

GULF KEYSTONE PETROLEUM LTD.



Proving our  
*discoveries*



Gulf Keystone Petroleum Limited  
Annual Report and Accounts 2010



Shaikan-2 rig site, March 2011



For more information visit:  
[www.gulfkeystone.com](http://www.gulfkeystone.com)





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Gulf Keystone Petroleum Limited (“Gulf Keystone” or the “Company”) is an independent oil and gas exploration and production company focused on exploration in the Kurdistan Region of Iraq. The Company is registered in Bermuda with further offices in Erbil, in the Kurdistan Region of Iraq, Algiers, Algeria and London, UK.

The Company was incorporated in Bermuda in 2001 and listed on the Alternative Investment Market (“AIM”) of the London Stock Exchange in 2004 (stock quote GKP). Gulf Keystone Petroleum International (“GKPI”), a wholly-owned subsidiary of Gulf Keystone Petroleum Limited, holds Production Sharing Contracts (“PSCs”) for four exploration blocks in the Kurdistan Region of Iraq: the Shaikan and Akri-Bijeel blocks (PSCs awarded in November 2007) and the Ber Bahr and Sheikh Adi blocks (PSCs awarded in July 2009). In July 2009, the Company announced its intention to undertake a gradual strategic exit from Algeria.

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### Governance

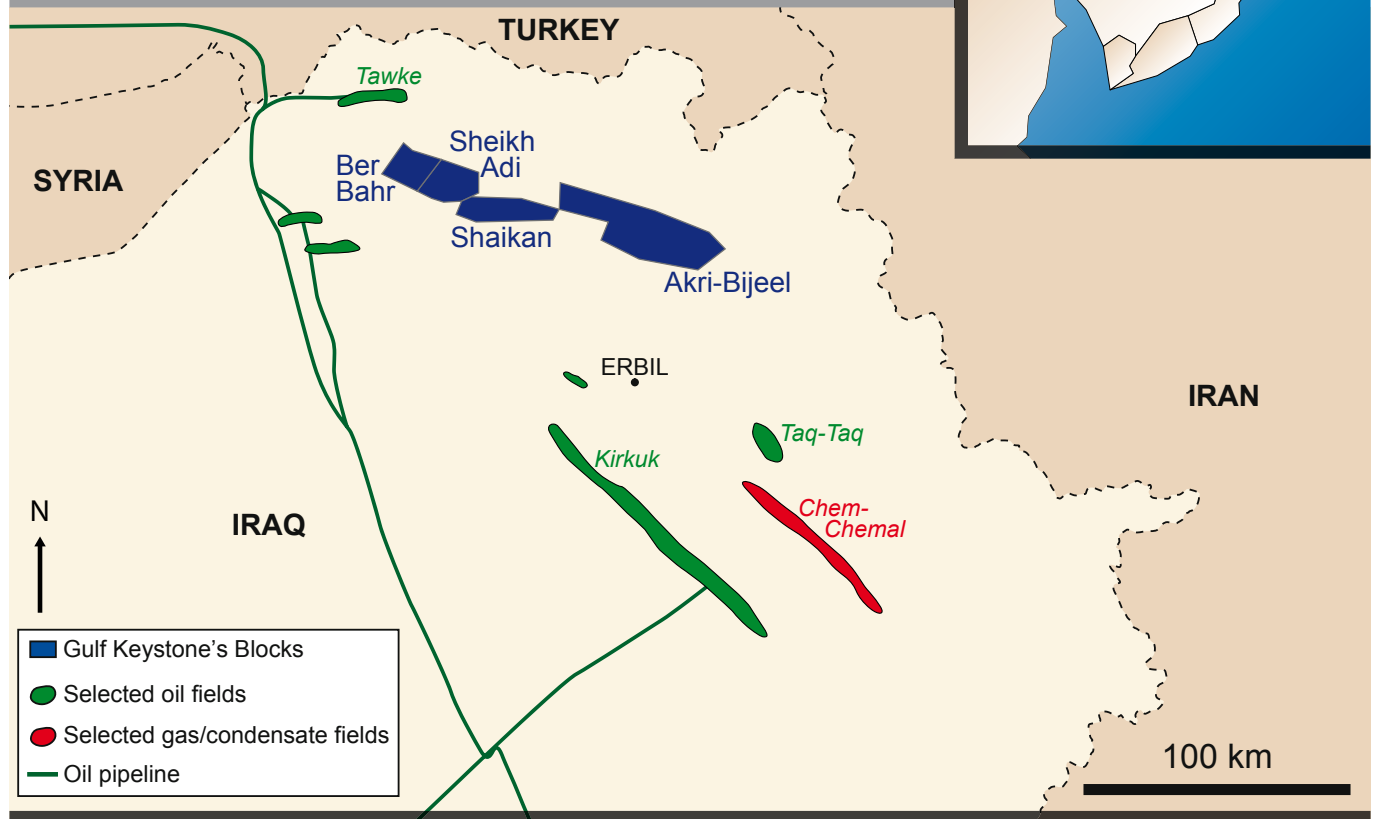
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## Kurdistan Assets at a Glance

We have four production sharing contracts in the Kurdistan Region of Iraq, which has the potential to be a world class hydrocarbon province.

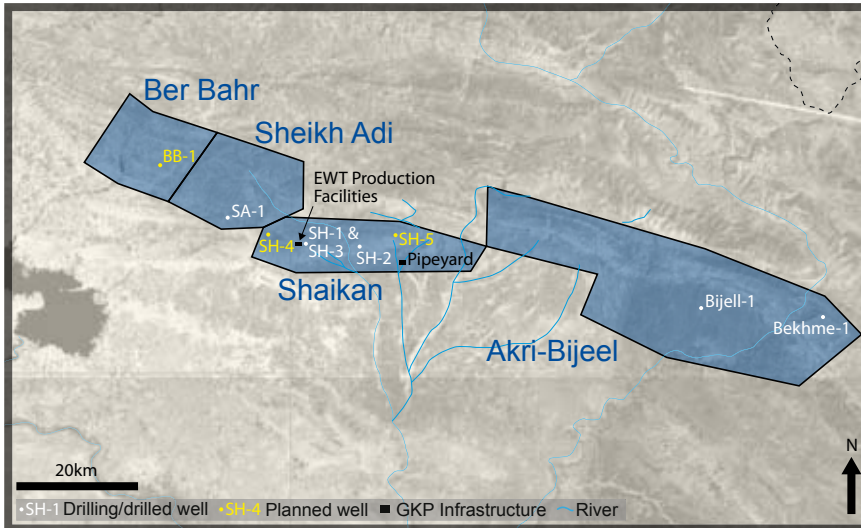


Gulf Keystone is focused on exploration in the Kurdistan Region of Iraq. Gulf Keystone Petroleum International Limited ("GKPI"), a wholly-owned subsidiary of Gulf Keystone Petroleum Limited, holds Production Sharing Contracts ("PSCs") for four exploration blocks with a total area under licence of 1,624 km<sup>2</sup>.

Over 150 people are employed by Gulf Keystone world-wide, including over 100 people in an operational or technical capacity.

- > Gulf Keystone's assets are located in the Kurdistan Region of Iraq, an area of about 40,000 km<sup>2</sup> in the north-east of the country, bordering Turkey and Iran
- > The Kurdistan Region of Iraq is a highly prospective oil province with very limited previous exploration and production activity and where about 40 international oil companies are in operation today
- > Gulf Keystone has one of the largest acreage positions in Kurdistan with a total area of 1,624 km<sup>2</sup> and four exploration blocks under licence, about 85 km from Erbil, the biggest regional centre, 50 km from the border with Turkey and over 400 km to the north-east from Baghdad
- > Gulf Keystone is a party to four PSCs for the Shaikan, Sheikh Adi, Akri-Bijeel and Ber Bahr blocks signed with the Kurdistan Regional Government ("KRG")
- > Gulf Keystone is the Operator of the Shaikan and Sheikh Adi PSCs and a partner under the Akri-Bijeel and Ber Bahr PSCs

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## Gulf Keystone's Kurdistan Licences

Block	Working interest	Acreage position	Status
Shaikan		<ul style="list-style-type: none"> <li>&gt; Operator: GKPI</li> <li>&gt; Estimated petroleum-initially-in-place: Mean (P50) 7.5 billion barrels<sup>(1)</sup></li> <li>&gt; Area under licence: 280 km<sup>2</sup></li> </ul>	<ul style="list-style-type: none"> <li>&gt; 171 km of 2D seismic data acquired in 2008</li> <li>&gt; Shaikan-1 discovery well drilled, completed in November 2009</li> <li>&gt; Shaikan Extended Well Test facilities completed in September 2010</li> <li>&gt; 599 km<sup>2</sup> of 3D seismic data acquired in 2010</li> <li>&gt; Shaikan-2 spudded in December 2010 and tested oil in March 2011</li> <li>&gt; Shaikan-3 drilled, completed in January 2011</li> <li>&gt; Further appraisal drilling in 2011/2012</li> </ul>
Sheikh Adi		<ul style="list-style-type: none"> <li>&gt; Operator: GKPI</li> <li>&gt; Estimated petroleum-initially-in-place: &gt; 1 billion barrels<sup>(4)</sup></li> <li>&gt; Area under licence: 249 km<sup>2</sup></li> </ul>	<ul style="list-style-type: none"> <li>&gt; Sheikh Adi-1 exploration well spudded in August 2010</li> <li>&gt; 215 km<sup>2</sup> of 3D seismic data acquired in 2010</li> </ul>
Ber Bahr		<ul style="list-style-type: none"> <li>&gt; Operator: Genel Energy International Ltd</li> <li>&gt; Estimated petroleum-initially-in-place: 1.9 billion barrels<sup>(5)</sup></li> <li>&gt; Area under licence: 206 km<sup>2</sup></li> </ul>	<ul style="list-style-type: none"> <li>&gt; Processing and interpretation of seismic data ongoing</li> <li>&gt; Ber Bahr exploration well to be drilled in late summer 2011</li> </ul>
Akri-Bijeel		<ul style="list-style-type: none"> <li>&gt; Operator: Kalegran Ltd (a 100% subsidiary of MOL Hungarian Oil &amp; Gas plc)</li> <li>&gt; Estimated petroleum-initially-in-place: Mean 2.4 billion barrels (P50 estimate released by the Operator)</li> <li>&gt; Area under licence: 889 km<sup>2</sup></li> </ul>	<ul style="list-style-type: none"> <li>&gt; 442 km of 2D seismic data acquired in 2008</li> <li>&gt; Bijell-1 exploration well spudded in December 2009</li> <li>&gt; Bijell-1 discovery announced in March 2010</li> <li>&gt; Bekhme-1 second exploration well spudded in March 2011</li> </ul>

(1) Dynamic Global Advisors ("DGA") report of April 2011 following further evaluation of the Shaikan discovery

(2) Texas Keystone Inc ("TKI") holds its interest in trust for GKPI pending transfer of its interest

(3) Minimum GKPI holding subject to the KRG's back-in rights and nomination of a third party if exercised in full

(4) GKP management estimate, unrisks prior to exploration drilling

(5) Operator's estimate as of June 2009, unrisks prior to exploration drilling.



## Proving our Discoveries

# Multi-billion barrel discovery

### Shaikan: a world-class discovery and a giant opportunity

In January 2010, Gulf Keystone published the Final Evaluation Report by Dynamic Global Advisors (“DGA”) on the Shaikan-1 discovery well.

In January 2011, Ryder Scott completed an additional third party analysis of the Shaikan-1 petroleum-initially-in-place resources confirming Gulf Keystone’s and DGA’s estimates.

In April 2011, Gulf Keystone announced a significant upward revision of the gross oil-in-place volumes supported by DGA’s further evaluation of the Shaikan discovery based on the new data acquired as a result of the Shaikan-1 extended well test production, Shaikan-2 oil discovery and well test, Shaikan-3 testing and production along with further additional data.

### Shaikan gross oil-in-place summary

Report	Date	Discovered gross oil-in-place volumes (billion barrels)		
		P90	Mean	P10
DGA	January 2010	1.89	4.18	7.42
Ryder Scott <sup>1</sup>	January 2011	1.52	4.04	7.52
DGA	April 2011	4.86	7.51	10.8

1 Petroleum-initially-in-place.

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*We have always believed that the initial gross oil-in-place range for the Shaikan discovery was a conservative estimate that would increase as more information became available. This gross oil-in-place volumes revision by DGA, entirely supported by the Company’s management and Board of Directors, confirms that belief*

*John Gerstenlauer, Gulf Keystone’s Chief Operating Officer*

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### Shaikan at a glance

- > The Shaikan block is situated approximately 85 km to the north-west of Erbil covering an area of 280 km<sup>2</sup>
- > The Production Sharing Contract for the Shaikan block was awarded in November 2007 to Gulf Keystone (Operator with a 75% working interest), Kalegran Ltd. (100% subsidiary of MOL Hungarian Oil and Gas Plc. with 20%) and Texas Keystone Inc. (5%)<sup>1</sup>
- > The Shaikan discovery was announced on 6 August 2009 with the Shaikan-1 well drilled to a total depth of 2,950m through multiple target horizons in Cretaceous, Jurassic and Triassic formations discovering over 1,000m of oil column and over 200m of net pay
- > Following successful retesting of Shaikan-1 in July 2010, the well was completed as a first Jurassic producer
- > In 2010, acquisition of 599 km<sup>2</sup> of 3D seismic data was completed with the data being processed in 2011
- > Extended Well Test (“EWT”) facilities completed in September 2010 with test production from Shaikan-1 commencing during October 2010 with a net entitlement to oil sales of 54,201 barrels to March 2011. The Company awaits guidance from the Kurdistan Regional Government (“KRG”) on further domestic sales.
- > Shaikan-2 deep appraisal well spudded on 1 December 2010 with a successful well test in March 2011 indicating that rates of up to 10,000 barrels of oil per day (“bopd”) can be achieved
- > Shaikan-2 tested 26 degree API oil in the first Jurassic zone encountered at a stabilised rate of 8,064 bopd
- > Shaikan-3 shallow appraisal well spudded on 2 September 2010 and completed as a second Jurassic producer in January 2011
- > Successful acid treatment of the Shaikan-1 & 3 wells in early 2011 indicate a combined production rate of up to 20,000 bopd
- > Work to upgrade the EWT facilities to meet increased well capability of Shaikan-1 & 3 and increased storage requirements and to process oil to export specification is under way, as well as an engineering study on a pipeline route to the main Kirkuk-Ceyhan oil export line
- > Shaikan-4 deep appraisal well is scheduled to be drilled in the second quarter of 2011 using the Discoverer 4 rig. The location for the Shaikan-5 appraisal well has been completed while the Shaikan-6 and 7 appraisal wells are contingent
- > Following the successful appraisal of the Shaikan discovery a development plan will be prepared for submission to and approval by the authorities and partners
- > The Kurdistan Regional Government has an option to nominate a third party interest of up to 15% in the Shaikan PSC and a further option to nominate a government interest of up to 20% following a commercial discovery

<sup>1</sup> Held in trust for GKPI pending transfer of its interest.



Sheikh Adi-1 rig site, March 2011



## Proving our Discoveries

# A unique investment opportunity

### Reasons to explore the unique investment opportunity

- > The Company's focus is on exploration and production in Kurdistan where a world-class discovery has been made
- > Four PSCs underpinned by a long-standing cooperation with the host Kurdistan Regional Government ("KRG")
- > An ambitious exploration and appraisal drilling programme in progress across the four adjacent blocks
- > Consistent story of success: two exploration wells resulted in two discoveries, Shaikan-1 and Bijell-1, significantly de-risking further exploration drilling
- > Sheikh Adi-1 and Bekhme-1 exploration wells are under way and the Ber Bahr-1 exploration well will be drilled in late summer 2011
- > Existing test production from Shaikan-1 & 3, potentially of up to 20,000 bopd
- > In preparation for higher production volumes and long-term oil exports, an engineering study on a pipeline route to the main Kirkuk-Ceyhan oil export line and the upgrade of the Shaikan Extended Well Test facilities are under way

### Significant Activities and Developments

- > Finalisation and approval by the KRG and partners of the re-organisation of interests in the four Production Sharing Contracts ("PSCs") which strengthens the Company's position in the region
- > 2011-2012 Kurdistan work programme includes five appraisal wells on the Shaikan block (two of them are contingent) and three exploration wells on the Sheikh Adi, Akri-Bijeel and Ber Bahr blocks
- > Gradual strategic exit from Algeria is in progress

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*Bekhme-1 is the first well to be drilled on the large surface feature that dominates the north of the Akri-Bijeel block, which is adjacent to the Shaikan block with a proven oil system. The discoveries at Bijell-1 and Shaikan have considerably de-risked this new drilling target making Bekhme an attractive prospect*

Todd F Kozel, Executive Chairman  
and Chief Executive Officer

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### Sheikh Adi

- > The Sheikh Adi block covers an area of 249 km<sup>2</sup> and lies to the west and on trend with the Shaikan structure
- > The PSC for the Sheikh Adi block was awarded in July 2009 to Gulf Keystone (Operator with a working interest of 80%) by the KRG which has a 20% carried interest in the Sheikh Adi PSC
- > Gulf Keystone's estimated unrisks oil-in-place resource potential for the Sheikh Adi structure is in excess of one billion barrels
- > In line with the initial three year exploration phase, which commenced in July 2009, the Sheikh Adi-1 first exploration well was spudded on 4 August 2010. Sheikh Adi-1 is designed to drill through the Cretaceous, Jurassic and Triassic formations to a planned total depth of +/-3,850 m
- > In 2010, acquisition of 215 km<sup>2</sup> of 3D seismic data for the Sheikh Adi block commenced and was completed in early 2011 with the data now being processed

### Akri-Bijeel

- > The Akri-Bijeel block is situated to the east of the Shaikan block and covers an area of 889 km<sup>2</sup>
- > The PSC for the Akri-Bijeel block was awarded in November 2007 to Kalegran Ltd. (Operator and a 100% subsidiary of MOL Hungarian Oil and Gas Plc, with a working interest of 80%) and Gulf Keystone (20%)
- > In line with the initial three year exploration phase, the Bijell-1 first exploration well on the Akri-Bijeel block was spudded on 11 December 2009 and announced as a discovery on 9 March 2010. The Operator's estimate for Bijell-1 petroleum-initially-in-place is 2.4 billion barrels (P50) in the Jurassic formations
- > Bekhme-1 second exploration well on the Akri-Bijeel block, 20 km to the north-east from the Bijell-1 discovery, was spudded on 21 March 2011. Bekhme-1 is designed to target prospective intervals in the Jurassic and Triassic formations with a planned depth of approximately 3,000 m
- > The Kurdistan Regional Government has an option to nominate a third party interest of up to 20% in the

