



**GULF KEYSTONE PETROLEUM LTD**  
("Gulf Keystone" or the "Company")

**2006 PRELIMINARY RESULTS ANNOUNCEMENT**

Gulf Keystone Petroleum Limited (AIM: GKP), an independent oil and gas exploration company operating in the Republic of Algeria, today announces its preliminary results for the year ending 31 December, 2006.

Highlights

- BG joined SONATRACH and Gulf Keystone as a strategic partner in the HBH licence.
- £13.4 (\$24.7) million raised in August 2006 via a placing of 21,600,000 new common shares.
- HBH seismic programme under way. Drilling operations expected to commence around the year end.
- Block 126a licence extension granted for finalization of commerciality of GKN and GKS.
- Management and technical teams have been significantly strengthened during 2006.
- Well HEK-3 in Block 129 acid-fractured and tested at a stabilized rate of 1,040 bbl/day in April 2007.
- Proposed acquisition of the company by RAK Petroleum has been recommended by the Board for shareholder approval.

**Todd Kozel, Chief Executive Officer of Gulf Keystone said:**

"2006 has been a transformational year for Gulf Keystone. Completion of the HBH farm out, a successful placing of new shares and the building of both a first rate technical and executive management team has provided the Company with the resources to pursue an aggressive programme of activities across its Algerian portfolio in the coming years."

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**GULF KEYSTONE PETROLEUM LTD**  
("Gulf Keystone" or the "Company")

**2006 PRELIMINARY RESULTS ANNOUNCEMENT**

**CHAIRMAN'S STATEMENT**

2006 was a pivotal year for the Gulf Keystone. Gazetting of the HBH concession ("HBH") farm out, a successful placing of new shares and the building of a highly experienced management and technical team placed the Company in a strong position by the year end.

The subsequent completion of the transaction with the BG Group ("BG") in early 2007 significantly enhanced the Company's financial position and provided the Company with the resources to pursue an aggressive programme of activities across its Algerian asset portfolio over the next 18 months.

BG's farm-in to the HBH Concession represented a strategically important transaction for the Company, substantially enhancing the technical, operational and commercial capabilities of the joint venture partnership. Under the agreement, BG assumed the role as operator of the concession and earned a 36.75% interest in the joint venture, leaving Gulf Keystone and SONATRACH with 38.25% and 25% interests respectively.

Operationally, the Company has made important strides forward as it embarks on a new and intensive programme of exploration and appraisal activities. On the regionally extensive HBH Concession, located in Central Algeria and acquired in 2005, significant progress has already been made on the acquisition of a major 2D seismic survey which, together with a planned 3D survey over the existing HBH gas discovery, will form the basis for a six well exploration and appraisal drilling programme, to be initiated in late 2007.

In addition to the gas discovery already made on the HBH Concession, the Directors believe that this area holds considerable future exploration potential for gas. Algeria is very well placed to exploit the international gas markets via pipelines into Southern Europe and as Liquefied Natural Gas into Northern Europe and other international markets. The Directors believe that BG's and SONATRACH's expertise in international gas commercialization will play an important part in ensuring early development and commercialization of gas from the HBH Concession.

In its northern, oil prone, licences the Company has made important progress in the exploration and appraisal of its portfolio of leads and prospects, and towards the development of its existing oil discoveries. On Block 126a, a significant volume of study work has been carried out in conjunction with our partner SONATRACH to finalise and optimize the first phase of development of the GKN and GKS oil discoveries. The reservoir complexity and the requirement, under new Algerian legislation, to develop a utilization scheme for gas produced in association with oil in this remote area, has introduced significant delays in progressing this important project.

However, I am now pleased to be able to report that all the technical elements relating to this combined development of the GKN and GKS fields have now been agreed fully with our partner SONATRACH and we now simply await formal approval from the SONATRACH Executive Committee before proceeding with a joint Declaration of Commerciality, the pre-cursor to an immediate commencement of development operations.

Elsewhere on Block 126a we were disappointed that it did not prove possible to access moveable hydrocarbons during our recent test of the GRJ-2 well and that well is presently being plugged and abandoned.

On Block 129, important progress has been made towards the evaluation and exploitation of exploration and appraisal opportunities on this licence. The Company has recently completed the workover and testing of well HEK-3, an oil discovery well drilled by SONATRACH in 2004. The Company is very pleased to have successfully re-entered well HEK-3 and achieved what we believe to be a commercial rate of oil production. The successful use of acid fracturing technology on this well, to optimise production performance from this complex reservoir, provides us with the encouragement to consider a wider use of this technology within the HEK area and elsewhere within our northern licence areas.



