3,924)
Investing activities			
Purchase of intangible assets		(37,663)	(25,620)
Purchase of property, plant and equipment		(804)	(43)
Net cash used in investing activities		(38,467)	(25,663)
Financing activities			
Proceeds on issue of share capital		–	112,494
Net cash used in financing activities		–	112,494
Net (decrease)/increase in cash and cash equivalents		(38,386)	82,907
Cash and cash equivalents at beginning of year		89,882	6,975
Effect of foreign exchange rate changes		(57)	–
Cash and cash equivalents at end of year			
Bank balances and cash		51,439	89,882

Accounting Policies

for the year ended 31 December 2005

Basis of accounting

The company is incorporated in Bermuda and it is quoted on the Alternative Investment Market of the London Stock Exchange.

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") for the first time. The disclosures required by IFRS 1 concerning the transition from UK GAAP to IFRS are given in note 25.

The financial statements have been prepared under the historical cost accounting rules and on a going concern basis. In common with many exploration companies, the Group raises finance for its exploration and appraisal activities in discrete tranches to finance its activities for limited periods. Further funding is raised as and when required. When any of the Group's projects move to the development stage, specific financing may be required to enable development to take place. The principal accounting policies adopted are set out below.

At the date of authorisation of these financial statements the following Standards and Interpretations which have not been applied in these financial statements were in issue but not yet effective:

IFRS 7	Financial instruments: Disclosures; and the related amendment to IAS 1 on capital disclosures
IFRIC 4	Determining whether an Arrangement contains a Lease
IFRIC 5	Rights to Interest Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 8	Scope of IFRS 2 Share –based Payment
IFRIC 9	Reassessment of Embedded Derivatives

The Directors anticipate that the adoption of these Standards and Interpretations in future periods will have no material impact on the financial statements of the Group when the relevant standards come into effect for periods commencing on or after 1 January 2007.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and enterprises controlled by the Company (its subsidiaries) made up to 31 December each year. The Group uses the purchase method of accounting for the acquisition of subsidiaries.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate. Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by other members of the Group.

All intra-Group transactions, balances, and unrealised gains on transactions between Group companies are eliminated on consolidation. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

Leasing

Rentals payable under operating leases are charged to income on a straight-line basis over the term of the relevant lease.

Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight line basis over the shorter of the period to the next rent review date and the lease term.

Foreign currencies

Transactions in currencies other than US Dollars are recorded at the rates of exchange prevailing on the dates of the transactions. At each balance sheet date, monetary assets and liabilities that are denominated in foreign currencies are retranslated at the rates prevailing on the balance sheet date. Non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Gains and losses arising on retranslation are included in the income statement for the period.

On consolidation, the assets and liabilities of the Group's overseas operations are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for each month in the period. Exchange differences arising, if any, are classified as equity and transferred to the Group's translation reserve. Such translation differences are recognised as income or as expenses in the period in which the operation is disposed of.

The functional and presentation currency of the company is dollars as the majority of the Group's transactions are transacted in this currency.

Taxation

Under current Bermuda laws, the Group is not required to pay taxes in Bermuda on either income or capital gains. The Group has received an undertaking from the Minister of Finance in Bermuda exempting it from any such taxes at least until the year 2016.

Algeria currently imposes no taxes on corporate income or capital gains

The tax currently payable is based on taxable profit for the year earned in the United Kingdom by the Group's subsidiary. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated by using tax rates that have been enacted or substantively enacted by the balance sheet date.

There is no deferred tax provided as there are no material timing differences which give rise to such a balance.

Property, plant and equipment other than oil and gas interests

Property, plant and equipment are stated at historical cost. Depreciation is provided at rates calculated to write each asset down to its estimated residual value evenly over its expected useful life as follows:-

Fixtures and equipment – 20% straight line

Intangible assets other than oil and gas

Intangible assets, other than oil and gas assets, have finite useful lives and are measured at cost and amortised over their expected useful economic lives as follows:-

Computer software – 33% straight line

Intangible and tangible non current assets – oil and gas interests

The Group adopts the full cost method of accounting for its oil and gas interests. Under the full cost method of accounting all costs relating to the exploration for and development of oil and gas interests, whether productive or not, are accumulated and capitalised as non-current assets. These costs, which are initially classified as intangible non-current assets during the exploration and evaluation phase, are only carried forward to the extent that they are expected to be recouped through the successful development of an area or where activities in an area have not yet reached a stage which permits reasonable assessment of the existence of economically recoverable reserves.

Costs dealt with in this way include seismic data, licence acquisition costs, technical work, exploration and appraisal drilling, general technical support and directly attributable administrative and overhead costs. In 2003 and 2004 not all of the directly attributable administrative and overhead costs were capitalised in line with the Group's policy. In order to rectify this, these costs have been capitalised and the opening balances restated. These adjustments are set out in note 26.

Costs are transferred to depreciable pools within property, plant and equipment upon declaration of commerciality or upon cessation of exploration on each license and amortised over the life of the area according to the rate of depletion of the economically recoverable costs. Any proceeds arising from the sale or farm-out of assets are deducted from the relevant cost pool.

Depreciation and depletion of costs in depreciable pools is provided under the unit of production method which uses the estimated commercial reserves in the cost pool and the sum of the total costs in the pool and any further anticipated costs to develop such reserves.

Impairment of tangible and intangible non-current assets

At each balance sheet date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs. An intangible asset with an indefinite useful life is tested for impairment annually and whenever there is an indication that the asset may be impaired.