Akri-Bijeel PSC and a further option to nominate a government interest of up to 20% following a commercial discovery

### Ber Bahr

- > The Ber Bahr block covers an area of 206 km<sup>2</sup> and lies to the north-west and on trend with the Shaikan and the Sheikh Adi blocks
- > The PSC for the Ber Bahr block was awarded to Genel Energy International Limited (Operator with a 40% working interest) and Gulf Keystone (40%) by the KRG which has a 20% carried interest in the Ber Bahr PSC
- > The Operator's estimate for the Ber Bahr oil-in-place (unrisks prior to exploration drilling) is 1.9 billion barrels
- > In line with the exploration phase, the Ber Bahr-1 first exploration well is scheduled to spud in late summer 2011
- > The Operator has selected a rig location and is in the process of procuring long lead items and constructing the rig pad

### Algeria

**Ben Guecha – Blocks 108 and 128b**  
After making a decision in 2009 to undertake a strategic exit from Algeria, Gulf Keystone relinquished Blocks 108 and 128b under the Ben Guecha Permit. In May 2010, Sonatrach exercised a guarantee of \$15.6 million in its favour in relation to these blocks as the exploration commitments were not satisfied

### HBH

In February 2010 a settlement agreement was negotiated with BG North Sea Holdings Limited ("BG") for the immediate stay of arbitration between the parties and the proposed withdrawal of the Company from the Hassi Ba Hamou ("HBH") Permit, in consideration for a net cash payment of \$10 million from BG, subject to the necessary Algerian approvals. On 23 August 2010 the parties to the HBH permit executed an amendment to the PSC providing for the extension of the expiry of the exploration period from 23 September 2010 until 23 September 2012

### Ferkane Permit – Block 126a

Gulf Keystone is currently evaluating a number of options with regard to its interests in Block 126a (GKN and GKS oilfields under the Ferkane Permit)

### Corporate Developments

- > In 2010, 251.2 million new common shares were issued to existing and new institutional investors raising gross proceeds of \$364.0 million
- > An additional 8.2 million new common shares were issued as part of the Standby Equity Distribution Agreement with YA Global Master SPV Ltd, an investment fund managed by Yorkville Advisors, LLC raising proceeds of \$10.8 million
- > Reorganisation of the Company's interests held through its subsidiary, Gulf Keystone Petroleum International Limited, following the withdrawal of Etamic Limited
- > Establishment of the Employee Benefit Trust and grant thereunder of Long Term Incentive Performance Share Options and Executive Bonus
- > Following the exercise of options by employees in February 2011, 1,000,507 new common shares were issued raising gross proceeds of £636,054 at an average price of 63.57 pence per share
- > On 17 December 2010, Excalibur Ventures LLC ("Excalibur") commenced an International Chamber of Commerce ("ICC") arbitration in New York and in the English Commercial Court against Gulf Keystone and two of its subsidiaries (the "Companies") asserting certain contractual and non-contractual claims and claiming entitlement to an interest of up to 30% in the Companies' blocks in the Kurdistan Region of Iraq. On 8 April 2011, the Companies obtained an injunction in the English Commercial Court restraining Excalibur from pursuing the ICC arbitration proceedings. The injunction continues until final determination of the English Commercial Court proceedings or until further order. The English Commercial Court will decide whether the Companies are bound by the Agreement that Excalibur seek to rely on

# Chairman's Statement

Todd F Kozel



“*Gulf Keystone has made one of the largest discoveries, holds one of the largest licence positions and has amongst the best pre-drill upside in its acreage in Kurdistan.*”

Todd F Kozel, Executive Chairman and Chief Executive Officer



Rig floor, Sheikh Adi-1

2010 was a year of unprecedented activity for Gulf Keystone as we continued to work hard and fast to capture the huge potential of our world class acreage in the Kurdistan Region of Iraq, one of the few great remaining under-explored hydrocarbon regions of the world.

Our ongoing exploration and appraisal campaign, spanning all four of our blocks (Shaikan, Sheikh Adi, Ber Bahr and Akri-Bijeel), is amongst the most aggressive of any company active in the Kurdistan Region of Iraq today. The resulting progress that has been made in a relatively short timeframe has been truly remarkable by any standards and is something of which I am incredibly proud.

Gulf Keystone's blocks are massive, undeveloped structures and this virgin territory represents an oil man's dream. To date the Shaikan block has been the crown jewel of our portfolio, but as we continue to progress work on the Sheikh Adi block, as well as with our partners Genel Energy International Limited ("Genel") and MOL Hungarian Oil & Gas Plc ("MOL") at the Ber Bahr and Akri-Bijeel blocks respectively, we are increasingly realising that the type of success that we have enjoyed there could in fact be replicated elsewhere across our portfolio.

As stated last year, I believe that of any public listed company active in the Kurdistan Region of Iraq today, Gulf Keystone has made one of the largest discoveries, holds one of the largest licence positions and has amongst the best pre-drill upside in its acreage. It is this upside that Gulf Keystone will test as it implements its ambitious work programme which commenced in 2010 and will continue into early 2012. In 2010, we completed a number of successful share placings with the support of a number of our existing and new institutional shareholders raising a total of \$375 million.

With a strengthened balance sheet we are fully funded to implement the Company's current plan.

Throughout 2010 considerable further progress was made in better understanding the true magnitude of our acreage.

In January 2010, Dynamic Global Advisors ("DGA") announced the final evaluation report on the Company's first discovery, Shaikan-1, which completed drilling in late 2009, with gross oil-in-place volumes of 1.9 (P90) to 4.2 (P50) to 7.4 (P10) billion barrels. Further upside is thought to be possible from appraisal drilling if the known oil bearing zones prove to be larger or additional oil is present in as yet untested deeper geological horizons. The Shaikan-1 well had to stop drilling at 2,950m measured depth due to high pressure beyond the tolerance of the well design. However, at this depth there was a significant inflow of hydrocarbons into the well bore. As yet this zone is untested and is a target for future Shaikan wells.

The first major drilling news of the year was announced in March 2010 as our second exploration well, Bijell-1 on the Akri-Bijeel block, following on from our first successful exploration well Shaikan-1, also tested oil and at an initial rate of 3,200 barrels of oil per day ("bopd") (the subsequent maximum reported rate on test for Bijell-1 was 3,743 bopd). On 8 November 2010, MOL, the Operator, successfully concluded drilling and testing of the Bijell-1 well and in the following month announced petroleum initially in place estimate of 2.4 (P50) billion barrels. These positive results highlight the clear potential of the Akri-Bijeel block which has a number of large exploration targets, one of which, Bekhme-1, began drilling in March 2011.

Following on from the initial results at Bijell-1, and in order to help us build a better picture over the blocks which the



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# Adding significant *value*



Bijell-1 rig site

Company operates, the acquisition of 814 km of 3D seismic data commenced in the second quarter of 2010, initially for Shaikan and later for Sheikh Adi, and was completed in early 2011. Processing, interpretation and analysis of this data will continue throughout 2011.

During July 2010, additional well testing began on Shaikan-1 to retest the Jurassic discovery zones in the Butmah and Mus formations. Data acquired during the original drilling indicated that higher test rates were achievable. In the Butmah the information indicated that a rate of approximately 5,000 bopd was achievable and on the original test of this zone no oil was produced to surface. On retest, a rate of 4,650 bopd was achieved under natural flow. In the Mus the original natural flow rate was 128 bopd which increased to 1,250 bopd on retest and with an electric submersible pump increased to 2,250 bopd. Following these successful tests the Shaikan-1 well was completed as a producer in the Sargelu section of the Jurassic.

Exploration drilling also commenced in August 2010 on the Sheikh Adi-1 well and operations are ongoing with results eagerly awaited. The depth on 7 April 2011 was 2,685m.

On the Shaikan block, a key milestone was the commencement of test production from the successful

Shaikan-1 well. Production from the Sargelu section of the Jurassic formation began at low rates in September with first sales in October. Currently oil is sold at the wellhead and transported by truck to either a refinery or processing plant in the Kurdistan Region of Iraq. To be producing and selling oil following first discovery in 2009 is a considerable achievement. Production testing continues and we have been securing a range of comprehensive data to enable us to analyse the potential recovery factors.

The Shaikan-3 shallow appraisal well, designed to evaluate the Cretaceous age reservoirs, commenced in September 2010. This well was ultimately completed as a Jurassic producer in January 2011 and tied into the nearby production testing facilities.

Meanwhile, appraisal drilling saw the commencement in December 2010 of the first deep well, Shaikan-2, which is targeting various formations down to the Permian at a depth of +/- 5,000m and is expected to reach a total depth of 4,994m. Following a successful well test in the upper section of the Jurassic in March 2011, the Shaikan-2 drilling operations continue. The depth on 7 April 2011 was 1,975m.

With regard to commercial and corporate activity, Gulf Keystone announced in

February 2010 an agreement with BG North Sea Holdings Limited ("BG") for the proposed withdrawal of the Company from the Hassi Ba Hamou ("HBH") Permit in Algeria (see note 11 to the accounts).

During August 2010, Gulf Keystone completed a reorganisation of its interests in Gulf Keystone Petroleum International ("GKPI") and in its four blocks in the Kurdistan Region of Iraq, which required, inter alia, approval by the Kurdistan Regional Government ("KRG") and partners. Further details of the reorganisation are included in the Financial Review.

In December 2010, Gulf Keystone received notice that an International Chamber of Commerce ("ICC") arbitration was commenced by Excalibur Ventures LLC in New York and similarly commenced proceedings in the English Commercial Court in London on the same grounds asserting certain contractual and non-contractual claims and up to 30% of the Companies' blocks in the Kurdistan Region of Iraq (see note 21 to the accounts). Gulf Keystone disputes the allegations and claims asserted in the New York arbitration and the English Commercial Court Claim in London and is contesting them vigorously.

On 8 April 2011 Gulf Keystone and two of its subsidiaries obtained an injunction in the English Commercial Court restraining

# Chairman's Statement

## continued

Excalibur from pursuing the ICC arbitration proceedings instituted against Gulf Keystone and two of its subsidiaries on 17 December 2010. The injunction continues until final determination of the English Commercial Court proceedings or until further order. The English Court will decide whether Gulf Keystone and its two subsidiaries are bound by the Agreement that Excalibur seek to rely on.

The financial results for 2010 show a loss of \$26.0 million (2009: \$96.3 million) a significant narrowing year on year as the Company directs its efforts away from Algeria to focus on the Kurdistan Region of Iraq. The main 2010 charge relates to non-cash share-based awards in line with the Company's recognition of exceptional performance with an exceptional reward and to ensure that employees have a meaningful stake in the business aligning them with shareholders in the future success of Gulf Keystone.

Whilst highly active in 2010, our work is not done and the momentum that was achieved is firmly continuing into 2011 as we make progress in our multi-well exploration and appraisal programme. In late 2010, in order to further demonstrate the validity of the data on the Shaikan block, we undertook an additional independent third party analysis of the gross oil-in-place resources resulting from the Shaikan-1 discovery well. The results of this study by Ryder Scott, using more conservative assumptions, supported the previous analysis by DGA and gave a range of 1.52 (P90) to 7.52 (P10) billion barrels of petroleum initially in place, with a mean of 4.04 billion barrels. The Shaikan appraisal drilling during 2011 is anticipated to both narrow the range and increase the high point.

During 2011, the Shaikan work programme allows for up to a further four wells, Shaikan-4 through to Shaikan-7, with the Shaikan-6 and Shaikan-7 wells being contingent. Shaikan-4 deep appraisal well is scheduled to commence drilling in the second quarter of 2011.

The first exploration well on the Ber Bahr block, operated by Genel, is expected to commence drilling in the third quarter of 2011.

We understand that we are guests in the Kurdistan Region of Iraq. This is a mindset that not only differentiates us from many others, it continues to serve us well as we have created a strong, lasting and mutually rewarding partnership with our hosts.

We are fully committed to our areas of operations, for example, we hire and train local employees and we are proud of having supported a number of community projects on a range of initiatives, including scholarships, school developments and healthcare projects.

At a time of some uncertainty in the world, particularly around North Africa and the Middle East, Iraq continues to make good progress. Iraq today is a young democracy and the Kurdistan Region of Iraq is a professional and business friendly region. We are highly confident of continuing political progress and co-operation which will see the people of Iraq, and in turn Gulf Keystone, continue to prosper.

However great your assets, any business is only as good as its people. To that end I would like to sincerely thank the entire team at Gulf Keystone for their commitment to help fulfil our operational capability whilst conducting operations in an effective, safe and responsible manner and creating value for all our shareholders. As well as extending this gratitude to our teams in the Kurdistan Region of Iraq and the UK, including our Board of Directors, I would also like to thank our shareholders for their continuing support and our hosts in the Kurdistan Region of Iraq for their partnership, support, friendship and trust.

**Todd F Kozel**  
Executive Chairman and  
Chief Executive Officer





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3D seismic acquisition, Shaikan

# Review of Operations



“2010 was a year of consolidation, planning, evaluation, initial implementation and discovery”

John B. Gerstenlauer,  
Chief Operating Officer



Extended well test facility

For Gulf Keystone, 2010 was a year of consolidation, planning, evaluation, initial implementation and discovery. The Company became increasingly focused on the Kurdistan Region of Iraq, while continuing to seek an equitable and graceful exit from our long-term relationships and business ties in Algeria.

## Kurdistan Region of Iraq Shaikan Block

In the Kurdistan Region of Iraq, the Company began implementation of the Shaikan field appraisal programme as proposed by Gulf Keystone and approved by the Kurdistan Regional Government through the Ministry of Natural Resources and by our partner, MOL Hungarian Oil and Gas Plc, through its wholly owned subsidiary Kalegran Ltd. The approved appraisal plan calls for:

- > Drilling four firm appraisal wells: Shaikan-3, a relatively shallow Cretaceous evaluation well adjacent to Shaikan-1; Shaikan-2, the first deep appraisal well targeted for all zones down to the Permian age rock to (+/-5,000m); Shaikan-4 and Shaikan-5, deep appraisal wells.
- > Two additional appraisal wells (Shaikan-6 and 7) will be contingent on the results of Shaikan-2 through to Shaikan-5.
- > Shaikan-1 retesting and completion as a producing well.
- > Installation of an extended well test (“EWT”) facility at Shaikan-1 that will allow the long-term production testing of Shaikan-1 as well as the sale of the produced crude oil into the domestic market.
- > Three dimensional (“3D”) seismic coverage of the entire Shaikan exploration block.

At Shaikan-1, the Mus and Butmah formations were retested using a workover rig. Both zones were cleaned and reperforated with significant improvements in performance. The Mus test rate increased from 128 barrels of oil per day (“bopd”) to 1,250 bopd on free flow and 2,250 bopd using a small electric submersible pump. The Butmah, which initially was incapable of getting oil to surface, retested at 4,650 bopd. The well was then completed as a production well in the Sargelu/Alan and hooked up to the EWT facility.

The EWT facility was constructed as a series of modular units by Qualitas in Calgary, Canada. The construction phase was completed both on schedule and on budget. The installation, hook-up, testing and commissioning work in the Kurdistan Region of Iraq was also completed in a timely fashion and the facility was put online in September.

Truck loading at the EWT facility has functioned extremely well and the facility is capable of loading more than 90 trucks per day with each truck taking a maximum of 30 tonnes of oil (200 barrels). The facility was originally designed to handle 8,000 to 10,000 bopd and while certain portions of the processing system can handle up to 18,000 bopd, other sections are limited in their handling capacity. In particular, the gas/oil separation unit will be expanded and a second oil storage tank will be added to enable the facility to handle a combined flow rate of up to 20,000 bopd. In addition, the facility will be modified to allow it to remove excess sulphur and, therefore, to meet oil pipeline specifications when the option to export arises.



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## Increasing our focus on *Kurdistan*

*Extended well test facility*

Shaikan-3 drilled, evaluated and tested the Cretaceous oil zones. Several of the Cretaceous zones are estimated to have significant quantities of oil-in-place (Gulf Keystone estimates of 200 million to 2.2 billion barrels of oil-in-place), however, none of the tested zones were capable of unassisted flow. The actual volume of oil-in-place, which is completely separate from the previous estimates of Shaikan oil resources, carries a wide range of values due to the uncertain nature of the areal extent of the highly fractured Cretaceous reservoirs. These zones are likely to remain undeveloped in the near term and may eventually lend themselves to steam flood development. The Shaikan-3 well was eventually completed as a Sargelu/Alan producer and tied into the EWT facility alongside Shaikan-1.

Following acid treatment of both Shaikan-1 and Shaikan-3 in order to remove formation plugging around the well bores, the combined flow rate from Shaikan-1 and 3 increased significantly and the Company anticipates a combined rate of up to 20,000 bopd after the completion of an EWT facility upgrade.

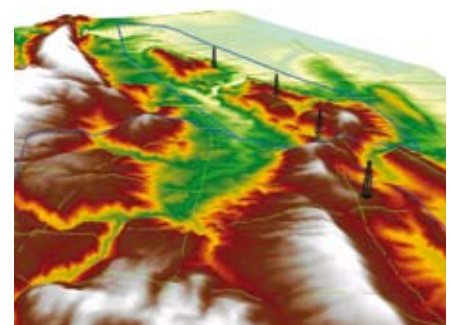
Shaikan-2 was spudded in late 2010 and, at the date of writing, was making good progress. Shaikan-2, a nine km step-out to Shaikan-1, has already discovered oil in the upper Jurassic confirmed by a production test of 26 degree API oil at a

rate of 8,064 bopd. The pressure gradients at the Shaikan-2 location are consistent with readings at Shaikan-1. This has increased the depth of the lowest known oil column and will lead to a material increase in the P90 oil-in-place. Updated oil-in-place estimates will be reported in the coming weeks.

The Shaikan-4 well location was constructed and a rig tender was put out to the market with 11 companies responding. The bid winner was the AOS Discoverer 4 and put under contract. The rig has since arrived by ship into Iskenderun, Turkey and the first truck loads have arrived at the Shaikan-4 location. In addition, a drilling location for Shaikan-5 was selected and construction has been completed.

