GULF KEYSTONE PETROLEUM LTD.

# THROUGH APPRAISAL TO DEVELOPMENT

Gulf Keystone Petroleum Limited

Annual report and accounts 2011

Gulf Keystone Petroleum Limited is an independent oil and gas exploration and production Company focused on exploration in the Kurdistan Region of Iraq. The Company holds working interests in four adjacent exploration blocks in the region, including the world-class discovery at the giant Shaikan field.

The Company is registered in Bermuda with further offices in Erbil in the Kurdistan Region of Iraq, Algiers, Algeria and London, UK. Gulf Keystone has been quoted on the AIM Market of the London Stock Exchange since 2004 (stock quote GKP). Today, we are a leading oil operator in the Kurdistan Region of Iraq with a plan to become one of the major independent exploration and production players listed on the London Stock Exchange.

Gulf Keystone is on the path of exploring and appraising at least 16 billion barrels of gross mean oil-in-place across its world-class assets, increasing Extended Well Test production from the Shaikan discovery and bringing over 400,000 barrels of oil per day to the international market.



Shaikan-5 appraisal well

# A STORY OF OPERATING SUCCESS IN THE KURDISTAN REGION OF IRAQ

2008

2009

## EXPLORATION/APPRAISAL HIGHLIGHTS

**November 2007**
Award of Production Sharing Contracts for the Shaikan and Akri-Bijeel blocks to Gulf Keystone Petroleum International, operator

**2008**
2D seismic data acquired on the Shaikan and Akri-Bijeel blocks

**July 2009**
Acquisition of interest in Production Sharing Contracts for the Sheikh Adi and Ber Bahr blocks

**August 2009**
Gulf Keystone's first exploration well Shaikan-1 makes a major discovery

## DRILLING MILESTONES

Measured Depth (MD) in metres

1,000
2,000
3,000
4,000
5,000

2007 | DEC 2008 | JAN 2009

**Shaikan-1**
Spud
27 April
2009

Total Depth (TD):
2,950m
November 2009

**Shaikan**
Discovery
August
2009

**Bijell-1**
Spud
11 December
2009

TD 4,377m
November
2010

## CORPORATE/FINANCIAL MILESTONES

**December 2008**
American Depositary Receipts (ADRs) traded in the US over-the-counter securities market (GFKSY)

**July 2009**
Gradual exit from Algeria announced

# 2010

**January 2010**
Report on the Shaikan-1 discovery by DGA estimates Shaikan resources at 1.9 billion (P90) to 7.4 billion (P10) barrels of gross oil-in-place

**March 2010**
Bijell-1, first exploration well on the Akri-Bijeel block announced a discovery with 2.4 billion (P50) barrels of gross oil-in-place

**Summer 2010**
814km² of 3D seismic data acquired for the Shaikan and Sheikh Adi blocks

**October 2010**
Shaikan Extended Well Test production facilities completed and domestic oil sales commenced

JAN 2010

**Bijell**
Discovery
March
2010

**Sheikh Adi-1**
Spud
4 August
2010
TD 3,730m
August
2011

**Shaikan-3**
Spud
2 September
2010
TD 1,518m
December
2010

**Shaikan-2**
Spud
1 December
2010
TD 3,300m
August
2011

**April 2010**
ADRs traded on the premier tier of OTCQX International

**May 2010**
Interest in the Ben Guecha Permit in Algeria relinquished

**October 2010**
Fully subscribed £109.24 million share placing

# HIGHLIGHTS

## 2011 2012

**January 2011**
Ryder Scott report in line with DGA's estimates of the Shaikan resources

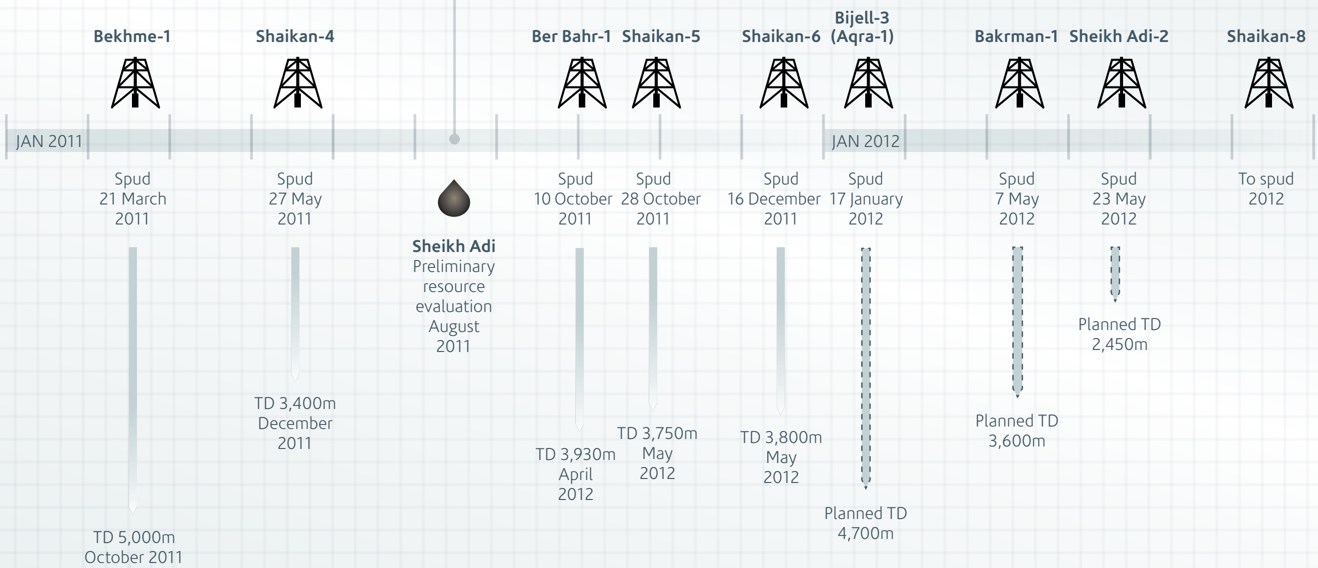
**April 2011**
Major upgrade of the Shaikan gross oil-in-place resources by DGA to 4.9 billion (P90) to 10.8 billion (P10) barrels

**August 2011**
Sheikh Adi preliminary resource evaluation by DGA of 1 billion (P90) to 3 billion (P10) barrels of gross oil-in-place

**Summer 2011**
Work on the Shaikan Field Development Plan and the pipeline project commenced

**November 2011**
Major upgrade of the Shaikan gross oil-in-place resources by DGA to 8 billion (P90) to 13.4 billion (P10) barrels

**January 2012**
DGA calculates that Aqra/Bekhme anticline on the Akri-Bijeel block contains 2.5 billion (P90) to 5.4 billion (P10) barrels of gross oil-in-place




### OPERATIONAL

- 420% (P90) – 181% (P10) increase in gross oil-in-place estimates for the Shaikan discovery with a range of 8.0 billion (P90) to 13.4 billion (P10) barrels, by DGA
- 13 wells drilled or being drilled across the Shaikan, Sheikh Adi, Akri-Bijeel and Ber Bahr blocks with 3 completed and 4 spudded in 2011
- Gross output of the Shaikan Extended Well Test production facility increased by 144% from 82,054 barrels of oil in 2010 to 200,137 barrels of oil in 2011

### CORPORATE/FINANCIAL

- Test production revenue of $6.9 million achieved, loss after tax of $62.4 million
- Combined cash, cash equivalents and liquid investments balance of $237.6 million as at 31 December 2011
- Successfully raised $200 million gross through a fully subscribed share placing
- Sale process for the Company's 20% interest in the Akri-Bijeel block initiated
- Appointment to the Board of two additional Non-Executive Directors
- Agreement on the exit from the Hassi Ba Hamou Permit in Algeria

# CHAIRMAN'S STATEMENT

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

"Gulf Keystone has a share of gross mean oil-in-place resources of at least 16 billion barrels in the Kurdistan Region of Iraq, one of the last frontier oil provinces in the world."

I am very pleased to welcome you to this overview of the results achieved by Gulf Keystone Petroleum Limited ("Gulf Keystone" or "the Company") in 2011.

2011 has been another excellent year of operational performance by Gulf Keystone, as we have continued to develop our world-class asset portfolio in the Kurdistan Region of Iraq. In what has been our most active operational period to date, we have made significant progress in continuing to prove up the value of our assets and to demonstrate further the truly world-class nature of our acreage. In parallel, we have continued developing our strong Kurdistan brand established with the Company's arrival in the region in 2007.

With four highly prized on-trend blocks, Gulf Keystone has a key position in the Kurdistan Region of Iraq. We have majority operated working interests in the Production Sharing Contracts for the Shaikan and Sheikh Adi blocks and further non-operated working interests in the Ber Bahr and Akri-Bijeel blocks. We have completed, or are currently drilling, 13 exploration and appraisal wells across the four blocks, which have discovered billions of barrels of gross oil-in-place or are currently targeting structures of similar size. Out of these wells, three were completed (Shaikan-2, Sheikh Adi-1, Bekhme-1) and four spudded (Shaikan-4, Shaikan-5, Shaikan-6 and Ber Bahr-1) in 2011, as part of one of the most active exploration and appraisal programmes in the region. Since the year end, Shaikan-4 has been completed, and on the Akri-Bijeel block, Bijell-3 (Aqra-1) and Bakrman-1 have spudded.

Taking into account resource estimates for the Shaikan discovery, as well as Akri-Bijeel, Ber Bahr and Sheikh Adi, today Gulf Keystone has a share of gross mean oil-in-place resources of at least 16 billion barrels in the Kurdistan Region of Iraq, one of the last frontier oil provinces in the world. This number is as remarkable as the massive size and potential of these structures.

In 2011, we were delighted to announce two major revisions of the gross oil-in-place volumes for the Shaikan discovery. Already significant gross oil-in-place numbers for Shaikan calculated in April 2011 by Dynamic Global Advisors ("DGA"), the independent Houston-based exploration consultants, were further upgraded by DGA in November 2011 to the range of 8.0 billion (P90) to 13.4 billion (P10) barrels of gross oil-in-place with a mean value of 10.5 billion barrels. A new Triassic discovery made with the Shaikan-2 appraisal well in August 2011 and promising early results of the Shaikan-4 appraisal well testing programme, contributed to the addition of new oil volumes. Calculated on the P90 basis, the most recent upgrade is an impressive 420% increase over the independently audited estimate provided by DGA in January 2010, which confirms Shaikan as one of the most significant discoveries in the world over the last ten years.

We firmly believe that even with these two upgrades in the course of one year, the existing gross oil-in-place range for the Shaikan discovery is still relatively conservative and we look forward to completing the Shaikan appraisal programme in 2012 and targeting Shaikan's untapped resources in the deeper Triassic section and the Permian thereafter.

In February 2011, we completed the Shaikan-3 shallow appraisal well as a Jurassic formation producer, which achieved a strong flow rate of 9,800 barrels of oil per day ("bopd"), an improvement of approximately 30% on the previously reported rate of 7,480 bopd for the Shaikan-1 discovery well. Today, both Shaikan-1 and -3 are tied to the Extended Well Test production facility ("EWT"), which became operational in October 2010.

Today, Gulf Keystone's Shaikan-1 and -3 wells are capable of producing, in aggregate, up to 18,000 bopd. We are working on an upgrade of the existing EWT and designing an additional facility for the Shaikan-2 location to increase the Shaikan EWT production to 20,000 gross bopd once the existing EWT facility has been upgraded, and to 40,000 gross bopd once the Shaikan-2 EWT has become operational. The upgraded and additional EWT facilities will allow test production of Shaikan crude to be processed to export specification and a subsequent ramp-up of our production operations.

Shaikan is just the start. We believe in the incremental billion barrel potential across the three other blocks, which will be targeted by the 2012/13 exploration and appraisal programme. In August 2011, Gulf Keystone announced a significant range of independently audited preliminary resources for the Sheikh Adi block. Following the completion of the Sheikh Adi-1 exploration well drilling operations, we have identified a location for the second exploration well on Sheikh Adi, which DGA have estimated to hold between 1 and 3 billion barrels of gross oil-in-place. The Sheikh Adi-2 exploration well spudded in May 2012.

On the Akri-Bijeel block, a high impact exploration and appraisal programme is underway to appraise the existing Bijell discovery (with the operator's P50 resource estimate of 2.4 billion barrels of gross oil-in-place) and target identified multiple hydrocarbon prospects. In 2012, an extended well test is planned to commence on the Bijell-1 discovery well, similar to the ongoing successful Shaikan EWT.

In October 2011, the first exploration well spudded on the Ber Bahr block, which is testing a large surface anticline and major reservoir targets in the Jurassic and Triassic. The operator's resource estimate for the Ber Bahr block is 1.5 billion barrels of oil equivalent-initially-in-place and the Ber Bahr-1 well is expected to complete by the end of Q2 2012.

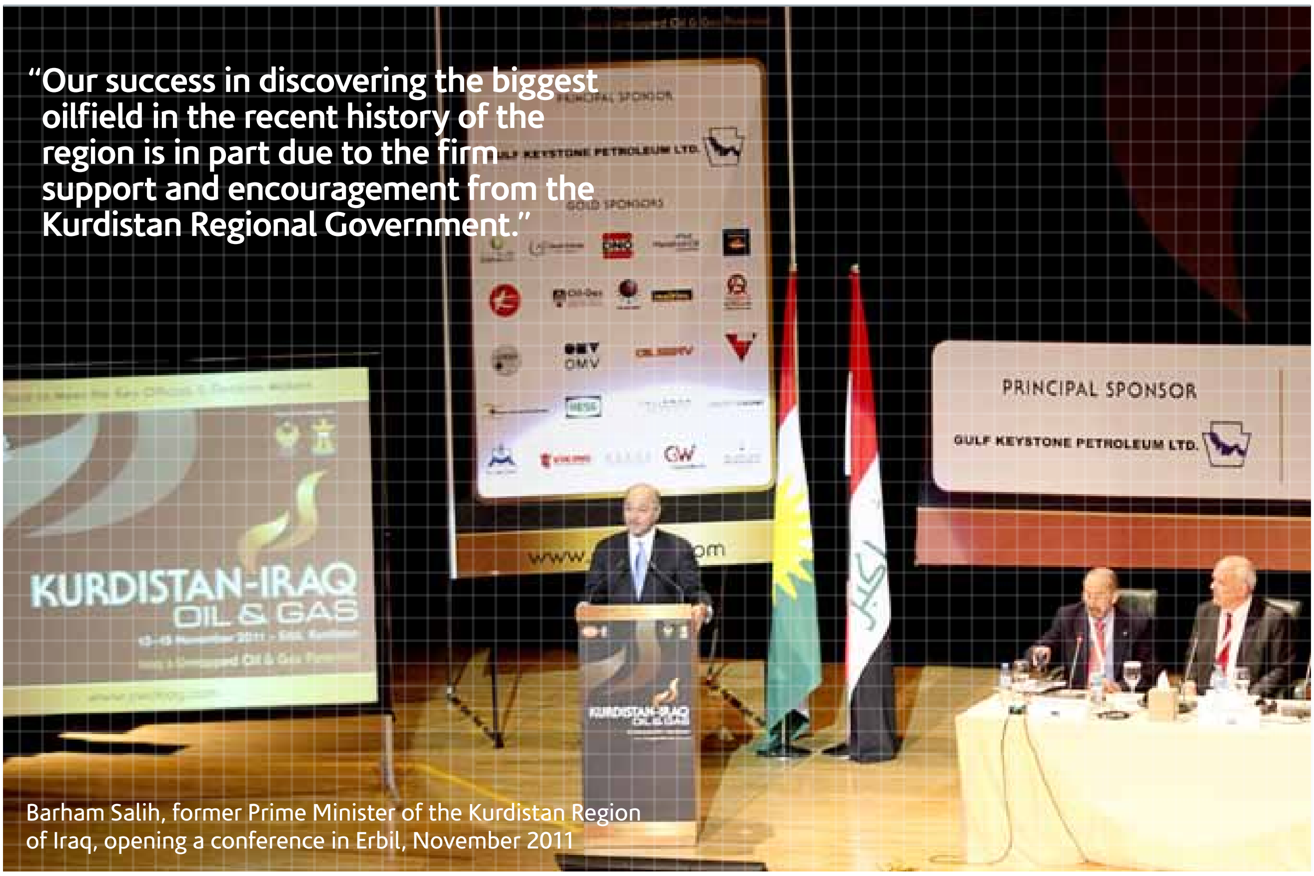
As part of the Shaikan appraisal programme, we commenced work on the Shaikan Field Development Plan during the course of 2011. In parallel with the growth of our test production capabilities, we are considering a plan for a dedicated 122km pipeline connecting the Shaikan field with the existing Kirkuk-Ceyhan export pipeline from Iraq to the world markets, capable of transporting a minimum of 440,000 bopd. A route survey for our pipeline is currently underway. In the longer term, our aim is to develop the Shaikan processing facilities to reach plateau production of 400,000 bopd with a potential of achieving 500,000 bopd.

# CAPTURING HUGE POTENTIAL

## OUR STRATEGIC PRIORITIES

1. Complete appraisal programme of the Shaikan field and explore deep undrilled horizons with Shaikan-7
2. Increase the Shaikan Extended Well Test production facilities output to 40,000 bopd to ramp up export and domestic sales and generate steady revenues
3. Design and construct a pipeline to bring increasing Shaikan production to international markets
4. Complete and submit the Shaikan Field Development Plan, select development concept, obtain required approvals and prepare to move to the large-scale 400,000+ bopd staged development
5. Continue aggressive exploration and appraisal of the Sheikh Adi, Ber Bahr and Akri-Bijeel blocks to prove up resource base with test production from Akri-Bijeel to follow
6. Establish the Company as one of the major independent exploration and production players listed on the London Stock Exchange

# 04 CHAIRMAN'S STATEMENT CONTINUED




**"Our success in discovering the biggest oilfield in the recent history of the region is in part due to the firm support and encouragement from the Kurdistan Regional Government."**

Barham Salih, former Prime Minister of the Kurdistan Region of Iraq, opening a conference in Erbil, November 2011

During 2011 we made a strategic decision to seek a buyer for the 20% interest in the Akri-Bijeel block in order to rationalise our asset portfolio and negotiations are ongoing with several interested bidders. In addition to this corporate initiative, we successfully raised $200 million through a fully subscribed share placing in September 2011, which contributed to the combined cash, cash equivalents and liquid investments balance of $237.6 million as at 31 December 2011. The results for 2011 show a loss after tax of $62.4 million (2010: $26.0 million), reflecting the significant increase in the operational activities in the Kurdistan Region of Iraq, a larger share based payments charge than in previous years and impairment of the Hassi Ba Hamou ("HBH") Permit in Algeria that was classified as held for sale in 2010.

We made good progress towards achieving our goal of a gradual strategic exit from Algeria by transferring Gulf Keystone's right, title and interest for nil consideration in the HBH Permit to BG Group and Sonatrach. Discussions are ongoing with Sonatrach regarding an orderly exit from the remaining GKN/GKS oil fields in the Ferkane area.

The Board of Gulf Keystone was strengthened in 2011 by the appointment of two additional Non-Executive Directors, General the Lord Guthrie and Mark Hanson who bring experience and skills in the area of leadership, management and capital markets.

Finally, Gulf Keystone continues vigorously to dispute and contest the allegations and claims asserted by Excalibur Ventures LLC ("Excalibur") in December 2010. October 2012 has been set as a date for the trial in the English Commercial Court of all the claims asserted by Excalibur.

I would also like to acknowledge the role that the Kurdistan Regional Government has played in Gulf Keystone's journey to this point. It is undeniable that our success in discovering the biggest oilfield in the recent history of the region is in part due to their firm support and encouragement and their focused quest to maximise the region's resources to benefit the local and national economic development. In particular, the effort of the Ministry of Natural Resources to develop an attractive and transparent investment environment in the oil and gas sector has resulted in the entry of large multinational oil companies to the region in 2011. We believe that this process will continue in 2012, reinforcing Gulf Keystone's early belief in the Kurdistan story and establishing Shaikan as a benchmark for other fields in the region.

Gulf Keystone's management and employees have already made considerable achievements, reflected in the increase in the Company's share price from £0.05 pence in March 2009, before the first Shaikan well was drilled, to today's levels. I would like to take this opportunity to thank every single member of the team for the hard work they continue to put in every day to make the Company the success story that it is.

As 2012 looks set to be another fantastic year for the Company, we will continue to work tirelessly to achieve our goal of developing the world-class acreage we possess, creating value for our shareholders.

I would like to thank our shareholders for their continued support, and hope that they are as excited as we are as we move through 2012, and to the next phase in the story of Gulf Keystone.

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

# ENDURING RELATIONSHIP

Adnan Samarrai
Country Manager
Kurdistan Region of Iraq

> "While in 2007 the Kurdistan Region of Iraq was not yet on the radar of international oil majors, Gulf Keystone could see that it was a world-class opportunity and took the plunge."

Gulf Keystone has been present in the Kurdistan Region of Iraq since 2007 and succeeded in bidding for prime acreage and making one of the largest discoveries at the giant Shaikan field. We are a leading operator in the region with an ambitious forward strategy for our operations striving to successfully prove the full potential of our assets, which in addition to the Shaikan discovery include the Sheikh Adi, Ber Bahr and Akri-Bijeel blocks.

Today the Kurdistan Region of Iraq is widely recognised as an underexplored prolific hydrocarbon province with exploration success rates in excess of 70%. However, back in 2007 things were very different for both the region where we operate today and the Company itself. Back then the daily news coming from wider Iraq was rather bleak and Gulf Keystone was a small independent oil explorer with a number of assets in Algeria. The visit of the Company's management to the region five years ago was transformational for Gulf Keystone and its shareholders. While at the time the region was not yet on the radar of international oil majors, Gulf Keystone could see that it was a world-class opportunity and took the plunge. In November 2007 we signed our first two Production Sharing Contracts ("PSCs") with the Kurdistan Regional Government for the Shaikan and Akri-Bijeel blocks.