**CHAIRMAN'S STATEMENT (continued)**

Further activity on Block 129 in 2007 will be geared towards the development and ranking of prospects ahead of the next phase of exploration drilling.

With regard to the Ben Guecha contract, covering Blocks 108 & 128b, formal approval of the contract has now been given by the Algerian Council of Ministers. The announcement of this approval in January 2007 marked the commencement of the first three year period of this exploration contract and enabled Gulf Keystone to commence the detailed evaluation of these blocks.

The full evaluation of Blocks 108, 128b and 129 during 2007 is geared towards a three well exploration drilling programme on the northern blocks, presently scheduled for the first quarter of 2008.

I'm pleased to be able to report the further strengthening of Gulf Keystone's management team, in particular the building of a strong technical team. This has completed the building of the management and operational team, and at a time when the market for skilled and highly qualified upstream personnel is extremely tight, this places Gulf Keystone in a strong competitive position to develop further its business activities.

Financially, the Company is now in a strong position. This transformation of the Company's finances has resulted firstly from the HBH transaction with BG, which included both a significant cash component and a material carry of the Company's share of expenditure during the first exploration and appraisal stage. Secondly, the Company achieved a successful share placing in the middle of the year which further enhanced its financial position.

However, notwithstanding the success of Gulf Keystone in building its portfolio of assets within Algeria and developing the prospects of the Company going forward, the Directors believe that for a Company of Gulf Keystone's size and resources in Algeria, there will continue to be material challenges in generating future cash flow and realising the full potential of the Company's portfolio, in a timely and predictable manner, given the regulatory and operational environment in which the Company is working.

In this regard, as I have already reported, progress towards securing the necessary declarations and consents to achieve first oil production from Block 126a has been significantly slower than expected. In addition, the Directors believe that active portfolio management within Algeria will continue to be a challenge for the Company and that Gulf Keystone cannot necessarily expect to be able to pursue the further risk spreading activities that would be an important part of the strategy of a company of its size. This, together with the relatively short exploration licence periods that govern the Company's present Production Sharing Contracts ("PSC's"), leads the Directors to conclude that the timely realisation of the full value of Gulf Keystone's portfolio would be best achieved by a Company of greater scale and wider financial and operational resources.

In the face of these continuing challenges, the unsolicited approach by RAK Petroleum ("RAK") to acquire the whole of the issued and to be issued share capital of Gulf Keystone was considered carefully, and ultimately leads to the proposed acquisition of the Company by RAK which has been recommended, by the Board, for approval by the Shareholders at the Special General Meeting to be held on 22nd May, 2007. Further details as to the background of, and remaining conditions to, this proposed transaction with RAK may be found in the recently issued Circular to Shareholders.

I would like in conclusion to express my thanks to all those employed by the Company in London, Algeria and Bermuda for their unstinting efforts in building the Company to its present position and transforming its prospects going forward. As the Company goes forward to a new phase in conjunction with RAK Petroleum, I would also like to express my deepest gratitude to you the shareholders for your support since the Company's flotation in 2004.

**Roger Parsons**  
Non-executive Chairman



## **CHIEF EXECUTIVE OFFICER'S STATEMENT**

I'm pleased to be able to report on the progress made by Gulf Keystone in its exploration and production business over the past year.

2006 has been a year of transformation for the Company. We commenced the year with a radically expanded portfolio of exploration and appraisal assets onshore Algeria, following significant success in the 6<sup>th</sup> Algerian International Licencing Round, and we set ourselves a number of important technical, financial and strategic objectives for the year, geared towards progressing, diversifying, and adding value to that portfolio of assets.

I am delighted to inform you that substantial progress has been made on a number of key fronts. Gulf Keystone commenced the year as operator, and a holder of, 100% of the working interest available to foreign partners in all of its Algerian Licence interests. A key objective was to embark on a portfolio management exercise with the objectives of spreading technical risk, crystallising elements of value from our existing portfolio, and introducing a strategic partner to make available, to the existing joint venture partnership, additional operational and commercial expertise. The introduction of BG as a partner in the Hassi Ba Hamou Concession achieved many of our objectives in that regard.