The 3D seismic data acquisition project has been completed and the data is being processed and evaluated. The entire Shaikan block was covered during the data acquisition phase with appropriate overlaps onto the neighbouring blocks. Early results fully support the structural assumptions from the analysis of the earlier 2D seismic lines.

The existing 1.9 to 7.4 billion barrels of oil-in-place estimate (P90 to P10) from Dynamic Global Advisors ("DGA") was verified by a further independent analysis conducted by Ryder Scott. The Ryder



*Representation of terrain over Sheikh Adi and Shaikan*

Scott findings, using more conservative formation porosity and water saturation cut-offs, provided an estimate of 1.5 to 7.5 billion barrels of petroleum initially in place, also on a P90 to P10 basis.

Oil-in-place volumes are being recalculated based on the Shaikan-2 results and an upgrade will be provided in the near future.

# Review of Operations

## continued

### Sheikh Adi Block

The Sheikh Adi-1 exploration well was spudded on 4 August 2010 and immediately began to experience borehole stability problems while trying to drill the long Cretaceous interval. There were a number of encouraging oil shows in the Cretaceous (not a primary target for this well) and several attempts were made to test particularly interesting zones. However, in each case the borehole was too unstable to get any kind of meaningful flow test.

The 12.25 inch pilot hole eventually reached the 13.375 inch casing setting depth and hole opening operations started. A 12.25 inch hole is drilled initially due to limited availability of electric logging tools and thus the hole had to be drilled at 12.25 inch diameter and then opened to 17.5 inch. Both drilling sequences suffered from extreme hole stability issues.

The 17.5 inch hole on Sheikh Adi-1 eventually reached what was anticipated to be just above the Jurassic and casing was set. Upon drilling out of the casing into what was expected to be the first of the primary target intervals it was discovered that the borehole had crossed a reverse fault and approximately 400m of Cretaceous interval still remained to be drilled before reaching the Jurassic.

Drilling operations have finally reached the Jurassic and well operations are on-going. At 7 April 2011 the well was at a depth of 2,685m.

Following the Shaikan 3D seismic programme, the southern half of the Sheikh Adi block was covered by 3D seismic.

### Akri-Bijeel Block

On the Akri-Bijeel block, a major oil discovery was made in March 2010 by the Bijell-1 exploration well. The Bijell structure was tested at 3,743 bopd with the Operator's P50 petroleum-initially-in-place estimate of 2.4 billion barrels. Kalegran Ltd, a 100% subsidiary of MOL, is preparing an extensive appraisal programme for the further evaluation of the Bijell structure.

Kalegran Ltd has begun drilling Bekhme-1, the second exploration well on the Akri-Bijeel block to test a structure that is potentially as large as Shaikan.

### Ber Bahr Block

The Ber Bahr block, operated by Genel, will also be the site of exploration drilling in 2011. In 2010, Genel selected a drilling location for the Ber Bahr-1 exploration well. The Ber Bahr structure is the largest single structure on any of the four blocks in which Gulf Keystone has an interest. If this structure contains oil it will be very large, even by Shaikan standards. The Ber Bahr-1 well is anticipated to begin drilling in the third quarter of 2011.

### Algeria

After making a decision in 2009 to undertake a strategic exit from Algeria, in early 2010 Gulf Keystone relinquished Blocks 108 and 128b under the Ben Guecha Permit. In February 2010, an agreement was reached between Gulf Keystone and BG Group, the Operator, providing for the transfer of the Company's interests in the Hassi Ba Hamou ("HBH") Permit to the Operator. The agreement is awaiting approval by Sonatrach and the Algerian government. Gulf Keystone is currently evaluating a number of options with regard to its interests in Block 126a (GKN and GKS oilfields under the Ferkane Permit).

### Summary

On the Shaikan block, Shaikan-2 is drilling in the top of the Jurassic and Shaikan-4 will begin drilling during the second quarter of 2011. Sheikh Adi-1 has reached the Jurassic. Bekhme-1, on the Akri-Bijeel block, spudded on 21 March 2011 and Ber Bahr will spud later in 2011. The EWT facility is to be expanded and domestic oil sales which commenced in 2010 have continued into 2011. In addition, oil exports by other international oil companies active in the Kurdistan Region of Iraq recommenced in February 2011. 2010 has been a very successful year for Gulf Keystone and 2011 promises even more opportunity for significant value addition.

**John Gerstenlauer**  
Chief Operating Officer



Maraiba Pipe Yard



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Rig floor, Sheikh Adi-1

# Corporate and Social Responsibility

## A safe and supportive operating environment

### Economic Dealings

- > We seek to be fair in our relationships and dealings with our counterparties
- > We strive to build strong relationships with our business partners, host governments, and within the local communities in which we operate

### Social Responsibility

- > We are sensitive to the diverse cultures with whom we interact and we aim to make a positive contribution to the communities in which we operate
- > We are committed to protecting the health and safety of our employees and our contractors

### Environmental Performance

- > We are keen to look after and care for the environment around our operations

“

*We understand that we are guests in the Kurdistan Region of Iraq. This is a mindset that not only differentiates us from many others, it continues to serve us well as we have created a strong, lasting and mutually rewarding partnership with our hosts*

*Todd F Kozel, Executive Chairman and Chief Executive Officer*

”



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Our goal is to be a partner of choice, a competent and responsible operator known for making a positive contribution to those with whom we interact.

The Company's Board of Directors bases its actions on the principles of openness, integrity and accountability. Gulf Keystone respects the traditions and cultures of the countries in which we operate.

#### **Economic dealings**

The Company strives to conduct business to high ethical standards and is committed to conducting its business in an open and honest manner. Gulf Keystone seeks to be fair in our relationships and dealings with our counterparties. Gulf Keystone strives to build strong relationships with our business partners, host governments and within the local communities in which we operate.

#### **Social responsibility**

We are sensitive to the diverse cultures with whom we interact and we aim to make a positive contribution to the communities in which we operate. Gulf Keystone values its diverse workforce and is committed to providing a workplace free of discrimination where all employees are afforded opportunities and are rewarded upon merit and ability.

#### **Environmental performance**

Gulf Keystone is focused on minimising the environmental impact of its operations. Gulf Keystone is committed to meeting the legal and regulatory requirements governing environmental practices within all countries in which it operates.

#### **Occupational health and safety**

Gulf Keystone is committed to protecting the health and safety of our employees and our contractors. The safety of the Company's employees, contractors and those in the local communities where we operate is of paramount importance.

We recognise the inherent potential risks associated with exploration and production of hydrocarbons and our responsibility to protect our employees and contractors from all work-related injuries and illnesses.

During 2010, the Company was focused on the drilling of the Sheikh Adi-1 exploration well, the Shaikan-2 exploration well in addition to the workover of Shaikan-1 and the Shaikan-3 shallow well, first production from the EWT facility and on the additional seismic activity in the region. Including all subcontractors, the Company worked just over 2.2 million man-hours in total.

In 2010, the Company dedicated a proportionate amount of time to Health, Safety and Environment ("HSE") training while continuously improving its HSE Management System and risk management activities, including work with subcontractors and on issues of road transportation safety. The Company hired a number of additional HSE experts and trained local HSE personnel.

In 2010, the Company's seismic and drilling contractors recorded four Lost Time Injuries ("LTIs"). All four incidents were fully investigated and recommendations to minimise the chance of a re-occurrence were implemented.

Despite the LTIs in 2010, the Company's Recordable Incident Rate was 0.45 per total man hours worked and the Lost Time Incident Rate was 0.36 per total man hours worked, each of which are better than a target rate of 1.0. These numbers were in line with the Company's targets and lower than the 2009 values.

The Company is determined to focus on reducing LTIs in 2011 by instigating further HSE training programmes and carrying out additional audits of its activities ensuring that risk identification and reduction remains its highest HSE priority.

# Financial Review



“  
Oil sales have enabled  
the Group to demonstrate  
the viability of generating  
revenues from the Shaikan-1  
discovery.”

Ewen Ainsworth  
Finance Director

**\$26**million

Loss after tax

**4.17**cents

Loss per share

**\$211.4**million

Cash, cash equivalents and  
liquid investments

## Results for the year

### Operating results

Gulf Keystone's test production facilities in the Kurdistan Region of Iraq were commissioned in September 2010 and oil sales from the Sargelu Jurassic section of the Shaikan-1 discovery well commenced in late October 2010. The Company's net entitlement to sales during 2010 was 30,193 barrels of oil which has generated net revenues for the Group of \$0.8 million (2009: \$nil) with an average realised price achieved for these sales of \$26.78 per barrel.

Most importantly, these initial sales have enabled the Group to demonstrate the viability of generating revenues from the Shaikan-1 discovery as well as providing valuable technical, commercial and marketing information.

Revenue from test production is shown in the income statement with an equal and offsetting amount against cost of sales and a nil gross profit for 2010 (2009: \$nil). As a result an amount equal to the revenue is credited to intangible assets against exploration and evaluation costs reducing the net book value in the balance sheet. In the future, if oil sales are established on a regular and consistent basis, the Company will consider recognising earnings from oil sales and account for this activity as a gross profit or loss in the income statement. Operating costs on a per barrel basis, excluding inventory movements, depreciation, depletion and amortisation costs were \$8.84 per barrel during the period.

There has been no further impairment of oil and gas assets during 2010 (2009: \$73.9 million).

### Non-operating results

General and administrative expenses for 2010 were \$32.6 million, compared to \$21.5 million in 2009. Administrative costs have increased by \$11.1 million primarily due to the 2010 share bonus awards and options under the long-term incentive plan, resulting in a share-based payment expense of \$21.7 million and associated taxes of \$3.1 million (2009: \$6.4 million), and payment of a cash bonus of \$3.7 million (2009: \$nil), of which \$6.5 million has been included within intangible assets. This increase was offset by a substantial reduction of \$5.7 million in costs for Algeria (2010: \$0.8 million; 2009: \$6.5 million). The remaining increase in administrative costs of \$1.2 million is due to the ramp up of operations in the Kurdistan Region of Iraq following the announcement of the Shaikan discovery and the appraisal activity under way.

Other gains of \$5.9 million (2009: other losses of \$0.1 million) comprise foreign exchange gains of \$5.8 million (2009: \$0.3 million gain), a mark-to-market valuation gain on a forward exchange contract entered into during the period (\$0.3 million; 2009: \$nil) and the change in the fair value of the Standby Equity Distribution Agreement ("SEDA") (\$0.2 million loss; 2009: \$0.4 million loss). The mark-to-market gain is as a result of the Company entering into a currency hedge to partly mitigate the risk associated with converting sterling to US dollars following funds received from shares placed by Gulf Keystone during 2010.

Interest revenue reduced to \$0.2 million in 2010 from \$0.3 million in 2009 due to lower rates of interest which more than offset higher average balances for cash, cash equivalents and liquid investments.

Finance costs of \$0.3 million (2009: \$1.0 million) relate to the accretion charge on the decommissioning provision. In contrast, 2009 included a charge on the bank guarantee relating to Blocks 108 and 128b in Algeria as well as the accretion charge on the decommissioning provision. The bank guarantee was exercised in favour of Sonatrach, Algeria's national oil company, during 2010 and no further charges were incurred.

The tax credit for 2010 is \$0.8 million (2009: expense of \$0.03 million) and arises on UK activities.

The results for 2010 show a decreased loss after tax of \$26.0 million (2009: \$96.3 million). Results are comparable to the prior year following the exclusion of foreign exchange gains, bonus awards and share options expenses and the impairment charge in relation to the Group's exit from Algeria.

### Cash flow

Net cash outflow from oil and gas operations after general and administrative expenses was \$26.2 million (2009: \$1.7 million). The significant increase arises from increased inventories held at year end for use in drilling operations and the ramp up in the cost of operations in the Kurdistan Region of Iraq (2010 inventory purchases: \$13.8 million; 2009 inventory utilised \$1.0 million). In addition the 2009 cash flow from operations also benefited from receipt of funds relating to 2008 oil sales in Algeria of \$6.4 million (2010: \$nil). Tax paid in 2010 was \$0.5 million (2009: \$0.1 million refunded) and



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### Share Price Performance for the 18 months to 31 December 2010



In addition, during 2010, 4.8 million shares were issued in lieu of advisors fees and to satisfy outstanding awards made under the Company's Executive Bonus Scheme.

### Etamic transaction

On 10 March 2010, the Company announced it had negotiated with the KRG to reorganise the Company's interest in GKPI following the withdrawal by Etamic and non-completion of the transaction as originally negotiated and announced on 20 July 2009. The main components of the reorganisation and transaction were as follows:

- > GKPI will continue to be a 100% subsidiary of GKP.
- > GKPI was required to pay \$40 million to the KRG which is an Infrastructure Support Payment in return for GKPI maintaining its 80% interest in Sheikh Adi and 40% interest in Ber Bahr.
- > GKP was required to make a termination payment of \$12 million to Etamic in full and final settlement of all of their rights.
- > The KRG shall also be entitled to receive an Additional Infrastructure Support Payment to be allocated to social programmes, amounting to 40% of GKPI's entitlement to Profit Petroleum derived from GKPI's share of profits in all four production sharing contracts ("PSCs").

As announced on 9 August 2010 this transaction was completed and effective from 1 August 2010 and payment of the \$52 million to the KRG (\$40 million) and Etamic (\$12 million) was made in July and August 2010.

The net effect of the total expenditure of \$52 million is that GKP's net share in each of the four PSCs will be as follows:

PSC	GKP's Interest %	Fully Diluted % <sup>(1)</sup>
Shaikan	75.0	51.0 <sup>(1)</sup>
Sheikh Adi	80.0	80.0
Ber Bahr	40.0	40.0
Akri-Bijee	20.0	12.8 <sup>(2)</sup>

(1) Minimum GKPI holding subject to Government back-in right of 20% and Third Party back-in right of 15% if exercised in full.

(2) Minimum GKPI holding subject to Government back-in right of 20% and Third Party back-in right of 20% if exercised in full.

(3) Subject to KRG 40% share of GKPI's profit petroleum.

### Other and further events

Gulf Keystone announced in February 2010 an agreement with BG North Sea Holdings Limited ("BG") for the proposed withdrawal of the Company from the

interest received \$0.2 million (2009: \$0.3 million). Net cash outflow from operating activities after tax and interest was \$26.5 million (2009: \$1.3 million).

Cash used in investing activities totalled \$157.2 million (2009: \$49.2 million). The majority of this relates to capital expenditure in the Kurdistan Region of Iraq and includes a payment of \$52.0 million associated with the completion of the Company's Kurdistan asset reorganisation and the acquisition of the interests in the Sheikh Adi and Ber Bahr PSCs. The Company has also invested \$10.2 million (2009: \$nil) in a short-term liquid investment of over three months maturity in order to maximise interest revenue.

The issue of new common shares during the year raised \$359.9 million (2009: \$35.7 million) net of issue costs.

Taking into account the net cash used in operations, capital expenditure, short-term liquid investments and proceeds from the issue of shares the net overall increase in cash and cash equivalents during the year was \$176.2 million (2009: \$14.9 million decrease) prior to a foreign exchange gain of \$5.9 million (2009: \$0.4 million).

Cash and cash equivalents totalled \$201.3 million at 31 December 2010 (2009: \$19.2 million). Inclusive of the liquid investment, cash and cash equivalents totalled \$211.4 million at 31 December (2009: \$19.2 million).

### Issue of equity

In order to fund the Company's stated work programme which commenced in 2010 and will continue into 2012, as well as the \$52 million payment associated with the acquisition of interests in the Sheikh Adi and Ber Bahr production sharing contracts, the Company completed a number of significant share placings with existing and new institutional holders during 2010.

Between January and May 2010, the Company issued 8,179,645 new common shares under the SEDA with YA Global Master SPV Ltd at a weighted average price of £0.84 per share for a total value of \$10.8 million. At the date of this report, the Company has access to a further £10.0 million funds under this agreement should this be required.

On 15 March 2010 the Company placed 20,915,034 new common shares of \$0.01 each at a price of £0.765 each, raising gross proceeds of \$24 million and on 25 May 2010 the Company placed a further 152,300,000 new common shares of \$0.01 each at a price of £0.75 each, raising gross proceeds of \$165 million.

In October 2010, the Company successfully raised gross proceeds of \$175 million through an oversubscribed placing of 78,028,000 new common shares of \$0.01 each at a placing price of £1.40 per share. This additional funding has placed the Company in a strong financial position as at 31 December 2010 allowing the Company to fully fund its active work programme for the foreseeable future.

## Financial Review

### continued

Hassi Ba Hamou ("HBH") Permit in consideration for a net cash payment of \$10.0 million from BG. The agreement is subject to the conclusion of separate withdrawal documentation which will require the approval of Sonatrach and the necessary Algerian governmental authorities. On 23 August 2010 the parties to the HBH permit executed an amendment to the production sharing contract extending the expiry of the exploration period from 23 September 2010 until 23 September 2012.

During April Gulf Keystone upgraded its American Depository Receipt ("ADR") programme in the United States and began trading on the OTCQX International under the symbol "GFKSY", where each ADR represents 20 ordinary shares listed on the AIM market under the symbol "GKP". US investment bank Madison Williams and Company LLC acted as sponsor and Principal American Liaison ("PAL") for Gulf Keystone.

During May 2010 Sonatrach exercised a guarantee of \$15.6 million in relation to the Ben Guecha Permit Blocks 108 and 128b in Algeria as the exploration commitments were not satisfied. This

guarantee had been provided for from existing cash resources prior to the various 2010 share placings.

The Company established an Employee Benefit Trust and thereunder i) granted Long Term Incentive Performance Share Options and awarded ii) an executive bonus, all of which are detailed in an announcement on 7 June 2010 and 25 June 2010. Full details were also provided in the 2009 Annual Report and Accounts.

At the Annual General Meeting in early August approval was obtained to increase the authorised share capital of the Company and to issue up to 900 million new common shares of \$0.01 each of which 762,233,948 are currently in issue.

Subsequent to year end, a further 7.9 million shares were issued under the Company's Executive Bonus Scheme and Share Option Plan, further details of which are given in the Directors' Report and notes 18 and 22 to the accounts. The shares issued during 2010 and subsequent to year end to satisfy awards under the Company's incentive schemes represent 1.05% of the Company's share capital at 1 April 2011.