**Shaikan: giant field in context**

The surface geology suggested that the Shaikan block, situated directly between the Tawke and Taq Taq oil fields and in an area of active oil seeps, contained a single elongate east to west trending, asymmetrical anticline with two culminations, an eastern and a western one. Our commitment for the block was to shoot 100km of 2D seismic data and to drill a well within three years. We started shooting a 170km 2D seismic programme, which was completed in April 2008. Choosing a site for the first well on Shaikan was a compromise between trying to get close to a crestal location and finding a topographic setting that could be accessed by a rig. While today we operate three rigs ourselves with three more operated by our partners, back in 2008 we faced a problem with finding a rig to drill a well. Eventually we brought Weatherford's Rig 842 from Houston to the Kurdistan Region of Iraq via Turkey and Shaikan-1 spudded in April 2009.

Shaikan-1 was designed to test the Cretaceous, Jurassic and Triassic formations with the possibility of extending to the Permian. In late July 2009, upon reaching the Sargelu section, a well-known source rock in Iraq, we decided to conduct an open hole drill stem test and on 2 August we had oil at the surface. We discovered a very significant oilfield, which we believe can ultimately produce over 400,000 barrels of oil per day.

We have been firmly focused on our operations in the Kurdistan Region of Iraq ever since. In July 2009, the Company acquired an interest in the Sheikh Adi and Ber Bahr blocks while deciding to start a gradual exit from Algeria. Today Gulf Keystone has a majority working interest in two out of four licences in the region and is the operator of the Shaikan and Sheikh Adi PSCs. We strive to achieve continuous drilling success and prove up the value of our assets, which currently include two confirmed (Shaikan-1 and Bijell-1) and one expected discovery at Sheikh Adi, which have transformed Gulf Keystone into a leading E&P player in the region and generated significant value for our shareholders.

# EXCELLENT RECORD ON THE GROUND

Shaikan-6 appraisal well

**Established Kurdistan brand**
Our early belief in the Kurdistan success story has recently been confirmed when an impressive number of international oil companies, including oil majors, decided to enter this region for the first time. In 2011, against the backdrop of the political unrest in some parts of the Middle East, once again the Kurdistan Region of Iraq has confirmed its status as one of the most stable and welcoming places for international business in Iraq and from among its neighbours. It is one of the most attractive upstream destinations in the world today.

There is no doubt that Gulf Keystone's consistent story of success in the Kurdistan Region of Iraq has significantly de-risked further exploration drilling in the region, contributing to the recent investment decisions by new entrants to the region. Moreover, the clear vision of the regional authorities with regard to the development of the energy sector cannot be underestimated. We believe that the growing number of large oil discoveries in the region, the entry of a several oil majors, as well as the increasing investment and infrastructure development will jointly pave the way for the Kurdistan Region of Iraq to achieve its 1 million barrels of oil per day production target by 2015.

Gulf Keystone's operations will play an important role in achieving this goal, as well as in supporting the overall development of the oil and gas sector of the Kurdistan Region of Iraq and, most importantly, in contributing to the overall economic growth in the interests of the people of Iraq.

**Kurdistan Region in brief**
The Kurdistan Region is an autonomous region in federal Iraq. It borders Syria to the west, Iran to the east, and Turkey to the north, where fertile plains meet the Zagros mountains, and is traversed by the Tigris, Greater Zab, and Lesser Zab rivers

**Area:** 40,643km$^2$

**Population:** 3,757,058

**Capital city:** Erbil (also known as Hawler)

**Languages:** mainly Kurdish; Turkmani, Arabic, Armenian, and Assyrian

**Currency:** Iraqi Dinar ("IQD")

**Source:** www.krg.org

## TRAINING AND REGIONAL DEVELOPMENT INITIATIVES

- Gulf Keystone has over 600 personnel including national staff, expats and contractors in the Kurdistan Region of Iraq
- We strive to conduct our operations in the spirit of co-operation with our host government and local communities by implementing a number of local employment and training initiatives
- In 2011, we organised training courses in the English language, IT and driving skills for a significant number of our personnel and funded a number of scholarships for short-term and long-term technical courses in the UK for our employees from Kurdistan
- We support a number of training initiatives for personnel of the Kurdistan Regional Government, including a two-day training seminar on Kurdistan Production Sharing Contracts for the Ministry of Natural Resources in November 2011
- Gulf Keystone supports the UK All-Party Parliamentary Group for the Kurdistan Region of Iraq, which promotes business links and awareness of the region in the UK and beyond

## ENVIRONMENTAL INITIATIVES

- Gulf Keystone's goal is to control and maintain its own environmental footprint and meet or exceed acceptable international standards for land reclamation
- In 2011, we developed and began implementing an environmental process consisting of a waste management initiative, bioremediation plans and evaporation and dewatering systems
- The Company purchased an incinerator, which is now used to burn all rubbish and garbage collected at all the drilling locations on the Shaikan and Sheikh Adi blocks, at the Shaikan-1 and -3 EWT facility and from the pipe yard
- Gulf Keystone's "Green Team" also collects rubbish from neighbouring villages which is burnt in the incinerator
- Once the waste is burnt, fly ash is used to treat oil cuttings and waste oil pits in conjunction with bioremediation product (kenaf fibres, a US EPA-approved product for remediation of hydrocarbon contaminated soil)
- An alternative fuel system is used in order to allow the incinerator to burn waste oil instead of diesel
- Evaporation and dewatering systems became operational at the Shaikan-6 location in March 2012

**1,698,204**

hours worked by the Company's personnel in the Kurdistan Region of Iraq

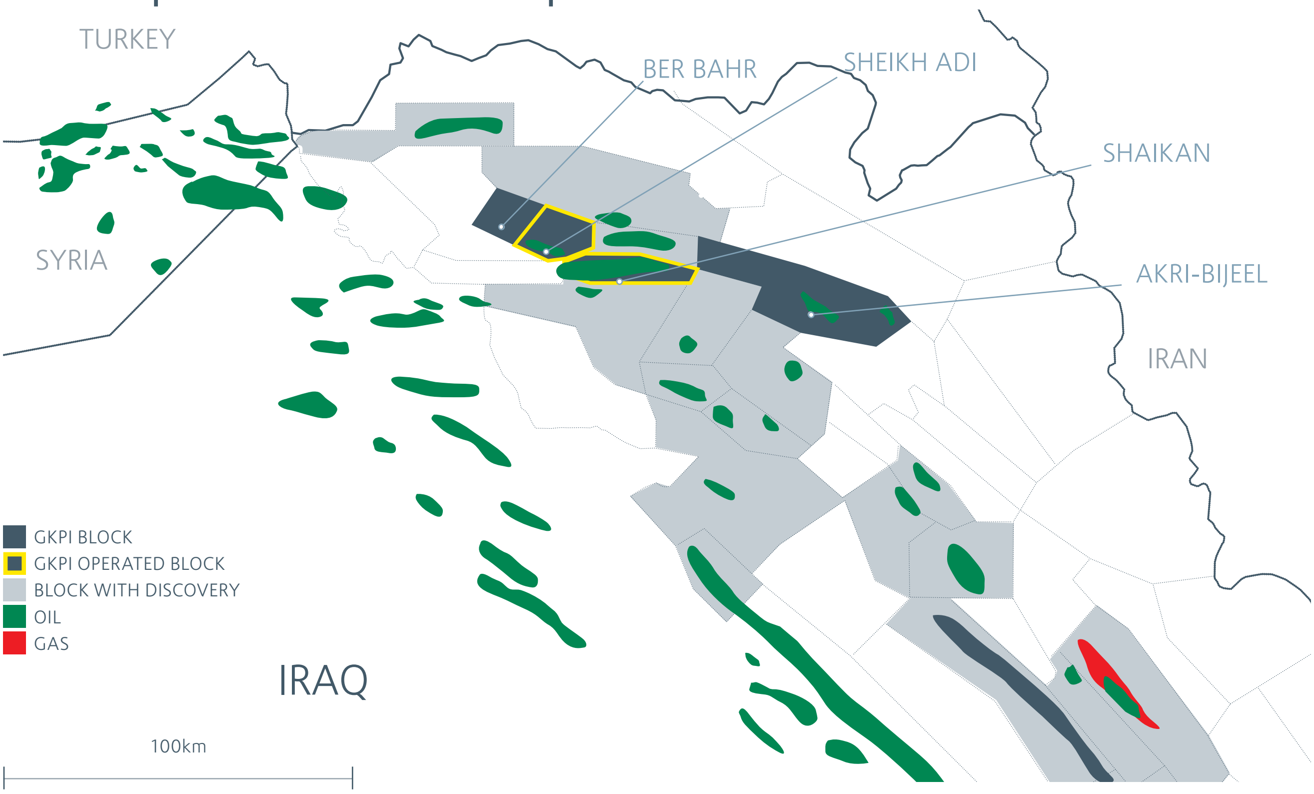
**1,110**

days spent by the Company's personnel on Health, Safety and Environment training

# ASSETS OVERVIEW

**Gulf Keystone Petroleum International Limited ("GKPI"), a wholly owned subsidiary of the Company, holds Production Sharing Contracts ("PSCs") for four exploration blocks with a total area under licence of 1,624km², about 85km from Erbil, the biggest regional centre of the Kurdistan Region of Iraq, 50km from the border with Turkey and over 400km to the north-east from Baghdad.**

## A coveted position in one of the last exploration frontiers




## Operator and partner

| Block | Working interest[1] | Fully diluted interest | Operator | Other partners |
|---|---|---|---|---|
| Shaikan[2] | 75% | 51% | GKPI | MOL (20%), TKI (5%)[3] |
| Sheikh Adi | 80% | 80% | GKPI | KRG (20%) |
| Ber Bahr | 40% | 40% | Genel Energy plc | Genel Energy plc (40%), KRG (20%) |
| Akri-Bijeel[2] | 20% | 12.8% | MOL[4] | MOL (80%) |

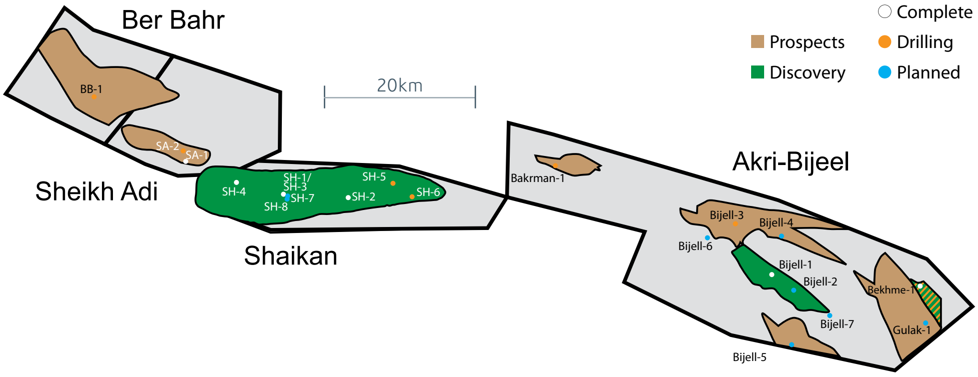
Notes:
(1) Information as of 25 May 2012
(2) GKPI's holding subject to the Kurdistan Regional Government's ("KRG") right to nominate a third party and the KRG's back-in rights
(3) Texas Keystone Inc ("TKI") holds its interest in trust for GKPI pending transfer of its interest to GKPI
(4) MOL Hungarian Oil & Gas plc holds its interest through Kalegran Ltd, a wholly owned subsidiary

**48**
international oil companies operating in the Kurdistan Region of Iraq

**20**
large, medium and small discoveries made to date

**45**bn barrels
estimated oil reserves in the Kurdistan Region of Iraq

## Four blocks with incremental billion barrel potential




### Shaikan

Area under licence: 280km²

### Sheikh Adi

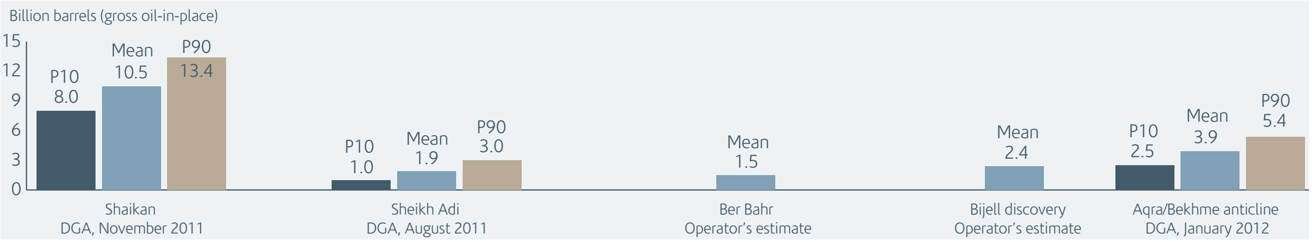
Area under licence: 249km²

### Ber Bahr

Area under licence: 206km²

### Akri-Bijeel

Area under licence: 889km²




**STATUS** (Shaikan)

- Shaikan-1 exploration well made a major discovery in August 2009, completed in November 2009
- Shaikan-3 shallow appraisal well drilled close to Shaikan-1 discovery well, completed in January 2011
- Shaikan EWT started in October 2010, ongoing on Shaikan-1 and -3 Jurassic producers
- 599km² of 3D seismic data acquired, fully processed in November 2011
- Multi-well appraisal programme will be completed with Shaikan-5 and -6
- Upgrade of Shaikan-1 and -3 EWT and construction of Shaikan-2 EWT are underway
- Shaikan-7 exploration well to target deeper untapped resources
- Shaikan-8 to be drilled as a gas injector well

**STATUS** (Sheikh Adi)

- Sheikh Adi-1 exploration well spudded in August 2010, tested and completed in August 2011
- 215km² of 3D seismic data acquired, fully processed in November 2011
- Oil indications in Sheikh Adi-1 to be confirmed with Sheikh Adi-2 exploration well, spudded in May 2012

**STATUS** (Ber Bahr)

- The first exploration well spudded in October 2011
- Ber Bahr-1 reached TD in May 2012 with testing results expected in mid-2012

**STATUS** (Akri-Bijeel)

- Bijell-1 exploration well spudded in December 2009
- Bijell discovery announced in March 2010
- Bekhme-1 exploration well drilled in 2011 on Aqra/Bekhme anticline
- Bijell-3 (Aqra-1) appraisal well spudded in January 2012 to appraise Bijell discovery
- Bakrman-1 exploration well spudded in May 2012
- Extensive 2012/2013 exploration/appraisal programme across the block
- Bijell-1 EWT planned for 2012

## Multi-billion barrel discovered resources

| Block | Report | Date | Gross oil-in-place volumes (billion barrels) P90 | Mean | P10 |
|---|---|---|---|---|---|
| Shaikan | DGA | January 2010 | 1.9 | 4.2 | 7.4 |
| | Ryder Scott[1] | January 2011 | 1.5 | 4.0 | 7.5 |
| | DGA | April 2011 | 4.9 | 7.5 | 10.8 |
| | DGA | November 2011 | 8.0 | 10.5 | 13.4 |
| Sheikh Adi | DGA | August 2011 | 1.0 | 1.9 | 3.0 |
| Akri-Bijeel – Bijell discovery | Operator's[2] estimate | December 2010 | | 2.4 | |
| Akri-Bijeel – Aqra/Bekhme anticline | DGA | February 2012 | 2.5 | 3.9 | 5.4 |
| Ber Bahr | Operator's[3] estimate of 1.5 billion barrels of oil equivalent-initially-in-place | | | | |

Notes:
(1) Petroleum-initially-in-place
(2) Kalegran Ltd., a wholly owned subsidiary of MOL Hungarian Oil & Gas plc
(3) Genel Energy plc

# REVIEW OF OPERATIONS


"2011 has seen Gulf Keystone make huge strides in adding billions of barrels of gross oil-in-place to the Company's resource base and further developing the Company into a leading operator in the Kurdistan Region of Iraq, a truly world-class oil exploration province."

## Kurdistan Region of Iraq

During 2011, Gulf Keystone has overseen a number of major developments in its operations in the Kurdistan Region of Iraq. Some of the most remarkable achievements of the year include the number of significant additions to the Company's resource base and exploration and appraisal wells drilled across all of our four blocks in the Kurdistan Region of Iraq. In 2011, we also dedicated a significant amount of time to Health, Safety and Environment ("HSE") training, including the areas of road transportation safety and emergency planning and response. Our HSE record has been good with only two Lost Time Injuries ("LTIs") recorded in 2011, which is an improvement on 2010, when four LTIs were recorded.

### Significant additions to the resource base

The revised gross oil-in-place volumes for the Shaikan discovery, as calculated by Dynamic Global Advisors ("DGA"), the independent Houston-based exploration consultants, in April 2011 range from a P90 value of 4.9 billion barrels to a P10 value of 10.8 billion barrels of oil-in-place with a mean value of 7.5 billion barrels. These already significant gross oil-in-place numbers for Shaikan were further upgraded by DGA in November 2011 to the range of 8.0 billion (P90) to 13.4 billion (P10) barrels of oil-in-place with a mean value of 10.5 billion barrels.

In August 2011, we announced the results of the first preliminary resource evaluation for the Sheikh Adi block. Based on the initial results obtained from Sheikh Adi-1, the first exploration well drilled on the block, DGA estimate that Sheikh Adi contains between 1 billion and 3 billion

## 2012/2013 Work programme

| Field/Prospect | Activity | Well | 2011 Q4 | 2012 Q1 | 2012 Q2 | 2012 Q3 | 2012 Q4 | 2013 Q1 | 2013 Q2 | Comments |
|---|---|---|---|---|---|---|---|---|---|---|
| Shaikan | Appraisal | Shaikan-5 | ▲ | → | ● | | | Development drilling | | Jurassic and Triassic eastward extension of known oil |
| | Appraisal | Shaikan-6 | ▲ | → | → | ● | | | | Jurassic and Triassic with possible OWC* definition |
| | Appraisal | Shaikan-8 | | | | ▲ | → | ● | | Gas injector to handle associated sour gas |
| | Exploration | Shaikan-7 | | | | | | ▲ | → | Deeper Triassic and Permian targets |
| Sheikh Adi | Exploration | Sheikh Adi-2 | | | ▲ | → | → | ● | | Jurassic, Triassic targets in hanging wall of the Sheikh Adi structure |
| Akri-Bijeel | Exploration/ Appraisal | Bijell-3 (Aqra-1) | | ▲ | → | → | ● | | | To prove northern extension of Bijell structure targeting Cretaceous and Jurassic |
| | Exploration | Bakrman-1 | | | ▲ | → | ● | | | Testing large undrilled anticline on trend with Shaikan |
| | Exploration | Gulak-1 | | | | ▲ | → | ● | | Large footwall prospect south of Bekhme |
| | Appraisal | Bijell-2 | | | | | ▲ | → | ● | Test southern extension of accumulation proved by Bijell-1 |
| | Appraisal | Bijell-4 | | | | ▲ | → | ● | | Part of the Bijell discovery appraisal programme |
| | Appraisal | Bijell-5 | | | | | ▲ | → | ● | Part of the Bijell discovery appraisal programme |
| Ber Bahr | Exploration | Ber Bahr-1 | ▲ | → | ● | | | | | Jurassic, Triassic reservoirs in major undrilled anticline |

▲ Well Spud ● Expected completion *OWC – Oil/Water contact

Source: Gulf Keystone's internal analysis

- High impact drilling campaign planned through 2012/2013
- Targeting 5 exploration wells and 7 appraisal wells
- 6 rigs across the 4 blocks in operation in 2012

barrels of gross oil-in-place, which are P90 and P10 estimates respectively.

Based on the results of the Bekhme-1 exploration well testing programme on the Akri-Bijeel block completed in December 2011, DGA issued an independent evaluation of estimated petroleum resources for the Aqra/Bekhme anticline. Whilst recognising the fact that no hydrocarbons had been produced to surface, the report indicated a significant range of between 2.5 billion barrels and 5.4 billion barrels of gross oil-in-place volumes calculated on the P90 to P10 basis, with the mean resource estimate for the reservoirs in the Aqra/Bekhme anticline of 3.9 billion barrels. While this range of resource estimates is significant, a considerable portion of the oil resource is likely to comprise heavy oil. Further evaluation will be required to determine whether the oil is commercially recoverable.

Taking into consideration these significant additions to the Company's resource base, we can conclude that under any reasonable recovery factor assumption, our 2011 oil finding costs were under 20 cents per recoverable barrel.

The discovery and appraisal effort on the Company's four blocks in the Kurdistan Region of Iraq is still far from over and the future looks bright for yet further additions to oil volumes, in particular as result of the ongoing appraisal programme on the Shaikan block.