Recoverable amount is the higher of fair value less costs to sell and value in use. 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 for which the estimates of future cash flows have been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

Inventories

Inventories relates to materials acquired for use in exploration activities. These are valued at the lower of cost and net realisable value.

Warrants

Proceeds in respect of convertible warrants subscribed are shown as a reserve and upon issue of the shares, the proceeds are transferred to share capital.

Accounting Policies

for the year ended 31 December 2005

Financial instruments

The Group's financial instruments comprise cash together with various items such as other receivables and trade payables etc, which arise directly from its operations. The main purpose of these financial instruments is to provide working capital

Financial assets and financial liabilities are recognised on the Group's balance sheet when the Group has become a party to the contractual provisions of the instrument.

Trade receivables

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities.

Bank borrowings

Interest-bearing bank loans and overdrafts are recorded at the proceeds received, net of direct issue costs. Finance charges, including premiums payable on settlement or redemption, are accounted for on an accrual basis and are added to the carrying amount of the instrument to the extent that they are not settled in the period in which they arise.

Trade payables

Trade payables are not interest bearing and are stated at their nominal value.

Equity instruments

Equity instruments issued by the company are recorded at the proceeds received, net of direct issue costs.

Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event which it is probable will result in an outflow of economic benefits that can be reliably estimated.

Decommissioning provision

The decommissioning provision represents management's best estimate of the Group's discounted liability when restoring the sites of drilled wells to their original status.

Share-based payments

The Group has applied the requirements of IFRS 2 to share option schemes allowing certain employees within the Group to acquire shares of the company. For all grants of share options, the fair value as at the date of grant is calculated using an appropriate option pricing model and the corresponding expense is recognised over the expected life of the option.

Critical accounting estimates and judgements

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Critical accounting estimates and assumptions

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates and assumptions will, by definition, seldom equal related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Abandonment

The Group has estimated that abandonment costs for wells will be \$410,000 per well. It has provided for this amount for GKS-3, RDL-1, GRJ-1, GRJ-2 and GKS-3. The carrying amount in the balance sheet as at 31 December 2005 is \$2,050,000.

Impairment Review of GKN and GKS

The Group employed a modelling specialist, PWX LTD, to calculate the net present value of GKN and GKS based on, and with sensitivities around, a gross production profile of 4 mbpd, an oil price of \$60bbl and a discount rate of 10%. The positive net present value from this model exceeded the carrying value as at 31 December 2005 of \$24.8 million which was, therefore, transferred from intangible to tangible assets.

Notes to the Financial Statements

for the year ended 31 December 2005

1 Presentation of financial statements

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") for the first time. The disclosures required by IFRS 1 concerning the transition from UK GAAP to IFRS are given in note 25.

These financial statements are presented in US Dollars since that is the currency in which the majority of the Group's transactions are denominated.

2 Business and geographical segments

For management purposes, the Group is currently organised into two legal entities– Gulf Keystone Petroleum Limited and its subsidiary Gulf Keystone Petroleum (UK) Limited.

Principal activities of Gulf Keystone Petroleum Limited are as follows:

The exploration and production of Oil and Gas principally in Algeria.

Principal activities of Gulf Keystone Petroleum (UK) Limited are as follows:

To provide geologic, geophysical and engineering services to its parent company.

Given that all the services provided by Gulf Keystone Petroleum (UK) Limited were for the parent company Gulf Keystone Petroleum Limited they are not shown as separate geographical segments.

3 Loss from operations

Loss from operations has been arrived at after charging:

	2005 \$'000	2004 \$'000
Depreciation of property, plant and equipment		
- owned assets	142	12
Amortisation of intangible assets	27	–
Impairment of intangible assets	35,145	–
Staff costs (see note 4)	3,347	1,425
Auditors' remuneration for audit services (see below)	123	50
Operating lease rentals	532	222
Exchange difference	33	–

Amounts payable to Baker Tilly in respect of both audit and non-audit services

	\$'000	2005 %	\$'000	2004 %
Audit services				
- Annual Audit	114	71	50	100
- Annual Audit UK subsidiary	9	6	–	–
	123	77	50	100
Other assurance services				
- Interims 2005	23	14	–	–
Tax services				
- compliance services	5	3	–	–
Other services				
- IFRS advice	8	5	–	–
- VAT advice	2	1	–	–
	161	100	50	100

Notes to the Financial Statements

for the year ended 31 December 2005

4 Staff costs

The average monthly number of employees (including executive Directors) for the year was as follows:

	2005 Number	2004 Number
Office and Management	8	3
Exploration Staff	27	25
	35	28

Their aggregate remuneration comprised:

	2005 \$'000	2004 \$'000
Wages and salaries	2,592	1,274
Social security costs	361	43
Share option charge	394	108
	3,347	1,425

5 Investment income

	2005 \$'000	2004 \$'000
Interest on bank deposits	2,213	1,928

6 Tax expense

	2005 \$'000	2004 \$'000
Provision for UK corporation tax	135	–
Tax attributable to the Company and its subsidiaries	135	–

Bermuda and Algeria currently imposes no taxes on corporate income or capital gains. UK corporation tax is calculated at 30% of the estimated assessable profit for the year of the UK subsidiary.