### Outlook

Following the completion of the reorganisation of the Company's Kurdistan assets during 2010 and the successful equity fundraisings, Gulf Keystone is in a strong financial position at 5 April 2011 with approximately \$171.9 million of cash and cash equivalents. The Company has seen its first revenues from oil production from Shaikan-1 during autumn 2010 and this revenue stream along with Shaikan-3 is expected to provide a growing contribution to the Group's funding throughout 2011 and beyond. The Group has achieved strong progress with its active and ambitious exploration and appraisal drilling programme during 2010, and 2011 offers the opportunity to further de-risk the exploration portfolio and add to Gulf Keystone's oil-in-place resources.

**Ewen Ainsworth**  
Finance Director



Vibreaseis trucks, Shaikan Block



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Tanker loading at the Extended Well Test Facility

## Board of Directors



**Todd F Kozel**  
Executive Chairman and  
Chief Executive Officer

Appointed to Board: October 2001

Mr Kozel co-founded the Company where he serves as the Executive Chairman and Chief Executive Officer. 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.



**Ali Al Qabandi**  
Business Development Director

Appointed to the Board: July 2007

Mr Al Qabandi co-founded the Company where he has served as a Director since July 2007. Prior to his appointment as the Business Development Director, Mr Al Qabandi had been serving the Company in the capacity of Executive Vice President and Business Development Officer. He has held numerous executive positions and committee chairmanships for the Kuwait Oil Company ("KOC") which he joined in 1979. Most recently, Mr Al Qabandi served as the Executive Assistant Managing Director of Planning and Finance for the KOC and as a Director of the Kuwait National Petroleum Company.

Mr Al Qabandi also served as Chairman of the Corporate Information Implementation Project and the KOC Profit Centre Committee, and was also a Board member of Kuwait Gulf Oil Company and the United Oil Projects and as a member of several Steering Committees.



**John B Gerstenlauer**  
Chief Operating Officer

Appointed to the Board: October 2008

Mr Gerstenlauer joined Gulf Keystone from BASF's Wintershall Nederland Group where he was Managing Director. He holds Bachelor of Science degrees in Marine Biology, Civil Engineering and a Master of Science degree in Ocean Engineering and has written numerous technical papers on petrophysical topics and drilling techniques. Mr Gerstenlauer's oil and gas industry career began when he joined Shell Coastal Division, New Orleans, as a petrophysical engineer in 1979. Over subsequent years, he assumed increasingly senior production engineering, drilling engineering and management roles within the Shell Group, Canadian Occidental Yemen and UMC Petroleum.

In 1998, Mr Gerstenlauer joined Wintershall AG, Kassel, Germany as Project Manager then Consultant before becoming Managing Director of Wintershall Nederland Group, The Hague in 2003.



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**Ewen Ainsworth**  
Finance Director

Appointed to the Board: January 2008

Mr Ainsworth was appointed as Finance Director of Gulf Keystone in January 2008. Mr Ainsworth has over 22 years' experience of finance roles within the oil and gas industry. Prior to joining Gulf Keystone, Mr Ainsworth was Finance Director of London AIM-listed Europa Oil & Gas (Holdings) plc ("Europa"). Mr Ainsworth has held increasingly senior finance positions within a number of oil and gas companies including Conoco (UK) Ltd, Murco Petroleum Ltd, Texaco Ltd and CIECO Exploration & Production (UK) Ltd. He joined Europa in September 2004 where he provided support to the business across a wide brief, including business development, compliance, legal and HR issues.

A qualified accountant, Mr Ainsworth gained ACMA accreditation in 1993. He has strong technical skills in managing public company finances and regulatory obligations as well as international transaction and funding experience.



**Mehdi Varzi**  
Non-Executive Director

Appointed to the Board: January 2008  
Committee membership: Remuneration and Appointments Committee, Audit Committee

Mr Varzi is President of Varzi Energy, an independent international energy consultancy set up in June 2001 in London, UK, after a 20-year career in the City of London. Mr Varzi retired in 2001 as the Managing Director of Global Energy Research at Dresdner Kleinwort Wasserstein. Varzi Energy's various activities currently include advising a select group of major international financial institutions and companies on global macro energy issues; advising private and public sector energy companies on international strategy; identifying potential partners for domestic and international projects, both upstream and downstream; and assisting in the process of securing the most appropriate access to international financial markets for financing energy projects.

Outside Varzi Energy, Mr Varzi is Advisor to the Board of Directors of Una Oil, a private international oil services company based in Monaco. Previously, Mr Varzi was a Diplomat in the Iranian Ministry of Foreign Affairs and a Senior Analyst at the National Iranian Oil Company based in Tehran. Mr Varzi also participates regularly as a speaker in major regional and international conferences and comments on global energy matters both on the radio and television.



**Lord Peter Truscott**  
Non-Executive Director

Appointed to the Board: May 2008  
Committee membership: Remuneration and Appointments Committee, Audit Committee

Lord Truscott of St James's is an independent Member of the House of Lords, and a Director and consultant with a number of publicly listed and private companies, mainly in the energy and mining sectors. He joined Gulf Keystone as a Non-Executive Director in May 2008. Lord Truscott was appointed as a Member of the House of Lords in 2004. Between 2006 and 2007, he was the UK's Energy Minister and Parliamentary Under-Secretary of State for Energy at the Department of Trade and Industry ("DTI") and the DTI Government Spokesperson in the House of Lords. He represented Hertfordshire in the European Parliament between 1994 and 1999, and was the Government's Foreign Affairs and Defence Spokesman and Vice-President of the Parliament's Security Committee.

He has been a member of the Lords European Union Select Committee, Sub-Committee C (Foreign Affairs, Defence and Development). An expert on Russia, he has written a biography of President Putin amongst other books and many articles on the former Soviet Union. He was Visiting Research Fellow with the Institute for Public Policy Research, and has written reports on European Defence (IPPR), on political risk management in the energy and defence sectors (RUSI), and European Energy Security (RUSI).

He has a doctorate in modern history from Oxford University, is a Fellow of the Industry and Parliament Trust and is currently an Associate Fellow with Royal United Services Institute for defence and security studies.

## Senior Management

# Highly experienced management

### Company's Milestones

#### 2001

- > Founded by UAE, Kuwaiti and US private equity
- > Incorporated in Bermuda

#### 2004

- > Listed on the Alternative Investment Market of the London Stock Exchange (GKP)

#### 2007

- > Award of two Production Sharing Contracts for the Shaikan and Akri-Bijeel blocks in the Kurdistan Region of Iraq

#### 2008

- > 2D seismic data acquired for the Shaikan and Akri-Bijeel blocks
- > American Depositary Receipts ("ADRs") traded in US over-the-counter securities market symbol GFKSY

#### 2009

- > Acquired interest in two further Production Sharing Contracts for the Sheikh Adi and Ber Bahr blocks in the Kurdistan Region of Iraq
- > The Company's first exploration well Shaikan-1 drilled and announced as a major discovery

#### 2010

- > Bijell-1, first exploration well on the Akri-Bijeel block, announced as a discovery
- > Shaikan Extended Well Test facilities completed and first domestic oil sales commenced
- > Significant amount of 3D seismic data acquired for the Shaikan and Sheikh Adi blocks
- > Shaikan-2 and Shaikan-3 appraisal wells spudded
- > Sheikh Adi-1, exploration well spudded
- > ADRs traded on the premier tier OTCQX International
- > Solid balance sheet following 2010 fund raisings for extensive 2011 and 2012 exploration and appraisal program

#### 2011

- > Bekhme-1, second exploration well on the Akri-Bijeel block spudded in March
- > Shaikan-4 appraisal well to be drilled in the second quarter
- > Shaikan-5 appraisal well location selected while Shaikan-6 & 7 are contingent
- > Ber Bahr-1, exploration well to be drilled in the summer



View of the extended well facility at night



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**Chris Garrett**  
**Vice President Operations**

Chris Garrett joined Gulf Keystone in 2004 shortly after the flotation of the Company on the AIM market. He holds the positions of Managing Director of Gulf Keystone Petroleum (UK) Limited and Vice President of Operations for Gulf Keystone Petroleum Ltd. Since joining Gulf Keystone he has lead all exploration and drilling operations in Algeria and Kurdistan. Chris's background is in geology and geophysics having gained an Honours degree in Geology and Geography from Exeter University and a Masters degree in Oceanography from Southampton University.

He is a certified Geologist with the American Association of Petroleum Geologists and a Fellow of The Geological Society. In his 35 years in the petroleum industry, he has spent 12 years overseas, working in Texas and the Middle East, mainly Saudi Arabia. He brings to Gulf Keystone oil field experience gained initially with Core Laboratories and Western Geophysical and latterly with Baker Hughes and Randall & Dewey.

He commenced his career with Core Laboratories as a Mud Logger and Wellsite Geologist in Saudi Arabia before moving to Core Labs headquarters in Dallas where he joined the Engineering and Consulting group; a team of leading geological and engineering consultants. He worked world wide on reserve evaluations and geological modeling studies; particularly reservoir fracture modelling projects.

He returned to London in 1988 and moved to Western Geophysical in the seismic interpretation department heading projects mainly in the Middle East, North Africa and Europe. In the 1990's he was General Manager for geological studies in Russia (CIS) for PetroAlliance; a Western Atlas joint venture. He subsequently worked for Baker Hughes and Randall & Dewey in a number of roles managing international exploration in West Africa and operations management through to property and prospect evaluation.



**Tony Peart**  
**Legal and Commercial Director**

Mr Peart joined Gulf Keystone in 2008 and has over 30 years of legal, commercial and management experience in the oil and gas industry. From 2006 to 2008 he was Legal and Commercial Director of African Arabian Petroleum Limited and from 2000 to 2005 he was Senior Vice President, General Counsel and Corporate Secretary of Petrokazakhstan Inc. which was acquired by the Chinese National Petroleum Corporation.

He was previously Managing Director of Bula Resources plc and MMS Petroleum plc and he has held senior management positions at Lasmo plc, Ultramar Exploration Limited and Veba Oil and Gas Limited. He is an Attorney and holds a Masters in General Management from the Vlerick Leuven Gent Management School and he has completed the Programme for Management Development at the Harvard Business School.



**Mohamed Messaoudi**  
**Country Manager – Algeria**

Mr Messaoudi, a petroleum geologist, has over 30 years' experience in the oil and gas industry in Algeria. Mr Messaoudi joined Sonatrach, the Algerian National Oil Enterprise in 1979, becoming Chief Geologist for the Hassi Messaoud Basin in 1996 and then the Regional Exploration Manager of the North Algeria Area/ Onshore and Offshore Basins. Prior to Mr Messaoudi's retirement from Sonatrach, he held the position of Regional Exploration Manager for the South East Algeria Region. The South East Algeria Region is Algeria's most important hydrocarbon area and contains the Hassi Messaoud, Berkine, Illizi and Oued Mya basins. Mr Messaoudi joined Gulf Keystone in 2007 as the Country Manager of Algeria.



**Adnan Samarrai**  
**Country Manager – Kurdistan**

Mr Samarrai holds a Bachelor of Science degree in geology and has been an active member of the American Association of Petroleum Geologists since 1972. He has over 47 years' experience in the oil and gas industry in Iraq including wide experience in petroleum geology and drilling technology. He joined the Iraq Petroleum Co. in the early sixties before joining the Iraq National Oil Company ("INOC") in 1972 where he held the position of Chief Exploration Geologist until his retirement in 1998. Since his retirement from INOC, Mr Samarrai has worked as Consulting Geologist to both BG International and Exploration Consultant Ltd before joining Gulf Keystone firstly as a consultant and subsequently as the Country Manager for Kurdistan in November 2006.

“Gulf Keystone was formed with the strategic intention of looking for under-developed, over looked assets in the Middle East and North Africa.”

Todd F Kozel, Executive Chairman  
and Chief Executive Officer

# Directors' Report

The Directors present their Annual Report and the consolidated financial statements of Gulf Keystone Petroleum Limited (the "Group") for the year ended 31 December 2010.

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 oil and gas exploration and production operating in the Kurdistan Region of Iraq and the Republic of Algeria. During 2009 a strategic decision was made to suspend investment in the Algerian projects and undertake an exit from Algeria.

The subsidiaries principally affecting the profits or net assets of the Group in the year are listed in note 12 to the consolidated financial statements.

## Results and Dividends

The Group's net loss after tax for the year was \$26.0 million (2009: net loss of \$96.3 million). The Directors do not recommend a dividend for the year (2009: \$nil).

## Capital Structure

Details of the authorised and issued share capital, together with movements in the Company's issued share capital during the year are shown in note 18.

There are no specific restrictions on the size of a holding nor on the transfer of shares, which are both governed by the general provisions of the Company's bye-laws and prevailing legislation.

The Directors are not aware of any agreements between holders of the Company's shares that may result in restrictions on the transfer of securities or on voting rights.

Details of the employee share scheme are set out in note 22 and details of the Directors awards are included in the Report of the Remuneration and Appointments Committee.

No person has any special rights of control over the Company's share capital and all issued shares are fully paid.

With regard to the appointment and replacement of directors, the Company is governed by its bye-laws, the Companies Act (Bermuda) and related legislation.

## Review of the Business and Future Developments

A review of the business is given in the Executive Chairman and Chief Executive Officer's Report, Operating Review and Financial Review.

## Directors

The following Directors have held office during the year:

**TF Kozel** – Executive Chairman and Chief Executive Officer  
**AA Al Qabandi** – Business Development Director  
**M Varzi** – Non-Executive Director<sup>(1)</sup>  
**J Asher** – Non-Executive Director<sup>(1)</sup> (resigned 1 April 2010)  
**P Truscott** – Non-Executive Director<sup>(1)</sup>  
**JB Gerstenlauer** – Chief Operating Officer  
**KE Ainsworth** – Finance Director

(1) Member of the Audit Committee and Remuneration and Appointments Committee.

## Directors' Interests in Shares and Options

Directors' interests in the shares of the Company, including family interests, were as follows:

	Number of Common Shares <sup>(1)</sup>						
	At 1 January 2010	Shares issued in 2010	Shares sold/transferred in 2010	At 31 December 2010	Shares issued post year end	Shares sold post year end	At date of report
TF Kozel	3,917,781	1,833,334	(2,050,000)	<b>3,701,115</b>	2,825,555	–	6,526,670
AA Al Qabandi	5,150,000	483,333	–	<b>5,633,333</b>	483,333	–	6,116,666
JB Gerstenlauer	–	333,333	(333,333)	–	531,777	(300,000)	231,777
KE Ainsworth	449,400	422,347	–	<b>871,747</b>	605,550	(240,000)	1,237,297
M Varzi	180,000	33,333	–	<b>213,333</b>	255,555	–	468,888
P Truscott	1,000,000	33,333	(533,000)	<b>500,333</b>	255,555	–	755,888

(1) Includes shares held directly and beneficially through the EBT.



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In addition to the above interests, TF Kozel and AA Al Qabandi are shareholders in Gulf Keystone Petroleum Company LLC which owns 40,000,000 common shares.

During February 2011, the Gulf Keystone Employee Benefit Trust ("EBT") subscribed for 5,886,332 new common shares so as to be able to fulfil the vested shares awarded under the Executive Bonus Scheme (see the Report of the Remuneration and Appointments Committee and note 22 to the accounts) and a further 1,000,507 new common shares so as to be able to fulfil the exercise of options by employees of the Company in February 2011. At the date of this report, the EBT held 8,765,323 common shares of the Company.

Directors' interests in share options of the Company and the Company's bonus scheme grants, including family interests, as at 31 December are disclosed under the Report of the Remuneration and Appointments Committee.

### Substantial Shareholdings

Other than the Directors' interests shown above, the Company has been notified of the following substantial interests as at 1 April 2011:

	Number of common shares	Percentage of issued share capital
TD Waterhouse	50,810,288	6.67%
M&G Investments	47,000,000	6.17%
Barclays Personal Investment Management	41,948,918	5.50%
Gulf Keystone Petroleum LLC	40,000,000	5.25%
Capital Research & Management Co.	39,362,382	5.16%
Halifax Share Dealing	36,642,748	4.81%
Gokana Trust	29,733,365	3.90%
Selftrade	25,335,227	3.32%

### Going Concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Executive Chairman and Chief Executive Officer's Report and Chief Operating Officer's Operating Review. The financial position of the Group, its cash flows, and an available funding facility are described in the Financial Review. In addition, note 24 to the consolidated financial statements includes the Group's objectives, policies and processes for managing its capital, its financial risk management objectives, and its exposures to credit risk and liquidity risk.

Following the share-placings during 2010, the Group is in a strong financial position at 5 April 2011 and has approximately \$171.9 million of cash and cash equivalents. The Group is receiving production revenue streams from its Kurdistan operations and has access to a further £10 million of funding through the Standby Equity Distribution Agreement facility if required. Consequently, the Directors believe that the Group is well placed to satisfy its obligations and finance its exploration and evaluation programme in the Kurdistan Region of Iraq for the foreseeable future, being at least the next 12 months.

Based on the forecasts and projections prepared at the time of preparation of these accounts and after making enquiries, the Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and accounts.

### Auditor

Each of the persons who is a Director at the date of approval of this annual report confirms that:

- > so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware; and
- > the Director has taken all the steps that he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

### Annual General Meeting 2011

The resolutions to be proposed at the Annual General Meeting ("AGM") to be held on 16 June 2011 will be set out in the Notice of the AGM.

By order of the Board

### TF Kozel

Executive Chairman and Chief Executive Officer  
8 April 2011

# Corporate Governance Statement

## Principles of Corporate Governance

Although not required to, 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 in so far as is appropriate given the circumstances of the Group.

## The Board

The Group is led and controlled by a Board which, during the year, comprised the Executive Chairman and Chief Executive Officer, three further Executive Directors and two Non-Executive Directors, three until April 2010.

There are no matters specifically reserved to the Board for its decision, although Board meetings are held on a regular basis, outside of the UK, 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 Remunerations and 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 further below.

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, however, independent professional advice is made available where considered appropriate.

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 2010, 13 scheduled Board meetings were held. 11 meetings took place in Europe, none of which were in the UK, four of which were in countries outside of the EU, and two meetings were held outside Europe.

## Board Committees

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

### 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 and is advised, as necessary, by a leading firm of recruitment consultants. Details of the Directors' remuneration are set out in the Report of the Remuneration and Appointments Committee.