### Shaikan (75% working interest; Operator)

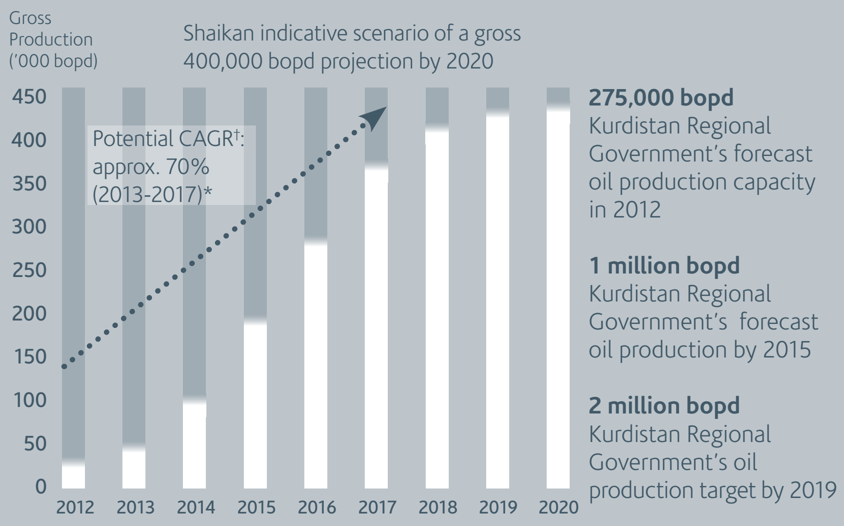
#### Appraisal programme

During 2011, the work programme to appraise the Shaikan discovery has achieved the following:

Full 3D seismic coverage of the Shaikan structure began in early April 2010 with a targeted completion for the data acquisition phase being October 2010, which was achieved. Processing and evaluation of the data was completed in November 2011. The complicated nature of the Shaikan geology and the difficulties created by the rugged surface topography have necessitated a significant amount of processing of the seismic data so as to eliminate noise without losing the overall picture of the subsurface strata. Results of

# REVIEW OF OPERATIONS CONTINUED

### Shaikan: from resources to development and production




† Cumulative Annual Growth Rate
* Shaikan only; excludes risked success production from Sheikh Adi, Ber Bahr and Akri-Bijeel
Source: Gulf Keystone's internal analysis

the 3D data interpretation indicate a larger Shaikan structure (by 5-10%) than originally mapped based on the earlier 2D seismic data.

The Shaikan-2 appraisal well was drilled to a total depth ("TD") of 3,300 metres. A new Triassic reservoir was discovered and tested in the Kurre Chine C formation at a maximum rate of 4,450 bopd of 36 degree API oil. This successful test in the upper Triassic points to additional prospectivity in the mid to lower Triassic.

The Shaikan-4 appraisal well spudded in May 2011 and reached TD of 3,387 metres in December 2011. Early well log results and core data in the mid to upper Jurassic indicated a massive oil column with net pay intervals of 278 metres in September 2011, even better than those seen on Shaikan-1. In the course of the well testing programme, which commenced in December 2011, log results have indicated that this is the best Shaikan well to date. When testing the Shaikan-1, -2 and -3 wells, we tested, for the most part, zones that looked good on the logs in order to verify productivity of the various reservoirs that make up the Shaikan field. However, in Shaikan-4, where we conducted a total of seven flow tests, we began to test some of the zones that looked more marginal on the logs. The resulting flow rates were extremely encouraging and resulted in aggregate test rates of over 24,000 bopd.

The Shaikan-5 appraisal well, 6km to the east from the Shaikan-2 appraisal well, spudded in October 2011 targeting the easternmost part of the crest of the Shaikan structure. The Shaikan-6 appraisal well spudded in December 2011 to assess the Shaikan structure down the flanks in an effort to find the all-important oil-water contact and complete the appraisal programme of the Shaikan field. Both Shaikan-5 and Shaikan-6 reached TD in May 2012 and are currently being tested.

In 2012, we plan to drill the Shaikan-8 well at a high location close to the completed wells-producers Shaikan-1 and Shaikan-3. Shaikan-8 will be drilled as a gas injector allowing the associated sour gas not used as fuel to be re-injected in a safe and environmentally responsible manner.

**Exploration of deeper resources**
In 2013, we plan to spud Shaikan-7, a deep exploration well, to gain insight into the deep horizons in the mid to lower Triassic and the Permian, which have not yet been explored.

**Shaikan Extended Well Test**
In 2011, as part of the ongoing Extended Well Test ("EWT") on the Shaikan block, we started working on a complete upgrade of the existing EWT facility. Construction of a significantly modified unit began in late 2011. We have already started working on the design and construction of EWT-2 which will be installed near the Shaikan-2 location. When both facilities are fully operational, we anticipate a production capacity of up to 40,000 bopd.

**Shaikan Full Field Development Plan**
After completion of the Shaikan-5 and -6 appraisal wells, the appraisal programme for the Shaikan discovery will have been completed and within six months the Field Development Plan will have to be submitted to the Ministry of Natural Resources of the Kurdistan Regional Government.

Gulf Keystone's in-house development team, together with a growing group of technical consultants, have been working on the Shaikan Field Development Plan since summer 2011. This complex development scheme will involve the construction of two central processing facilities and the drilling of a large number

# SHAIKAN IS JUST THE START

Operator at the Shaikan-1 and -3 EWT facility

of development wells in order to increase field production up to plateau rates and maintain the plateau during at least the first half of the Production Sharing Contract term. Plateau production rates are still being evaluated but are expected to be at least 400,000 bopd.

Using the Shaikan exploration and appraisal wells as producers, in addition to a number of production wells and a series of EWT-type facilities, an initial production level of 100,000 bopd will be targeted subject to the approval of the Shaikan Field Development Plan. The full field development is estimated to cost in the order of $7 billion to $10 billion gross, with the first 100,000 bopd of production estimated to cost less than 5% of that amount.

**Shaikan export pipeline project**
A route has been selected for the Company's dedicated pipeline to connect the Shaikan field with the existing Kirkuk-Ceyhan oil export line. Preliminary design of the 36-inch diameter, 122km pipeline has been prepared and a route survey is ongoing.

## Algeria

In line with the Company's decision to undertake a gradual strategic exit from Algeria in order to focus on our extensive operations in the Kurdistan Region of Iraq, we have completed the transfer of Gulf Keystone's interest in the Hassi Ba Hamou (HBH) Permit to BG Group, the operator, and Sonatrach.

Our remaining limited activities in Algeria will focus on an orderly exit from the small GKN/GKS oil fields in the Ferkane area.

## Looking forward

2011 has seen Gulf Keystone make huge strides in adding billions of barrels of gross oil-in-place to the Company's resource base and further developing the Company into a leading operator in the Kurdistan Region of Iraq, a truly world-class oil exploration province. We have made good progress in the engineering and planning activities for the Field Development Plan of the Shaikan discovery. We have also taken the first steps towards becoming a significant and stable oil producer in the region. 2012 shows every sign of being just as significant as the past year, perhaps more so, and we look forward to the future with great excitement and enthusiasm.

# REVIEW OF OPERATIONS CONTINUED

## PROVEN OPERATING CAPABILITY

- 814km² of 3D seismic data on the Shaikan and Sheikh Adi blocks acquired and processed
- 100% success on the Shaikan-1 and Bijell-1 exploration wells
- 13 wells drilled or being drilled
- Shaikan flow tests of up to 24,000 bopd on a single well
- Shaikan-1 and -3 capable of producing 18,000 bopd
- Shaikan EWT's current production and domestic oil sales of 6,000-7,000 bopd
- Shaikan EWT's total gross output of over 450,000 barrels of oil as at 30 April 2012
- Good HSE track record


Sheikh Adi-2


Bijell-3 (Aqra-1)


Ber Bahr-1

**Sheikh Adi (80% working interest; Operator)**
The Sheikh Adi-1 exploration well reached TD at 3,800 metres in August 2011 with a gross pay interval of 2,790 metres, 35% more than Shaikan-1. Further drilling was not possible due to hole size and casing integrity limitations combined with high formation pressures. Following the testing programme, the well was suspended. Based on well logs results, gross oil-in-place resources of 1 billion to 3 billion barrels (P90 to P10) with a mean of 2 billion barrels of oil-in-place have been assigned to the western portion of the Sheikh Adi field by DGA.

Sheikh Adi-2, the second exploration well on the block and located 1.45km to the north of Sheikh Adi-1, spudded in May 2012. The location for Sheikh Adi-2 was selected after detailed analysis of the 3D seismic data and we believe it to be a more optimal location than that of Sheikh Adi-1.

The western side of the Sheikh Adi field, where Sheikh Adi-1 was drilled, does not appear to have the well-developed system of natural fractures that is evident at the Shaikan field. The northern part of the field, where Sheikh Adi-2 is drilling, appears to be more folded and thus more likely to be naturally fractured and, therefore, more similar to Shaikan.

**Akri-Bijeel (20% working interest)**
Bekhme-1, the second exploration well on the Akri Bijeel block, spudded in March 2011. Bekhme-1 was drilled to a TD of 5,000 metres at a location which appears to have encountered problems similar to those experienced by the Sheikh Adi-1 well, in that it was drilled in an area with fewer natural fractures. While no commercial inflow of hydrocarbons was encountered in Bekhme-1, new data gained during the well testing programme significantly decreases uncertainty for the remaining Akri-Bijeel prospects.

As a result of DGA's report based on the Bekhme-1 wireline logging data and 2D seismic data, 3.9 billion barrels of gross oil-in-place have been added to our resource estimates. We expect this number to be significantly bolstered by the results of the Bijell-3 (Aqra-1) appraisal well and the Bakrman-1 exploration well, which spudded in January and May 2012 respectively and are currently drilling.

Bijell-3 (Aqra-1) is appraising the Bijell discovery, which the operator estimates to hold 2.4 billion barrels of gross oil-in-place. Both Bijell-3 (Aqra-1) and Bakrman-1 are part of ongoing 2012/13 exploration and appraisal programme, which is targeting existing and identified hydrocarbon prospects in the Akri-Bijeel block.

An extended well test is planned for the Bijell-1 discovery well in 2012, similar to the ongoing Shaikan-1 and -3 EWT.

**Ber Bahr (40% working interest)**
Ber Bahr-1, the first exploration on the Ber Bahr block, spudded in October 2011. The well reached TD in April 2012 and is currently being tested with results expected by the end of Q2 2012.

**John Gerstenlauer**
**Chief Operating Officer**


### Outlook for 2012 and beyond

The main objective of the Board of Directors and the management team will be to remain focused on the Group's operations in the Kurdistan Region of Iraq.

During 2012, we will complete the appraisal programme of the Shaikan field, explore deep untapped resources of this structure and prepare to move to the first phase of the large-scale development in 2013. Prior to that we will complete the preparation of the Shaikan Field Development Plan and submit it for approval to the Ministry of Natural Resources of the Kurdistan Regional Government.

We expect to increase test production from the Shaikan EWT from the current level to the target of 30,000 – 40,000 bopd once the Shaikan-1 and -3 EWT has been upgraded and the Shaikan-2 EWT facility has become operational. The new processing facilities will allow Shaikan crude to be processed to meet export specification. Shaikan crude will then be either sold into the domestic market in the Kurdistan Region of Iraq or exported. Depending on market conditions, we may pursue both routes simultaneously.

Shaikan-8 will be drilled as a gas injection well to handle associated sour gas which is not used for fuel. In this way we will be able to re-inject the sour gas in a safe and environmentally responsible manner and manage increasing production from the existing and future Shaikan EWTs.

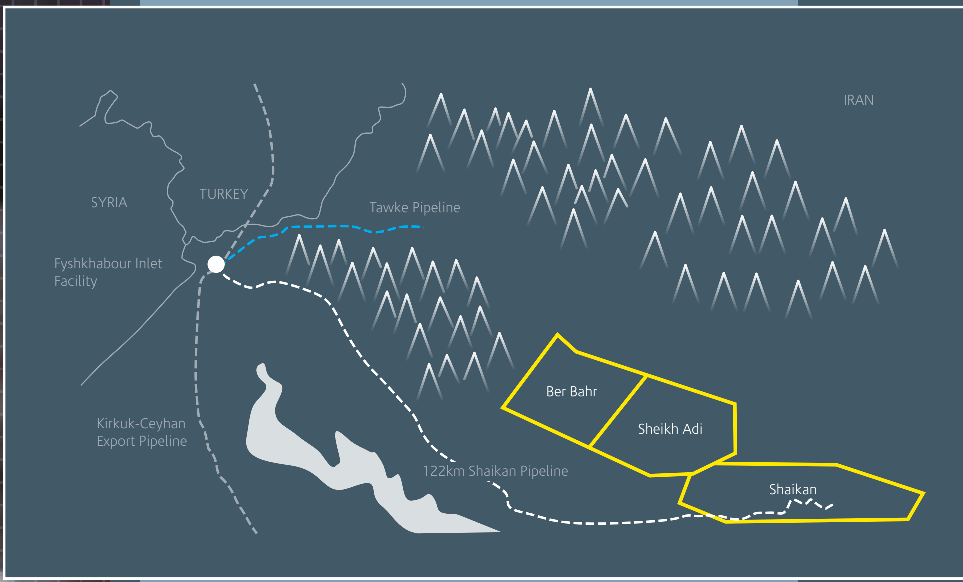
Shaikan's deeper resources will be targeted by the Shaikan-7 exploration well, while exploration and appraisal will continue at the Sheikh Adi, Ber Bahr and Akri-Bijeel blocks, with the aim of increasing our resource base and establishing production capability similar to Shaikan's.

### EXTENDING PRODUCTION HORIZONS

- Shaikan-1 and -3 wells are capable of producing 18,000 bopd
- Shaikan-1 and -3 EWT production facility's output of 6,000 - 7,000 bopd
- When upgraded in late 2012, the Shaikan-1 and -3 EWT will produce 20,000 bopd
- Shaikan-2 EWT will add a further 20,000 bopd
- Shaikan-4 will be tied to the EWT-1; Shaikan-5 and -6 to the EWT-2
- Shaikan Field Development Plan will target 100,000 bopd initially
- Ultimate goal is to achieve 400,000+ bopd plateau production
- Bijell-1 EWT will commence in 2012
- Sheikh Adi and Ber Bahr EWT potential will be evaluated subject to drilling results

## PIPELINE OF OPPORTUNITIES

- Proposal to construct a dedicated 36-inch diameter, 122km pipeline to connect the Shaikan field with the Kirkuk-Ceyhan export pipeline near Fyshkhabour
- The pipeline will accommodate our future production capacity of over 400,000 bopd and provide an efficient route to market




- Feasibility study and pipeline route survey evaluation have been completed prior to contract awards
- The Company's decisions are contingent on the regional pipeline outlook, which includes a 1 million bopd oil export line to the Turkish border and a 500,000 bopd heavy crude oil pipeline

Already a leading operator in the Kurdistan Region of Iraq, we remain committed to undertaking the move from AIM, where we are one of the largest quoted companies today, to the premium segment of the Official List of the London Stock Exchange, subject to meeting the eligibility criteria. Whilst work has been ongoing in this regard to achieve such a move as soon as practicable, no discussions have as yet been held with the UK Listing Authority regarding the Company's eligibility for the premium segment due to the emphasis of matter in the independent auditor's report on the consolidated financial statements. A further update will be issued in due course and, in any event, as part of the Company's Interim Results for the six months ended 30 June 2012.

**40,000 bopd**

Shaikan medium-term test production target

**100,000, bopd**

Shaikan Field Development Plan's initial target

**400,000 bopd**

Shaikan plateau production

# FINANCIAL REVIEW

**"The Company continues to be in a strong cash position at the end of 2011 with cash balances having increased since the beginning of the year… inclusive of liquid investments, cash and cash equivalents totalled $237.6 million as at 31 December 2011."**

| 2011 RESULTS SUMMARY | $ million |
|---|---|
| Revenue | 6.9 |
| Loss after tax | 62.4 |
| Cash invested in intangible assets | 152.5 |
| Cash, cash equivalents and liquid investments at 31 December 2011 | 237.6 |

## Results for the year

### Operating results

Following the commissioning of Gulf Keystone's Extended Well Test facility ("EWT") in 2010, the Company has continued to produce from the Shaikan-1 and -3 wells. Gross production for 2011 totalled 200,137 barrels of oil (2010: 82,054 barrels of oil) and gross sales were 207,848 barrels (2010: 56,583 barrels of oil). These sales have generated net revenues of $6.9 million (2010: $0.8 million) for the Company. The Company's net entitlement to sales during 2011 was 166,277 barrels of oil (2010: 30,193 barrels of oil) with an average realised price achieved for these sales of $41.61 per barrel (2010: $26.78 per barrel). Operating costs on a per barrel basis, excluding inventory movements, depreciation, depletion and amortisation costs and share-based payment charges were $33.97 per barrel during the period (2010: $8.84 per barrel).

Over half the production for the year was achieved in November and December 2011 and this stabilisation of output has continued into 2012, enabling Gulf Keystone to demonstrate its ability to realise revenues from the Shaikan discovery as well as providing valuable technical, commercial and marketing information.

As the Company is still in the early stages of producing oil from the Shaikan Field and production rates are variable, revenue continues to be shown in the income statement with an equal and offsetting amount against cost of sales and a nil gross profit. 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. The Company will consider recognising earnings and accounting for this activity as a gross profit or loss in the income statement if oil sales continue on a regular and consistent basis as experienced in Q1 2012 and as the development of the full field commences.

### Non-operating results

General and administrative expenses for 2011 were $60.4 million, compared to $32.6 million in 2010. Administrative costs have increased by $27.8 million primarily due to the 2011 share bonus awards and options under the long term incentive plan, resulting in a share-based payment expense of $42.5 million (2010: $21.7 million) and associated social security taxes of $5.9 million (2010: $3.1 million), as well as payment of a cash bonus of $6.3 million (2010: $3.7 million). Of these charges, $10.2 million has been included within intangible assets (2010: $6.5 million) as these employment costs are directly attributable to technical staff. The remaining increase in administrative costs is due to the significant increase in the operational activities in the Kurdistan Region of Iraq as the Company's projects mature from exploration assets through appraisal to development, as well as increased advisors' fees incurred in relation to the Group's defence of the claim made by Excalibur Ventures LLC ("Excalibur"). For further details of the Group's response to the claim please refer to the Corporate activities section.

The Group recognised a $10.0 million (2010: nil) impairment of the Hassi Ba Hamou ("HBH") Permit that was classified as an asset held for sale in 2010 following the agreement negotiated with BG North Sea Holdings Limited ("BG"). In 2011, an amendment to the agreement was signed whereby the Group agreed to transfer the HBH Permit to BG for nil consideration resulting in a full impairment of the asset. The re-negotiation of the agreement facilitated the Company's exit from this permit which was concluded on 28 December 2011.

Other gains of $5.8 million (2010: other gains of $5.9 million) comprise foreign exchange gains of $4.7 million (2010: $5.8 million gain) and a mark-to-market valuation gain on forward exchange contracts entered into during the year of $1.1 million (2010: $0.3 million gain). The mark-to-market gain is a result of the Company entering into currency hedges to partly mitigate the risk associated with converting sterling to U.S. dollars following funds received from shares placed by Gulf Keystone during 2010 and 2011.

Interest revenue increased to $1.2 million in 2011 from $0.2 million in 2010 due to higher average balances for cash, cash equivalents and liquid investments and the use of longer term deposits to

Shaikan-1 well-producer

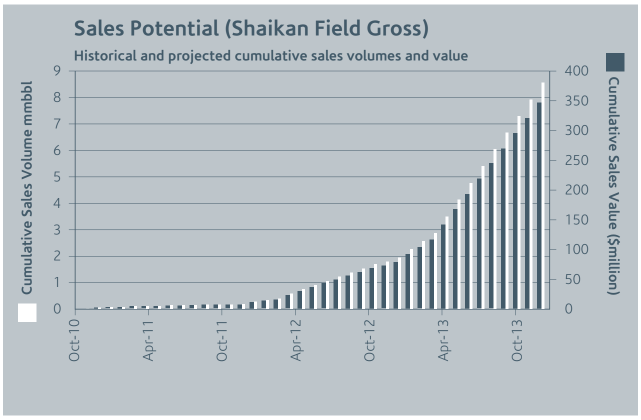
maximise returns to the Company. Finance costs of $0.5 million (2010: $0.3 million) relate to the accretion charge on the decommissioning provision.

The tax credit for 2011 is $1.4 million (2010: credit of $0.8 million) and arises on UK activities.

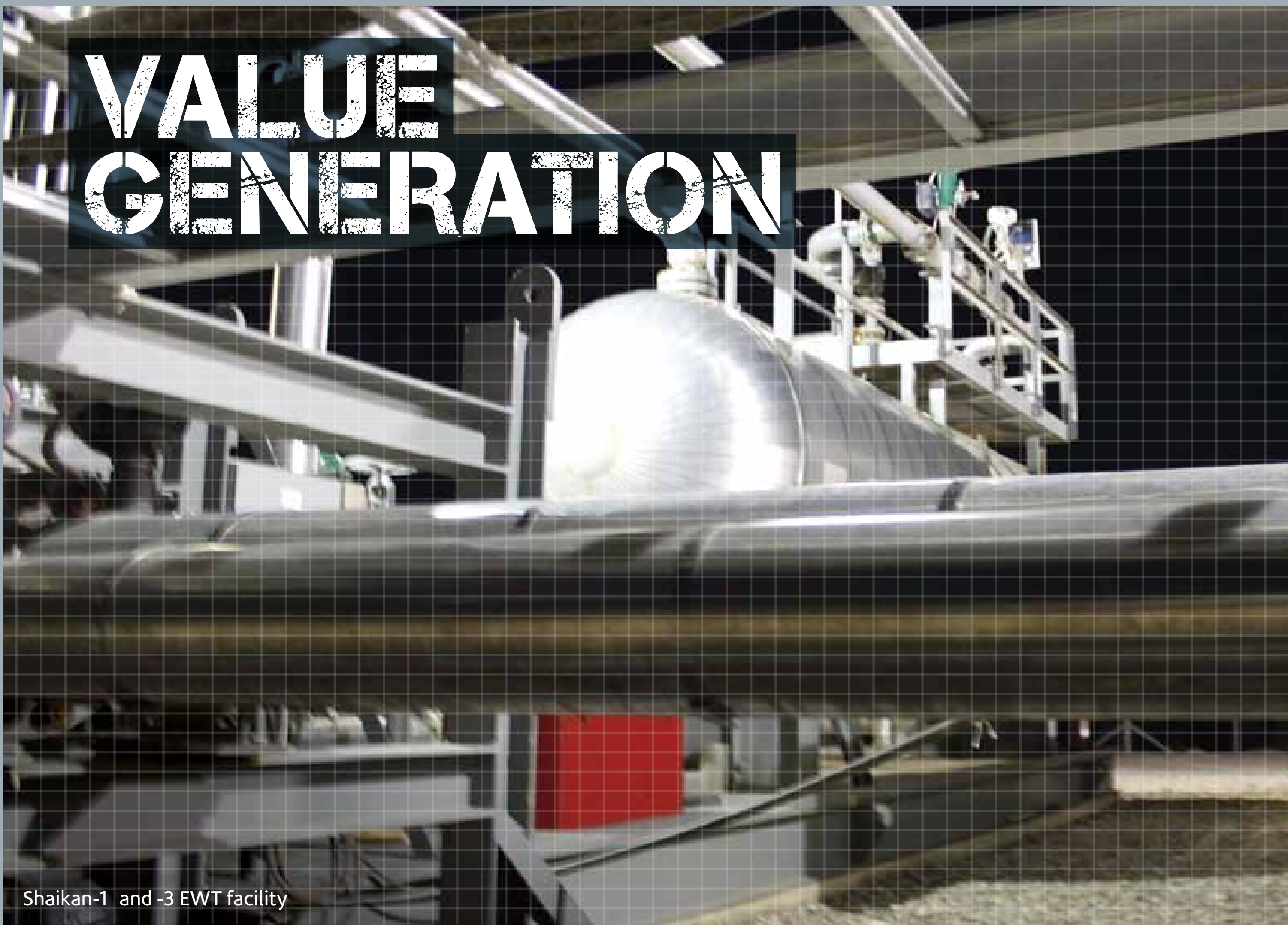
The results for 2011 show an increased loss after tax of $62.4 million (2010: $26.0 million) reflecting the increase in the administrative expenses and impairment of assets held for sale as discussed above.