Under current Bermuda laws, the Group is not required to pay taxes in Bermuda on either income or capital gains. The Group has received an undertaking from the Minister of Finance in Bermuda exempting it from any such taxes at least until the year 2016

The charge for the year can be reconciled to the loss per the income statement as follows:

	2005 \$'000	2004 \$'000
Loss before tax	(40,651)	(2,377)
Tax at the domestic tax rate 30% (2004: 0%)	–	–
Profits of the UK subsidiary assessable to UK tax	(135)	–
Tax expense and effective tax rate for the year	(135)	–

7 Loss per share

The calculation of the basic and diluted earnings per share is based on the following data:

Earnings	2005 \$'000	2004 \$'000
Loss for the purposes of basic and diluted loss per share	(40,786)	(2,377)
Number of shares		
Weighted average number of ordinary shares for the purposes of basic and diluted loss per share	253,677,757	138,101,276

There is no dilutive effect from the options or warrants issued by the company.

8 Property, plant and equipment

	Oil & Gas Properties \$'000	Restated Fixtures & Equipment \$'000	Restated Total \$'000
At 1 January 2004			
Cost	–	73	73
- Prior year adjustment re overheads capitalised (see note 26)	–	3	3
- As restated	–	76	76
Accumulated depreciation	–	(24)	(24)
Net book value	–	52	52
Year ended 31 December 2004			
Opening net book value	–	52	52
Additions	–	43	43
Depreciation charge	–	(12)	(12)
Closing net book value	–	83	83
At 31 December 2004			
Cost	–	119	119
Accumulated depreciation	–	(36)	(36)
Net book value	–	83	83
Year ended 31 December 2005			
Opening net book value	–	83	83
Additions	–	804	804
Transfer from intangible assets	24,849	–	24,849
Depreciation charge	–	(142)	(142)
Closing net book value	24,849	745	25,594
At 31 December 2005			
Cost	24,849	923	25,772
Accumulated depreciation	–	(178)	(178)
Net book value	24,849	745	25,594

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for the year ended 31 December 2005

9 Intangible assets

	Restated Exploration & evaluation costs \$'000	Computer software \$'000	Restated Total \$'000
At 1 January 2004			
Cost and net book value	22,393	–	22,393
- Prior year adjustment re overheads capitalised (see note 26)	1,375	–	1,375
- As restated	23,768	–	23,768
Year ended 31 December 2004			
Opening net book value	23,768	–	23,768
Additions	17,940	–	17,940
Closing net book value	41,708	–	41,708
At 31 December 2004			
Cost and net book value	41,708	–	41,708
Year ended 31 December 2005			
Opening net book value	41,708	–	41,708
Additions	46,808	156	46,964
Transferred to tangible assets	(24,849)	–	(24,849)
Impairment write off	(35,145)	–	(35,145)
Amortisation charge	–	(27)	(27)
Closing net book value	28,522	129	28,651
At 31 December 2005			
Cost	63,667	156	63,823
Accumulated amortisation	(35,145)	(27)	(35,172)
Net book value	28,522	129	28,651

\$24.8 million was transferred from oil & gas exploration and evaluation costs to oil & gas properties within property, plant and equipment during the year. This transfer was triggered by the SONATRACH and Gulf Keystone Petroleum Limited joint venture management committee i) declaring commerciality of the GKN field and sending a recommendation via SONATRACH to the Ministry of Energy and Mining in Algeria endorsing a production license; ii) the anticipated declaration of commerciality of GKS and subsequent recommendation via SONATRACH to the Ministry of Energy and Mining in Algeria for the award of an early production license.

This transfer, together with the expiry of the exploration license from Block 126a and the Groups decision only to focus on GKN, GKS and GRJ fields within Block 126a has triggered an impairment test under IFRS 6 and IAS 36 for Block 126a's Group of cash generating units. \$35.1million has been written off intangible fixed assets as a result of this impairment test in relation to the exploration activities on OGZ, RDL and RTBW.

The amortisation charge of \$27,000 has been included in general and administrative expenses.

10 Subsidiary

Details of the Company's subsidiary at 31 December 2005 is as follows:

Name of subsidiary	Place of incorporation	Proportion of ownership interest %	Proportion of voting power held %	Principal activity
Gulf Keystone Petroleum (UK) Limited	UK	100	100	Geological, geophysical and engineering services

On 17 November 2004 the company incorporated a new subsidiary, Gulf Keystone Petroleum (UK) Limited, a UK company with £2 share capital.

11 Inventories

	2005 \$'000	2004 \$'000
Exploration materials	3,472	2,485

12 Financial assets

Trade and other receivables comprise amounts prepaid for inventories \$1,921,000 (2004: \$nil) that will be delivered during the first half of 2006. Other prepayments include insurance, the deposit for the UK office and prepaid rent for the Algerian offices \$1,359,000 (2004: \$279,000) and others of \$106,000 (2004: \$146,000).

The deposit for the UK office of \$458,000 is receivable after more than one year.

The Directors consider that the carrying amount of trade and other receivables approximates to their fair value.

Bank balances and cash comprise cash and short-term deposits held by the Group. The carrying amount of these assets approximates to their fair value.

13 Trade and other payables

With the exception of the amount due to the joint venture partner, trade and other payables principally comprise amounts outstanding for trade purchases and ongoing costs.

The Directors consider that the carrying amount of trade payables approximates to their fair value.

	2005 \$'000	2004 \$'000
Due within one year:		
Trade payables	630	705
Amounts due to production sharing partner (see note 19)	11,800	2,500
Other creditors (see note 23)	336	–
Accrued expenses	7,525	863
	20,291	4,068

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14 Provisions

	Decommissioning provision \$'000
At 1 January 2005	–
Provision in year	2,050
At 31 December 2005	2,050

The expense is expected to be incurred within the next 2 years.