### The Audit Committee

The Audit Committee's primary 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 Audit Committee is responsible for the development, implementation and monitoring of the Group's policy on external audit. To fulfil its responsibility regarding the independence of the external auditors, the Audit Committee reviewed:

- > the external auditor's plan for the current year, noting the role of the audit partner, who signs the audit report and who, in accordance with professional rules, has not held office for more than five years, and any changes in the key audit staff;
- > the overall extent of non-audit services provided by the external auditor, in addition to its case-by-case approval of the provision of non-audit services by the external auditor; and



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- > the past service of the auditor who was first appointed in 2006.

The Committee has considered the likelihood of a withdrawal of the auditor from the market and noted that there are no contractual obligations to restrict the choice of external auditor.

To assess the effectiveness of the external auditor, the Audit Committee reviewed:

- > the arrangements for ensuring the external auditor's independence and objectivity;
- > the external auditor's fulfilment of the agreed audit plan and any variations from the plan; and
- > the robustness and perceptiveness of the auditor in its handling of the key accounting and audit judgements.

Following the above, the Audit Committee has recommended to the Board that Deloitte LLP is reappointed.

The external auditor confirms its 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 auditor. Meetings are also attended, by invitation, by the Finance Director and Chief Executive 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; and
- > 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. The Audit Committee will continue to review this decision annually particularly in light of the Group's expansion.

### Relations with Shareholders

The Executive Chairman and 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 are 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 AGM will be held on 16 June 2011.

# Report of the Remuneration and Appointments Committee

## Remuneration and Appointments Committee

The Remuneration and Appointments Committee comprised Jeremy Asher (until April 2010), Mehdi Varzi and Lord Truscott in 2010, who are Non-Executive Directors of the Company. The Committee provides recommendations to the Board regarding the individual remuneration packages of each Executive Director. No Director plays a part in any discussion about his own remuneration. 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, bonus payable and benefits; and
- > share option and bonus share incentives.

There are no Company-funded 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 and length of employment. The conditions vary from grant to grant.

The Remuneration Committee based their recommendation of the 2010 bonus proposals on the following factors:

- > the share price performance in 2010;
- > the successful fund raisings in 2010; and
- > the operational activity, in particular the further discoveries and commencement of production.

## Directors' Interests in Options

### 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, Ali Al Qabandi, John Gerstenlauer and Ewen Ainsworth have service contracts with the Company. These can be terminated by either side on 12 months' notice for Todd Kozel, six months for John Gerstenlauer and Ewen Ainsworth and one week for Ali Al Qabandi.

## 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

	Fees/basic salary \$	Benefits in kind \$	Share bonus <sup>(1)</sup> \$	Cash bonus \$	2010 Total \$	2009 Total \$
Todd Kozel	675,000	–	7,907,649	1,393,387	<b>9,976,036</b>	2,613,272
Ali Al Qabandi	270,000	–	1,352,664	–	<b>1,622,664</b>	789,533
John Gerstenlauer	594,000	124,181	1,488,241	278,677	<b>2,485,099</b>	981,838
Ewen Ainsworth	278,292	3,418	1,694,703	278,677	<b>2,255,090</b>	754,381
Mehdi Varzi	80,000	–	715,201	312,069	<b>1,107,270</b>	118,784
Peter Truscott	117,106	–	715,201	312,069	<b>1,144,376</b>	156,360
Jeremy Asher	20,000	–	–	–	<b>20,000</b>	80,000
	2,034,398	127,599	13,873,659	2,574,879	<b>18,610,535</b>	5,494,168

(1) Share bonus is based on market value of shares at vesting date.

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Details of share option awards for Directors who served during the year are as follows:

	Scheme	1 January 2010	Granted	31 December 2010
Todd Kozel	Share Option Plan	3,000,000	–	3,000,000
Ali Al Qabandi	Share Option Plan	1,000,000	–	1,000,000
John Gerstenlauer	Share Option Plan	2,000,000	–	2,000,000
Ewen Ainsworth	Share Option Plan	1,000,000	–	1,000,000
Mehdi Varzi	Share Option Plan	100,000	–	100,000
Peter Truscott	Share Option Plan	100,000	–	100,000
Todd Kozel	2009 LTIP Options	–	9,766,473	9,766,473
John Gerstenlauer	2009 LTIP Options	–	1,953,295	1,953,295
Ewen Ainsworth	2009 LTIP Options	–	1,953,295	1,953,295

At 31 December 2010, one third of the 2009 LTIP Options have vested and are exercisable (Todd Kozel: 3,255,491; John Gerstenlauer: 651,098; Ewen Ainsworth: 651,098). There have been no variations to the terms and conditions or performance criteria for the schemes during the financial year.

#### Long Term Incentive Plan “LTIP” Options

During the year, the Remuneration Committee of the Company proposed structured option grants under the existing Share Option Plan with stretching performance criteria known as the Long Term Incentive Performance Conditions. The Company also established the Gulf Keystone Employee Benefit Trust (“EBT”) for the purpose of encouraging and facilitating the holding of shares in the Company by or for the benefit of its employees and others and settled an initial cash contribution on the independent trustee (the “Trustee”). The Trustee may acquire common shares in the Company, by subscription or by purchase, and, at the discretion of the Trustee, make available interests in those common shares for the benefit of Directors and employees under the Company’s Share Option Plan and Executive Bonus Scheme.

Details of the LTIP awards granted by the Trustees of the EBT following the recommendation of the Remuneration Committee during the year are as follows:

	Scheme	Date of grant	No of awards granted	Exercise price	Market price at award date
Todd Kozel	2009 LTIP Options	24 Jun 2010	9,766,473	75.00p	71.25p
John Gerstenlauer	2009 LTIP Options	24 Jun 2010	1,953,295	75.00p	71.25p
Ewen Ainsworth	2009 LTIP Options	24 Jun 2010	1,953,295	75.00p	71.25p

The 2009 LTIP options are available for exercise in equal tranches over three financial years and are subject to the following performance conditions:

- i) One third of the LTIP Share Options will be subject to operational performance conditions as follows:
  - > 50% of the one third tranche of LTIP Share Options will vest only on the achievement of sustained production of at least 8,000 barrels of oil per day resulting in sustained oil sales and revenue flow;
  - > 30% of the one third tranche of LTIP Share Options will vest only on successful resource addition through a combination of appraisal and production testing resulting in a significant movement of P10 hydrocarbon in place resources to P90 hydrocarbon in place resources; and
  - > 20% of the one third tranche of LTIP Share Options will vest only in the event of a significant new discovery.
- ii) One third of the LTIP Share Options will vest on the share price reaching 150 pence.
- iii) One third of the LTIP Share Options will vest on the share price reaching 200 pence.

During 2010 the share price reached 150 pence and as a result one third of the 2009 LTIP options vested.

Details of the LTIP awards which vested during the year are as follows:

	Scheme	No of awards vested	Exercise price	Market price at award date	Market price at vesting date
Todd Kozel	2009 LTIP Options	3,255,491	75.00p	71.25p	157.50p
John Gerstenlauer	2009 LTIP Options	651,098	75.00p	71.25p	157.50p
Ewen Ainsworth	2009 LTIP Options	651,098	75.00p	71.25p	157.50p

No LTIP Share Options were exercised by the Directors during the year.



# Report of the Remuneration and Appointments Committee *continued*

Subsequent to year end the following LTIP awards were granted by the Trustees of the EBT on the recommendation of the Remuneration Committee:

	Scheme	Date of grant	No of awards granted	Exercise price	Market price at award date
Todd Kozel	2010 LTIP Options	4 Feb 2011	4,195,000	175.00p	173.50p
John Gerstenlauer	2010 LTIP Options	4 Feb 2011	839,000	175.00p	173.50p
Ewen Ainsworth	2010 LTIP Options	4 Feb 2011	839,000	175.00p	173.50p

The 2010 LTIP Options are available for exercise in equal tranches over three financial years, subject to the following performance conditions:

- (i) One third of the 2010 LTIP Options will vest on the share price reaching 275 pence.
- (ii) One third of the 2010 LTIP Options will vest on the share price reaching 325 pence.
- (iii) One third of the 2010 LTIP Options will vest on the share price reaching 375 pence.

## Bonus shares granted and vested

On 4 February 2011, the Remuneration Committee recommended to the Trustee of the EBT that it makes discretionary awards for 2010 under the Company's Executive Bonus Scheme as follows:

	Scheme	Market price at award date	Maximum no of common shares awarded
Todd Kozel	2010 Executive Bonus Scheme	173.50p	3,968,889
John Gerstenlauer	2010 Executive Bonus Scheme	173.50p	793,778
Ewen Ainsworth	2010 Executive Bonus Scheme	173.50p	793,778

In addition, awards were made by the Company directly under the Company's Bonus Scheme as follows:

	Scheme	Market price at award date	Maximum no of common shares awarded
Mehdi Varzi	2010 Executive Bonus Scheme	173.50p	888,889
Peter Truscott	2010 Executive Bonus Scheme	173.50p	888,889

Two eighths of the maximum number of common shares vested on 4 February 2011 and have been included in the 2010 Directors' remuneration. Shares were issued to the EBT to satisfy this part of the award in February 2011. In accordance with the Company's Executive Bonus Scheme guidelines, one half of the remaining award will be considered for vesting at the end of 2011 with the second half being considered for vesting at the end of 2012.

On 4 February 2011, the Remuneration Committee further recommended to the Trustee of the EBT that the second third of the 2009 Executive Bonus Scheme awards are deemed to have vested as follows:

	Scheme	Market price at vesting date	No of common shares vested
Todd Kozel	2009 Executive Bonus Scheme	173.50p	1,666,667
Ali Al Qabandi	2009 Executive Bonus Scheme	173.50p	333,333
John Gerstenlauer	2009 Executive Bonus Scheme	173.50p	333,333
Ewen Ainsworth	2009 Executive Bonus Scheme	173.50p	333,333

In addition, awards were made by the Company directly under the Company's Bonus Scheme as follows:

	Scheme	Market price at vesting date	No of common shares vested
Mehdi Varzi	2009 Executive Bonus Scheme	173.50p	33,333
Peter Truscott	2009 Executive Bonus Scheme	173.50p	33,333

This second issue has been included in the 2010 Directors' remuneration. Shares were issued to the EBT in February 2011 respectively to satisfy the vested awards.

Also on 4 February 2011 it was resolved to issue the following new common shares of \$0.01 in respect of the remaining awards due for 2008 pursuant to and in accordance with the terms of the Company's Executive Bonus Scheme. This third and final issue relating to the 2008 awards has been included in the 2010 Directors' remuneration.

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Details of Directors receiving bonus shares under the scheme are as follows:

	Scheme	Market price at vesting date	No of common shares vested
Todd Kozel	2008 Executive Bonus Scheme	173.5p	166,667
Ali Al Qabandi	2008 Executive Bonus Scheme	173.5p	150,000
Ewen Ainsworth	2008 Executive Bonus Scheme	173.5p	150,000

### Bonus shares

Details of outstanding bonus share awards for Directors who served during the year are as follows:

	Scheme	1 January 2010 <sup>(1)</sup>	2010 Awards Granted	Vested <sup>(2)</sup>	31 December 2010 <sup>(3)</sup>
Todd Kozel	Executive Bonus Scheme	3,499,999	3,968,889	(2,825,555)	4,643,333
Ali Al Qabandi	Executive Bonus Scheme	816,667	–	(483,333)	333,334
John Gerstenlauer	Executive Bonus Scheme	666,667	793,778	(531,777)	928,668
Ewen Ainsworth	Executive Bonus Scheme	816,667	793,778	(681,777)	928,668
Mehdi Varzi	Executive Bonus Scheme	66,667	888,889	(255,555)	700,001
Peter Truscott	Executive Bonus Scheme	66,667	888,889	(255,555)	700,001

(1) Bonus share awards at 1 January 2010 include the 2009 Executive Bonus Scheme awards made on 24 June 2010 that did not vest immediately. These awards were granted based on 2009 performance.

(2) "Vested" awards are the 2008, 2009 and 2010 Executive Bonus Scheme awards that were deemed to have vested on 4 February 2011 as a result of the Group's performance during 2010. Shares for these vested awards have been issued either directly to the beneficiary or to the EBT and are included in the Directors' Interests in Shares and Options as shares issued post-year end.

(3) Bonus share awards at 31 December 2010 include the 2010 Executive Bonus Scheme awards made on 4 February 2011 that did not vest immediately and which are granted based on 2010 performance.

### Bonus shares lapsed

No bonus shares lapsed during the year or subsequent to year end.

The market price of the shares at 31 December 2010 and 31 December 2009 was £1.69 and £0.90 respectively and the range during 2010 was £0.66 to £1.94.

Approved by the Board

### TF Kozel

Executive Chairman and Chief Executive Officer

8 April 2011

## Directors' Responsibilities in the Preparation of the Financial Statements

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

The Directors have elected to prepare the Group financial statements under International Financial Reporting Standards ("IFRSs").

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements". In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRSs. However, the Directors are also responsible for:

- > properly selecting and applying accounting policies;
- > presenting information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

- > providing additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- > making an assessment of the Company's ability to continue as a going concern.

The Directors are responsible for keeping proper accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company. They are also responsible for safeguarding assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website.

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



# Independent Auditor's Report

## to the Members of Gulf Keystone Petroleum Limited

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We have audited the consolidated financial statements of Gulf Keystone Petroleum Limited for the year ended 31 December 2010 which comprise the Consolidated Income Statement, Consolidated Statement of Comprehensive Income, Consolidated Balance Sheet, Consolidated Statement of Changes in Equity, Consolidated Cash Flow Statement, Summary of Significant Accounting Policies and the related notes 1 to 25. The financial reporting framework that has been applied in their preparation is International Financial Reporting Standards (IFRSs).

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 independent 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 auditor

As explained more fully in the Directors' Responsibilities Statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

### Opinion on financial statements

In our opinion the financial statements:

- > give a true and fair view of the state of the Group's affairs as at 31 December 2010 and of its loss for the year then ended; and
- > have been properly prepared in accordance with International Financial Reporting Standards.

### Emphasis of matter – uncertain outcome of legal proceedings

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosures made in note 21 to the financial statements concerning the uncertain outcome of legal proceedings which include a claim against up to 30% of the Group's blocks in the Kurdistan Region of Iraq, which comprise the substantial majority of the Group's petroleum operations. The Company and two of its subsidiaries received notice on 23 December 2010 of the claims, since which time they have been vigorously contesting the claims. The ultimate outcome of the matter cannot presently be determined, and consequently no provision for any liability that may result has been made in the financial statements.

### Opinion on other matters

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

### Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where we are required to report to you if, in our opinion:

- > adequate accounting records have not been kept; or
- > we have not received all the information and explanations we require for our audit.

### Deloitte LLP

Chartered Accountants  
London, United Kingdom  
8 April 2011

# Consolidated Income Statement

for the year ended 31 December 2010

	Notes	2010 \$'000	2009 \$'000
<b>Continuing operations</b>			
Revenue	5	808	–
Cost of sales		(808)	–
<b>Gross profit</b>		–	–
<b>Other operating expenses</b>			
Impairment of intangible exploration assets	9	–	(57,418)
Impairment of tangible oil and gas properties	10	–	(12,182)
Impairment of inventories	13	–	(4,343)
General and administrative expenses		(32,595)	(21,516)
<b>Loss from operations</b>	3	(32,595)	(95,459)
Other gains and losses	6	5,940	(106)
Interest revenue	5	192	318
Finance costs	16	(348)	(1,027)
<b>Loss before tax</b>		(26,811)	(96,274)
Tax benefit/(expense)	7	819	(28)
<b>Loss after tax for the year</b>		(25,992)	(96,302)
<b>Loss per share (cents)</b>			
Basic	8	(4.17)	(22.80)
Diluted	8	(4.17)	(22.80)

# Consolidated Statement of Comprehensive Income

for the year ended 31 December 2010

	2010 \$'000	2009 \$'000
Loss for the period	(25,992)	(96,302)
Foreign currency translation differences	(154)	27
<b>Total comprehensive loss for the period</b>	<b>(26,146)</b>	<b>(96,275)</b>

# Consolidated Balance Sheet

as at 31 December 2010

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	Notes	2010 \$'000	2009 \$'000
<b>Non-current assets</b>			
Intangible assets	9	223,824	90,482
Property, plant and equipment	10	4,102	3,433
Deferred tax asset	17	4,106	960
		<b>232,032</b>	<b>94,875</b>
<b>Current assets</b>			
Assets held for sale	11	10,441	–
Inventories	13	14,423	574
Trade and other receivables	14	3,663	2,214
Liquid investments		10,177	–
Cash and cash equivalents		201,268	19,156
Derivative financial instruments	24	659	574
		<b>240,631</b>	<b>22,518</b>
<b>Total assets</b>		<b>472,663</b>	<b>117,393</b>
<b>Current liabilities</b>			
Trade and other payables	15	(39,103)	(44,117)
Current tax liabilities		(320)	(524)
		<b>(39,423)</b>	<b>(44,641)</b>
<b>Non-current liabilities</b>			
Trade and other payables	15	–	(113)
Provisions	16	(6,399)	(3,545)
		<b>(6,399)</b>	<b>(3,658)</b>
<b>Total liabilities</b>		<b>(45,822)</b>	<b>(48,299)</b>
<b>Net assets</b>		<b>426,841</b>	<b>69,094</b>
<b>Equity</b>			
Share capital	18	6,628	3,985
Share premium account	18	593,470	239,813
Share option reserve		20,468	11,745
Exchange translation reserve		(311)	(157)
Accumulated losses		(193,414)	(186,292)
<b>Total equity</b>		<b>426,841</b>	<b>69,094</b>

The financial statements were approved by the Board of Directors and authorised for issue on 8 April 2011 and are signed on its behalf by:

**TF Kozel**  
Executive Chairman and Chief Executive Officer

**KE Ainsworth**  
Finance Director



# Consolidated Statement of Changes in Equity

for the year ended 31 December 2010

	Notes	Attributable to equity holders of the Group					Total equity \$'000
		Share capital \$'000	Share premium account \$'000	Share option reserve \$'000	Exchange translation reserve \$'000	Accumulated losses \$'000	
Balance as at 1 January 2009		2,765	204,919	4,890	(184)	(89,990)	122,400
Share-based payment expense	22	–	–	6,361	–	–	6,361
Deferred tax on share-based payment transactions	17	–	–	494	–	–	494
Share issue	18	1,220	34,894	–	–	–	36,114
Foreign currency translation differences		–	–	–	27	–	27
Net loss for the year		–	–	–	–	(96,302)	(96,302)
Balance at 1 January 2010		3,985	239,813	11,745	(157)	(186,292)	69,094
Transfer relating to share-based payments		–	–	(18,904)	–	18,904	–
Share-based payment expense	22	–	–	21,730	–	–	21,730
Deferred tax on share-based payment transactions	17	–	–	2,057	–	–	2,057
Share issue	18	2,643	353,657	3,840	–	–	360,140
Foreign currency translation differences		–	–	–	(154)	–	(154)
Own shares held	18	–	–	–	–	(34)	(34)
Net loss for the year		–	–	–	–	(25,992)	(25,992)
<b>Balance at 31 December 2010</b>		<b>6,628</b>	<b>593,470</b>	<b>20,468</b>	<b>(311)</b>	<b>(193,414)</b>	<b>426,841</b>

# Consolidated Cash Flow Statement

for the year ended 31 December 2010

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	Notes	2010 \$'000	2009 \$'000
<b>Operating activities</b>			
Cash used in operations	19	(26,225)	(1,663)
Tax (paid)/refunded		(503)	56
Interest received		192	318
<b>Net cash used in operating activities</b>		<b>(26,536)</b>	<b>(1,289)</b>
<b>Investing activities</b>			
Proceeds on sale of property, plant and equipment		–	37
Purchase of intangible assets		(145,877)	(48,984)
Purchase of property, plant and equipment		(1,132)	(279)
Increase in liquid investments <sup>1</sup>		(10,177)	–
<b>Net cash used in investing activities</b>		<b>(157,186)</b>	<b>(49,226)</b>
<b>Financing activities</b>			
Proceeds on issue of share capital		359,895	35,657
<b>Net cash generated by financing activities</b>		<b>359,895</b>	<b>35,657</b>
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>176,173</b>	<b>(14,858)</b>
Cash and cash equivalents at beginning of year		19,156	33,606
Effect of foreign exchange rate changes		5,939	408
<b>Cash and cash equivalents at end of the year being bank balances and cash on hand</b>		<b>201,268</b>	<b>19,156</b>

<sup>1</sup> Liquid investments comprise short-term liquid investments of between three to 12 months maturity while cash and cash equivalents comprise cash at bank and other short-term highly liquid investments of less than three months maturity. The combined cash, cash equivalents and liquid investments balance at 31 December 2010 was \$211.4 million (2009: \$19.2 million).