### Cash flow

After adjustments for non-cash expenditure relating to share-based payments ($34.6 million), impairment of the HBH asset held for sale ($10.0 million) and depreciation and amortisation ($0.5 million), cash outflow from operations was $25.2 million (2010: $15.2 million) reflecting increasing activity in the Kurdistan Region of Iraq, and the recruitment of a Field Development plan team for Shaikan, as well as the Company's expenditure in defence of Excalibur's claims.




# FINANCIAL REVIEW CONTINUED



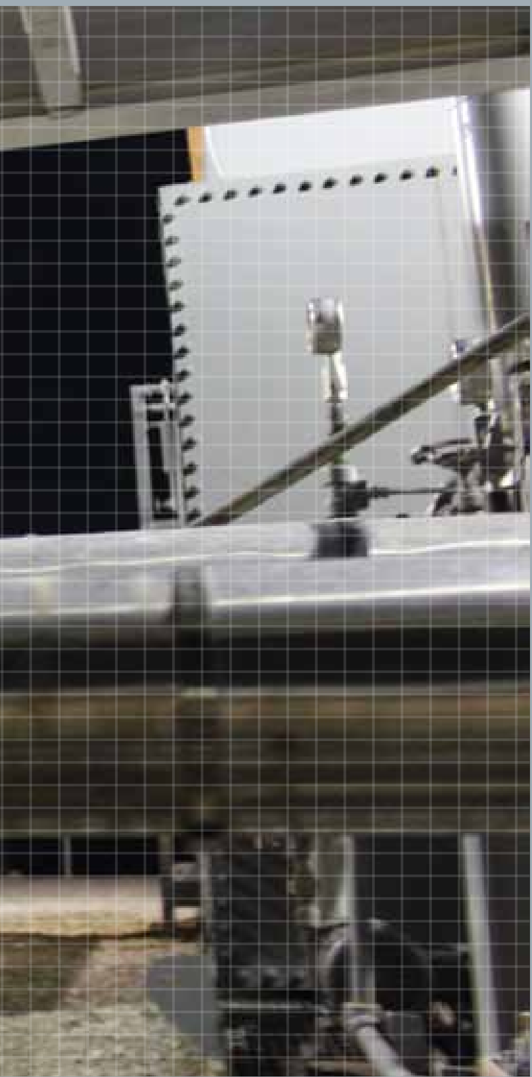

Shaikan-1 and -3 EWT facility

Working capital adjustments ($1.0 million favourable) are due to an increase in payables, partially offset by a rise in inventories and receivables. The higher payables balance is in line with the increase in general and administrative expenses as discussed above and is mostly attributable to the cash element of the 2011 bonus, while the increase in inventories and receivables results from increased operational activity and higher oil sales during the year. Net cash outflow from oil and gas operations after general and administrative expenses was comparable to 2010 at $24.2 million (2010: $26.2 million). Tax paid in 2011 was $0.7 million (2010: $0.5 million) and interest received $1.2 million (2010: $0.2 million). Net cash outflow from operating activities after tax and interest was $23.7 million (2010: $26.5 million).

Cash used in investing activities totalled $172.5 million (2010: $157.2 million). The majority of this relates to capital expenditure in the Kurdistan Region of Iraq of which $152.5 million was spent on the Group's exploration activities, including the drilling of Shaikan-2, Shaikan-4, Shaikan-5, Shaikan-6, Sheikh Adi-1, Ber Bahr-1 and Bekhme-1 wells as well as the ongoing facilities work to upgrade the existing Shaikan-1 and -3 EWT facility and construct a new EWT facility for the Shaikan-2 location. The Company has also invested an additional $19.4 million (2010: $10.2 million) in short-term liquid investments of over three months maturity to maximise interest revenue, bringing the total liquid investment balance to $29.5 million.

During 2011, a total of $197.9 million (2010: $359.9 million) net of issue costs was raised through the issue of new common shares in September 2011, the exercise of warrants, the exercise of options under the Company's share option plan and the subscription costs paid for bonus shares vesting at the end of 2010, associated with performance over the period from 2008 to 2010.

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 $1.8 million (2010: $176.2 million decrease) prior to a foreign exchange gain of $5.1 million (2010: $5.9 million gain). The Company continues to be in a strong cash position at the end of 2011 with



cash balances having increased since the beginning of the year. Cash and cash equivalents totalled $208.1 million at 31 December 2011 (2010: $201.3 million). Inclusive of liquid investments, cash and cash equivalents totalled $237.6 million at 31 December (2010: $211.4 million).

**Corporate activities**

The Group continues vigorously to dispute and contest the allegations and claims asserted by Excalibur in its claim against Gulf Keystone and two of its subsidiaries ("the Companies"). On 8 April 2011, the Companies obtained an injunction in the English Commercial Court restraining Excalibur from pursuing the International Chamber of Commerce ("ICC") arbitration proceedings and an interim payment on account of costs was made to the Companies by Excalibur in July 2011 as directed by the Court. In July 2011, Excalibur confirmed in the English Commercial Court in London that it no longer intended to pursue the ICC Arbitration in New York against the Companies and that it was content that all its claims against the Companies should be determined in the English Commercial Court in London.

In April 2012, further to the decision of the English Commercial Court in London a payment of £6,000,000 has been made into Court by Excalibur as security for the costs of the Companies of defending the legal action commenced by Excalibur in December 2010. Excalibur has also made a payment of £3,500,000 into Court as security for the costs of Texas Keystone Inc. October 2012 has been set as a date for a trial in the English Commercial Court of all the claims asserted by Excalibur. Further details are given in note 20 to the consolidated financial statements.

At the Annual General Meeting on 16 June 2011, approval was obtained to increase the authorised share capital of the Company by $500,000 through the creation of an additional 50,000,000 new common shares of $0.01. At the date of this report, 876,181,620 common shares are currently in issue.

In order to fund the Group's stated work programme communicated through the Group's forward strategy and to increase the focus on the aggressive programme of exploration and appraisal of the Shaikan, Sheikh Adi and Ber Bahr blocks, the Group completed a significant fully subscribed share placing on 20 September 2011. The Company placed 91,120,000 new common shares of $0.01 each at a price of £1.40 each raising gross proceeds of $200 million. Also in September 2011, 0.8 million shares were issued in relation to warrants exercised by Renaissance Securities (Cyprus) Limited. The warrants were issued in 2010 in lieu of placing fees.

During February 2011, the Gulf Keystone Petroleum Employee Benefit Trust ("EBT") made grants of options with stretching long term incentive performance conditions to incentivise the Directors and employees of the Group to create further shareholder value. A total of 9,490,000 options were granted at a price of 175 pence per share (the "2010 LTIP Options").

The 2010 LTIP Options are available for exercise in equal tranches over three financial years subject to one third vesting on the share price reaching 275 pence per share, one third vesting on the share price reaching 325 pence per share and the final third vesting on the share price reaching 375 pence per share. Further option grants have been made over 2,300,000 common shares during the period, and over 300,000 common shares post-year end, to new employees and Non-Executive Directors.

During February 2011, 7.0 million shares were also issued in relation to outstanding awards made under the 2008, 2009, and 2010 Executive Bonus Schemes and 1.0 million shares in response to option exercises by the Group's employees. These issues were previously detailed in the 2010 annual report and accounts.

# FINANCIAL REVIEW CONTINUED


Trucks loading at the Shaikan-1 and -3 EWT facility

"Fully subscribed share placing raising gross proceeds of $200 million."

"$183 million cash, cash equivalents and liquid investments as at 1 May 2012."

Subsequent to 31 December 2011, discretionary grants of 10.0 million common shares have been made by the Company to Directors and employees under the 2011 Executive Bonus Scheme and 11.0 million shares have been issued, including 10.2 million to the EBT, to satisfy awards made under the 2009, 2010, and 2011 Executive Bonus Scheme that were deemed to have vested. Further details of the awards granted and vested are given in the Directors' Report and notes 17 and 21 to the accounts. The shares issued during 2011 and subsequent to year end to satisfy awards under the Company's bonus and option incentive schemes represent 2.20% of the Company's share capital as at 1 May 2012.

In March 2012, the Company announced that the Remuneration Committee had recommended that the Company makes cash-settled awards to certain Executive Directors and employees conditional on the occurrence of an Exit Event (as defined below) ("Exit Event Awards"), up to a maximum amount equivalent to the value of 10,000,000 common shares of $0.01 each ("common shares") at the time of an Exit Event. A trustee (the "Exit Event Trustee") was appointed to hold and, subject to the occurrence of an Exit Event, to sell sufficient common shares to satisfy the Exit Event Awards.

The value of the common shares to be settled pursuant to the Exit Event Awards is dependent on the Company's share price, if and when an Exit Event occurs.

The Independent Directors of the Company approved Exit Event Awards equivalent to the value of 2,000,000 common shares to certain Executive Directors and employees, subject to the occurrence of an Exit Event. The Exit Event Trustee will hold the remaining 8,000,000 common shares to satisfy any future Exit Event Awards to full-time employees of the Company and subsidiary companies, with such beneficiaries to be determined in due course.

An Exit Event is defined in detail in the Share Award Agreement in relation to an Exit Event Award and envisages a sale of either the Company or a substantial proportion (i.e. more than 50%) of its assets.

The preparation of the Exit Event Awards commenced in June 2011 and involved detailed discussions with a number of the Company's leading institutional and other shareholders, as well as consultation with the Company's advisers. The Exit Event Awards, the awards under the 2011 Executive Bonus Scheme and the cash bonus were made after consultation with a number of the Company's leading institutional and other shareholders who hold, in aggregate, in excess of 35% of the issued share capital of the Company.

### Other and further events

On 14 September 2011, the Group announced its intention to sell the Group's 20% working interest in the Akri-Bijeel block as part of the Group's forward strategy to rationalise its asset portfolio. The Company has appointed Corporate Advisers who are responsible for the co-ordination of and advice on the sale. The sale process is ongoing at the date of this report. The Akri-Bijeel intangible asset (2011: $30.4 million; 2010: $19.4 million) and associated working capital balances (31 December 2011: $5.5 million) have been reclassified as an asset held for sale.

The Group continues to effect an orderly exit from its Algerian operations and, as announced in February 2012, all required documentation has been executed and all necessary Government approvals obtained pursuant to the agreement between the Company and BG Group, the Operator, providing for the transfer of the Company's right, title and interest in the Hassi Ba Hamou ("HBH") Permit for nil consideration to the Operator. The Group has one remaining interest in Algeria, the Ferkane Perimeter (block 126) and discussions are underway with a view to a similar exit.

### Outlook

The Group, together with its partners, continues actively to explore the prospects identified in the Sheikh Adi, Akri Bijeel and Ber Bahr blocks and realise the potential of the licence interests it holds. Gulf Keystone has made significant progress in appraising the Shaikan Field and has recruited a Full Field Development Plan team during 2011. Development Plan preparation is almost complete for Phase One of the Full Field Development Plan.

Production since November 2011 has been encouraging. Stabilised output of an average 2,520 gross barrels of oil per day ("bopd") has been achieved from the Shaikan-1 and -3 EWT from the latter part of November to the end of 2011, and by the end of Q1 2012, this had increased to an average of over 5,000 gross bopd.


Gulf Keystone has a strong balance sheet at 31 December 2011, with the previously stated drilling programme being funded through existing resources together with oil sales revenues. The Group's ongoing work also includes the upgrade and expansion of the existing EWT production facilities and construction of additional test production facilities which are expected to be completed in the second half of 2012. Output levels are due to increase further after the new and upgraded facilities have been completed.

Gulf Keystone is now entering a new phase of its development as it matures from a proven oil explorer to a production company. As the commercial viability of the Shaikan Field is demonstrated, and the Company's exploration and appraisal programmes on Sheikh Adi, Akri Bijeel and Ber Bahr progress, there continue to be excellent opportunities for increasing shareholder value.

**Ewen Ainsworth**
**Finance Director**

# MANAGEMENT OF PRINCIPAL RISKS AND UNCERTAINTIES

**Getting risk management right is an essential component of business success. The identification, evaluation and management of risk, together with the way we respond to changes in the external operating environment, are key to our success and underpin the safe delivery of our business plans and strategic objectives, protect our licence to operate and reputation, and help to create long-term competitive advantage.**

**During 2011 we have regularly considered our risk profile and updated the Group risk register. The following table indicates the key risks the Company faces, their potential impact and the mitigation measures that we have in place. The list is not exhaustive or in priority order, and may change at any time.**

## STRATEGIC RISKS

| Principal risk | Possible impact | Mitigation |
|---|---|---|
| Meeting shareholder expectations | Ineffective or poorly executed strategy fails to create shareholder value and to meet shareholder expectations. It may lead to loss of investor confidence and reduction in the share price, which reduces the ability to access finance and increases vulnerability to a hostile takeover. | – The Company maintains a regular dialogue with the Group's shareholder base and the general public.<br>– Gulf Keystone employs an investor relations specialist.<br>– The Board is aware of reporting responsibilities and ensures that material information is released on a timely basis. |
| Loss of key staff and succession planning | Inability of the Group to recruit and retain staff with the right skills and to implement succession plans may lead to loss of knowledge and skills to the Group and other short and long-term disruption to the business. | – Remuneration packages are reviewed regularly to ensure key executives and Senior Management are appropriately compensated.<br>– Long-term incentive programmes have been established.<br>– The senior executives and permanent employees are issued with share options.<br>– Turnover rate in the Group continues to remain at low levels. |
| Political and regional risk | Unfavourable developments in politics, laws and regulations can affect our operations, earnings and our ability to deliver the strategy. Consequences may include limits on production or cost recovery, import and export restrictions, price controls, tax increases and other retroactive tax claims, expropriation of property, cancellation of contract rights, and increase in regulatory burden. | – Gulf Keystone strives to be a good corporate citizen globally, and fosters reputation by strong and positive relationships with the governments and communities where we do business. The Group has a number of ongoing corporate social responsibility initiatives which are discussed in more detail in the Regional Overview: Kurdistan Region of Iraq.<br>– The Group continuously monitors the local situation for emerging risks to the business and has business continuity plans in place. |
| Business conduct and bribery act | Due to the nature of the industry sector and the regions in which Gulf Keystone operates, the Group is potentially exposed to accusations of poor practice when it comes to the requirements introduced by the UK Anti-bribery and Corruption Act in 2010. Violations of the Act may result in a criminal case against Gulf Keystone and/or our employees, leading to reputational damage, possible imprisonment and fines. | – The Group ensures that it has appropriate procedures in place to eliminate bribery and that all employees, agents and other associated persons are made fully aware of the Group's policies and procedures with regard to ethical behaviour, business conduct and transparency.<br>– A detailed bribery risk assessment has been performed and reviewed by the Board with measures to mitigate the risks identified and implemented. |

## OPERATIONAL RISKS

| Principal risk | Possible impact | Mitigation |
|---|---|---|
| Field delivery risk | Field delivery risk applies to all phases of the E&P cycle from seismic acquisition through to production operations. At each phase the mitigating measures will be different; however, failure to control risks will manifest itself as project delays, cost overruns, high production costs, early field decommissioning and ultimately lower than expected reserves. | – Technical, financial and Board approvals are required for all projects and for all dedicated project teams.<br>– The technical team analyses results from appraisal wells and determines the appropriate course of action in terms of drilling programme and facility design.<br>– All projects are closely monitored to ensure the project delivers against plan and to enable actions to be taken to maintain progress.<br>– Project finances are monitored against budget to minimise overruns. |
| Health, safety, environment and security (“HSES”) | The Group may be exposed to specific risks in relation to social and environmental factors as well as health and safety matters, including security.<br><br>Consequences may include accidents resulting in loss of life, injury and/or significant pollution of the local environment, destruction of facilities and disruption to business activities. | – Gulf Keystone has put in place comprehensive HSES and operations management procedures including emergency and incident response plans.<br>– The Group actively engages with local communities and governments using specialist consultants.<br>– Clear policies and procedures are supported by strong leadership, accountability and commitment throughout the organisation. |

## FINANCIAL RISKS

| Principal risk | Possible impact | Mitigation |
|---|---|---|
| Capital availability | Access to financing to maintain the ongoing operations of the business is critical.<br>If the Group’s financial performance and access to funding do not match the capital requirements, it will be impossible for Gulf Keystone to fulfil commitments and deliver the exploration and development programme.<br>In the extreme case this could impact the Group’s ability to continue as a going concern. | – Finances are controlled through a comprehensive annual budgeting process and periodic forecast updates, including sensitivity reviews. The projected cash balance is reviewed on an ongoing basis.<br>– All significant expenditure is approved by the Board.<br>– Active dialogue is maintained with financial institutions and investors.<br>– Gulf Keystone’s management has a strong track record of successful fundraisings. |
| Foreign currency, liquidity and credit risk | Fluctuations in the exchange rates may lead to material losses and increase the cost of conducting the business.<br><br>The Group carries significant cash balances thereby increasing its exposure to liquidity and credit risk. | – The Company enters into short-term hedging positions to protect the value of any cash balances it holds in non-US dollar currencies.<br>– Cash balances are invested in short-term, non-equity instruments with multiple institutions that have good credit ratings. Rates offered are reviewed on an ongoing basis to ensure returns are maximised.<br>– Short-term and long-term cash forecasts are monitored and reported regularly to Senior Management and the Board. |

# BOARD OF DIRECTORS




| | **Todd Kozel**<br>Executive Chairman and Chief Executive Officer | **John Gerstenlauer**<br>Chief Operating Officer | **Ewen Ainsworth**<br>Finance Director | **Ali Al Qabandi**<br>Business Development Director |
|---|---|---|---|---|
| BIOGRAPHY | Todd is a co-founder of Gulf Keystone Petroleum. He also founded Texas Keystone Inc., an independent oil and gas exploration, development and production company, headquartered in Pittsburgh, USA where he has served as a director since its founding in 1988. He served as Texas Keystone's President from 1995 to 2004. Todd also co-founded Falcon Drilling Company LLC, an American independent drilling and oilfield services company, in 2001 and serves on its Board of Directors. | Prior to joining Gulf Keystone, John was Managing Director for BASF's Wintershall Nederland Group, The Hague. He has over 33 years' experience within the oil and gas sector and he began his career with Shell as a Petrophysical Engineer in 1979. He assumed increasingly senior production and drilling engineering roles within Shell until he was seconded to Canadian Occidental Yemen as Operations Manager in 1993. Here, John managed the project from start-up to full production of 210,000 bopd before leaving to join UMC. | Ewen is a qualified accountant with over 20 years' experience in finance roles within the oil and gas industry. Prior to joining Gulf Keystone, he was Finance Director of London AIM-listed Europa Oil & Gas (Holdings) plc. Ewen has held increasingly senior finance positions within companies such as Conoco (U.K.) Ltd, Murco Petroleum Ltd, Texaco Ltd and CIECO Exploration & Production (UK) Ltd. He brings significant transaction and funding experience to the Board as well as experience of managing public company finances. | Alongside Todd, Ali is a co-founder of Gulf Keystone Petroleum. He has held numerous executive positions and committee chairmanships at 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 a director of the Kuwait National Petroleum Company. He has been a board member of Kuwait Gulf Oil Company and of United Oil Projects, as well as serving on several Steering Committees. |
| TERM OF OFFICE | Todd is a co-founder of the Company where he has served as Director and Chief Executive Officer since incorporation. | John was appointed to the Board as Chief Operating Officer in October 2008. | Ewen was appointed as Finance Director in January 2008. | Ali is a co-founder of the Company and was appointed to the Board in July 2007. |
| EXTERNAL APPOINTMENTS | Director, Texas Keystone Inc.<br>Director, Falcon Drilling Co. LLC | | Director, Discovery Energy Ltd | Director, United Oil Projects |
| COMMITTEE MEMBERSHIP | Chair of Nominations and Appointments prior to formation of the Nominations Committee in February 2012. | Attendee of Committees by invitation. | Attendee of Audit Committee and other Committees by invitation. | Attendee of Committees by invitation. |

**Mehdi Varzi**
**Vice-Chairman and Non-Executive Director**

Mehdi is President of Varzi Energy, an independent global energy consultancy which he set up in June 2001 following his retirement from Dresdner Kleinwort Wasserstein as Managing Director of Global Energy Research. Varzi Energy has advised a large number of leading international financial institutions on global oil and gas developments.