A second core objective for the year was to initiate, and make solid progress on, the exploration and appraisal programmes for the newly acquired licences in both the northern, oil prone area of Algeria and the gas prone central area, and again I'm pleased to be able to report important progress on that front. I am disappointed that it has not, as yet, been possible to secure first production from our GKN and GKS oil discoveries in Block 126a. This has been due primarily to a change in Algerian legislation which now precludes gas flaring on future oil and gas developments, and which therefore required a solution to be found for any gas that will be produced in association with oil from the joint GKN and GKS oil development. Together with our partner SONATRACH, a solution to this challenge has now been found and agreed, which should enable us to progress towards the commencement of development operations.

A further key objective for the year was a re-financing of the Company to enable the Company to embark on an aggressive second phase of exploration and appraisal activities, and to expand further its upstream portfolio. A successful share placing in August 2006 and completion of the transaction with BG in January 2007 has transformed the financial position of the Company.

Finally, in order to maximise the competitive edge of the Company going forward, it was important to ensure that, during 2006, we completed the recruitment of a first rate technical and management team. That team is now in place and the Company is well positioned to move into the next phase of its development.

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

In August 2006, BG was introduced as a strategic partner to the HBH Concession. BG is a world class operator who brings highly complementary technical and operational expertise and is firmly focussed on proving and commercialising the gas from this concession area. Under the agreement, BG has acquired 49% of Gulf Keystone's interest in HBH and has assumed the role of Operator. Gulf Keystone now holds a 38.25% interest, BG a 36.75% interest and SONATRACH a 25% interest in HBH.

The HBH Concession covers 18,380 km<sup>2</sup> in the Bechar Oued Namous Basin of Central Algeria, a gas prone area that includes the HBH gas discovery and a number of significant leads and prospects. The main reservoir targets lie at Devonian level where gas is contained in sandstones at average depths of between 750 and 1,000 metres.

In line with the significant prospectivity that we see within this concession, the partnership has embarked upon a materially expanded work program including the acquisition of 2,000 line km's of 2D seismic, 500 km<sup>2</sup> of 3D seismic and the drilling of 3 appraisal wells and 3 exploration wells during the initial licence phase. Acquisition of the 2D seismic commenced in February 2007, and approximately 600 line kms have been completed to date. Early, field processed, seismic lines from the first phase of this acquisition programme are encouraging. The 500 km<sup>2</sup> 3D seismic survey will be focused on the existing HBH gas discovery, and this started in May 2007. The first drilling on the block is scheduled for Q4 2007.



**CHIEF EXECUTIVE OFFICER'S STATEMENT (continued)**

**Northern Blocks**

**Ben Guecha (Blocks 108/128b) - Gulf Keystone: 75% equity interest**

**Bottena Perimeter (Block 129) - Gulf Keystone: 75% equity interest**

**Block 126a - Gulf Keystone: 60% interest**

Over the last year the Company has made considerable progress in its technical understanding of its north-eastern Algerian asset base. The geology of this tectonically active area is complex with hydrocarbons often residing in fractured carbonates with low matrix porosity. Commercial exploitation of such reservoirs requires specific techniques that are likely to include the acquisition of 3D seismic data, specialist testing and completion techniques, and, potentially, high angle or horizontal wells. In pursuit of this strategy, the Company has completed a two well workover and testing operation of potential oil discoveries in Blocks 129 (well HEK-3) and 126a (well GRJ-2).

In Block 129, the completion of the HEK-3 well test produced a large amount of good quality engineering data. This, combined with the produced volume of oil and the long flow and shut in periods, will provide valuable data for reservoir evaluation and field development study purposes. The well achieved a stabilised flow rate of 1040bopd. Production optimisation studies will be carried out to analyse options for further increasing well productivity with a view to the possible early development of this discovery. In this regard, consideration will be given to pump and/or gas lift options to further improve both the rate and delivery pressure of the well.

The Company carried out a test of well GRJ-2 located on Block 126a. Well GRJ-2 was drilled by Gulf Keystone in late 2005. The well encountered encouraging hydrocarbon indications, from both core and log data in Cenomanian / Turonian carbonates, the same reservoir interval that is producing in the GKN-1 well. At the time of drilling, the well was not tested due to the lack of availability of suitable test equipment within Algeria.

During April/May 2007, Gulf Keystone tested two potential reservoir zones and performed an injectivity and step rate test followed by matrix acidisation (mini frac) in both zones. The aim of the test program was to connect the fracture and/or the matrix permeability in the surrounding reservoir, and thereby access moveable hydrocarbons.