# Summary of Significant Accounting Policies

## General information

The Company is incorporated in Bermuda and it is quoted on the Alternative Investment Market of the London Stock Exchange (registered address: Cumberland House, 9th Floor, 1 Victoria Street, Hamilton, Bermuda). In 2008 the Company established a Level 1 American Depositary Receipt programme in conjunction with the Bank of New York Mellon which has been appointed as the depositary bank. The Company serves as the holding Company for the Group, which is engaged in oil and gas exploration and production, operating in the Republic of Algeria and the Kurdistan Region of Iraq.

## Adoption of new and revised accounting standards

### Standards not affecting the reported results or the financial position

In the current year, the following new and revised Standards and Interpretations have been adopted. Their adoption has not had any impact on the amounts reported in these financial statements but may impact the accounting for future transactions.

IFRS 2 (amended) Group Cash-settled Share-based Payment Transactions	The amendment clarifies the accounting for share-based payment transactions between group entities.
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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 9	<i>Financial Instruments</i>
IAS 24 (amended)	<i>Related Party Disclosures</i>
IAS 32 (amended)	<i>Classification of Rights Issues</i>
IFRIC 19	<i>Extinguishing Financial Liabilities with Equity Instruments</i>
IFRIC 14 (amended)	<i>Prepayment of a Minimum Funding Requirement</i>
Improvements to IFRS (May 2010)	

The Directors do not anticipate that the adoption of the other Standards and Interpretations listed above will have a material impact on the financial statements of the Group in future periods.

## Statement of compliance

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

## Basis of accounting

The financial statements have been prepared under the historical cost basis, except for the valuation of hydrocarbon inventory and the valuation of certain financial instruments, and on a going concern basis as discussed in the Annual Report of Directors and in note 1 below. The principal accounting policies adopted are set out below.

## 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 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.

## Assets held for sale

Non-current assets (and disposal groups) classified as held for sale are measured at the lower of carrying value and fair value less costs to sell.

Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. The condition is regarded as met only when the sale is highly probable and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale which should be expected to qualify for recognition as a completed sale within one year from date of classification.

## Revenue

Revenue is recognised to the extent that it is probable that economic benefits will flow to the Group and the revenue and costs incurred or to be incurred in respect of the transaction can be reliably measured. Revenue is measured at the fair value of consideration received or receivable and reflects actual sales value in respect of petroleum production in the normal course of business, net of sales related taxes. Petroleum sales reflect the Group's share of volumes sold and are recorded when goods are delivered and title has passed. To the extent that revenue arises from test production during an evaluation programme, an amount is charged from evaluation costs to cost of sales so as to reflect a zero net margin.



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Interest revenue is accrued on a time basis, with reference to the principal outstanding and at the effective rate of interest applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount on initial recognition.

### Leasing

Rentals payable under operating leases are charged to the income statement 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

The functional and presentation currency of the Company, and the presentation currency of the Group, is US dollars.

In preparing the financial statements of the individual Group companies, transactions in currencies other than the entity's functional currency 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 year.

On consolidation, the assets and liabilities of the Group's operations which use functional currencies other than the US dollar 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 year. Exchange differences arising, if any, are recognised in other comprehensive income and 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.

### Taxation

The tax expense represents the sum of tax currently payable and deferred tax.

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.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from the initial recognition of goodwill or from the initial recognition of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates and interests in joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part assets to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised using rates that have been enacted or substantially enacted by the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

### Property, plant and equipment other than oil and gas interests

Property, plant and equipment are stated at cost less accumulated depreciation and any accumulated impairment losses. 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 interests

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

# Summary of Significant Accounting Policies

## continued

### 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 having regard to the requirements of IFRS 6 Exploration for and Evaluation of Mineral Resources. Under the full cost method of accounting all costs relating to the exploration for and development of oil and gas exploration and evaluation interests, whether productive or not, are accumulated and capitalised as non-current assets within geographic cost pools.

Exploration and evaluation costs are generally classified as intangible non-current assets during the exploration and evaluation phase and are carried forward where activities in an area have not yet reached a stage which permits reasonable assessment of the existence of economically recoverable reserves, and subject to there being no impairment. Costs dealt with in this way include seismic data, licence acquisition costs, technical work, education and training fund production sharing contract costs, exploration and appraisal drilling (including installed test production equipment), general technical support and directly attributable administrative and overhead costs.

Exploration and evaluation costs are transferred to property, plant and equipment upon declaration of commerciality and amortised, together with development costs and decommissioning costs capitalised, on a unit of production basis as discussed below.

Depreciation, depletion and amortisation is provided under the unit of production method which uses the estimated remaining commercial reserves and the net book value of the cost pool, including any unsuccessful exploration and evaluation costs, 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, or group of assets, is estimated in order to determine the extent of the impairment loss (if any). For exploration and evaluation assets, the group of assets is the relevant full cost pool. Where the assets fall into an area that does not have an established pool or if there are no producing assets to cover the unsuccessful exploration and evaluation costs, those assets would fail the impairment test and be written off to the income statement in full.

For other assets 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.

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 is estimated to be less than its carrying amount, the carrying amount is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately.

### Disposals of oil and gas interests

The difference between the fair value of the consideration receivable and the carrying value of the relevant proportion of the oil and gas asset disposed of is first applied to reduce any unsuccessful exploration and evaluation cost carried in the pool, with any excess gain recognised in the income statement.

### Carry of expenditures and farm-in arrangements

Where the Group enters into a commercial agreement which includes carry of expenditures or a farm-in, the arrangement is accounted for according to its commercial substance. Generally, in the case of a farm-in, the substance is that the counterparty has acquired a share, or a greater share, of the underlying oil and gas reserves and the arrangement is treated as a partial disposal. Where the substance is that the counterparty has acquired a right, or a conditional right to be reimbursed by the Group out of future production, a liability is recognised at the time the obligation arises. In the case of a carry, a liability is recognised when the obligation is probable and is no longer conditional upon factors under the Group's control.

### Inventories

Inventories relating to materials acquired for use in exploration activities and those overheads that have been incurred in bringing the inventories to their present location and condition are valued at the lower of cost and net realisable value.

Hydrocarbon inventories are valued at net realisable value with changes in hydrocarbon inventories being adjusted through cost of sales.

### Capitalisation of interest

Any interest payable on funds borrowed for the purpose of obtaining a qualifying asset will be capitalised as a cost of that asset. However, any associated interest charge from funds borrowed principally to address a short-term cash flow shortfall during the suspension of development activities shall be expensed in the year.

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### Financial instruments

The Group's financial instruments comprise cash and borrowings together with various items such as trade and other receivables and trade payables, 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 assets at fair value through profit and loss

Financial assets are held at fair value through profit and loss ("FVTPL") when the financial asset is either held for trading or it is designated at FVTPL.

A financial asset other than a financial asset held for trading may be designated as FVTPL upon initial recognition if:

- > such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise; or
- > the financial asset forms part of a group of financial assets or financial liabilities or both which is managed and its performance is evaluated on a fair value basis in accordance with the Group's risk management or investment strategy and information about the grouping is provided internally on that basis; or
- > it forms part of a contract containing one or more embedded derivatives and IAS 39 Financial Instruments: Recognition and Measurement permits the entire combined contract (asset or liability) to be designated as at FVTPL.

Financial assets at FVTPL are stated at fair value, with any gains or losses arising on remeasurement recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset and is included in the other gains and losses line in the income statement.

The Standby Equity Distribution Agreement ("SEDA") has been designated as a financial asset at FVTPL upon initial recognition and the fair value has been estimated with reference to the fees payable for the SEDA and the percentage of the SEDA drawn down at balance sheet date.

#### Contingent deferred consideration

Contingent deferred consideration embedded in certain asset sale contracts is treated as a financial instrument and recognised immediately at its fair value and then reviewed on a periodic basis until the contractual rights to the cash flows from the financial asset expire. Movements in the fair value are taken to the income statement.

#### Impairment of financial assets

Financial assets, other than those valued at fair value through the profit and loss, are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted.

Objective evidence of impairment could include:

- > significant financial difficulty of the issuer or counterparty; or
- > default or delinquency in interest or principal payments; or
- > it becoming probable that the borrower will enter bankruptcy or financial reorganisation.

For certain categories of financial asset, such as trade receivables, assets that are assessed not to be impaired individually are subsequently assessed for impairment on a collective basis. Objective evidence of impairment for a portfolio of receivables could include the Group's past experience of collecting payments, an increase in the number of delayed payments in the portfolio past the average credit period, as well as observable changes in local or national economic conditions that correlate with default on receivables.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets. If in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through income statement to the extent that the carrying amount of the investment at the date the impairment is reversed does not exceed what the amortised cost would have been had the impairment not been recognised.

#### 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.

#### Borrowings

Interest-bearing 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 year in which they arise.



# Summary of Significant Accounting Policies

## continued

### Trade payables

Trade payables are not interest bearing and are stated at amortised cost. The average maturity for trade and other payables is one to three months.

### Derivative financial instruments

The Group may enter into derivative financial instruments including foreign exchange forward contracts to manage its exposure to foreign exchange rate risk.

Derivatives are initially recognised at fair value at the date a derivative contract is entered into and are subsequently remeasured to their fair value at each balance sheet date. The resulting gain or loss is recognised in the profit or loss immediately unless the derivative is designated and effective as a hedging instrument, in which event the timing of the recognition in profit or loss depends on the nature of the hedge relationship.

A derivative with a positive fair value is recognised as a financial asset whereas a derivative with a negative fair value is recognised as a liability. A derivative is presented as a non-current asset or a non-current liability if the remaining maturity of the instrument is more than 12 months and it is not expected to be realised or settled within 12 months. Other derivatives are presented as current assets or current liabilities.

### Equity instruments

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

### Cash, cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits and other short-term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

### Liquid investments

Liquid investments comprise short-term liquid investments of between three to 12 months maturity.

### 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 liability for restoring the sites of drilled wells to their original status, discounted where the effect is material. A corresponding amount equivalent to the provision is also recognised as part of the cost of the related property, plant and equipment. The amount recognised is reassessed each year in accordance with local conditions and requirements. Changes in the estimated timing of decommissioning or decommissioning cost estimates are dealt with prospectively. The unwinding of the discount on the decommissioning provision is included as a finance cost.

### Share-based payments

The Group has applied the requirements of IFRS 2 to bonus shares and share option schemes allowing certain employees within the Group to acquire or receive 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 cost is recognised over the expected life of the option.

The fair value of the bonuses granted in shares is recognised as an employee expense with a corresponding increase in equity to the extent that Company performance conditions are expected to be met. The fair value of the bonuses granted is measured using the standard methodology applied by the Group taking into account the terms and conditions upon which the bonuses were granted. To the extent that previous estimates relating to the satisfaction of performance conditions change, a corresponding adjustment is recognised in the income statement.

### 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.

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.

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### Impairment review

An impairment test of the Group's cost pool requires a comparison of the carrying value of the assets or group of assets (for example, a full cost pool) with its recoverable amount, that is, the higher of fair value less costs to sell and value in use. Value in use is usually determined on the basis of discounted estimated future net cash flows from future production. The future net cash flows from production reflect estimates of reserves, productive rates, future oil and gas prices and costs, all of which are inherently uncertain, together with the application of an appropriate discount rate. Management uses a set of assumptions as at the date of the test which it considers to be collectively reasonable in its judgement, and employs an economist to assist in performing the tests. However, because of these uncertainties the actual future cash flows could materially differ from those estimated. When an asset is expected to be disposed of or abandoned, the recoverable amount reflects the expected net disposal consideration, together with the value of any liabilities avoided or transferred.

### Carrying value of intangible exploration and evaluation assets

The outcome of ongoing exploration, and therefore whether the carrying value of intangible exploration and evaluation assets will ultimately be recovered, is inherently uncertain. Management makes the judgements necessary to implement the Group's policy with respect to exploration and evaluation assets and considers these assets for impairment at least annually with reference to indicators in IFRS 6.

### Decommissioning costs

The accounting policy for decommissioning provision is discussed above. The cost of decommissioning is estimated by reference to the Group's experience. Further details are provided in note 16.

### Reserves

Commercial reserves are determined using estimates of oil-in-place, recovery factors and future oil prices. Future development costs are estimated using assumptions as to numbers of wells required to produce the commercial reserves, the cost of such wells and associated production facilities, and other capital and operating costs. Reserves' estimates principally affect the depreciation, depletion and amortisation charges.

### Standby equity distribution agreement

In May 2009 the Group secured £30 million by way of a SEDA. The Company entered into the £30 million SEDA with YA Global Master SPV Ltd, an investment fund managed by Yorkville Advisors, LLC. The SEDA has been treated as a derivative financial instrument and its fair value is being determined with reference to the fees payable for the SEDA and the percentage of the SEDA drawn down at balance sheet date.

# Notes to the Consolidated Financial Statements

## For the year ended 31 December 2010

### 1. Presentation of financial statements

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

#### Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Executive Chairman and Chief Executive Officer's Report and Chief Operating Officer's Operating Review. The financial position of the Group, its cash flows, and an available funding facility are described in the Financial Review. In addition, note 24 to the consolidated financial statements includes the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; and its exposures to credit risk and liquidity risk.

Following the equity placings during 2010, the Group is in a strong financial position at 5 April 2011 and has approximately \$171.9 million of cash and cash equivalents. The Group is receiving production revenue streams from its operations in the Kurdistan Region of Iraq and has access to a further £10 million of funding through the Standby Equity Distribution Agreement facility if required (see note 18). Consequently, the Directors believe that the Group is well placed to satisfy its obligations and finance its exploration and evaluation programme for the foreseeable future, being at least the next 12 months.

Based on the forecasts and projections prepared at the time of preparation of these accounts and after making enquiries, the Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and accounts.

### 2. Segment information

For the purposes of resource allocation and assessment of segment performance, the Group is organised into three business segments based on geography. The chief operating decision maker is the Executive Chairman and Chief Executive Officer. He is assisted by the Chief Operating Officer, the Finance Director and the Vice President of Operations as well as the Country Managers in the Kurdistan Region of Iraq and Algeria.

The accounting policies of the reportable segments are consistent with the Group's accounting policies.

Each segment is described in more detail below:

- > Algeria: the Algerian segment consists of the Algiers office and the Group's operations in Algeria.
- > Kurdistan Region of Iraq: the Kurdistan segment consists of the Shaikan, Akri-Bijeel, Sheikh Adi and Ber Bahr Blocks and the Erbil office which provides support to the operations in Kurdistan.
- > United Kingdom: the UK segment provides geological, geophysical and engineering services to the Gulf Keystone Group.

Corporate manages activities that serve more than one segment. It represents all overhead and administration costs incurred that cannot be directly linked to one of the above segments.