A graduate of the London School of Economics and Political Science, Mehdi began his career with the National Iranian Oil Company before joining the Iranian Ministry of Foreign Affairs.

Mehdi was appointed as an independent Non-Executive Director in January 2008.

Director, Varzi Energy
Board Adviser, Una Oil

Chair of the Remuneration Committee and a member of the Audit and the newly formed Nominations Committees.

**Lord Truscott of St James's**
**Non-Executive Director**

Lord Truscott was appointed as a member of the House of Lords in 2004. Between 2006 and 2007, he was Parliamentary Under-Secretary of State for Energy at the Department of Trade and Industry. He is currently Parliamentary British Council Ambassador, Russian Federation and republics of the former Soviet Union ("FSU").

Lord Truscott has extensive contacts in Russia and the FSU, and is widely regarded as a world expert and author on the region. He has also written extensively on foreign, energy and security policy.

Lord Truscott was appointed as an independent Non-Executive Director in May 2008.

Director, Energy Enterprises Ltd
Associate Fellow, Royal United Services Institute for Defence and Security Studies
Consultant, African Minerals Ltd

Chair of the Audit Committee during 2011 as well as a member of the Remuneration and Nominations Committees.

**General the Lord Guthrie of Craigiebank**
**Non-Executive Director**

Lord Guthrie served in the British Army from 1957 to 2001 and was Chief of the Defence Staff from 1997 to 2001 and the Principal Military Adviser to two Prime Ministers and three Secretaries of State for Defence. He was Colonel Commandant of the SAS from 2001 to 2010 and was Colonel Commandant of the Intelligence Corps for 10 years. He is currently Colonel of The Life Guards, Gold Stick to The Queen.

Lord Guthrie was Director of NM Rothschild & Sons Limited from 2001 to 2011.

General the Lord Guthrie was appointed as an independent Non-Executive Director in October 2011.

Director, Sciens Capital (US)
Director, Colt Defense (US)
Director, Petropavlosk plc.
Director, Rivada Networks
Director, Region Holdings

Chair of the recently formed Nominations Committee and a member of the Audit and Remuneration Committees.

**Mark Hanson**
**Non-Executive Director**

Mark is a qualified barrister and solicitor and was CEO of Global Banking Corporation in Bahrain from 2006 to 2008. He has served as Chief Executive of Bain Securities Limited, MD of Peregrine Capital Limited, Deputy CEO at the Hong Kong Stock Exchange and COO of Crosby Financial Holdings.

His previous experience includes the listing in Hong Kong and New York of Shanghai Petrochemical Company, the first mainland upstream Chinese oil company to list outside of the People's Republic of China.

Mark was appointed as an independent Non-Executive Director in November 2011.

Director, Cynosure Associates Ltd

Chair of the Audit Committee since February 2012 and a member of the Nominations and Remuneration Committees.

# SENIOR MANAGEMENT

**Chris Garrett**
**Vice President Operations and Managing Director, UK**

BIOGRAPHY

Chris 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 the USA and the Middle East. He brings oil field experience to Gulf Keystone, gained initially with Core Laboratories and Western Geophysical and latterly with Baker Hughes and Randall & Dewey where he assumed a number of roles ranging from international exploration and operations management through to property and prospect evaluation.

ROLE AND RESPONSIBILITIES

Chris joined the Company in 2004 as Managing Director of the UK entity and Operations Manager for Algeria. He currently leads all exploration and drilling operations in Kurdistan, Iraq.

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

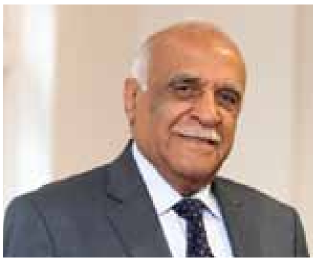
BIOGRAPHY

Tony has over 32 years' 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. He is an Attorney and holds a Master's degree in General Management from the Vlerick Leuven Gent Management School.

ROLE AND RESPONSIBILITIES

Tony joined the Company in 2008 and became the Company's Legal and Commercial Director in 2009.



**Adnan Samarrai**
**Country Manager Kurdistan Region of Iraq**

BIOGRAPHY

Adnan has been an active member of the American Association of Petroleum Geologists since 1972. He has over 45 years of 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 1960s 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, Adnan has worked as Consulting Geologist to both BG International and Exploration Consultant Ltd before joining Gulf Keystone.

ROLE AND RESPONSIBILITIES

Adnan joined the Company firstly as a consultant in July 2006 and subsequently became the Country Manager for Kurdistan, Iraq.

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

BIOGRAPHY

Mohamed is a petroleum geologist with over 30 years' experience in the oil and gas industry in Algeria. He 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 his retirement from Sonatrach, he held the position of Regional Exploration Manager for the South East Algeria Region, Algeria's most important hydrocarbon area containing the Hassi Messaoud, Berkine, Illizi and Oued Mya basins.

ROLE AND RESPONSIBILITIES

Mohamed joined the Company in 2007 as the Country Manager of Algeria.

Shaikan-5 appraisal well

# DIRECTORS' REPORT

The Directors are pleased to present their reports of the affairs of the Group, together with the consolidated financial statements of the Company and auditor's report, for the year ended 31 December 2011. A review of the business is set out in the proceeding sections of this annual report, including the Chairman's Statement, Review of Operations and Financial Review, which are incorporated into this report by reference. The Corporate Governance statement set out on pages 32 to 35 also forms part of this report.

**Company history and principal activities**
Gulf Keystone Petroleum Limited ("Gulf Keystone" or the "Company") is an independent oil and gas exploration and production company with operations in the Kurdistan Region of Iraq. The Company incorporated in Bermuda in 2001 and listed on the AIM Market of the London Stock Exchange in 2004 (stock quote GKP).

In addition to Gulf Keystone's registered office in Bermuda, the Gulf Keystone Group has further offices in Erbil, Kurdistan Region of Iraq, Algiers, Algeria and London, UK. The Group operates through a number of subsidiaries which are detailed in note 11 to the consolidated financial statements and include Gulf Keystone Petroleum International ("GKPI"), which holds the Production Sharing Contracts ("PSCs") for four exploration blocks in the Kurdistan Region of Iraq.

**Results and dividends**
The Group's financial results for the year ended 31 December 2011 are set out in the consolidated financial statements. The Group made a net loss after taxation for the year of $62.4 million (2010: $26.0 million loss) and the Directors do not recommend a dividend for the year (2010: $nil). Future payments of dividends are expected to depend on the earnings and financial condition of the Company and such factors as the Board of Directors consider are appropriate.

**Capital structure**
Given the current stage of development of the Group's assets, the business is financed by means of internally generated funds and external share capital. 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 17 to the financial statements.

There are no specific restrictions on the size of a holding nor on the transfer of shares, both of which are 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. No person has any special rights of control over the Company's share capital and all issued shares are fully paid.

Details of the employee share schemes are set out in note 21 and details of the Directors' awards are included in the Report of the Remuneration and Appointments Committee.

**Voting rights and Bye-law amendments**
The Company's Bye-laws may only be revoked or amended by the Shareholders by resolution passed by a majority of not less than three-fourths of such shareholders as vote in person, or where proxies are allowed, by proxy at a general meeting. Resolutions put to the vote of any general meeting are decided on a show of hands unless a poll is demanded in accordance with the Company's Bye-laws.

**Directors**
With regard to the appointment and replacement of Directors, the Company is governed by its Bye-laws, the Companies Act (Bermuda) and related legislation. Every year, one third of all the Directors retire by rotation and stand for re-election. During 2011, the Company appointed two new Non-Executive Directors who, alongside the two Directors standing for re-election, will stand for election by shareholders at the 2012 Annual General Meeting.

The following Directors have held office during the year:
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(1)
P Truscott – Non-Executive Director(1)
MAC Hanson – Non-Executive Director (appointed Nov 2011)(1)
CRL Guthrie – Non-Executive Director (appointed Oct 2011)(1)

(1) Member of the Audit, Remuneration and Nominations Committees

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

| | Number of Common Shares(2) | | | | | | |
|---|---|---|---|---|---|---|---|
| | At 1 January 2011 | Shares issued in 2011 | Shares sold/transferred in 2011 | **At 31 December 2011** | Shares issued post year end | Shares sold/transferred post year end | At date of report |
| TF Kozel | 3,701,115 | 2,825,555 | 11,600,000 | **18,126,670** | 4,614,166 | (17,433,333) | 5,307,503 |
| AA Al Qabandi | 5,633,333 | 483,333 | 4,000,000 | **10,116,666** | 333,334 | – | 10,450,000 |
| JB Gerstenlauer | – | 531,777 | (300,000) | **231,777** | 922,834 | – | 1,154,611 |
| KE Ainsworth | 871,747 | 605,550 | (240,000) | **1,237,297** | 922,834 | – | 2,160,131 |
| M Varzi | 213,333 | 255,555 | – | **468,888** | 366,667 | (257,347) | 578,208 |
| P Truscott | 500,333 | 255,555 | – | **755,888** | 366,667 | – | 1,122,555 |
| MAC Hanson | – | – | – | **–** | – | – | – |
| CRL Guthrie | – | – | – | **–** | – | – | – |

(2) Includes common shares held directly, by family members and through the Gulf Keystone Employee Benefit Trust ("EBT") which are held subject to the discretion of the EBT Trustee.

Subsequent to year end, the Gulf Keystone Employee Benefit Trust ("EBT") subscribed for 10,246,338 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 21 to the accounts) and released 6,115,105 common shares. At the date of this report, the EBT held 12,896,556 common shares of the Company. A further 10,000,000 common shares are held by the Exit Event Trustee in relation to the Exit Event Award (see note 21 to the consolidated financial statements).

Directors' interests in share options of the Company and the Company's bonus scheme grants, including family interests, as at 31 December 2011 are disclosed under the Report of the Remuneration and Appointments Committee.

**Significant shareholdings**
Other than the Directors' interests shown above, the Company has been notified of the following significant shareholdings as at 1 May 2012:

| | Number of Common Shares | Percentage of issued share capital |
|---|---|---|
| TD Direct Investing | 59,727,737 | 6.82% |
| Baillie Gifford | 53,301,446 | 6.08% |
| M&G Investments | 50,350,000 | 5.75% |
| Barclays Personal Investment Management | 47,870,758 | 5.46% |
| Capital Research & Management Co | 40,871,564 | 4.66% |
| Hargreaves Lansdown Asset Management | 31,560,830 | 3.60% |
| Gokana Trust | 29,695,515 | 3.39% |
| Selftrade | 27,677,852 | 3.16% |
| Halifax Share Dealing | 27,663,042 | 3.16% |
| Kuok Group Companies | 27,227,017 | 3.11% |

**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 Chairman's Statement and Review of Operations. The financial position of the Group at the year end and its cash flows and liquidity position are included in the Financial Review. In addition, note 23 to the consolidated financial statements includes the Group's objectives, policies and processes for managing its capital; its financial risk management objectives and details of its financial instruments and hedging activities. Note 23 also describes exposures to credit risk and liquidity risk.

The Group closely monitors and manages its capital position and liquidity risk regularly throughout the year to ensure that it has sufficient funds to meet forecast cash requirements and satisfy the planned capital programme. Following the equity placing during 2011, the Group is in a strong financial position and at 1 May 2012 had approximately $183 million of cash, cash equivalents and liquid investments. Further, the Group is receiving production revenue streams from its operations in the Kurdistan Region of Iraq. 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 this annual report 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 this annual report and financial statements.

**Significant agreements – change of control**
There are a number of agreements that take effect, alter or terminate upon a change of control of the Company including employee share plans. None of these are considered to be significant in terms of their likely impact on the business of the Group as a whole. Furthermore, the Directors are not aware of any agreements between the Company, and its Directors or employees that provide for compensation for loss of office or employment that occurs because of a takeover bid.

**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 2012**
The resolutions to be proposed at the Annual General Meeting ("AGM") to be held on 19 July 2012 will be set out in the Notice of the AGM.

By order of the Board

**TF Kozel**
**Executive Chairman and Chief Executive Officer**
25 May 2012

# CORPORATE GOVERNANCE STATEMENT

**Gulf Keystone's commitment to corporate governance**
The Board is committed to high standards of governance and aims to create a culture which demands the same commitment and performance from all of our employees and in all our business activities. Although Gulf Keystone is not required to comply with the UK Corporate Governance Code (the "Code"), it is the policy of the Board to manage the Company's affairs in accordance with the underlying principles in so far as is appropriate given the circumstances of the Group. While the Board supports the values of the Code, it does not believe that good governance can be defined merely in terms of compliance with a set of rules. Set out below is a statement of how the Company has applied the principles of the Code for the year ended 31 December 2011.

**The Gulf Keystone Board**
Gulf Keystone's business is international in scope and carries political, commercial and technical risks. Accordingly, particular attention is paid to the composition and balance of the Board to ensure that it has wide experience of the sector and regulatory environments in which the Group operates and appropriate financial and risk management skills. In each Board appointment, the Board considers that objectivity and integrity are prerequisites for appointment, as well as the skills, experience, ability and diversity that will assist the Board in its key functions and decision-making.

The Board currently comprises the Executive Chairman and Chief Executive Officer, three further Executive Directors and four Non-Executive Directors, two of whom were appointed in the final quarter of 2011. The Directors' biographies along with those of senior management personnel are on pages 26 to 28. As part of the Company's commitment to good governance, the two Non-Executive Directors who were appointed to the Board during 2011, bring new ideas and perspectives, as well as ensuring that the Company's Directors have the right experience to meet business needs. The appointment of these individuals to the Board demonstrates the importance the Company places on having a sufficient number of independent Non-Executive Directors to ensure that the strategies proposed by the Executive Directors are fully considered and appropriately challenged.

The Company acknowledges that the offices of Chairman and Chief Executive Officer continue to be held by one individual. However, the Board unanimously considers that, at present, this is in the best interests of the Company and its shareholders due to the instrumental role this individual has played in leading the Company and its development to date. As Chairman of the Company, Todd Kozel leads the Board and ensures it is effective in all aspects of its role; while as Chief Executive Officer, he is best placed to develop and implement the business strategy and enable the Company to access the opportunities that the Kurdistan Region of Iraq offers. This is mitigated by the fact that oversight over executive decisions is exercised by the independent Non-Executive Directors, and in particular, the Company's Vice Chairman, Mehdi Varzi, who is the Company's most senior independent Director. The Company recognises the importance of independent challenge and has improved its balance of independent and Executive Directors with the most recent appointments.

**Independence of Directors**
The independence of each of the Non-Executive Directors is considered upon appointment, annually and at any other time a Director's circumstances change in a way that warrants reconsideration. The Board considers whether the Director is independent of management and any business or other relationship that could materially interfere with the exercise of objective and independent judgement by the Director or the Director's ability to act in the best interests of the shareholders. In particular, the Board has considered each Non-Executive Director's interest in share compensation schemes and any positions which the Director holds, or held, in companies with which Gulf Keystone has commercial relationships. The Board has concluded that, in all cases, compensation arrangements are not material to any Non-Executive Director and that any relationship between the Company and companies in which the Director holds, or held, positions does not interfere with that Director's ability to exercise independent and objective judgement.

**The role of the Board**
The Board is responsible for the overall Group strategy, acquisition and divestment policy, approval of major capital expenditures, the overall capital structure of the Group and consideration of significant financing and operational matters. The Board has continued to focus its efforts in 2011 on strategic objectives that will create shareholder value and ensuring that these are properly pursued. In addition, the Board is responsible for ensuring that the major business risks are actively monitored and managed and is responsible to shareholders for the proper management of the Group.

**Re-election of Directors**
The Company's Bye-laws provide for each Director to be re-elected by shareholders at least once every three years. The Board believes that continuity is essential for a business like Gulf Keystone and that allowing each Director to serve a three-year term prior to standing for re-election facilitates the retention of experienced and appropriately skilled individuals.

**Performance of the Board and its Committees**
The Board and its Committees are satisfied that they are operating effectively and that each Director has performed well in respect of his individual role on the Board. The Board believes that the performance of all the Directors continues to be effective and that they each demonstrate commitment to the role.

**How the Board operates**
The Board has a formal schedule of matters specifically reserved to it for decision. These reserved matters include determination of the overall strategy of the Group, the appointment and removal of any Director, the approval of the Group's annual budget, any borrowing and security arrangements, acquisitions and disposals and the approval of management incentive schemes. 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 all key areas of decision-making. During 2011, a total of 18 Board meetings were held, none of which were in the UK and 12 of

which were held outside Europe. The agenda for each Board meeting is set by the Chairman in consultation with other members of the Executive Management. To enable the Board to discharge its duties, all the 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. The Company has directors' and officers' liability insurance in place.

**Appointments to the Board**

The Board regularly reviews the structure, size and composition (including the skills, knowledge and experience) required of the Board. Following a review of the Board composition undertaken in 2011, the Company undertook a process, with the help of external consultants, to identify independent Non-Executive Director candidates who could add value to the Board through complementary qualifications. This has resulted in the appointments of Lord Guthrie and Mark Hanson in October and November 2011 respectively. While each brings a broad range of skills to the Board, they additionally provide specific complementary qualifications through added expertise within the Middle East region and in finance. The Board benefits from both the additional expertise and refreshment of the Board and Committee membership derived from these appointments.

The Board is satisfied that the individuals currently fulfilling key senior management positions in the organisation have the requisite depth and breadth of skills, knowledge and experience.

**Delegated authorities**

During 2011, the Board had two established Committees, the Remuneration and Appointments Committee and the Audit Committee, each of which deals with specific aspects of the Group's affairs and has written terms of reference. Subsequent to the year end and following reviews of the Board Committees, their composition and terms of reference in February 2012, the Remuneration and Appointments Committee was re-named the Remuneration Committee and a Nominations Committee was formed.

**The Remuneration and Appointments Committee**

In 2011, the Remuneration and Appointments Committee was 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 for approval, 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 the external auditor and on its remuneration for both audit and non-audit work, and discusses the nature and scope of the audit with the external auditor. The Committee assesses the performance of the external auditor as well as its independence and objectivity.

Set out below are reports from the Audit Committee and Remuneration and Appointments Committee.

**Audit Committee Report**

The Audit Committee currently comprises the four Non-Executive Directors, all of whom are considered to be independent. However, during 2011, the members of the Committee were as follows:

– P Truscott (2011 Chairman)
– M Varzi

Subsequent to year end, Lord Truscott has passed the Chairmanship of the Audit Committee to Mark Hanson who has joined the Committee along with General the Lord Guthrie. The Audit Committee met three times during 2011 and at the request of the Committee, the Company's Finance Director and Legal and Commercial Director as well as senior members of the finance team attended these meetings. Two of the meetings were also attended by the external auditor.

The role of the Committee includes:

– monitoring the integrity of the financial statements of the Company and reviewing any significant financial reporting judgements contained in them;
– reviewing accounting policies, accounting treatments and disclosures in financial reports;
– reviewing the Company's internal financial controls and internal control and risk management systems; and
– overseeing the Company's relationship with the external auditor, including making recommendations to the Board as to the appointment or reappointment of the external auditor and monitoring the external auditor's independence, objectivity and effectiveness.

Of the three Audit Committee meetings held during 2011, the first meeting was in respect of the 2010 year-end reporting process, the second meeting was in respect of the 2011 half-year report and the final meeting for 2011 considered planning for the 2011 year-end process. The external auditor reported its results in respect of the 2010 year end accounts at the first meeting of the year and presented its audit plan for the 2011 financial statements at the final meeting of the year.

During 2011, the Audit Committee established a policy on the supply of non-audit services by the external auditor. The Company engages external advisors to provide non-audit services based on the skills and experience required for the work, and cost. The Company may engage the external auditor to provide a limited range of non-audit services where this is the most effective and efficient way of procuring such services as long as the Company is satisfied that the auditor's objectivity and independence will not be compromised as a result.

The Audit Committee is responsible for the development, implementation and monitoring of the Group's policy on external audit including ensuring that the auditor remains objective and independent. To fulfil its responsibility regarding independence, the Audit Committee considered:
- 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;
- the external auditor's written confirmation of independence to the Audit Committee; and
- 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.

In addition, as part of the assessment of the effectiveness of the external auditors, a shortlist of audit firms was invited to submit an informal audit proposal to the Company. All of the proposals were considered and it was resolved that the scope of services the Company receives from its current auditors, Deloitte LLP, is adequate.

Following the above, the Audit Committee has recommended to the Board that Deloitte LLP is re-appointed.

**Remuneration and Appointments Committee summary report**

The Remuneration Committee currently comprises of the four Non-Executive Directors, all of whom are considered by the Board to be independent. The members of the Remuneration and Appointments Committee during the year were as follows:
- M Varzi (Chairman)
- P Truscott

Certain of the Executive Directors and the Legal and Commercial Director attended meetings of the Committee on being invited to do so by the Committee. None of the Directors participated in any meetings or discussions relating to their own remuneration.

The role of the Committee includes:
- determining and agreeing with the Board the remuneration policy for all the Executive Directors;
- determining the level of awards made under the Company's share option and bonus plans and long-term incentive plans and the performance conditions which are to apply;
- determining bonuses payable under the Company's annual cash bonus scheme; and
- determining the vesting of awards under the Company's long-term incentive plans and exercise of share options.