15 Share capital

	2005 \$'000	2004 \$'000
Authorised:		
500,000,000 Common shares of \$0.01 each	5,000	5,000
50,000,000 Non – voting shares \$0.01 each	500	500
60,000 Series A Preferred share of \$1,000 each	60,000	60,000
	65,500	65,500
Issued and fully paid:		
	Shares No	Common shares Amount \$000
Balance 1 January 2004	90,000,000	–
Private placement	–	–
Conversion of preferred shares	37,564,500	37,565
AIM placing	125,000,000	107,880
Issue costs	–	(8,470)
Balance 31 December 2004	252,564,500	136,975
Warrant exercise	1,167,640	12
Balance 31 December 2005	253,732,140	136,987
	Shares No	Preferred shares Amount \$000
Balance 1 January 2004	24,493	24,493
Private placement	13,072	13,072
Conversion of preferred shares	(37,565)	(37,565)
AIM placing	–	–
Issue costs	–	–
Balance 31 December 2004	–	–
Warrant exercise	–	–
Balance 31 December 2005	–	–
	Share Capital \$000	Share Premium \$000
Balance 1 January 2004	24,493	–
Private placement	13,072	–
Conversion of preferred shares	(37,189)	37,189
AIM placing	1,250	106,630
Issue costs	–	(8,470)
Balance 31 December 2004	1,626	135,349
Warrant exercise	12	–
Balance 31 December 2005	1,638	135,349

90,000,000 Common Shares of \$0.01 had prior to 1 January 2004 been issued as fully paid with no par value.

On 26 May 2004 the authorised share capital of the Company was subdivided. Each of the common shares of US\$1.00 were subdivided into 100 Common Shares of US\$0.01 each and each of the non-voting shares of US\$1.00 were sub-divided into 100 Non-Voting Shares of US\$0.01 each.

On 26 May 2004 the authorised share capital of the Company was increased from US\$62,500,000 to US\$65,500,000 by the creation of 300,000,000 additional Common Shares of US\$0.01 each.

Between 17 May 2002 and 8 June 2004, 37,564.5 Series A Convertible Preferred Shares were issued to subscribers at a price of US\$1,000 per Preferred Share. Included within the above were 9,542 and 14,951 Series A Preferred Shares that were subscribed for in the period ended 31 December 2002 and the year ended 31 December 2003, respectively.

On 8 September 2004, 37,564.5 Series A Convertible Preferred Shares of \$1,000 each were converted into 37,564,500 Common Shares of \$0.01 each.

On 8 September 2004, 125,000,000 Common shares of \$0.01 each were placed at 48p per Common Share on admission to trading on AIM raising \$107,880,000.

Under warrant instruments dated 31 August 2004, warrants were granted in connection with the AIM flotation entitling the holders to subscribe for 1,167,640 Common Shares at a subscription price of US\$ 0.01 per Common share. The warrants were exercised in full on 18 February 2005

Rights attached to share capital

The holders of the Common Shares and the Series A Preferred Shares had the following rights:

(a) Common Shares

The holders of the Common Shares (subject to the other provisions of the Bye-laws) are:

- (i) Entitled to one vote per share;
- (ii) Entitled to receive notice of, and attend and vote at, general meetings of the Company;
- (iii) Entitled to dividends or other distributions; and
- (iv) In the event of a winding-up or dissolution of the Company, whether voluntary or involuntary or for a reorganisation or otherwise or upon a distribution of capital, entitled to receive the amount of capital paid up on their Common Shares and to participate further in the surplus assets of the Company only after payment of the Series A Liquidation Value (as defined in the Bye-laws) on the Series A Preferred Shares.

(b) Series A Preferred Shares

The holders of Series A Preferred Shares had the following rights:

- (i) They are not entitled to receive any dividends or other distributions of the Company;
- (ii) If the Company is liquidated, dissolved or wound up (a "Liquidating Event"), after all creditors of the Company have been paid in full, the holders of the Series A Preferred Shares shall be entitled to receive, out of the assets of the Company legally available for distribution to its Shareholders before any amount is paid to the holders of any shares ranking below the Series A Preferred Shares, an aggregate amount equal to US\$1,000 in cash per share;
- (iii) Each outstanding Series A Preferred Share shall automatically convert into a number of fully paid and non-convertible Common Shares, with full voting rights, by reference to a formula (which will equate to 1,000 Common Shares per Series A Preferred Share converted) immediately prior to a Listing (as defined in the company's articles);
- (iv) Any Series A Preferred Shares converted pursuant to the Bye-laws shall be cancelled and shall not be re-issuable again as such by the Company. Further, following automatic conversion of the Series A Preferred Shares, the Company will not issue any further Series A Preferred Shares.
- (v) The terms of the Series A Preferred Shares may be amended with the consent of the holders of a majority of the Series A Preferred Shares outstanding.