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31 December 2010	Algeria \$'000	Kurdistan \$'000	United Kingdom \$'000	Corporate \$'000	Elimination \$'000	Total \$'000
<b>Revenue</b>						
Oil Sales	–	808	–	–	–	808
Inter-segment sales	–	–	7,434	–	(7,434)	–
<b>Total revenue</b>	–	808	7,434	–	(7,434)	808
<b>Cost of sales</b>						
Production costs	–	(808)	–	–	–	(808)
<b>Gross profit</b>	–	–	7,434	–	(7,434)	–
Allocated general and administrative expenses	(1,207)	(388)	(10,222)	(30,430)	10,146	(32,101)
Depreciation and amortisation expense	(143)	(273)	(75)	(3)	–	(494)
<b>Loss from operations</b>	(1,350)	(661)	(2,863)	(30,433)	2,712	(32,595)
Other gains and losses	–	(65)	(63)	6,068	–	5,940
Interest revenue	–	–	–	192	–	192
Finance costs	(313)	(35)	–	–	–	(348)
<b>Loss before tax</b>	(1,663)	(761)	(2,926)	(24,173)	2,712	(26,811)
Tax benefit	–	–	819	–	–	819
<b>Loss after tax</b>	(1,663)	(761)	(2,107)	(24,173)	2,712	(25,992)
Capital expenditure	24	144,857	61	1	–	144,943
Total assets	14,837	245,902	14,691	567,268	(370,035)	472,663

31 December 2009	Algeria \$'000	Kurdistan \$'000	United Kingdom \$'000	Corporate \$'000	Elimination \$'000	Total \$'000
<b>Revenue</b>						
Inter-segment sales	–	–	3,991	–	(3,991)	–
<b>Total revenue</b>	–	–	3,991	–	(3,991)	–
Impairment of intangible assets	(57,418)	–	–	–	–	(57,418)
Impairment of tangible oil and gas properties	(12,182)	–	–	–	–	(12,182)
Impairment of inventories	(4,343)	–	–	–	–	(4,343)
Allocated general and administrative expenses	(6,667)	(2,126)	(3,622)	(11,791)	3,409	(20,797)
Depreciation and amortisation expense	(88)	(122)	(171)	(2)	–	(383)
<b>(Loss)/profit from operations</b>	(80,698)	(2,248)	198	(11,793)	(582)	(95,123)
Other gains and losses	–	–	–	(442)	–	(442)
Interest revenue	–	4	96	218	–	318
Finance costs	(1,027)	–	–	–	–	(1,027)
<b>(Loss)/profit before tax</b>	(81,725)	(2,244)	294	(12,017)	(582)	(96,274)
Tax expense	–	–	(28)	–	–	(28)
<b>(Loss)/profit after tax</b>	(81,725)	(2,244)	266	(12,017)	(582)	(96,302)
Capital expenditure	8,537	44,139	3	–	–	52,679
Total assets	13,591	82,769	4,813	227,393	(211,173)	117,393

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 2. Segment information continued

#### Geographical information

The Group's information about its segment assets (non-current assets excluding deferred tax assets and other financial assets) by geographical location are detailed below:

	2010 \$'000	2009 \$'000
Algeria	2,712	13,272
Kurdistan	225,139	80,555
Bermuda	3	5
Other	72	83
	<b>227,926</b>	<b>93,915</b>

### 3. Loss from operations

	2010 \$'000	2009 \$'000
Loss from operations has been arrived at after charging:		
Depreciation of property, plant and equipment	464	363
Amortisation of intangible assets	30	20
Impairment of intangible exploration assets	–	57,418
Impairment of tangible oil and gas properties	–	12,182
Impairment of inventories	–	4,343
Staff costs (see note 4)	25,570	10,711
Auditor's remuneration for audit services (see below)	80	113
Operating lease rentals (see note 20)	377	371

	2010 \$'000	2009 \$'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts	64	93
<i>Fees payable to the Company's auditor for other services to the Group</i>		
– The audit of the Company's subsidiaries pursuant to legislation and other	16	20
<i>Total audit fees</i>	<b>80</b>	<b>113</b>
Tax services	19	13
<i>Total fees</i>	<b>99</b>	<b>126</b>

### 4. Staff costs

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

	2010 Number	2009 Number
Office and management	43	14
Technical and operational	108	53
	<b>151</b>	<b>67</b>

Employee benefits recognised as an expense during the year comprised:

	2010 \$'000	2009 \$'000
Wages and salaries	4,885	3,474
Social security costs	3,812	876
Share-based payment (see note 22)	16,873	6,361
	<b>25,570</b>	<b>10,711</b>

### 5. Revenue

	2010 \$'000	2009 \$'000
Oil sales	808	–
Interest revenue	192	318
	<b>1,000</b>	<b>318</b>

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## 6. Other gains and (losses)

	2010 \$'000	2009 \$'000
Exchange gains	5,855	336
Mark-to-market valuation of foreign exchange contracts	319	–
Change in the fair value of the SEDA derivative financial instrument	(234)	(442)
	<b>5,940</b>	<b>(106)</b>

Exchange gains have been reclassified from general and administrative expenses to other gains and losses. Exchange gains primarily arise on cash, cash equivalents and liquid investments which are held in currencies other than the functional currency of the holding entity.

## 7. Tax expense

	2010 \$'000	2009 \$'000
Provision for current UK corporation tax	322	509
Credit for deferred UK corporation tax	(1,141)	(481)
Tax attributable to the Company and its subsidiaries	<b>(819)</b>	<b>28</b>

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.

Any corporate tax liability in Algeria is settled out of Sonatrach's share of oil under the terms of the Production Sharing Contracts and is therefore not reflected in the tax charge for the year.

In the Kurdistan Region of Iraq, the Group is subject to corporate income tax on its income from petroleum operations under the production sharing contract. The rate of corporate income tax is currently 15% on total income. However, any corporate income tax arising from petroleum operations will be paid from the Kurdistan Regional Government of Iraq's share of petroleum profits.

The tax currently payable is based on taxable profit for the year earned in the United Kingdom by the Group's subsidiary. UK corporation tax is calculated at 28% (2009: 28%) of the estimated assessable profit for the year of the UK subsidiary.

Deferred tax is provided for due to the temporary differences which give rise to such a balance in jurisdictions subject to income tax. During the current period no taxable profits were made in respect of the Group's Kurdistan PSCs, nor were there any temporary differences on which deferred tax is required to be provided. As a result, no corporate income tax or deferred tax has been provided for Kurdistan in the period.

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

	2010 \$'000	2009 \$'000
Loss before tax	<b>(26,811)</b>	<b>(96,274)</b>
Tax at the Bermudan tax rate of 0% (2009: 0%)	–	–
Effect of different tax rates of subsidiaries operating in other jurisdictions	819	(28)
Tax benefit/(expense) for the year	<b>819</b>	<b>(28)</b>

In addition to the amount charged to the income statement, \$2.1 million deferred tax credit (2009: \$0.5 million credit) relating to estimated excess tax deductions related to share-based payments has been recognised directly in equity (see note 17).



# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 8. Loss per share

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

	2010 \$'000	2009 \$'000
<b>Loss</b>		
Loss for the purposes of basic and diluted loss per share	<b>(25,992)</b>	(96,302)
	2010 Number (000s)	2009 Number (000s)
<b>Number of shares</b>		
Weighted average number of common shares for the purposes of basic loss per share	<b>622,613</b>	422,471
Adjustments for:		
–bonus shares	n/a	n/a
–share options	n/a	n/a
–warrants	n/a	n/a
–ordinary shares held by the Employee Benefit Trust	n/a	n/a
Weighted average number of common shares for the purposes of diluted loss per share	<b>622,613</b>	422,471

There is no difference between basic and diluted earnings per share as the Group was loss making in each year and hence the effect of bonus shares, share options, warrants and ordinary shares held by the Employee Benefit Trust is anti-dilutive.

As at 31 December 2010, 31.2 million share options (2009: 11.0 million), 18.6 million un-issued bonus shares (2009: 13.0 million), 2.5 million warrants (2009: nil) and 3.4 million shares held by the Employee Benefit Trust (2009: nil) were excluded from the loss per share calculation as they were anti-dilutive.

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## 9. Intangible assets

	Exploration & evaluation costs \$'000	Computer software \$'000	Total \$'000
<b>At 1 January 2009</b>			
Cost	95,483	284	95,767
Accumulated amortisation	–	(247)	(247)
Net book value	95,483	37	95,520
<b>Year ended 31 December 2009</b>			
Opening net book value	95,483	37	95,520
Additions	52,398	2	52,400
Impairment write off	(57,418)	–	(57,418)
Amortisation charge	–	(20)	(20)
Closing net book value	90,463	19	90,482
<b>At 31 December 2009</b>			
Cost	90,463	286	90,749
Accumulated amortisation	–	(267)	(267)
Net book value	90,463	19	90,482
<b>Year ended 31 December 2010</b>			
Opening net book value	90,463	19	90,482
Additions	143,727	84	143,811
Reclassification as held for sale (note 11)	(10,441)	–	(10,441)
Amortisation charge	–	(30)	(30)
Foreign currency translation differences	–	2	2
Closing net book value	223,749	75	223,824
<b>At 31 December 2010</b>			
Cost	223,749	369	224,118
Accumulated amortisation	–	(294)	(294)
<b>Net book value</b>	<b>223,749</b>	<b>75</b>	<b>223,824</b>

The net book value at 31 December 2010 includes intangible assets relating to: Shaikan \$117.8 million (2009: \$59.5 million); Ber Bahr \$27.9 million (2009: \$10.0 million), Akri-Bijeel \$19.4 million (2009: \$10.5 million) and Sheikh Adi \$58.6 million (2009: \$nil).

The additions to oil and gas exploration and evaluation costs in the year include the acquisition of seismic, the drilling of the Bijell-1 exploration well, the drilling of the Shaikan-2 and Shaikan-3 appraisal wells in addition to site preparation for further appraisal wells on the Shaikan block and the drilling of the Sheikh Adi exploration well.

Following the signing of the settlement agreement with BG in February 2010, the HBH asset has been reclassified as an asset held for sale (2010: \$10.4 million; 2009: \$10.4 million) (see note 11).

During 2009, the Group recognised an impairment loss in respect of the Algerian Northern Blocks cost pool and the HBH cost pool due to management's decision to withdraw from Algeria. This impairment loss comprises a charge to the exploration and evaluation costs of \$57.4 million relating to the impairment of the HBH project and a charge to the oil and gas properties of \$12.2 million (see note 10).

The amortisation charge of \$30,000 (2009: \$20,000) for computer software has been included in general and administrative expenses.

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 10. Property, plant and equipment

	Oil and Gas Properties \$'000	Fixtures and Equipment \$'000	Total \$'000
<b>At 1 January 2009</b>			
Cost	19,064	1,783	20,847
Accumulated depreciation	(4,192)	(942)	(5,134)
<b>Net book value</b>	<b>14,872</b>	<b>841</b>	<b>15,713</b>
<b>Year ended 31 December 2009</b>			
Opening net book value	14,872	841	15,713
Additions	–	279	279
Impairment write off (note 9)	(12,182)	–	(12,182)
Disposals	–	(51)	(51)
Depreciation charge	–	(363)	(363)
Foreign currency translation differences	–	37	37
<b>Closing net book value</b>	<b>2,690</b>	<b>743</b>	<b>3,433</b>
<b>At 31 December 2009</b>			
Cost	2,690	2,048	4,738
Accumulated depreciation	–	(1,305)	(1,305)
<b>Net book value</b>	<b>2,690</b>	<b>743</b>	<b>3,433</b>
<b>Year ended 31 December 2010</b>			
Opening net book value	2,690	743	3,433
Additions	–	1,132	1,132
Disposals	–	(10)	(10)
Depreciation charge	–	(464)	(464)
Foreign currency translation differences	–	11	11
<b>Closing net book value</b>	<b>2,690</b>	<b>1,412</b>	<b>4,102</b>
<b>At 31 December 2010</b>			
Cost	2,690	3,126	5,816
Accumulated depreciation	–	(1,714)	(1,714)
<b>Net book value</b>	<b>2,690</b>	<b>1,412</b>	<b>4,102</b>

The depreciation charge of \$0.5 million on fixtures and equipment (2009: \$0.4 million) has been included in general and administrative expenses.

### 11. Asset held for sale

On 18 February 2010, the Company announced that it had negotiated an agreement with BG North Sea Holdings Limited ("BG") that settled, on confidential terms, the claims and counterclaims between the parties. The agreement provides for the immediate stay of the arbitration and the proposed withdrawal of the Company from the Hassi Ba Hamou ("HBH") Permit for a net cash payment from BG of \$10.0 million to the Company.

Following the signing of this agreement, the HBH intangible asset of \$10.4 million (2009: \$10.4 million), which is included within the Algerian operating segment, has been reclassified as an asset held for sale as at 31 December 2010. A further amount of \$0.5 million, representing the net present value of the decommissioning costs associated with this asset is included within the provisions balance at 31 December 2010 (see note 16). The agreement is subject to the conclusion of separate transfer documentation which will require the approval of Sonatrach and any necessary Algerian governmental authorities, which the Company expects to receive in due course. Whilst the Company is confident that the necessary approvals will be forthcoming, there is no guarantee this will be the case.



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## 12. Subsidiary

Details of the Company's subsidiaries at 31 December 2010 are as follows:

Name of subsidiary	Place of incorporation	Proportion of ownership interest	Proportion of voting power held	Principal activity
Gulf Keystone Petroleum (UK) Limited	Great Britain	100%	100%	Geological, geophysical and engineering services and administration
Gulf Keystone Petroleum International Limited	Bermuda	100%	100%	Exploration and evaluation activities
Gulf Keystone Petroleum Numidia Limited	Bermuda	100%	100%	Exploration and evaluation activities
Gulf Keystone Petroleum HBH Limited	Bermuda	100%	100%	Exploration and evaluation activities
Shaikan Petroleum Limited	Bermuda	100%	100%	Exploration and evaluation activities

## 13. Inventories

	2010 \$'000	2009 \$'000
Exploration materials	14,081	574
Crude oil	342	–
	<b>14,423</b>	<b>574</b>

During 2009, the Algerian inventory was written down to its net realisable value, being \$nil, due to the Group's intention to exit Algeria. The impairment expense relating to the write down of inventory in 2009 was \$4.3 million.

## 14. Trade and other receivables

	2010 \$'000	2009 \$'000
Trade receivables	77	–
Other receivables	3,261	1,507
Prepayments and accrued income	325	707
	<b>3,663</b>	<b>2,214</b>

Included within other receivables for 2010 is an amount of \$0.2 million (2009: \$0.4 million) being the deposit for the UK office which is receivable after more than one year.

The Directors consider that the carrying amount of trade and other receivables approximates to their fair value and no amounts are provided against them.

## 15. Trade and other payables

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.

	2010 \$'000	2009 \$'000
<b>Current</b>		
Trade payables	13,363	8,282
Accrued expenses	25,740	35,835
	<b>39,103</b>	<b>44,117</b>
<b>Non-current</b>		
Accrued expenses	–	113

The non-current accrued expenses in 2009 relate to the fees payable on entering into the Standby Equity Distribution Agreement.

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 16. Provisions

Decommissioning provision	\$'000
At 1 January 2010	3,545
Additional provision in the year	2,506
Unwinding of discount	348
<b>At 31 December 2010</b>	<b>6,399</b>

The provision for decommissioning is based on the net present value of the Group's share of expenditure which may be incurred in the removal and decommissioning of the facilities currently in place. This expenditure is estimated to be incurred over the next five to 30 years. Included within the provision are decommissioning costs of \$0.5 million associated with the HBH asset (see note 11).

### 17. Deferred tax

The following are the major deferred tax liabilities and assets recognised by the Group and movements thereon during the current and prior reporting period.

	Accelerated tax depreciation \$'000	Share-based payments \$'000	Total \$'000
At 1 January 2009	(15)	–	(15)
Credit to income	31	450	481
Credit direct to equity	–	494	494
At 1 January 2010	16	944	960
Credit/(charge) to income	(6)	1,147	1,141
Credit direct to equity	–	2,057	2,057
Exchange differences	(1)	(51)	(52)
<b>At 31 December 2010</b>	<b>9</b>	<b>4,097</b>	<b>4,106</b>

### 18. Share capital

	2010 \$'000	2009 \$'000
<b>Authorised</b>		
Common shares of \$0.01 each	9,000	7,500
Non-voting shares \$0.01 each	500	500
Series A Preferred shares of \$1,000 each	60,000	60,000
	<b>69,500</b>	<b>68,000</b>

The authorised common share capital was increased from \$7.5 million to \$9 million at the 2010 Annual General Meeting.

	Common shares		Share capital \$'000	Share premium \$'000
	No. of shares 000	Amount \$'000		
<b>Issued and fully paid</b>				
Balance at 1 January 2009	368,008	207,684	2,765	204,919
Bonus scheme shares March 2009	1,119	11	11	–
Shares issued under the SEDA	27,501	21,099	275	20,824
Private placement	91,260	14,807	913	13,894
Issue costs	n/a	(259)	–	(259)
SEDA costs	2,088	456	21	435
Balance 31 December 2009	489,976	243,798	3,985	239,813
Bonus scheme shares issued	4,654	47	47	–
Shares issued under the SEDA	8,180	10,781	82	10,699
Private placement	251,243	363,985	2,512	361,473
Issue costs	n/a	(18,719)	–	(18,719)
Shares issued in lieu of cash payment for fees	190	206	2	204
<b>Balance 31 December 2010</b>	<b>754,243</b>	<b>600,098</b>	<b>6,628</b>	<b>593,470</b>

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### 18. Share capital continued

During March, May and October 2010 a total of 251.2 million shares were placed at an average price of £0.95 per share to continue financing exploration and development activities. A further 0.2 million shares were issued during the year in lieu of advisor fees at an average price of £0.75.

Between January and May 2010, a total of 8.2 million shares were issued under the Standby Equity Distribution Agreement (“SEDA”) with YA Global Master SPV Ltd, an investment fund managed by Yorkville Advisors, LLC, at an average price of £0.84 per share.

In June 2010, the Company announced that it had executed the Gulf Keystone Employee Benefit Trust (the “Trust”) and settled an initial cash contribution on the independent trustee (the “Trustee”). The Trustee may acquire common shares in the Company, by subscription or by purchase, and, at the discretion of the Trustee, make available interests in those common shares for the benefit of Directors and employees under the Company’s Share Option Plan and Executive Bonus Scheme (the “Plans”).

During the year, a total of 4,653,700 shares were issued as part of the Company’s bonus share scheme (2009: 1,119,419), of which 3,772,998 new common shares were issued to the Trust at par value of \$0.01 (see note 22).

At 31 December 2010, a total of 3,403,991 shares were held by the Trust and included within reserves.

Subsequent to year end, a further 6,990,280 new common shares were issued as part of the Company’s bonus share scheme, including 5,886,332 to the Trust. In addition, the Company has been notified by the Trustee of the Company’s Employee Benefit Trust and by certain employees of an exercise of options under the Share Option Plan. Consequently, the Board has approved the issue of 1,000,507 new common shares of \$0.01 (“Option Shares”) raising gross proceeds of £636,054 at an average price of £0.64 per share. The total number of shares in issue on 8 April 2011 is 762,233,948.