Details of the Company's policies on remuneration, service contracts and compensation payments are given in the full Report of the Remuneration and Appointments Committee on pages 36 to 41.

Subsequent to year end, the Committee has been renamed the Remuneration Committee and General the Lord Guthrie and Mark Hanson have been appointed to the Committee.

**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 Board regularly reviews the effectiveness of the systems of internal control and considers the major business risks and the control environment. The Board is accordingly satisfied that effective controls are in place and that risks have been mitigated to an acceptable level.

The Company is subject to a variety of risks which derive from the nature of the oil and gas exploration and production business and relate to the countries in which it conducts its activities. The key procedures that have been established and which are designed to provide effective control are as follows:
- executive management and the Board meet regularly to discuss all issues affecting the Group; and
- a clearly defined framework for investment appraisal, with Board approval required as appropriate.

The Board also believes that the ability to recognise the value of working as a partnership with host governments is a critical ingredient in managing risk successfully.

The Directors have derived assurance over the control environment from the following internal and external controls during 2011:
- implementation of policies and procedures for key business activities;
- an appropriate organisational structure;
- control over non-operated activities through delegated representatives;
- specific delegations of authority for all financial and other transactions;
- segregation of duties where appropriate and cost effective;
- business and financial reporting, including KPIs;
- reports from the Group Audit Committee; and
- reports from the Group external auditor on matters identified during its audit.

The above procedures and controls have been in place in respect of the Group for the 2011 accounting period and up to the date of approval of the annual report and accounts. The Board considers that in light of the control environment described above, there is no current requirement for a separate internal audit function at present. The Audit Committee will continue to review this decision annually, particularly in light of the Group's expansion.

**Relations with shareholders**

Communications with shareholders are given high priority by the Board. 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 is available to attend meetings with major shareholders (without the Executive Directors present), if requested by such major shareholders.

Gulf Keystone seeks to respond to all correspondence from shareholders as far as applicable and its website contains a wide range of information on the Company, including a dedicated investor section. The Executive Directors of the Board regularly present at conferences, and at the Annual General Meeting, private investors are given the opportunity to question the Board. Throughout 2011 and during 2012, the Company has given a number of investor presentations, all of which are available to the public on the Company's website.

In accordance with its Bye-laws, this year the Company has also implemented the provisions of the Bermuda Companies Act 1981, in accordance with the AIM rules, regarding electronic communications with its shareholders in order to give shareholders more choice and flexibility in how they receive information from the Company. The number of communications sent by post has been reduced resulting not only in cost savings for the Company but also speeding up the provision of information to shareholders.

A list of the Company's major shareholders can be found in the Directors' Report on page 31.

**Annual General Meeting ("AGM")**

The Board uses the AGM to communicate with private and institutional investors and welcomes their participation. It is policy for all Directors to attend the AGM if at all possible.

Details of resolutions to be proposed at the AGM on 19 July 2012 can be found in the Notice of Annual General Meeting together with further explanation of the resolutions.

# REPORT OF THE REMUNERATION AND APPOINTMENTS COMMITTEE

This report has been prepared by the Remuneration and Appointments Committee and has been approved by the Board for presentation to shareholders.

**Performance of the Company and remuneration policy highlights**

2011 has been an excellent year for Gulf Keystone. We have seen two remarkable upgrades in independently audited gross oil-in-place numbers for the Shaikan discovery, have made significant progress in our ambitious exploration and appraisal programme across the four blocks in the Kurdistan Region of Iraq and have set a challenging forward looking strategy aiming at proving the full potential of our assets and delivering maximum value to our shareholders. The oversubscribed share placing in September 2011 raised $200,000,000 gross proceeds, transforming the Group's financial position and serving as an important vote of confidence from the existing shareholders and new institutional investors in our ability to deliver results. Further 2011 performance highlights are set out within the other sections of this report.

The above achievements were promptly reflected in Gulf Keystone's share price which, despite short-term volatility, did not fail to deliver an outstanding return on shareholders' investments. A £100 investment in our shares three years ago in January 2009 would return £1,134 in January 2012 and £1,182 as at 23 May 2012.


These results would not be possible without the high calibre executive leadership and the commitment of our employees who always perform to the best of their ability despite the many challenges posed by the current economic environment.

Reward in the oil and gas industry is increasingly competitive and we must provide a robust pay package that reflects the increasing complexity, growth and achievements of our business. We designed our remuneration policy in a way that will allow us to retain and motivate our high performing team and attract new talent as required.

The Remuneration Committee continues to focus on aligning our remuneration policy with the shareholders' interests so that it closely reflects the Group's business strategy, whilst remaining mindful of the external focus on executive remuneration.

2011 did not see any increases in salaries or Directors' fees as the emphasis was placed on incentive-based remuneration via share-based rewards that would encourage senior executives to focus on longer-term goals and remain with the business.

In the past two years, an increasing portion of the Executive remuneration has been delivered though share-based rewards discussed in summary below and in more detail in the main body of the report.

- Share options granted under the share option plan are granted to the senior executives upon their first appointment and vest after three years of employment, with certain market-based performance criteria attached to them.
- Long Term Incentive Plan "LTIP" options were introduced in 2010 and have a set of stretching market-based and operational conditions attached to them. These options vest in three equal tranches over three years assuming that the performance conditions are satisfied. There have been two LTIP awards made as at the date of this report.
- Bonus share awards are discretionary awards made in the form of the Company's common shares that vest over three years. The size of the award in any given year depends on the share price and the Company's performance in the year as discussed in the Remuneration Policy section below.

We believe that it is critical for permanent employees to have a stakeholding in the business to achieve alignment with shareholders. This is reinforced through the issuance of share options to the senior executives and our employees.

Further details of our remuneration policy and the remuneration of each Director are set out below.

**Remuneration and Appointments Committee**

In 2011, the Remuneration and Appointments Committee comprised Mehdi Varzi (Chairman) and Lord Truscott, who are independent Non-Executive Directors of the Company. Subsequent to year end, Lord Guthrie and Mark Hanson have been appointed to the Committee and it has been re-named the Remuneration Committee, following the formation of a separate Nominations Committee in February 2012. 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.

The Nominations Committee comprises Lord Guthrie (Chairman), Mark Hanson, Lord Truscott and Mehdi Varzi, who are independent Non-Executive Directors of the Company. The Nominations Committee reviews the structure, size and composition required of the Board, makes recommendations with regard to any changes to the Board and succession planning, identifies and nominates candidates to fill Board vacancies as and when they arise, and reviews the results of the Board performance evaluation process.

### Remuneration policy

The policy of the Committee is to reward Executive Directors in line with the current remuneration of directors in comparable businesses in order to recruit, motivate and retain high quality executives within a competitive market place. The Committee regularly seeks the advice of independent remuneration consultants when making a recommendation on any awards to be granted to the Company's senior executives and employees. With regard to any significant share-based awards, the Committee consults with the Group's largest shareholders where appropriate, to ensure maximum transparency and alignment of the management's and shareholders' interests and opinions, as well as extensive consultation with advisers.

In 2011, extensive consultations were undertaken in relation to the Company's Exit Event Awards, the 2011 Executive Bonus Scheme and the cash bonus, the details of which are given below.

There are two main elements of the remuneration packages for Executive Directors and senior management:
- basic annual salary, cash bonus payable and benefits; and
- LTIPs, 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 contingent upon the satisfaction of conditions relating to the share price and length of employment. The conditions vary from grant to grant.

The Remuneration and Appointments Committee based their recommendation for the 2011 bonus proposals on the following factors:
- the operational activity, in particular the further discoveries and increased test production from the Extended Well Facilities;
- the strong share price performance in 2011; and
- the successful fund raisings in 2011.

### 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 for 2011

| | Fees/ basic salary $ | Benefits in kind $ | Share Bonus(1) $ | Cash bonus $ | **2011 Total $** | 2010 Total $ |
|---|---|---|---|---|---|---|
| Todd Kozel | 675,000 | – | 18,804,243 | 2,751,568 | **22,230,811** | 9,976,036 |
| Ali Al Qabandi | 270,000 | – | 1,358,446 | – | **1,628,446** | 1,622,664 |
| John Gerstenlauer | 594,000 | 138,965 | 3,760,854 | 550,314 | **5,044,133** | 2,485,099 |
| Ewen Ainsworth | 288,740 | 3,714 | 3,760,854 | 550,314 | **4,603,622** | 2,255,090 |
| Mehdi Varzi | 80,000 | – | 1,494,289 | – | **1,574,289** | 1,107,270 |
| Peter Truscott | 112,082 | – | 1,494,289 | – | **1,606,371** | 1,144,376 |
| Mark Hanson | 15,265 | – | – | – | **15,265** | – |
| Charles Guthrie | 32,082 | – | – | – | **32,082** | – |
| | 2,067,169 | 142,679 | 30,672,975 | 3,852,196 | **36,735,019** | 18,590,535 |

(1) The share bonus quantums are based on the market value of the common shares awarded pursuant to the 2009, 2010 and 2011 Executive Bonus Schemes on the vesting date, being 21 March 2012.

# REPORT OF THE REMUNERATION AND APPOINTMENTS COMMITTEE CONTINUED

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

| | Scheme | 1 January 2011 | Granted | 31 December 2011 |
|---|---|---|---|---|
| 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 |
| Charles Guthrie | Share Option Plan | – | 250,000 | 250,000 |
| 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 |
| Todd Kozel | 2010 LTIP Options | – | 4,195,000 | 4,195,000 |
| John Gerstenlauer | 2010 LTIP Options | – | 839,000 | 839,000 |
| Ewen Ainsworth | 2010 LTIP Options | – | 839,000 | 839,000 |

At 31 December 2011, 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) and subsequent to the year end, a second third of these options has vested. There have been no variations to the terms and conditions or performance criteria for the schemes during the financial year. During the year, the Company Share Option Plan options for John Gerstenlauer, Ewen Ainsworth, Mehdi Varzi and Peter Truscott (2,000,000; 1,000,000; 100,000 and 100,000 options respectively) have vested. The Share Option Plan options for Todd Kozel (3,000,000 options), and Ali Al Qabandi (1,000,000 options), have vested subsequent to the year end.

On 21 March 2012, an option to acquire 250,000 common shares in the capital of the Company at a price of 250 pence per common share was granted under Gulf Keystone's Share Option Plan to Mark Hanson, who joined the Company as a Non-Executive Director in November 2011. Subject to certain performance criteria having been met prior to exercise, these options will vest after a three year period and can be exercised at any time until expiry on 25 November 2021.

### LTIP Options

LTIP options are structured option grants under the existing Share Option Plan with stretching performance criteria known as the Long Term Incentive Performance Conditions.

Details of the LTIP awards granted by the Trustees of the Gulf Keystone Employee Benefit Trust ("EBT") following the recommendation of the Remuneration Committee during the year are as follows:

| | Scheme | Date of grant | Number of awards granted | Exercise price | Market price at award date |
|---|---|---|---|---|---|
| Todd Kozel | 2010 LTIP Options | 4 Feb 2011 | 4,195,000 | 175p | 173.50p |
| John Gerstenlauer | 2010 LTIP Options | 4 Feb 2011 | 839,000 | 175p | 173.50p |
| Ewen Ainsworth | 2010 LTIP Options | 4 Feb 2011 | 839,000 | 175p | 173.50p |

It is recommended that the 2010 LTIP Options will 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.

Subsequent to year end the share price reached 200 pence and as a result the second third of the 2009 LTIP options vested.

Details of the LTIP awards which vested subsequent to the year-end are as follows:

| | Scheme | Number of awards vested | Exercise price | Market price at award date | Market price at vesting date |
|---|---|---|---|---|---|
| Todd Kozel | 2009 LTIP Options | 3,255,491 | 75p | 71.25p | 201p |
| John Gerstenlauer | 2009 LTIP Options | 651,098 | 75p | 71.25p | 201p |
| Ewen Ainsworth | 2009 LTIP Options | 651,098 | 75p | 71.25p | 201p |

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

**Bonus shares granted and vested**

On 21 March 2012, on the recommendation of the Remuneration Committee, the Independent Directors approved the 2011 awards made under the Company's 2011 Executive Bonus Scheme as follows:

| | Scheme | Market price at award date | Maximum number of common shares awarded |
|---|---|---|---|
| Todd Kozel | 2011 Executive Bonus Scheme | 251.75p | 4,377,500 |
| John Gerstenlauer | 2011 Executive Bonus Scheme | 251.75p | 875,500 |
| Ewen Ainsworth | 2011 Executive Bonus Scheme | 251.75p | 875,500 |

The EBT Trustees have agreed to satisfy these awards on behalf of the Company. One third of the maximum number of common shares vested on 21 March 2012 and has been included in the 2011 Directors' remuneration. Sufficient shares were issued to the EBT to satisfy this part of the award in March 2012. 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 2012 with the second half being considered for vesting at the end of 2013.

On 21 March 2012, on the recommendation of the Remuneration Committee, the Independent Directors resolved that one half of the remaining 2010 Company's Executive Bonus Scheme awards are deemed vested. The EBT Trustees agreed to satisfy these awards and subscribed for sufficient shares as follows:

| | Scheme | Market price at vesting date | Number of common shares vested |
|---|---|---|---|
| Todd Kozel | 2010 Executive Bonus Scheme | 251.75p | 1,488,333 |
| John Gerstenlauer | 2010 Executive Bonus Scheme | 251.75p | 297,667 |
| Ewen Ainsworth | 2010 Executive Bonus Scheme | 251.75p | 297,667 |

The awards of one half of the remaining 2010 Company's Executive Bonus Scheme to the Non-Executive Directors were made and have been satisfied by the Company directly as follows:

| | Scheme | Market price at vesting date | Number of common shares vested |
|---|---|---|---|
| Mehdi Varzi | 2010 Executive Bonus Scheme | 251.75p | 333,333 |
| Peter Truscott | 2010 Executive Bonus Scheme | 251.75p | 333,333 |

All of the second issue of the 2010 Executive Bonus Scheme awards has been included in the 2011 Directors' remuneration.

# REPORT OF THE REMUNERATION AND APPOINTMENTS COMMITTEE CONTINUED

Also on 21 March 2012, on the recommendation of the Remuneration Committee, the Independent Directors resolved that the remaining awards granted under the 2009 Company's Executive Bonus Scheme are deemed to have vested.

Details of Directors receiving bonus shares under the 2009 scheme are as follows:

| | Scheme | Market price at vesting date | Number of common shares vested |
|---|---|---|---|
| Todd Kozel | 2009 Executive Bonus Scheme | 251.75p | 1,666,666 |
| Ali Al Qabandi | 2009 Executive Bonus Scheme | 251.75p | 333,334 |
| John Gerstenlauer | 2009 Executive Bonus Scheme | 251.75p | 333,334 |
| Ewen Ainsworth | 2009 Executive Bonus Scheme | 251.75p | 333,334 |

The EBT Trustees have agreed to satisfy these awards and shares were issued to the EBT in March 2012 respectively to satisfy the vested awards.

The awards of the remaining third of the 2009 Company's Executive Bonus Scheme to the Non-Executive Directors were made and have been satisfied by the Company directly under the Company's Bonus Scheme as follows:

| | Scheme | Market price at vesting date | Number of common shares vested |
|---|---|---|---|
| Mehdi Varzi | 2009 Executive Bonus Scheme | 251.75p | 33,334 |
| Peter Truscott | 2009 Executive Bonus Scheme | 251.75p | 33,334 |

All of the remaining 2009 Executive Bonus Scheme awards disclosed above have been included in the 2011 Directors' remuneration.

### Bonus shares

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

| | Scheme | 1 January 2011(1) | 2011 Awards Granted(2) | Vested(3) | 31 December 2011(4) |
|---|---|---|---|---|---|
| Todd Kozel | Executive Bonus Scheme | 4,643,333 | 4,377,500 | (4,614,166) | 4,406,667 |
| Ali Al Qabandi | Executive Bonus Scheme | 333,334 | – | (333,334) | – |
| John Gerstenlauer | Executive Bonus Scheme | 928,668 | 875,500 | (922,834) | 881,334 |
| Ewen Ainsworth | Executive Bonus Scheme | 928,668 | 875,500 | (922,834) | 881,334 |
| Mehdi Varzi | Executive Bonus Scheme | 700,001 | – | (366,667) | 333,334 |
| Peter Truscott | Executive Bonus Scheme | 700,001 | – | (366,667) | 333,334 |

(1) The bonus shares awarded as at 1 January 2011 include the bonus shares awarded pursuant to the 2010 and 2009 Executive Bonus Schemes that had as yet not vested following the awards of 4 February 2011.

(2) "2011 Awards Granted" relate to the bonus shares awarded pursuant to the 2011 Executive Bonus Scheme on 21 March 2012.

(3) "Vested" awards are the 2009, 2010 and 2011 Executive Bonus Scheme awards that were deemed to have vested on 21 March 2012 as a result of the Group's performance during 2011. Shares for these vested awards have been issued either directly to the beneficiary or to the EBT, which are held at the discretion of the EBT Trustee, and are included in Directors' Interests in Shares and Options as shares issued post-year end.

(4) Bonus share awards as at 31 December 2011 include the bonus shares awarded pursuant to the 2011 and 2010 Executive Bonus Scheme awards made on 21 March 2012 and 4 February 2011 respectively but have not yet vested.

### Bonus shares lapsed

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

### Exit Event Awards

The Remuneration Committee has recommended that the Company makes cash-settled awards to certain Executive Directors and employees conditional on the occurrence of an Exit Event (as defined below) ("Exit Event Awards"), up to a maximum amount equivalent to the value of 10,000,000 common shares at the time of an Exit Event, and that a trustee (the "Exit Event Trustee") be appointed to hold and, subject to the occurrence of an Exit Event, to sell sufficient common shares to satisfy the Exit Event Awards.

On 21 March 2012, the Independent Directors (as defined previously) approved Exit Event Awards, subject to the occurrence of an Exit Event, as follows:

| | Number of common shares to be cash-settled, subject to the occurrence of an Exit Event |
|---|---|
| Todd Kozel | 300,000 |
| John Gerstenlauer | 140,000 |
| Ewen Ainsworth | 140,000 |

The value of the common shares to be settled pursuant to the Exit Event Awards is dependent on the Company's share price, if and when an Exit Event occurs.

Preparation of the Exit Event Awards commenced in June 2011 and subsequently involved detailed discussion and consultation with the Company's advisers and a number of the Company's leading institutional and other shareholders who cumulatively held in excess of 35% of the issued share capital of the Company. The discussions and consultations latterly also included the 2011 Executive Bonus Scheme and 2011 cash bonus and resulted in extensive changes to the initially proposed awards.

The objective of the Exit Event Awards is to retain and incentivise the Company executives and staff in the event of any corporate transaction. The Exit Event Awards align the interests of the Company employees and key management personnel with shareholders and reward the loyalty of all members of staff.

An Exit Event is defined in detail in the Share Award Agreement in relation to an Exit Event Award and envisages a sale of either the Company or a substantial proportion (i.e. more than 50%) of its assets. No such event has occurred as of the date of this report.

The market price of the shares at 31 December 2011 and 31 December 2010 was £1.90 and £1.69 respectively and the range during 2011 was £1.01 to £1.96.

This report was approved by the Board on 25 May 2012 and signed on its behalf by:

**M Varzi**
**Remuneration and Appointments Committee Chairman**

# 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") as adopted by the European Union and Article 3 of the IAS regulation.

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. 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 adequate 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.

**Directors' Responsibility Statement**

We confirm that to the best of our knowledge:

1. the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and
2. the sections of the annual report include a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

**TF Kozel**
**Executive Chairman and Chief Executive Officer**
25 May 2012

# INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF GULF KEYSTONE PETROLEUM LIMITED





We have audited the consolidated financial statements of Gulf Keystone Petroleum Limited for the year ended 31 December 2011 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 23. The financial reporting framework that has been applied in their preparation is International Financial Reporting Standards (IFRSs) as adopted by the European Union.

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

**Respective responsibilities of Directors and 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 Group'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. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

**Opinion on financial statements**

In our opinion the consolidated financial statements:

– give a true and fair view of the state of the Group's affairs as at 31 December 2011 and of the Group's loss for the year then ended; and
– have been properly prepared in accordance with IFRSs as adopted by the European Union.

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

In forming our opinion on the consolidated financial statements, which is not modified, we have considered the adequacy of the disclosures made in note 20 to the consolidated 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. The operations in the Kurdistan Region of Iraq comprise the substantial majority of the Group's overall 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 trial is due to be heard in the UK courts in October 2012. The ultimate outcome of the matter cannot presently be reliably estimated, and consequently no provision for any liability that may result has been made in the consolidated financial statements.