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for the year ended 31 December 2005

16 Other reserves

	Share option reserve \$'000	Share Exchange reserve \$000	Convertible warrants \$000
Balance at 1 January 2004			
Share conversion and issue	–	–	–
Warrant proceeds received	–	–	12
Employee share option charge	108	–	–
Balance at 31 December 2004	108	–	12
Currency Exchange difference	–	(57)	–
Employee share options charge	394	–	–
Exercise of warrants	–	–	(12)
Balance at 31 December 2005	502	(57)	–

17 Accumulated loss

	\$'000
Balance at 1 January 2004	(5,578)
- prior year adjustment re overheads capitalised (see note 26)	1,375
- as restated	(4,203)
Net loss for the year	(2,377)
Balance at 1 January 2005	(7,836)
- prior year adjustment re overheads capitalised (see note 26)	1,363
- Prior period adjustment re share option expense	(108)
- as restated	(6,580)
Net loss for the year	(40,786)
Balance at 31 December 2005	(47,366)

18 Reconciliation of loss from operations to net cash used in operating activities

	2005 \$'000	Restated 2004 \$'000
Loss from operations	(42,864)	(4,305)
Adjustments for:		
Depreciation of property, plant & equipment	142	12
Amortisation of intangibles	27	–
Impairment of intangibles	35,145	–
Share based payment expense	394	108
Increase in inventories	(987)	(1,616)
Increase in provision	2,050	–
Increase in receivables	(2,961)	(361)
Increase in payables	6,922	310
Cash used in operations	(2,132)	(5,852)

19 Contingent assets and liabilities

Block 126a ("126a Contract")

Under the 126a Contract for the Exploration, Evaluation and Exploitation of Hydrocarbons with SONATRACH concerning the Ferkane Perimeter (Block 126), the company agreed to acquire 600 kilometres of seismic data and drill two exploration wells. This exploration and evaluation phase of the 126a Contract consisted of a three year period and the agreed work programme was completed by 2004. An option to extend for two more years was granted on 29 April 2004; this required the Group to acquire an additional 600 kilometres of seismic data and drill one exploration well, both of which were completed in 2005.

In accordance with Article 7.5 of the 126a Contract, 50 kilometres of 2D seismic were performed by SONATRACH during 2000 and were acquired by the Group. The compensation for the data acquired was US\$2.5 million. The US\$2.5 million will come as a deduction from SONATRACH's share of reimbursable petroleum cost in the event a discovered deposit is declared commercially exploitable. However, if no commercially exploitable deposits are discovered, the Group does not owe SONATRACH for the data acquired. As of 31 December 2005 and 2004, the Group had recorded a US\$2.5 million seismic data asset and reflected a liability of US\$2.5 million to SONATRACH representing the amount reimbursable from SONATRACH's share of petroleum cost upon commercial declaration. The Group also paid US\$230,000 to SONATRACH to acquire all of SONATRACH's pre-existing data on Block 126.

Additionally, in accordance with Article 15 of the 126a Contract, the rate of participation of the investors in the financing of the investment costs for exploration, evaluation, development, exploitation and operating costs is set at 40 per cent for SONATRACH and 60 per cent for Gulf Keystone. However, in the absence of the discovery of a commercial exploitable deposit, the Group may not claim any reimbursement or compensation. As at 31 December 2005, potentially reimbursable petroleum costs, in the event that commercial exploitable deposits are discovered, total US \$77.1 million of which 40% is recoverable from SONATRACH.

Block 129 ("129 Contract")

Under the 129 Contract for the Exploration, Evaluation and Exploitation of Hydrocarbons with SONATRACH concerning the Bottena Perimeter (Block 129), the Group agreed to acquire 879 kilometres of seismic data and drill one exploration well. The exploration and evaluation phase of the 129 Contract consists of a three year period, with an option to extend for two more years upon SONATRACH's request. If extended, the Group will acquire an additional 250 kilometres of seismic data and drill one exploration well. The investment commitment of performing the minimum work program is US\$13.4 million for the first period and US\$7.3 million for the second. During the year the Group performed some preliminary geological and geophysical analysis. At 31 December 2005 an investment of US\$0.8 million has been expended.

In accordance with Article 7.7 of the 129 Contract, 379 and 500 kilometres of 2D and 3D seismic respectively were performed by SONATRACH during 2005 and were acquired by the Group. The compensation for the data acquired was US\$7.4 million. The US\$7.4 million will come as a deduction from SONATRACH's share of reimbursable petroleum cost in the event a discovered deposit is declared commercially exploitable. However, if no commercially exploitable deposits are discovered, the Group does not owe SONATRACH for the data acquired. As of 31 December 2005, the Group had recorded a US\$ 7.4 million seismic data asset and reflected a liability of US\$ 7.4 million to SONATRACH representing the amount reimbursable from SONATRACH's share of petroleum cost upon commercial declaration.

Additionally, in accordance with Article 14 of the 129 Contract, the rate of participation of the investors in the financing of the investment costs for exploration, evaluation, development, exploitation and operating costs is set at 25 per cent for SONATRACH and 75 per cent for Gulf Keystone. However, in the absence of the discovery of a commercially exploitable deposit, the Group may not claim any reimbursement or compensation. As at 31 December 2005, potentially reimbursable petroleum costs, in the event that commercial exploitable deposits are discovered, total US \$788,951 of which 25% is recoverable from SONATRACH.

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Perimeter HBH ("HBH Contract")

Under the HBH Contract for the Exploration, Evaluation and Exploitation of Hydrocarbons with SONATRACH concerning the Hassi Ba Hamou Perimeter (Blocks 317b, 322b3, 347b, 348 and 349b), the Group agreed to acquire 500 kilometres of seismic data and drill two exploration wells. The exploration and evaluation phase of the HBH Contract consists of a three year period, with an option to extend for two more years upon SONATRACH's request. If extended, the Group will acquire an additional 200 kilometres of seismic data and drill one exploration well. The investment commitment of performing the minimum work program is US\$ 13.1 million for the first period and US\$ 6 million for the second. During the year the Group performed some preliminary geological and geophysical analysis. At 31 December 2005 an investment of US\$0.1 million has been expended.