Whilst technically, operations were performed successfully, no hydrocarbons flowed into the wellbore under test. Although it is unlikely that there will be any further operations on the GRJ structure, we will, as part of our wider ongoing technical assessment of the northern blocks, now review all geological, geophysical and engineering data that was collected during this operation to establish the likely reasons for lack of commercial flow from this particular well.

The second phase of the Block 126a exploration and appraisal licence ended in April 2006. However, a fifteen month licence extension was awarded by the Algerian authorities to facilitate completion of the process leading to the Declaration of Commerciality for the GKN/GKS oil discoveries and the testing of well GRJ-2.

A comprehensive programme of exploration and appraisal activities is now planned for the northern blocks over the next two years. During the remainder of 2007, the focus of activities in Block 129 will be on building and ranking an inventory of exploration leads and prospects utilizing the 3D seismic survey that the Company has recently processed over the DDN area of the block, and pre-existing 2D seismic acquired by SONATRACH.

The award of the Block 108 / 128b licence which was negotiated and agreed during 2005, was ratified in January 2007 by publication in the Algerian official gazette. Publication marks commencement of the first (three year) exploration and appraisal phase of the licence. Preliminary analysis has already been made of the 3D seismic survey acquired by the Company in the region of the Ras Toumb oil field in Block 108 and, as further pre-existing seismic and well data is acquired from SONATRACH, following this licence award, so the pace of evaluation of these blocks will accelerate.

The above detailed evaluation of Blocks 108, 128b and 129 is geared towards a three well drilling programme, currently planned for the first quarter of 2008.



**CHIEF EXECUTIVE OFFICER'S STATEMENT (continued)**

**GKN / GKS oil development**

In late 2006, new legislation necessitated a revision to the field development plan for the GKN Field and the GKS oil discovery. The revised Phase 1 development plan now includes the injection and storage of gas produced in association with oil, at the nearby Ras Toumb Field. The GKN Field currently produces approximately 1,000 bopd (from a single well). On entering the exploitation phase of the licence, the Company will take over production from the GKN Field and bring the GKS-2 discovery into production. This latter well produced, under test, at a rate of 4,586 barrels of oil and 4.61 million cubic feet of gas per day in 2005. In addition, Phase 1 of the combined GKN / GKS development calls for the acquisition of 3D seismic data over the two structures, to firm up the reservoir morphology, and the drilling of two further development wells. Plans for Phases 2 and 3 of the GKN / GKS development will depend on data acquired during the first phase.

All discussions with our partner SONATRACH relating to the technical, operational and environmental plans for Phase 1 of the GKN / GKS development have now been completed. Commencement of the Exploitation Phase of the licence now awaits formal approval from SONATRACH and gazetting by the competent authorities.

Management

2006 has seen a strong focus on building the optimum technical and management team to run and grow our business. During the year, the Company recruited 7 additional technical staff in the key disciplines; geology, geophysics, engineering and economics. The Company also completed the building of its Executive Team with a Finance Director, a group Commercial / Legal Director and an EVP of Exploration and Technical. We believe that this is a particularly strong achievement given the background of an unprecedented skills shortage within the industry.

Financial

Following the successful share placing in August 2006 and completion of the HBH deal in January 2007, Gulf Keystone is on a solid financial footing. The Company reports a profit for the year after taxation of US\$46.3 million (2005 loss US\$40.8 million). At the end of the year, the Company had cash and cash equivalents of US\$59.3 million (2005 US\$51.4 million) and trade and other receivables US\$60 million (2005 US\$3.4 million). The increase in profit and the trade and other receivables was primarily a result of the HBH farm out transaction. The conditions of this transaction were fully satisfied prior to the end of 2006 hence the transaction has been accounted for as a 2006 event. However, the outstanding cash consideration contained within trade receivables was paid by BG during January 2007 following legal completion of the deal. The Company has US\$21.6 million (2005 US\$34.7 million) of cash guarantees in place for the Company's Algerian work programme. The Company had trade and other payables of US\$10.8 million (2005 US\$8.5 million). This included US\$5 million of short term debt that was repaid shortly after the year end.