**Opinion on other matters**

In our opinion the information given in the Directors' Report for the financial year for which the consolidated financial statements are prepared is consistent with the consolidated 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
25 May 2012

# CONSOLIDATED INCOME STATEMENT

## For the year ended 31 December 2011

| | Notes | 2011 $'000 | 2010 $'000 |
|---|---|---|---|
| **Continuing operations** | | | |
| Revenue | 4 | **6,919** | 808 |
| Cost of sales | | **(6,919)** | (808) |
| **Gross profit** | | **–** | – |
| **Other operating expenses** | | | |
| Impairment of assets held for sale | 10 | **(10,000)** | – |
| General and administrative expenses | | **(60,350)** | (32,595) |
| **Loss from operations** | 2 | **(70,350)** | (32,595) |
| Other gains and losses | 5 | **5,791** | 5,940 |
| Interest revenue | 4 | **1,239** | 192 |
| Finance costs | 15 | **(473)** | (348) |
| **Loss before tax** | | **(63,793)** | (26,811) |
| Tax benefit | 6 | **1,437** | 819 |
| **Loss after tax for the year** | | **(62,356)** | (25,992) |
| **Loss per share (cents)** | | | |
| Basic | 7 | **(8.01)** | (4.17) |
| Diluted | 7 | **(8.01)** | (4.17) |

# CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

## For the year ended 31 December 2011

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Loss for the period | **(62,356)** | (25,992) |
| Foreign currency translation differences | **(250)** | (154) |
| **Total comprehensive loss for the period** | **(62,606)** | (26,146) |

# CONSOLIDATED BALANCE SHEET

## As at 31 December 2011

| | Notes | 2011 $'000 | 2010 $'000 |
|---|---|---|---|
| **Non-current assets** | | | |
| Intangible assets | 8 | **360,005** | 223,824 |
| Property, plant and equipment | 9 | **4,295** | 4,102 |
| Deferred tax asset | 16 | **7,977** | 4,106 |
| | | **372,277** | 232,032 |
| **Current assets** | | | |
| Assets held for sale | 10 | **35,840** | 10,441 |
| Inventories | 12 | **17,233** | 14,423 |
| Trade and other receivables | 13 | **8,594** | 3,663 |
| Liquid investments | | **29,528** | 10,177 |
| Cash and cash equivalents | | **208,103** | 201,268 |
| Derivative financial instruments | 23 | **1,838** | 659 |
| | | **301,136** | 240,631 |
| **Total assets** | | **673,413** | 472,663 |
| **Current liabilities** | | | |
| Trade and other payables | 14 | **(58,199)** | (39,103) |
| Derivative financial instruments | 23 | **(358)** | – |
| Current tax liabilities | | **(712)** | (320) |
| | | **(59,269)** | (39,423) |
| **Non-current liabilities** | | | |
| Provisions | 15 | **(8,070)** | (6,399) |
| | | **(8,070)** | (6,399) |
| **Total liabilities** | | **(67,339)** | (45,822) |
| **Net assets** | | **606,074** | 426,841 |
| **Equity** | | | |
| Share capital | 17 | **7,627** | 6,628 |
| Share premium account | 17 | **790,435** | 593,470 |
| Share option reserve | | **34,065** | 20,468 |
| Exchange translation reserve | | **(561)** | (311) |
| Accumulated losses | | **(225,492)** | (193,414) |
| **Total equity** | | **606,074** | 426,841 |

The financial statements were approved by the Board of Directors and authorised for issue on 25 May 2012 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 2011

| | | Attributable to equity holders of the Group | | | | | |
|---|---|---|---|---|---|---|---|
| | Notes | Share capital $'000 | Share premium account $'000 | Share option reserve $'000 | Exchange translation reserve $'000 | Accumulated losses $'000 | Total equity $'000 |
| 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 | 21 | – | – | 21,730 | – | – | 21,730 |
| Deferred tax on share-based payment transactions | 16 | – | – | 2,057 | – | – | 2,057 |
| Share issue | 17 | 2,643 | 353,657 | 3,840 | – | – | 360,140 |
| Foreign currency translation differences | | – | – | – | (154) | – | (154) |
| Own shares held | 17 | – | – | – | – | (34) | (34) |
| Net loss for the year | | – | – | – | – | (25,992) | (25,992) |
| Balance at 1 January 2011 | | 6,628 | 593,470 | 20,468 | (311) | (193,414) | **426,841** |
| Transfer relating to share-based payments | | – | – | (30,332) | – | 30,332 | **–** |
| Share-based payment expense | 21 | – | – | 42,540 | – | – | **42,540** |
| Deferred tax on share-based payment transactions | 16 | – | – | 1,389 | – | – | **1,389** |
| Share issue | 17 | 999 | 196,965 | – | – | – | **197,964** |
| Foreign currency translation differences | | – | – | – | (250) | – | **(250)** |
| Own shares held | 17 | – | – | – | – | (54) | **(54)** |
| Net loss for the year | | – | – | – | – | (62,356) | **(62,356)** |
| **Balance at 31 December 2011** | | **7,627** | **790,435** | **34,065** | **(561)** | **(225,492)** | **606,074** |

# CONSOLIDATED CASH FLOW STATEMENT



## For the year ended 31 December 2011

| | Notes | 2011 $'000 | 2010 $'000 |
|---|---|---|---|
| **Operating activities** | | | |
| Cash used in operations | 18 | **(24,236)** | (26,225) |
| Tax paid | | **(665)** | (503) |
| Interest received | | **1,239** | 192 |
| **Net cash used in operating activities** | | **(23,662)** | (26,536) |
| **Investing activities** | | | |
| Purchase of intangible assets | | **(152,508)** | (145,877) |
| Purchase of property, plant and equipment | | **(612)** | (1,132) |
| Increase in liquid investments(1) | | **(19,351)** | (10,177) |
| **Net cash used in investing activities** | | **(172,471)** | (157,186) |
| **Financing activities** | | | |
| Proceeds on issue of share capital | | **197,905** | 359,895 |
| **Net cash generated by financing activities** | | **197,905** | 359,895 |
| **Net increase in cash and cash equivalents** | | **1,772** | 176,173 |
| Cash and cash equivalents at beginning of year | | **201,268** | 19,156 |
| Effect of foreign exchange rate changes | | **5,063** | 5,939 |
| **Cash and cash equivalents at end of the year being bank balances and cash on hand** | | **208,103** | 201,268 |

(1). 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 2011 was $237.6 million (2010: $211.4 million).

# SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**General information**
The Company is incorporated in Bermuda and is quoted on the AIM 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 Kurdistan Region of Iraq and the Republic of Algeria.

**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.

| | |
|---|---|
| IAS 24 | Clarification of the definition of a related party |
| IAS 32 | Classification of rights issues as equity instruments |
| IFRIC 14 | Amendments to remedy the circumstances where entities are not permitted to recognise as asset prepayments of minimum funding contributions |
| IFRIC 19 | Clarification of accounting for debt for equity swaps |

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 1 (amended) | Severe Hyperinflation and Removal of Fixed Dates for First-Time Adopters |
| IFRS 7 (amended) | Financial Instruments: Disclosures |
| IFRS 9 | Financial Instruments |
| IFRS 10 | Consolidated Financial Statements |
| IFRS 11 | Joint Arrangements |
| IFRS 12 | Disclosure of Interests in Other Entities |
| IFRS 13 | Fair Value Measurements |
| IAS 1 (amended) | Presentation of Financial Statements |
| IAS 12 (amended) | Deferred Tax: Recovery of Underlying Assets |
| IAS 19 (revised) | Employee Benefits |
| IAS 27 (revised) | Separate Financial Statements |
| IAS 28 (revised) | Investments in Associates and Joint Ventures |
| IAS 32 (amended) | Financial Instruments: Presentation |
| IFRIC 20 | Stripping Costs in the Production Phase of Surface Mine |

Other than to expand the disclosure on fair value measurements within the financial statements, the Directors do not anticipate that the adoption of the 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") as adopted by the European Union.

**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. The principal accounting policies adopted are set out below.

**Going concern**
The Directors have, at the time of approving the financial statements, a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the financial statements. Further detail is contained in the Going Concern section of the Directors' Report on page 31.

**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. Control is achieved where the Company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

**Sales and interest revenue**
Revenue is measured at the fair value of the consideration received or receivable. Sales revenue represents the Group's share of sales from petroleum production, net of sales related taxes, VAT and royalties.

Revenue is recognised when all of the following conditions are satisfied:
– the amount of revenue can be measured reliably;
– it is probable that the economic benefits associated with the transaction will flow to the entity; and
– the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Sales revenue is recognised when the goods are delivered and the 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.

Interest revenue is accrued on a time basis, by reference to the principal outstanding and at the effective rate of interest applicable.

**Property, plant and equipment other than oil and gas interests**
Property, plant and equipment is 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

**Oil and gas assets**
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'.

**Pre-licence costs**
Costs incurred prior to having obtained the legal rights to explore an area are expensed directly to the income statement as they are incurred.

**Exploration and evaluation costs**
Under the full cost method of accounting all costs relating to the exploration for and appraisal of oil and gas exploration and evaluation ("E&E") interests, whether commercial or not, are accumulated and capitalised as non-current assets within geographic cost pools.

Expenditure directly associated with evaluation or appraisal activities is initially capitalised as intangible non-current assets. Such costs include licence acquisition, technical services and studies, seismic acquisition, exploration and appraisal well drilling, payments to contractors and directly attributable administration and overhead costs.

E&E costs incurred during the exploration and evaluation phase are carried forward, subject to there being no indication of impairment, where activities in an area have not reached a stage which permits reasonable assessment of the existence of economically recoverable reserves. E&E costs are transferred to property, plant and equipment upon declaration of commerciality. Unsuccessful E&E costs are retained within intangible non-current assets and amortised as described below. E&E costs are not amortised prior to the conclusion of appraisal activities.

**Development and production assets**
Development and production assets are accumulated within geographic cost pools and represent the cost of developing the commercial reserves discovered and bringing them into production, together with the E&E expenditures incurred in finding commercial reserves transferred from intangible E&E assets as outlined above.

# SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

The cost of development and production assets also includes the cost of acquisition and purchases of such assets, directly attributable overheads, and costs for future restoration and decommissioning.

### Depreciation of oil and gas assets

The net book values of producing assets are depreciated generally on a field-by-field basis using the unit of production ("UOP") basis which uses the ratio of oil and gas production in the period to the remaining commercial reserves plus the production in the period. Costs used in the calculation comprise the net book value of the field, and any further anticipated costs to develop such reserves. Any unsuccessful E&E costs retained within intangible non-current assets are depreciated on a UOP basis by reference to the commercial reserves of the wider geographic cost pool. Commercial reserves are proven and probable ("2P") reserves estimated using standard recognised evaluation techniques. The estimate is regularly reviewed by independent consultants.

### 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.

Any impairment identified is immediately recognised as an expense.

### 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 used 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.

## Non-current 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.

## Taxation

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

The tax currently payable is based on taxable profit for the year. Current tax assets and liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities, based on tax rates and laws that are 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.

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 period when the liability is settled or the asset is realised based on tax laws and rates that have been enacted or substantively 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 recognised in equity.

**Foreign currencies**
The individual financial statements of each Group company are presented in the currency of the primary economic environment in which it operates (its functional currency). For the purpose of the consolidated financial statements, the results and the financial position of the Group are expressed in US Dollars, which is the functional currency of the Company, and the presentation currency for the consolidated financial statements.

In preparing the financial statements of the individual 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 foreign operations which use functional currencies other than US Dollars are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for the period. Exchange differences arising, if any, are recognised in other comprehensive income and accumulated in equity in the Group's translation reserve. On the disposal of a foreign operation, such translation differences are reclassified to profit or loss.

**Inventories**
Inventories, except for hydrocarbon inventories, are valued at the lower of cost and net realisable value. Hydrocarbon inventories are recorded at net realisable value with changes in hydrocarbon inventories being adjusted through cost of sales.

**Financial instruments**
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 are measured at amortised cost using the effective interest method less any impairment.

**Cash and 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.

**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.

Financial assets at FVTPL are stated at fair value, with any gains or losses arising on re-measurement 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.

# SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

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.

### 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 re-measured 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.

### Impairment of financial assets

Financial assets, other than those valued at FVTPL, 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.

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.

### 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.

### Equity instruments

Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue costs, which are charged to share premium.

### 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.

### Trade payables

Trade payables are stated at amortised cost. The average maturity for trade and other payables is one to three months.

### 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

Provision for decommissioning is recognised in full when damage is done to the site and an obligation to restore the site to its original condition exists. The amount recognised is the present value of the estimated future expenditure for restoring the sites of drilled wells and related facilities to their original status. A corresponding amount equivalent to the provision is also recognised as part of the cost of the related oil and gas property. The amount recognised is reassessed each year in accordance with local conditions and requirements. Any change in the present value of the estimated expenditure is dealt with prospectively.
The unwinding of the discount is included as a finance cost.

**Share-based payments**

Equity-settled share-based payments to employees and others providing similar services are measured at the fair value of the entity instruments at the grant date. Details regarding the determination of the fair value of equity-settled share-based transactions are set out in note 21.

The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight line basis over the vesting period, based on the Group's estimate of equity instruments that will eventually vest. At each balance sheet date, the Group revises its estimate of the number of equity instruments expected to vest as a result of the effect of non-market based vesting conditions. The impact of the revision of the original estimates, if any, is recognised in profit or loss such that the cumulative expense reflects the revised estimate, with a corresponding adjustment to equity reserve.

**Leasing**

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

**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 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.

**Carrying value of intangible exploration and evaluation assets**

The outcome of ongoing exploration, and therefore the recoverability of the carrying value of intangible exploration and evaluation assets, 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. Further details are provided in note 8.

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.

**Decommissioning costs**

The accounting policy for decommissioning provision is discussed above. The cost of decommissioning is estimated by reference to the Group's experience, with key judgements including the application of local laws and regulations, estimates of the related costs, inflation and discount rates. Further details are provided in note 15 to the accounts.

**Reserves estimates**

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.

**Recoverability of deferred tax assets**

Deferred tax assets are recognised for unused tax losses to the extent that it is probable that future taxable profits will be available against which the losses can be utilised. Judgement is required to determine the value of the deferred tax asset, based upon the timing and level of future taxable profits. The accounting policy for deferred tax is discussed above. Further details are provided in note 16.

**Share-based payments**

The share-based payments charge is determined based on a number of assumptions which include but are not limited to the fair value of awards, vesting period and number of shares to vest. The accounting policy for share-based payments is disclosed above. Further details are provided in note 21 to the accounts.

**Contingent liabilities**

The outcome of the legal proceedings related to the Excalibur's claim for up to 30% in the Group's blocks in the Kurdistan Region of Iraq is one of the critical judgements that the Directors of the Company have made in applying the Group's accounting policies. For further information and disclosures see note 20 to the accounts.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## For the year ended 31 December 2011

### 1. Segment information

For the purposes of resource allocation and assessment of segment performance, the Group is organised into three regional business units – Algeria, Kurdistan and the United Kingdom. These geographical segments are the basis on which the Group reports its segmental information. 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; and
- 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.

| 31 December 2011 | Algeria $'000 | Kurdistan $'000 | United Kingdom $'000 | Corporate $'000 | Elimination $'000 | Total $'000 |
|---|---|---|---|---|---|---|
| **Revenue** | | | | | | |
| Oil sales | – | 6,919 | – | – | – | **6,919** |
| Inter-segment sales | – | – | 15,166 | – | (15,166) | **–** |
| **Total revenue** | **–** | **6,919** | **15,166** | **–** | **(15,166)** | **6,919** |
| **Cost of sales** | | | | | | |
| Production costs | **–** | (6,919) | **–** | **–** | **–** | **(6,919)** |
| **Gross profit/(loss)** | **–** | **–** | **15,166** | **–** | **(15,166)** | **–** |
| Impairment of assets held for sale | (10,000) | – | – | – | – | **(10,000)** |
| Allocated general and administrative expenses | (3,099) | (1,634) | (18,779) | (57,463) | 21,154 | **(59,821)** |
| Depreciation and amortisation expense | (1) | (402) | (124) | (2) | – | **(529)** |
| **(Loss)/profit from operations** | **(13,100)** | **(2,036)** | **(18,903)** | **(57,465)** | **21,154** | **(70,350)** |
| Other gains and losses | (36) | (7) | – | 5,834 | – | **5,791** |
| Interest revenue | – | – | 179 | 1,237 | (177) | **1,239** |
| Finance costs | (344) | (129) | (177) | – | 177 | **(473)** |
| **(Loss)/profit before tax** | **(13,480)** | **(2,172)** | **(3,735)** | **(50,393)** | **5,988** | **(63,793)** |
| Tax benefit | – | – | 1,437 | – | – | **1,437** |
| **(Loss)/profit after tax** | **(13,480)** | **(2,172)** | **(2,298)** | **(50,393)** | **5,988** | **(62,356)** |
| Capital expenditure | – | 166,643 | 645 | 2 | – | **167,290** |
| Total assets | 2,863 | 426,002 | 92,217 | 823,943 | (671,612) | **673,413** |

### 1. Segment information continued

| 31 December 2010 | Algeria $'000 | Kurdistan $'000 | United Kingdom $'000 | Corporate $'000 | Elimination $'000 | **Total $'000** |
|---|---|---|---|---|---|---|
| **Revenue** | | | | | | |
| Oil sales | – | 808 | – | – | – | **808** |
| Inter-segment sales | – | – | 7,434 | – | (7,434) | **–** |
| **Total revenue** | **–** | **808** | **7,434** | **–** | **(7,434)** | **808** |
| **Cost of sales** | | | | | | |
| Production costs | – | (808) | – | – | – | **(808)** |
| **Gross profit** | **–** | **–** | **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)** |
| **Loss from operations** | **(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)** |
| **Loss before tax** | **(1,663)** | **(761)** | **(2,926)** | **(24,173)** | **2,712** | **(26,811)** |
| Tax benefit | – | – | 819 | – | – | **819** |
| **Loss after tax** | **(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** |

#### Geographical information

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

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| Algeria | **2,690** | 2,712 |
| Kurdistan | **361,014** | 225,139 |
| Bermuda | **3** | 3 |
| United Kingdom | **593** | 72 |
| | **364,300** | 227,926 |

#### Information about major customers

Included in revenues arising from the Kurdistan Segment are revenues of approximately $4.9 million (2010: $0.5 million) and $0.8 million (2010: $nil) which arose from sales to the Group's largest customers.

### 2. Loss from operations

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Loss from operations has been arrived at after charging: | | |
| Depreciation of property, plant and equipment | **412** | 464 |
| Amortisation of intangible assets | **117** | 30 |
| Impairment of assets held for sale | **10,000** | – |
| Staff costs (see note 3) | **45,007** | 25,570 |
| Auditor's remuneration for audit services (see below) | **91** | 80 |
| Operating lease rentals (see note 19) | **766** | 377 |

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Fees payable to the Company's auditor for the audit of the Company's annual accounts | **73** | 64 |
| *Fees payable to the Company's auditor for other services to the Group* | | |
| – The audit of the Company's subsidiaries pursuant to legislation | **18** | 16 |
| *Total audit fees* | **91** | 80 |
| Corporate finance services | **290** | – |
| Tax services | **–** | 19 |
| *Total fees* | **381** | 99 |

### 3. Staff costs

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

| | 2011 Number | 2010 Number |
|---|---|---|
| Office and management | **41** | 43 |
| Technical and operational | **98** | 108 |
| | **139** | 151 |

Employee benefits recognised as an expense during the year comprised:

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Wages and salaries | **6,831** | 4,885 |
| Social security costs | **3,539** | 3,812 |
| Share-based payment (see note 21) | **34,637** | 16,873 |
| | **45,007** | 25,570 |

### 4. Revenue

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Oil sales | **6,919** | 808 |
| Interest revenue | **1,239** | 192 |
| | **8,158** | 1,000 |

Oil sales relate entirely to test production.

### 5. Other gains and (losses)

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Exchange gains | **4,673** | 5,855 |
| Mark-to-market valuation of foreign exchange contracts | **1,118** | 319 |
| Change in the fair value of the SEDA derivative financial instrument | **–** | (234) |
| | **5,791** | 5,940 |

### 6. Tax benefit

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Provision for current UK corporation tax | **1,043** | 322 |
| Credit for deferred UK corporation tax | **(2,480)** | (1,141) |
| Tax attributable to the Company and its subsidiaries | **(1,437)** | (819) |

Under current Bermudian 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 2035.

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 UK subsidiary. UK corporation tax is calculated at 26.5% (2010: 28%) of the estimated assessable profit for the year of the UK subsidiary.

On 21 March 2012, the UK Government announced a reduction in the main rate of UK corporation tax from 26% to 24% effective from 1 April 2012. The Government has also indicated that it intends to enact future reductions in the main UK tax rate of 1% each year down to 22% by 1 April 2014. As it was not substantively enacted at the balance sheet date, the rate reduction is not yet reflected in these financial statements in accordance with IAS 10, as it is a non-adjusting event occurring after the reporting period.

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.

In addition to the amount credited to the income statement, a $1.4 million deferred tax credit (2010: $2.1 million credit) relating to estimated excess tax deductions related to share-based payments has been recognised directly in equity (see note 16). All deferred tax arises in the UK.

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

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Loss before tax | **(63,793)** | (26,811) |
| | | |
| Tax at the Bermudan tax rate of 0% (2010: 0%) | **–** | – |
| Effect of different tax rates of subsidiaries operating in other jurisdictions | **1,437** | 819 |
| Tax benefit for the year | **1,437** | 819 |

**7. Loss per share**

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

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| **Loss** | | |
| Loss for the purposes of basic and diluted loss per share | **(62,356)** | (25,992) |

| | 2011 Number ('000s) | 2010 Number ('000s) |
|---|---|---|
| **Number of shares** | | |
| Weighted average number of common shares for the purposes of basic loss per share | **778,858** | 622,613 |
| 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 | **778,858** | 622,613 |

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 2011, 41.8 million share options (2010: 31.2 million), 21.5 million un-issued bonus shares (2010: 18.6 million), 1.7 million warrants (2010: 2.5 million), and 8.8 million shares held by the Employee Benefit Trust (2010: 3.4 million) were excluded from the loss per share calculation as they were anti-dilutive. Subsequent to the year end, a further 10.0 million shares were issued to the Exit Event Trustee in relation to the Exit Event Award (see note 17).