Additionally, in accordance with Article 14 of the HBH Contract, the rate of participation of the investors in the financing of the investment costs for exploration, evaluation, development, exploitation and operating costs is set at 25 per cent for SONATRACH and 75 per cent for Gulf Keystone. However, in the absence of the discovery of a commercially exploitable deposit, the Group may not claim any reimbursement or compensation. As at 31 December 2005, potentially reimbursable petroleum costs, in the event that commercial exploitable deposits are discovered, total US \$108,755 of which 25% is recoverable from SONATRACH.

Blocks 108/128b ("108/128b Contract")

Under the 108/128b Contract for the Exploration, Evaluation and Exploitation of Hydrocarbons with SONATRACH concerning the Ben Guecha Perimeter (Blocks 108/128b), the Group agreed to acquire 660 kilometres of seismic data and drill one appraisal well and one exploration well. The exploration and evaluation phase of the 108/128b Contract consists of a three year period, with an option to extend for two more years upon SONATRACH's request. If extended, the Group will acquire an additional 450 kilometres of seismic data and drill one exploration well. The investment commitment of performing the minimum work program is US\$15.6 million for the first period and US\$7.5 million for the second. The contract for Ben Guecha is not yet gazetted and is waiting gazetting by the state authorities in Algeria. However as part of the gazetting process the Group has paid SONATRACH US\$1 million for 200km of 2D seismic performed by SONATRACH in 2005. During the year the Group performed some preliminary geological and geophysical analysis. At 31 December 2005 an expense of US\$1.14 million has been expended.

In accordance with Article 7.5 of the 108/128b Contract, 387.36 kilometres of 2D seismic surveys were performed by SONATRACH during 2002 which has been acquired by the Group at a cost of \$1.9 million. The US\$1.9 million will come as a deduction from SONATRACH's share of reimbursable petroleum cost in the event a discovered deposit is declared commercially exploitable. However, if no commercially exploitable deposits are discovered, the Group will not owe SONATRACH for the data acquired. As of 31 December 2005, the Group had recorded a US\$ 1.9 million seismic data asset and reflected a liability of US\$ 1.9 million to SONATRACH representing the amount reimbursable from SONATRACH's share of petroleum cost upon commercial declaration.

Additionally, in accordance with Article 14 of the 108/128b Contract, the rate of participation of the investors in the financing of the investment costs for exploration, evaluation, development, exploitation and operating costs is set at 25 per cent for SONATRACH and 75 per cent for Gulf Keystone. However, in the absence of the discovery of a commercially exploitable deposit, the Group may not claim any reimbursement or compensation.

20 Bank guarantees

As part of the contractual terms of the Algerian contracts, the Group has given bank guarantees to SONATRACH of \$34.7 million. These are cash backed guarantees which effectively reduce the free cash available that the Group has on its balance sheet. That is \$6 million for the Bottena ("129 Contract") work programme, \$15.6 million for the Ben Guecha ("108/128b Contract") work programme and \$13.1 million for the Hassi Be Hamou (Blocks 317b, 322b3, 347b, 348 and 349b) work programme. These guarantees are against the exploration and evaluation programmes stipulated in the contracts and are reduced as the work programmes are completed.

21 Operating lease arrangements

The Group as a lessee:	2005 \$'000	2004 \$'000
Minimum lease payments under operating leases recognised as expense for the period	532	222

At the balance sheet date, the Group had outstanding total commitments under non-cancellable operating leases, which fall due as follows:

	2005 \$'000	2004 \$'000
Within one year	590	7,357
In the second to fifth years inclusive	1,147	124
	1,737	7,481

Operating lease payments represent rentals payable by the Group for certain of its office properties in the UK and Algeria and residential properties in Algeria. The UK lease is for ten years with a break clause at year 5. The Algerian properties are leased for two years or less.

22 Share based payments

Equity settled share option plan

The Group plan provides for a grant price equal to the closing market price of the Group shares on the date of grant. The vesting period is generally 10 years. If options remain unexercised after a period of 10 years from the date of grant, the options expire. Furthermore, options are forfeited if the employee leaves the Group before the options vest.

The weighted average contractual life relating to the share options outstanding at the year end was 9 years.

	2005 Options	Weighted average exercise price	2004 Options	Weighted average exercise price
Outstanding at 1 January	5,700,000	48p	—	—
Granted during the year	1,891,500	69.5p	5,700,000	48p
Forfeited during the year	(600,000)	48p	—	—
Outstanding at 31 December	6,991,500	53.8p	5,700,000	48p
Exercisable at 31 December	2,263,833	52.9p	—	—

The inputs into the stochastic (Monte-Carlo) valuation model are as follows:

	2005	2004
Weighted average share price	69.5p	48p
Weighted average exercise price	69.5p	48p

Expected volatility was determined by using the average of a peer Group of similar oil and gas companies over a seven year period. This was thought more instructive than the limited nature of the company's history. The expected volatility was calculated as 46%/45.8% at the interims for the September 2004 and May 2005 grants and 43.5%/43.1% for the September 2005 and October 2005 grants respectively.

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The expected term at the September 2004 and May 2005 grants respectively was seven to nine years and is calculated as five to nine years for the September 2005 and October 2005 grants respectively.

The risk free rate was 4.94% and 4.48% for the September 2004 and May 2005 grants respectively and 4.2% and 4.3% for the September 2005 and October 2005 grants respectively.

The Company has made no dividend payments to date and as there is no expectation of making payments in the immediate future, this variable has been set at zero for all grants.

The exercise prices for the September 2004 and May 2005 grants were 48 pence and 60.5 pence respectively. The exercise prices for the September 2005 and October 2005 grants were 85 pence and 86.5 pence respectively.