### Rights attached to share capital

The holders of the common shares have the following rights (subject to the other provisions of the bye-laws):

- (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.

### 19. Reconciliation of loss from operations to net cash used in operating activities

	2010 \$'000	2009 \$'000
Loss from operations	(32,595)	(95,459)
<i>Adjustments for:</i>		
Depreciation of property, plant and equipment	464	363
Amortisation of intangible assets	30	20
Impairment of intangible exploration assets	–	57,418
Impairment of tangible oil and gas properties	–	12,182
Loss on disposal of property, plant and equipment	–	14
Impairment of inventories	–	4,343
Share-based payment expense	16,873	6,361
(Increase)/decrease in inventories	(13,849)	1,005
(Increase)/decrease in receivables	(1,449)	5,643
Increase in payables	4,301	6,447
<b>Net cash used in operating activities</b>	<b>(26,225)</b>	<b>(1,663)</b>

### 20. Commitments

#### Operating lease commitments – the Group as a lessee

	2010 \$'000	2009 \$'000
Minimum lease payments under operating leases recognised as expense for the year	377	371

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

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

	2010 \$'000	2009 \$'000
Within one year	766	377
In the second to fifth years inclusive	1,209	1,540
After five years	–	64
	<b>1,975</b>	<b>1,981</b>

Operating lease payments represent rentals payable by the Group for certain of its office and residence properties and facilities in the United Kingdom and the Kurdistan Region of Iraq. The UK office lease is for five years from February 2010. The office equipment lease is for five years and commenced in 2009. The non-cancellable operating leases within Kurdistan range from one to two years in duration.

### Exploration commitments

Due to the nature of the Group's operations in exploring and evaluating areas of interest, it is difficult to accurately forecast the nature or amount of future expenditure, although it will be necessary to incur expenditure in order to retain present exploration and appraisal rights.

Expenditure commitments on current permits for the Group could be reduced by selective relinquishment of exploration tenure or by the renegotiation of expenditure commitments. The level of exploration expenditure expected in the year ending 31 December 2011 for the Group is approximately \$154.1 million (2010: \$109.8 million) of which the majority is contracted. This includes the minimum amounts required to retain the relevant licences.

### 21. Contingent liabilities

On 23 December 2010, the Company and two of its subsidiaries (the "Companies") received notice that an arbitration (the "ICC Arbitration") was commenced by Excalibur Ventures LLC ("Excalibur") in New York on 17 December 2010 asserting certain contractual and non-contractual claims against the Companies and claiming that Excalibur is entitled to an interest of up to 30% in the Companies' blocks in the Kurdistan Region of Iraq, which comprise the substantial majority of the Group's petroleum operations.

On 21 December 2010, Excalibur applied without notice to the Companies to the Commercial Court in London for a "worldwide freezing injunction" against the Companies' assets, which was refused by the Commercial Court on the basis that the Judge did not consider there was a risk of dissipation of assets. Excalibur also commenced proceedings in the Commercial Court in London on 17 December 2010 on the same grounds as in the ICC Arbitration (the "Commercial Court Claim") in order allegedly to protect its position in relation to potential limitation of actions under New York and/or English law. The Companies received notice on 23 December 2010 of the claims, since which time they have been vigorously contesting the claims. The ultimate outcome of the matter cannot presently be determined, and consequently no provision for any liability that may result has been made in the financial statements.

### 22. Share-based payments

	2010 \$'000	2009 \$'000
Bonus shares charge	19,351	6,340
Share options charge	2,379	21
	<b>21,730</b>	<b>6,361</b>

	2010 \$'000	2009 \$'000
Warrants – share issue costs	<b>3,840</b>	–

### Equity settled share option plan

The Group's share option plan provides for a grant price at least equal to the closing market price of the Group shares on the date of grant. Awards made under the Group's share option plan have a vesting period of three years except for awards made under the Long Term Incentive Plan, further details of which are given below. 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.

### Share Option Plan with Long Term Incentive Performance Conditions

During 2010, following the recommendations of the Remuneration Committee of the Company, the Trustees granted share options over 19,532,948 common shares to Directors and employees of the Group under the existing Share Option Plan with stretching performance criteria known as the Long Term Incentive Performance Conditions ("LTIP Share Options").



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## 22. Share-based payments continued

The LTIP Share Options vest in equal tranches over three financial years subject to the achievement of the following performance conditions:

- i) One third of the LTIP Share Options are subject to operational performance conditions as follows:
  - > 50% of the one third tranche of LTIP Share Options vest only on the achievement of sustained production of at least 8,000 barrels of oil per day resulting in sustained oil sales and revenue flow;
  - > 30% of the one third tranche of LTIP Share Options vest only on successful resource addition through a combination of appraisal and production testing resulting in a significant movement of P10 hydrocarbon in place resources to P90 hydrocarbon in place resources; and
  - > 20% of the one third tranche of LTIP Share Options vest only in the event of a significant new discovery.
- ii) One third of the LTIP Share Options vest on the share price reaching 150 pence.
- iii) One third of the LTIP Share Options vest on the share price reaching 200 pence.

	2010		2009	
	Number of share options '000	Weighted average exercise price (in pence)	Number of share options '000	Weighted average exercise price (in pence)
Outstanding at 1 January	11,000	32.8	9,491	39.5
Granted during the year	20,283	77.2	6,650	33.9
Cancelled during the year	–	–	(3,550)	46.2
Forfeited during the year	(100)	30.0	(1,591)	47.3
Outstanding at 31 December	31,183	61.4	11,000	32.8p
Exercisable at 31 December	7,161	71.6	–	–

The inputs into the stochastic (binomial) valuation model are as follows:

	2010	2009
Weighted average share price on date of grant (in pence)	76.3	11.5
Weighted average exercise price of options granted in the year (in pence)	77.2	33.9

The expected volatility was calculated as 79%, 95% and 94% for the June 2010, September 2010 and October 2010 awards respectively (2009: 58%, 68% and 87% for the March 2009, July 2009 and March 2010 awards respectively) and has been based on the Company's share price averaged for the three years prior to grant date.

The expected term of the 2010 awards is three to 7.5 years (2009: three years). The risk free rate was 2.5% for the June 2010 awards and 1.5% for the September 2010 and October 2010 awards (2009: 5% for the March and July 2009 awards, 4.5% for the March 2010 award).

The market-based performance criteria have been included in the fair value of the options with the weighted average fair value of the options granted in 2010 being £0.51 (2009: £0.045).

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

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

Expiry date	Exercise price (pence)	Options ('000)	
		2010	2009
10 October 2017	39.50	400	400
4 December 2017	33.00	250	250
13 February 2018	30.00	1,450	1,550
24 September 2018	30.00	2,150	2,150
31 December 2018	30.00	4,400	4,400
15 March 2019	30.00	250	250
30 July 2019	30.00	1,650	1,650
18 October 2019	80.75	100	100
7 December 2019	80.75	250	250
3 June 2020	80.75	250	–
23 June 2020	75.00	19,533	–
22 September 2020	147.50	250	–
11 October 2020	175.00	250	–
		31,183	11,000

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 22. Share-based payments continued

#### Bonus Shares

The Group issues bonus shares to certain employees for a nominal consideration. Bonuses are generally awarded over three years and vest in three equal tranches during those years subject to continued employment. These share-based payments are measured at fair value at the date of grant. The fair value of the shares granted is recognised as an employee expense with a corresponding increase in equity. The fair value of the shares granted is the market price on the date of the award and is charged to the income statement over the vesting period taking into account the terms and conditions upon which the shares were granted.

#### Executive Bonus Scheme

Discretionary grants to Directors and employees of 8,453,334 common shares have been made by the Gulf Keystone Employee Benefit Trust as part of the 2010 Executive Bonus Scheme. The awards have been made on the same terms as the Company's Executive Bonus Scheme. In addition, the Company has directly granted 1,777,778 common shares to Directors during February 2011 as part of the 2010 Executive Bonus Scheme.

Awards of 7,114,111 relating to the 2008, 2009 and 2010 Executive Bonus Schemes have vested during the year. Details of all awards to Directors have been included in the Directors Emoluments for the year ended 31 December 2010.

	Bonus Shares ('000)	
	2010	2009
Balance at 1 January	8,397	1,854
Granted during the year	10,231	11,519
Forfeited during the year	–	(160)
Issued during the year	(7,114)	(4,816)
<b>Balance at 31 December</b>	<b>11,514</b>	<b>8,397</b>

The weighted average fair value of the bonus shares granted in 2010 was £1.73 (2009: £0.75).

#### Warrants

During the year the Company issued a total of 2,498,350 warrants in lieu of cash payment for placing fees (note 18) (2009: nil). In respect of the May 2010 fund raising, 1,523,000 warrants were issued with an exercise price of £0.75 and a maximum term of three years, expiring on 23 May 2013. In respect of the October 2010 placing, 975,350 warrants were issued with an exercise price of £1.40 and a maximum term of five years, expiring on 14 October 2015. No warrants were exercised during the year.

The fair value of the warrants was determined with reference to the value of the services received and is the amount that would otherwise have been payable to the placing agents had the warrants not been issued.

### 23. Related party transactions

#### Transactions with related parties

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

#### Texas Keystone Inc.

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").

On 21 December 2007, GKPI entered into a Joint Operating Agreement (the "Agreement") for the Shaikan Block in the Kurdistan Region of Iraq in which TKI holds a 5% participating interest. TKI initially led the pursuit of opportunities in the Kurdistan Region of Iraq and participated in the successful signature of the Production Sharing Contract for the Shaikan Block. In return for this and TKI's continuing participation, GKPI was liable to pay for TKI's share of the costs of the Exploration Work Programme and all costs ancillary to the Joint Operations up until the drilling of the first exploration well. TKI elected not to participate in the drilling of the Shaikan-1 well and by failing to exercise this election agreed to assign its interest under the contract to GKPI. Consequently TKI holds its interest in trust for GKPI pending transfer of its interest which is subject to the approval of the Kurdistan Regional Government.

#### Opus Executive Partners

Opus Executive Partners ("Opus"), a specialist recruitment company, is a related party of the Group because Lord Peter Truscott, a Director of the Company, is an Associate Partner of Opus. During 2010, \$72,840 was paid to Opus for advice regarding executive remuneration packages provided to the Company (2009: \$nil). Opus did not provide any other services to the Group.

No guarantees have been given or received. No provisions have been made for doubtful debts in respect of the amounts owed by related parties.

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### 23. Related party transactions continued

#### Remuneration of key management personnel

The remuneration of the Directors and officers, the key management personnel of the Group, is set out below in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. The names and positions held by those Directors and employees identified as key management personnel are as follows:

TF Kozel – Executive Chairman and Chief Executive Officer  
 AA Al Qabandi – Business Development Director  
 JB Gerstenlauer – Chief Operating Officer  
 KE Ainsworth – Finance Director  
 M Varzi – Non-Executive Director  
 J Asher – Non-Executive Director (resigned 1 April 2010)  
 P Truscott – Non-Executive Director  
 AA Samarrai – Kurdistan Country Manager  
 M Messaoudi – Algeria Country Manager  
 CH Garrett – Vice President Operations  
 AR Peart – Legal and Commercial Director

Further information about the remuneration of individual directors is provided in the Report of the Remuneration and Appointments Committee.

	2010 \$'000	2009 \$'000
Short-term employee benefits	6,199	3,123
Other allowances	134	–
Share-based payment – options	2,175	14
Share-based payment – bonus shares	18,670	6,172
	<b>27,178</b>	<b>9,309</b>

### 24. Financial instruments

	2010 \$'000	2009 \$'000
<b>Financial assets</b>		
Cash and cash equivalents	201,268	19,156
Liquid investments	10,177	–
Loans and receivables	3,338	1,507
Derivative asset – SEDA	340	574
Derivative asset – foreign exchange contracts	319	–
	<b>215,442</b>	<b>21,237</b>
<b>Financial liabilities</b>		
Loans and payables	39,103	44,230
	<b>39,103</b>	<b>44,230</b>

All financial liabilities are due to be settled within one year and are classified as current liabilities.

#### Capital Risk Management

The Group manages its capital to ensure that the entities within the Group will be able to continue as going concerns while maximising the return to stakeholders through the optimisation of the debt and equity balance. The Group is not subject to externally imposed capital requirements. The capital structure of the Group consists of cash, cash equivalents and liquid investments and equity attributable to equity holders of the parent, comprising issued capital, reserves and accumulated losses as disclosed in note 18, the Consolidated Statement of Comprehensive Income and the Consolidated Statement of Changes in Equity.

#### Gearing Ratio

The Group's Board of Directors reviews the capital structure on a regular basis. As part of this review, the Board considers the cost of capital and the risks associated with each class of capital.

Given the current stage of development of the Group's assets, it is the Group's policy to finance its business by means of internally generated funds and external share capital. As a result, there was no debt at 31 December 2010.

#### Significant Accounting Policies

Details of the significant accounting policies and methods adopted, including the criteria for recognition, the basis of measurement and the basis on which income and expenses are recognised, in respect of each class of financial asset, financial liability and equity instrument are disclosed in the Summary of Significant Accounting Policies.

# Notes to the Consolidated Financial Statements continued

## For the year ended 31 December 2010

### 24. Financial instruments continued

#### Financial Risk Management Objectives

The Group's management monitors and manages the financial risks relating to the operations of the Group. These financial risks include market risk (including commodity price, currency and fair value interest rate risk), credit risk, liquidity risk and cash flow interest rate risk.

The Group has entered into a currency risk hedge during 2010. Otherwise, the Group does not presently hedge against other financial risks as the benefit of entering into such agreements is not considered to be significant enough as to outweigh the significant cost and administrative burden associated with such hedging contracts.

The risks are closely reviewed by the Board on a regular basis and steps are taken where necessary to ensure these risks are minimised.

#### Market risk

The Group's activities expose it primarily to the financial risks of changes in foreign currency exchange rates, oil prices and changes in interest rates in relation to the Group's cash balances.

The operating currencies of the Group are Great British Pounds (GBP), US Dollars (USD), Algerian Dinars (DZD) and Iraqi Dinars (IQD).

The Group's exposure to currency risk during the year has increased following significant sterling fund-raising during the year and this risk has been addressed by entering into a currency hedge during the year. There have been no changes to the Group's exposure to other market risks or any changes to the manner in which the Group manages and measures the risk. The Group does not hedge against the effects of movement in oil prices or interest rates. The risks are monitored by the Board on a regular basis.

The Group is also party to a SEDA which represents a derivative over the Company's equity. The fair value of the SEDA reflects the liquidity in the market for the Company's shares at the prevailing share price but since the shares are valued under the SEDA at prices based on the market price, the fair value of the SEDA is not material. Changes in the fair value of the SEDA are recognised in the income statement (see note 6).

#### Foreign currency risk management

The Group undertakes certain transactions denominated in foreign currencies, being any currency other than the functional currency of the Group subsidiary concerned. Hence, exposures to exchange rate fluctuations arise.

At 31 December 2010, a 10% weakening of the USD against the GBP would have resulted in an increase in the Group's net current assets of \$16.9 million and a 10% strengthening would have resulted in a decrease in net current assets of \$13.8 million. The carrying amounts of the Group's other foreign currency denominated monetary assets and monetary liabilities at the reporting date were not material to the Group and a 10% change would not have a material effect.

#### Interest rate risk management

The Group's policy on interest rate management is agreed at the Board level and is reviewed on an ongoing basis. The current policy is to maintain a certain amount of funds in the form of cash for short-term liabilities and have the rest on relatively short-term deposits, usually one month notice to maximise returns and accessibility.

#### Interest rate sensitivity analysis

Based on the exposure to the interest rates for cash and cash equivalents at the balance sheet date, a 0.5% increase or decrease would not have a material impact on the Group's profit for the year. A rate of 0.5% is used as it represents management's assessment of the reasonably possible changes in interest rates.

#### Credit risk management

Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the Group. The Group does not have any significant trade and other receivables outstanding from any one creditor at balance sheet date (2009: \$nil).

The credit risk on liquid funds is limited because the counterparties for a significant portion of the cash and cash equivalents at the balance sheet date are banks with good credit ratings assigned by international credit-rating agencies.

The Group has no other major counterparties.

#### Liquidity risk management

Ultimate responsibility for liquidity risk management rests with the Board of Directors. It is the Group's policy to finance its business by means of internally generated funds and external share capital. 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. The Group seeks to raise further funding as and when required. When any of the Group's projects move to the development stage, specific financing, including debt, may be required to enable development to take place.

The maturity profile of the Group's financial liabilities is indicated by their classification in the balance sheet as "current" or "non-current". Further information relevant to the Group's liquidity position is disclosed in note 1 under "Going Concern".



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## 25. Subsequent events

### Share Option Plan with Long Term Incentive Performance Conditions

On 4 February 2011, in addition to the 2010 Bonus share awards (see note 22), the Remuneration Committee recommended to the Trustee grants of options under the existing Share Option Plan with stretching long-term incentive performance conditions ("2010 LTIP Options"). It recommended that the Trustee grants 2010 LTIP Options over common shares at a price of 175 pence per share to the following Directors as set out below:

Todd Kozel	4,195,000
Ewen Ainsworth	839,000
John Gerstenlauer	839,000

It was recommended that the 2010 LTIP Options be available for exercise in equal tranches over three financial years subject to the following performance conditions:

- (i) One third of the 2010 LTIP Options will vest on the share price reaching 275 pence.
- (ii) One third of the 2010 LTIP Options will vest on the share price reaching 325 pence.
- (iii) One third of the 2010 LTIP Options will vest on the share price reaching 375 pence.

It was recommended to the Trustee that a total of 9,490,000 common shares may be the subject of 2010 LTIP Options for Directors and employees.

The Trustee confirmed on 4 February 2011 that it wished to grant 2010 LTIP Options at a price of 175 pence per share over a total 9,490,000 common shares including the recommended grant to Todd Kozel, Ewen Ainsworth and John Gerstenlauer as set out above. The closing share price of the Company on the 4 February 2011 was 173.5 pence per share.

# Notes

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# Notes

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# Directors and Advisors

## Directors

Todd Kozel

Ali Al Qabandi  
John Gerstenlauer  
Kristian Ewen Ainsworth  
Mehdi Varzi  
Peter Truscott

Executive Chairman  
and Chief Executive Officer  
Business Development Director  
Chief Operating Officer  
Finance Director  
Non-Executive Director  
Non-Executive Director

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