### 8. Intangible assets

| | Exploration & evaluation costs $'000 | Computer software $'000 | Total $'000 |
|---|---|---|---|
| **At 1 January 2010** | | | |
| Cost | 90,463 | 286 | 90,749 |
| Accumulated amortisation | – | (267) | (267) |
| Net book value | 90,463 | 19 | 90,482 |
| **Year ended 31 December 2010** | | | |
| Opening net book value | 90,463 | 19 | 90,482 |
| Additions | 143,727 | 84 | 143,811 |
| Reclassification as held for sale | (10,441) | – | (10,441) |
| Amortisation charge | – | (30) | (30) |
| Foreign currency translation differences | – | 2 | 2 |
| Closing net book value | 223,749 | 75 | 223,824 |
| **At 31 December 2010** | | | |
| Cost | 223,749 | 369 | 224,118 |
| Accumulated amortisation | – | (294) | (294) |
| Net book value | 223,749 | 75 | 223,824 |
| **Year ended 31 December 2011** | | | |
| Opening net book value | 223,749 | 75 | 223,824 |
| Additions | 166,163 | 507 | 166,670 |
| Reclassification as held for sale (note 10) | (30,355) | – | (30,355) |
| Amortisation charge | – | (117) | (117) |
| Foreign currency translation differences | – | (17) | (17) |
| **Closing net book value** | **359,557** | **448** | **360,005** |
| **At 31 December 2011** | | | |
| Cost | 359,557 | 849 | 360,406 |
| Accumulated amortisation | – | (401) | (401) |
| **Net book value** | **359,557** | **448** | **360,005** |

The net book value at 31 December 2011 includes intangible assets relating to: Shaikan $220.0 million (2010: $117.8 million); Ber Bahr $37.4 million (2010: $27.9 million), and Sheikh Adi $102.1 million (2010: $58.6 million).

The additions to oil and gas exploration and evaluation costs in the year include the Shaikan-4 and Shaikan-2 appraisal wells drilling and testing, the drilling of Shaikan-5 and Shaikan-6 appraisal wells, the drilling of the Sheikh Adi exploration well, Extended Well Test facilities upgrade, the drilling of the Ber Bahr exploration well, and the acquisition and processing of seismic.

The Akri-Bijeel asset has been re-classified as an asset held for sale (2011: $30.4 million; 2010: $19.4 million) (see note 10) following the Board's resolution to dispose of the Group's 20 per cent working interest in the block.

The amortisation charge of $117,000 (2010: $30,000) for computer software has been included in general and administrative expenses.

### 9. Property, plant and equipment

| | Oil & gas properties $'000 | Fixtures & equipment $'000 | Total $'000 |
|---|---|---|---|
| **At 1 January 2010** | | | |
| Cost | 2,690 | 2,048 | 4,738 |
| Accumulated depreciation | – | (1,305) | (1,305) |
| Net book value | 2,690 | 743 | 3,433 |
| **Year ended 31 December 2010** | | | |
| 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 |
| Closing net book value | 2,690 | 1,412 | 4,102 |
| **At 31 December 2010** | | | |
| Cost | 2,690 | 3,126 | 5,816 |
| Accumulated depreciation | – | (1,714) | (1,714) |
| Net book value | 2,690 | 1,412 | 4,102 |
| **Year ended 31 December 2011** | | | |
| Opening net book value | 2,690 | 1,412 | 4,102 |
| Additions | – | 620 | 620 |
| Disposals | – | (8) | (8) |
| Depreciation charge | – | (412) | (412) |
| Foreign currency translation differences | – | (7) | (7) |
| **Closing net book value** | **2,690** | **1,605** | **4,295** |
| **At 31 December 2011** | | | |
| Cost | 2,690 | 3,718 | 6,408 |
| Accumulated depreciation | – | (2,113) | (2,113) |
| **Net book value** | **2,690** | **1,605** | **4,295** |

The depreciation charge of $0.4 million on fixtures and equipment (2010: $0.5 million) has been included in general and administrative expenses.

### 10. Asset held for sale

On 14 September 2011, the Group announced the intention to sell the Group's 20% working interest in the Akri-Bijeel block as part of the Group's forward strategy to rationalise its asset portfolio. The Group subsequently appointed Joint Corporate Advisers responsible for co-ordination of and advice on the sale and this process is ongoing.

The Akri-Bijeel intangible asset of $35.8 million (2010: $19.4 million), which is included within the Kurdistan operating segment, is expected to be sold within 12 months and has been classified as an asset held for sale as at 31 December 2011 and presented separately in the balance sheet. The value of the asset held for sale as at 31 December 2011 includes $5.5 million that relates to a prepayment balance to the operator. The proceeds of disposal are expected to substantially exceed the book value of the related net assets and accordingly no impairment losses have been recognised on the classification of this asset as held for sale. A further amount of $0.2 million, representing the net present value of the decommissioning costs associated with this asset is included within the provisions balance at 31 December 2011 (see note 15).

In 2010, the Company negotiated an agreement with BG North Sea Holdings Limited ("BG") which provided for the immediate stay of the arbitration and the proposed withdrawal of the Company from the Hassi Ba Hamou ("HBH") Permit in Algeria for a net cash payment from BG of $10.0 million to the Company. On 19 September 2011, an amendment was signed to this agreement resulting in the project being transferred for nil consideration to BG.

**10. Asset held for sale** continued
All the required documentation was executed and all necessary Government approvals obtained pursuant to the agreement between the Group and BG on 28 December 2011.

As a result the Group recognised an impairment loss of $10 million in respect of the asset and decommissioning provision previously associated with the project (2010: $10.4 million and $0.5 million respectively).

**11. Subsidiary**
Details of the Company's subsidiaries at 31 December 2011 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 |

**12. Inventories**

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Exploration materials | **16,822** | 14,081 |
| Crude oil | **411** | 342 |
| | **17,233** | 14,423 |

**13. Trade and other receivables**

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Trade receivables | **4,122** | 77 |
| Other receivables | **2,185** | 3,261 |
| Prepayments and accrued income | **2,287** | 325 |
| | **8,594** | 3,663 |

Included within other receivables for 2011 is an amount of $0.3 million (2010: $0.2 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.

**14. 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.

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Trade payables | **23,450** | 13,363 |
| Accrued expenses | **34,749** | 25,740 |
| | **58,199** | 39,103 |

### 15. Provisions

| Decommissioning provision | $'000 |
|---|---|
| At 1 January 2011 | 6,399 |
| Additional provision in the year | 1,730 |
| Relinquishment of HBH permit | (532) |
| Unwinding of discount | 473 |
| **At 31 December 2011** | **8,070** |

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 wells and facilities currently in place and restoration of the sites to their original state. This expenditure is estimated to be incurred over the next four to 30 years. Included within the provision are decommissioning costs of $0.2 million associated with the Akri-Bijeel asset (see note 10). The $0.5 million decommissioning provision associated with the HBH asset was derecognised on the relinquishment of the block (see note 10).

### 16. Deferred tax asset

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 2010 | 16 | 944 | 960 |
| (Charge)/credit to income statement | (6) | 1,147 | 1,141 |
| Credit direct to equity | – | 2,057 | 2,057 |
| Exchange differences | (1) | (51) | (52) |
| At 1 January 2011 | 9 | 4,097 | 4,106 |
| (Charge)/credit to income statement | (43) | 2,523 | 2,480 |
| Credit direct to equity | – | 1,389 | 1,389 |
| Exchange differences | 2 | – | 2 |
| **At 31 December 2011** | **(32)** | **8,009** | **7,977** |

### 17. Share capital

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| **Authorised** | | |
| Common shares of $0.01 each | **9,500** | 9,000 |
| Non-voting shares $0.01 each | **500** | 500 |
| Series A Preferred shares of $1,000 each | **60,000** | 60,000 |
| | **70,000** | 69,500 |

The authorised common share capital was increased from $9.0 million to $9.5 million at the 2011 Annual General Meeting.

**17. Share capital** continued

| | Common shares No. of shares '000 | Common shares Amount $'000 | Share capital $'000 | Share premium $'000 |
|---|---|---|---|---|
| **Issued and fully paid** | | | | |
| Balance at 1 January 2010 | 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 |
| **Balance 31 December 2010** | 754,243 | 600,098 | 6,628 | 593,470 |
| Bonus scheme shares issued | 6,966 | 70 | 70 | – |
| Share placement | 91,120 | 200,001 | 911 | 199,090 |
| Shares issued under Option Scheme | 1,028 | 1,038 | 10 | 1,028 |
| Warrants exercised | 762 | 905 | 8 | 897 |
| Issue costs | n/a | (4,050) | – | (4,050) |
| **Balance 31 December 2011** | **854,119** | **798,062** | **7,627** | **790,435** |

During September 2011, a total of 91.1 million shares were placed at a placing price of £1.40 per share to continue financing exploration and development activities. A further 0.8 million shares were issued at a price of £0.75 per share following an exercise of warrants.

During the year, a total of 6,965,689 shares were issued as part of the Company's bonus share scheme (2010: 4,653,700), of which 5,886,332 new common shares were issued to the Gulf Keystone Employee Benefit Trust ("EBT") at par value of $0.01 (see note 21).

A further 1,028,098 shares were issued following exercise of options by the employees of the Company. The details of the issues were as follows:

| Date of issue | Number of shares issued | Weighted average option exercise price | Weighted average share price realised on issue |
|---|---|---|---|
| 7 February 2011 | 1,025,098 | 62.05 pence | 182.16 pence |
| 8 July 2011 | 3,000 | 39.50 pence | 144.50 pence |

At 31 December 2011, a total of 8,765,323 shares were held by the EBT and included within reserves.

Subsequent to year end, a further 10,979,672 new common shares were issued as part of the Company's bonus share scheme to satisfy the awards granted for 2009, 2010 and 2011 performance, including 10,246,338 to the Trust. The compensation charge related to the 2011 services provided is included in the 2011 Income Statement (see note 21 for further details). 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 322,000 new common shares of $0.01 ("Option Shares") raising gross proceeds of £106,285 at an average price of £0.33 per share. A further 761,500 shares were issued at a price of £0.75 per share raising £571,125 following an exercise of warrants.

Post year end, an additional 10,000,000 common shares of $0.01 each were issued to the Exit Event Trustee who were appointed to hold and, subject to the occurrence of an Exit Event, to sell sufficient common shares to satisfy the Exit Event Awards (see note 21 to the accounts).

The total number of common shares in issue on 25 May 2012, including those held by the EBT Trustee and the Exit Event Trustee, is 876,181,620.

**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;

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

### 17. Share capital continued

(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.

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

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Loss from operations | **(70,350)** | (32,595) |
| *Adjustments for:* | | |
| Depreciation of property, plant and equipment | **412** | 464 |
| Amortisation of intangible assets | **117** | 30 |
| Impairment loss on assets held for sale | **10,000** | – |
| Share-based payment expense | **34,637** | 16,873 |
| Increase in inventories | **(2,810)** | (13,849) |
| Increase in receivables | **(4,897)** | (1,449) |
| Increase in payables | **8,655** | 4,301 |
| **Net cash used in operating activities** | **(24,236)** | (26,225) |

### 19. Commitments

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

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Minimum lease payments under operating leases recognised as expense for the year | **766** | 377 |

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

| | 2011 $'000 | 2010 $'000 |
|---|---|---|
| Within one year | **660** | 766 |
| In the second to fifth years inclusive | **308** | 1,209 |
| After five years | **–** | – |
| | **968** | 1,975 |

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 leases are for five and four years from February 2010 and April 2011 respectively, with break clauses after three and two years. 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.

## 19. Commitments continued

### 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 2012 for the Group is approximately $209 million (2011: $154 million) of which the majority is contracted. This includes the minimum amounts required to retain the relevant licences.

## 20. Contingent liabilities

In December 2010, Excalibur commenced legal action against the Companies and Texas Keystone Inc. 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. The operations in the Kurdistan Region of Iraq comprise the substantial majority of the Group's overall petroleum operations.

On 8 April 2011, the Companies obtained an injunction in the English Commercial Court restraining Excalibur from pursuing the ICC Arbitration proceedings instituted in December 2010. The English Commercial Court gave the reasons for this judgment in favour of the Companies during June 2011 with costs being awarded to the Companies. Excalibur made the required interim payment of £250,000 on account of costs to the Companies in July 2011. In July 2011, Excalibur also confirmed in the English Commercial Court in London that it no longer intended to pursue the ICC Arbitration in New York against the Companies and that it was content that all its claims against the Companies should be determined in the English Commercial Court in London. The trial date in the English Commercial Court of all the claims asserted by Excalibur has been set for October 2012.

Subsequent to year end, in April 2012 and further to the decision of the English Commercial Court in London a payment of £6,000,000 has been made into Court by Excalibur as security for the costs of the Companies of defending the legal action commenced by Excalibur in December 2010. Excalibur has also made a payment of £3,500,000 into Court as security for the costs of Texas Keystone Inc.

The Companies continue vigorously to dispute and contest the allegations and claims asserted by Excalibur.

Due to the uncertain outcome of the legal proceedings and the wide range of potential financial outcomes the ultimate outcome of the legal case cannot presently be reliably estimated, and consequently no provision for any liability that may result has been made in the financial statements.

## 21. Share-based payments

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| Bonus shares charge | **33,560** | 19,351 |
| Share options charge | **8,980** | 2,379 |
| | **42,540** | 21,730 |

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| Warrants – share issue costs | **–** | 3,840 |

During the year $7,903,000 (2010: $4,857,000) of the above charge has been capitalised into the cost of the Group's intangible assets in accordance with the Group's accounting policy for E&E assets.

## 21. Share-based payments continued

### 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 prior to grant. Awards made under the Group's share option plan have a vesting period of at least three years except for awards made under the Long Term Incentive Plan, which vest in equal tranches over a minimum of three years subsequent to the achievement of a number of operational and market-based performance conditions. 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 2011, following the recommendations of the Remuneration and Appointments Committee, the Trustees granted share options over 9,490,000 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").

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

In addition a further 2,300,000 options with market-based performance conditions attached were granted to new employees and Directors under the Group's share option plan.

| | **2011** | | 2010 | |
|---|---|---|---|---|
| | **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 | **31,183** | **61.4** | 11,000 | 32.8 |
| Granted during the year | **11,790** | **170.1** | 20,283 | 77.2 |
| Exercised during the year | **(1,028)** | **61.9** | – | – |
| Forfeited during the year | **(150)** | **112.2** | (100) | 30.0 |
| Outstanding at 31 December | **41,795** | **91.9** | 31,183 | 61.4 |
| Exercisable at 31 December | **20,644** | **57.0** | 7,161 | 71.6 |

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

| | **2011** | 2010 |
|---|---|---|
| Weighted average closing share price on date of grant (in pence) | **180.0** | 76.3 |
| Weighted average exercise price of options granted in the year (in pence) | **170.1** | 77.2 |

The expected volatility was calculated as 81%, for the February, June and July 2011 awards, 82% for the September and October 2011 awards (2010: 79%, 95% and 94% for the June 2010, September 2010 and October 2010 awards respectively) and has been based on the Company's share price averaged for the five years prior to grant date.

The expected term of the 2011 awards is 2.5 to 4.5 years (2010: three to 7.5 years). The risk free rate was 2.86% for the February, June and 8 July 2011 awards, 1.3% for the 21 July 2011 award, 0.9% for the September 2011 award and 0.6% for the October 2011 award (June 2010 awards: 2.5%; September 2010 and October 2010 awards: 1.5%).

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 2011 being £0.96 (2010: £0.51).

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.

**21. Share-based payments** continued

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

| Expiry date | Exercise price (pence) | Options ('000) 2011 | Options ('000) 2010 |
|---|---|---|---|
| 10 October 2017 | 39.50 | **23** | 400 |
| 04 December 2017 | 33.00 | **250** | 250 |
| 13 February 2018 | 30.00 | **1,450** | 1,450 |
| 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 |
| 7 December 2019 | 80.75 | **250** | 250 |
| 3 June 2020 | 80.75 | **250** | 250 |
| 23 June 2020 | 75.00 | **18,882** | 19,533 |
| 22 September 2020 | 147.50 | **250** | 250 |
| 11 October 2020 | 175.00 | **250** | 250 |
| 06 February 2021 | 175.00 | **9,690** | – |
| 19 June 2021 | 146.25 | **550** | – |
| 07 July 2021 | 146.25 | **250** | – |
| 14 July 2021 | 146.25 | **250** | – |
| 21 July 2021 | 146.25 | **500** | – |
| 19 September 2021 | 152.50 | **250** | – |
| 26 October 2021 | 146.25 | **250** | – |
| | | **41,795** | 31,183 |

### Bonus Shares

Through the Company's Executive Bonus Scheme, the Group issues bonus shares to certain employees for nil 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.

Discretionary grants to Directors and employees of 10,000,000 common shares have been made by the Company as part of the 2011 Executive Bonus Scheme.

Awards of 10,979,672 relating to the 2009, 2010 and 2011 Executive Bonus Schemes have vested in March 2012. Details of all awards to Directors have been included in the Directors Emoluments for the year ended 31 December 2011.

| | Bonus shares ('000) 2011 | Bonus shares ('000) 2010 |
|---|---|---|
| Balance at 1 January | **11,514** | 8,397 |
| Granted during the year | **10,000** | 10,231 |
| Forfeited during the year | **(60)** | – |
| Issued during the year | **(10,980)** | (7,114) |
| **Balance at 31 December** | **10,474** | 11,514 |

The weighted average fair value of the bonus shares granted in 2011 was £2.52 (2010: £1.73).

**21. Share-based payments** continued

**Exit Event Awards**

Subsequent to the year end, the Remuneration Committee recommended that the Company makes cash settled awards to certain Executive Directors and employees conditional on the occurrence of an Exit Event (as defined below) up to a maximum amount equivalent to the value of 10,000,000 common shares of $0.01 each at the time of an Exit Event, and that a trustee (the "Exit Event Trustee") be appointed to hold and, subject to the occurrence of an Exit Event, to sell sufficient common shares to satisfy the Exit Event Awards.

On 21 March 2012, the Independent Directors approved the Exit Event Awards to certain Executive Directors and employees, subject to the occurrence of an Exit Event, equivalent to the value of 2,000,000 common shares. The Exit Event Trustee will hold the remaining 8,000,000 common shares to satisfy any future Exit Event Awards to full-time employees of the Company and subsidiary companies, subject to the occurrence of an Exit Event, with such beneficiaries to be determined in due course.

An Exit Event envisages a sale of either the Company or a substantial proportion (i.e. more than 50%) of its assets.

**Warrants**

During the year the Company issued no warrants (2010: 2,498,350).

**22. 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, Gulf Keystone Petroleum International Limited ("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 as a consequence agreed to assign its interest under the contract to GKPI. Currently TKI holds its interest in trust for GKPI pending the transfer of its interest to GKPI.

**Directors' Transactions**

During 2011, the Company paid for certain personal expenses on behalf of a Director of the Company that will be refunded to the Company at its demand during 2012. By virtue of his directorship, this individual is a related party of the Group. The following amounts were outstanding at the balance sheet date and are included within other receivables:

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| Personal expenses of key management personnel to be refunded to the Group | **1,742** | – |
| | **1,742** | – |

The outstanding receivable is non-interest bearing and is repayable to the Company on demand. Subsequent to the year end, $1.6 million of the outstanding $1.7 million has been settled.

## 22. 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
PDT Truscott – Non-Executive Director
MAC Hanson – Non-Executive Director
CRL Guthrie – 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 Directors' Emoluments section of the Report of the Remuneration and Appointments Committee.

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| Short-term employee benefits | **8,347** | 6,199 |
| Other allowances | **150** | 134 |
| Share-based payment – options | **7,657** | 2,175 |
| Share-based payment – bonus shares | **30,322** | 18,670 |
| | **46,476** | 27,178 |

## 23. Financial instruments

| | **2011 $'000** | 2010 $'000 |
|---|---|---|
| **Financial assets** | | |
| Cash and cash equivalents | **208,103** | 201,268 |
| Liquid investments | **29,528** | 10,177 |
| Loans and receivables | **6,307** | 3,338 |
| Derivative asset – SEDA (Level 3) | **351** | 340 |
| Other derivative assets (Level 2) | **1,487** | 319 |
| | **245,776** | 215,442 |
| **Financial liabilities** | | |
| Loans and payables | **58,199** | 39,103 |
| Other derivative liabilities (Level 2) | **358** | – |
| | **58,557** | 39,103 |

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

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 the Directors' Report under "Going Concern".

### Fair value hierarchy

In line with IAS 39 – "Financial Instruments: Recognition and Measurement" the Group uses the following hierarchy for determining the fair value of financial instruments by valuation technique:
Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and

**23. Financial instruments** continued

Level 3: techniques which use inputs which have a significant effect on the recorded value that are not based on observable market data.

### 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 17, the Consolidated Statement of Comprehensive Income and the Consolidated Statement of Changes in Equity.

### Capital structure
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 2011.

### 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.

### 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 currency risk hedges during 2011. 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 has increased following a significant sterling fund-raising during the year and this risk has been addressed by entering into currency hedges. 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 5).

### 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 2011, a 10% weakening of the USD against the GBP would have resulted in an increase in the Group's net current assets and a decrease in loss before tax of $18.3 million and a 10% strengthening would have resulted in a decrease in net current assets and an increase in loss before tax of $15.0 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.

**23. Financial instruments** continued

**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's notice to maximise returns and accessibility. The Group has entered into additional liquid investments of up to 12 months maturity during 2011 to maximise interest returns.

**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 in interest rates would have resulted in a $1.1 million increase or decrease in the Group's loss 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 customer at balance sheet date (2010: $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.

**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.

# DIRECTORS, ADVISORS AND OFFICERS

**Directors**

| | |
|---|---|
| Todd Kozel | Executive Chairman and Chief Executive Officer |
| John Gerstenlauer | Chief Operating Officer |
| Ewen Ainsworth | Finance Director |
| Ali Al Qabandi | Business Development Director |
| Mehdi Varzi | Non-Executive Director |
| Peter Truscott | Non-Executive Director |
| Charles Guthrie | Non-Executive Director |
| Mark Hanson | Non-Executive Director |

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Shaikan-2 appraisal well, also pictured on the front cover

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