Share options outstanding at the end of the year have the following expiry date and exercise prices:

Expiry date	Exercise price (pence)	Options (in thousands)	
		2005	2004
19 August 2014	48.0	5,100	5,700
13 May 2015	60.5	1,200	–
29 September 2015	85.0	591.5	–
11 October 2015	86.5	100	–

23 Related party transactions

Transactions between the company and its subsidiaries and associates are disclosed below

During the year the parent company entered into the following transactions with its subsidiary:

	2005 \$000
Purchases of services in year	2,636
Amount owed by related parties at year end	510

Purchase of geologic, geophysical and engineering services provided by Gulf Keystone Petroleum (UK) Limited.

During the year, Group companies entered into the following transactions with related parties which are not members of the Group

	Texas Keystone Inc.	
	2005 \$000	2004 \$000
Purchase of services in year	942	1,874
Amounts owed to related parties at the year end	336	–

Texas Keystone Inc is a related party of the Group because Mr Todd Kozel, a Director of the company, is also a Director of Texas Keystone, Inc. ("TKI"). The company entered into an agreement with TKI in which the Group pays a fee to TKI for professional management and administrative services. The fee for administrative services is equal to TKI's actual cost of providing the administrative services plus 10 per cent; the fee for professional services is equal to the then hourly rates charged by TKI to third parties for such services and the reimbursement of reasonable out-of-pocket expenses. The amounts outstanding are unsecured and will be settled in cash. No guarantees have been given or received. No provisions have been made for doubtful debts in respect of the amounts owed by related parties.

Remuneration of key management personnel

The remuneration of the Directors, and other key management personnel of the Group, is set out below in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. Further information about the remuneration of individual Directors is provided in the Report of the Remuneration and Appointment Committee on pages 23 to 24.

	2005 \$'000	2004 \$'000
Short-term employee benefits	1,718	1,131
Share based payment	366	95
	2,084	1226

24 Financial instruments

The main risks arising from the Group's financial instruments are interest rate risks, exchange rate risk and liquidity risk. The policies for managing these risks are regularly reviewed and agreed by the Board.

It is, and has been throughout the period under review, the Group's policy that no trading in financial instruments should be undertaken.

Foreign exchange risk

The operating currencies of the Group are Sterling, Algerian Dinars and US Dollars. The Group does not hedge against the effects of movement in exchange rates. The risks are monitored by the Board on a regular basis.

Interest rate risk

The Group's policy on interest rate management is agreed at Board level and is reviewed on an ongoing basis.

Interest rate profile of financial assets

The interest rate risk profile of the Group's financial assets, except for trade and other receivables, as at 31 December 2005 was:

	Fixed Rate \$'000	Floating Rate \$'000	Non-Interest Bearing Rate \$'000	Total \$'000
US dollars	—	50,429	—	50,429
GBP	95	61	—	156
Algerian Dinars	—	—	854	854
	95	50,490	854	51,439
Of which:				
Cash at bank and in hand	95	50,490	854	51,439

31 December 2004

	Floating Rate \$'000	Non-Interest bearing Rate \$'000	Total \$'000
US dollars	89,408	—	89,408
Algerian Dinars	—	474	474
	89,408	474	89,882
Of which:			
Cash at bank and in hand	89,408	474	89,882

Floating rate instant access deposits in US Dollar and Sterling accounts earn interest at prevailing bank rates. Funds held in Algeria are non interest bearing. Funds in Sterling held in the UK are on a fixed rate of 2% gross.

Liquidity risk

It is the Group's policy to finance its business by means of internally generated funds and external share capital.

Facility

The Group does not currently have an overdraft facility.

Fair value

There is no material difference between the fair value of financial assets and their book value at the balance sheet date.

Notes to the Financial Statements

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25 Explanation of transition to IFRS

As required by IFRS 1, the impact of the transition from UK GAAP to IFRS is explained below.

The accounting policies set out above have been applied consistently to all periods presented in this financial information and in preparing an opening IFRS balance sheet at 1 January 2004 for the purposes of the transition to IFRS.

IAS 1 – Presentation of Financial Statements

The form and presentation of the UK GAAP financial statements has been changed to be in compliance with IAS 1.

IFRS 2 – Share Based Payments

Under IFRS 2, share awards are measured at fair value at grant date and recognised as an expense to the income statement over the expected term.

The fair value of the incentives granted is measured using a stochastic model. The impact of this standard on the financial statements of the Group is a \$108,000 charge to the year ended 31 December 2004 income statement and an equivalent increase in share option reserve.

IAS 7 – Cash Flow Statements

The IFRS Cash Flow Statement, prepared under IAS 7, presents cash flows in three categories; cash flows from operating activities, cash flows from investing activities and cash flows from financing activities. Other than the reclassification of cash flow into the new disclosure categories, there are no significant differences between the Group's Cash Flow Statement under UK GAAP and IFRS. Consequently, no cash flow reconciliations are provided. Purchases of tangible fixed assets under UK GAAP have been reclassified to purchases of intangible assets and purchases of property, plant and equipment under IFRS.

Details of the adjustments to the Group's financial performance for the year ended 31 December 2004 are set out in the following tables:

	Restated UK GAAP \$'000	IFRS 2 Share based payment \$'000	Restated under IFRS \$'000
Administrative expenses	(4,197)	–	(4,197)
Share option expense	–	(108)	(108)
Loss from operations	(4,197)	(108)	(4,305)
Investment income	1,928	–	1,928
Loss before tax	(2,269)	(108)	(2,377)
Tax expense	–	–	–
Loss after tax for the year	(2,269)	(108)	(2,377)
Basic and diluted loss per share	1.6c		1.7c

	Restated UK GAAP \$'000	IFRS 2 Share based payment \$'000	Restated under IFRS \$'000
Non-current assets			
Property, plant and equipment	83	–	83
Intangible assets	41,708	–	41,708
	41,791	–	41,791
Current assets			
Inventories	2,485	–	2,485
Trade and other receivables	425	–	425
Cash and cash equivalents	89,882	–	89,882
	92,792	–	92,792
Total assets	134,583	–	134,583
Current liabilities			
Trade and other payables	4,068	–	4,068
Total liabilities	4,068	–	4,068
Net assets	130,515	–	130,515
Equity			
Share capital	1,626	–	1,626
Share premium	135,349	–	135,349
Other reserves	12	–	12
Share options charge reserve	–	108	108
Accumulated losses	(6,472)	(108)	(6,580)
Total equity	130,515	–	130,515

The transition to IFRS has had no effect on cash flow.

The UK GAAP figures have been restated for the prior year adjustment per note 26.

26 Explanation of retrospective changes under IAS 8

In 2003 and 2004 not all attributable administrative and overhead costs were capitalised according to the Group's policy. The 2004 financial statements have been restated to correct this. The effect of the restatement on those financial statements is summarised below.

Effect on 2004	\$'000
Increase in intangibles	1,360
Increase in tangibles	3
Decrease in general and administration expense	1,363
Decrease in loss before tax	1,363
Decrease in loss per share	0.98
Effect on period prior to 2004	\$'000
Increase in intangibles	1,375
Decrease in general and administration expense	1,375
Decrease in loss before tax	1,375
Decrease in loss per share	1.53

27 Post balance sheet event

On 9 June 2006 the Group signed loan agreements with GIBCA Limited and Falcon Partners Trust, both related parties, to provide an unsecured debt facility in aggregate of \$5 million at an interest rate of 7% and for a term of 12 months.

Notice

To the holders of common shares

Notice is hereby given that the second annual general meeting of the Company will be held at Gulf Keystone Petroleum offices, Villa 42B Cite Des PTT, Hydra, Algiers, Algeria on Saturday 15 July 2006 at 11.00 am for the following purposes:

To consider, and if thought fit, approve the following resolutions:

1. That the report of the Directors and the annual financial statements for the year ended 31 December 2005 be and hereby are adopted;
2. That Jonathan Cooper, who has been appointed to the board since the last annual general meeting, be elected as Director;
3. Mr J W Guest who retires by rotation in accordance with the company's bye-laws, be and is re-appointed as a Director
4. That Baker Tilly is re-appointed as auditors and the Directors be authorised to fix their remuneration.

By Order of the Board

Secretary Louisa Barbosa
Canon's Court,
22 Victoria Street,
Hamilton,
Bermuda HM12

13 June 2006

Note

Every member entitled to attend and vote at the meeting may appoint another person as his/her proxy to attend and vote thereat instead of him/her and such proxy need not be a member. Forms appointing proxies must be deposited at the Company's Branch Registrar in Jersey, Channel Islands (for the attention of Sophie de Freitas, Registry Manager, Computershare Investor Services (CI) Limited, Ordinance House, 31 Pier Road, St. Helier, Jersey JE4 8PW, Channel Islands, not less than 48 hours before the time appointed for holding the said meeting or any adjourned meeting .

Directors, advisers and officers

for the year ended 31 December 2005

Directors

Roger Parsons Non-Executive Chairman
Todd Kozel Chief Executive
Sheikh Sultan Bin Saqr Al-Qassimi Non-Executive Director
William Guest President
Jonathan Cooper Finance Director

Secretary

Louisa Barbosa
Canon's Court
22 Victoria Street
Hamilton HM12
Bermuda

Registered Office

Canon's Court
22 Victoria Street
Hamilton HM12
Bermuda

UK Solicitor

Memery Crystal
44 Southampton Buildings
London
WC2A 1AP

Algerian Solicitor

Thompson & Knight
Cabinet Yassine
Parc Paradou
Rue no 3
Villa 4.5, Hydra
Algiers, Algeria

Registrar

Computershare Services PLC
PO Box 82
The Pavilions
Bridgwater Road
Bristol BS99 7NH

Nominated Adviser and Joint Broker

Hoare Govett Limited
250 Bishopsgate
London
EC2M 4AA

Joint Broker

Tristone Capital
28 Grosvenor Street
London
W1K 4QR

Bermudian Legal Adviser

Appleby Spurling Hunter
Canon's Court
22 Victoria Street
Hamilton HM12
Bermuda

Bankers

Bank of N.T. Butterfield & Son Limited
65 Front Street
PO Box HM 195
Hamilton HMAX
Bermuda

Credit Agricole (Suisse) S.A.
Lintheschergasse 15
CH-8023
Zurich

HSBC
79 Piccadilly
W1J 8EU

Auditors

Baker Tilly
Registered Auditor
Chartered Accountants
2 Bloomsbury Street
London WC1B 3ST

Bermuda

Gulf Keystone Petroleum Ltd
Canon's Court
22 Victoria Street
Hamilton, HM12
Bermuda

Algeria

Gulf Keystone Petroleum Ltd
Villa 42B
Cité des PTT Hydra
Algeria

UK

Gulf Keystone Petroleum (UK) Ltd
16 Berkeley Street
Mayfair
London
W1J 8DZ
UK