**Todd Kozel**  
*Chief Executive Officer*



**CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2006**

	NOTES	2006 \$'000	2005 \$'000
<b>Continuing Operations</b>			
<b>Other income/(expense):</b>			
Gain on sale of assets	3	61,103	-
Impairment of intangible exploration assets		-	(35,145)
General and administrative expenses		(16,589)	(7,719)
Profit/(Loss) from operations		44,514	(42,864)
Interest revenue		2,160	2,213
Interest expense		(229)	-
<b>Profit/(Loss) before tax</b>		46,445	(40,651)
Tax expense		(136)	(135)
<b>Profit/(Loss) after tax for the year</b>		46,309	(40,786)
<b>Profit/(Loss) per share (cents)</b>			
Basic	1	17.69	(16.08)
Diluted		16.74	(16.08)



**CONSOLIDATED BALANCE SHEET AS AT 31 DECEMBER 2006**

	NOTES	2006 \$'000	2005 \$'000
<b>Non-current assets</b>			
Property, plant and equipment	2	26,782	25,594
Intangible assets (2005 restated -note 3)	3	19,955	16,851
Financial asset		5,597	-
		<u>52,334</u>	<u>42,445</u>
<b>Current assets</b>			
Inventories		4,711	3,472
Trade and other receivables		59,999	3,386
Cash and cash equivalents		59,328	51,439
		<u>124,038</u>	<u>58,297</u>
<b>Total Assets</b>		<u>176,372</u>	<u>100,742</u>
<b>Current liabilities</b>			
Trade and other payables		10,835	8,491
Tax liabilities		136	135
Provisions		2,050	2,050
		<u>13,021</u>	<u>10,676</u>
<b>Total liabilities (2005 restated – note 3)</b>		<u>13,021</u>	<u>10,676</u>
<b>Net Assets</b>		<u>163,351</u>	<u>90,066</u>
<b>Equity</b>			
Share capital		1,853	1,638
Share premium account		159,063	135,349
Share option reserve		3,535	502
Exchange translation reserve		(43)	(57)
Accumulated losses		(1,057)	(47,366)
<b>Total Equity</b>		<u>163,351</u>	<u>90,066</u>



**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2006**

	Attributable to equity holders of the Group						Total Equity \$'000
	Share Capital \$'000	Share premium \$'000	Share based Payment reserve \$'000	Convertible warrants \$'000	Accumulated Deficit \$'000	Exchange Translation Reserve \$'000	
Balance as at 1 January 2005	1,626	135,349	108	12	(6,580)	-	130,515
Share based payment expense	-	-	394	-	-	-	394
Exchange differences arising on translation of overseas operations	-	-	-	-	-	(57)	(57)
Warrants subscribed	12	-	-	(12)	-	-	-
Net profit for the year	-	-	-	-	(40,786)	-	(40,786)
Balance at 1 January 2006	1,638	135,349	502	-	(47,366)	(57)	90,066
Share based payment expense	-	-	3,033	-	-	-	3,033
Exchange differences arising on translation of overseas operations	-	-	-	-	-	14	14
Share conversion and issue	215	23,714	-	-	-	-	23,929
Net profit for the year	-	-	-	-	46,309	-	46,309
Balance at 31 December 2006	1,853	159,063	3,535	-	(1,057)	(43)	163,351



**CONSOLIDATED CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2006**

	NOTES	2006 \$'000	2005 \$'000
<b>Operating activities</b>			
Cash used in operations	4	(13,418)	(13,932)
Interest received		2,160	2,213
<b>Net cash (used)/generated in operating activities</b>		<u>(11,258)</u>	<u>(11,719)</u>
<b>Investing Activities</b>			
Purchase of intangible assets		(3,166)	(25,863)
Purchase of property, plant and equipment		(1,401)	(804)
<b>Net cash used in investing activities</b>		<u>(4,567)</u>	<u>(26,667)</u>
<b>Financing activities</b>			
Interest paid		(229)	-
Proceeds on issue of share capital		23,929	-
<b>Net cash generated in financing activities</b>		<u>23,700</u>	<u>-</u>
<b>Net increase/(decrease) in cash and cash equivalents</b>		7,875	(38,386)
Cash and cash equivalents at beginning of year		51,439	89,882
Effect of foreign exchange rate changes		14	(57)
		<u>59,328</u>	<u>51,439</u>
<b>Cash and cash equivalents at end of the year being bank balances and cash</b>		<u>59,328</u>	<u>51,439</u>



**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**General Information**

The Company is incorporated in Bermuda and it is quoted on the Alternative Investment Market of the London Stock Exchange. The Company serves as the holding company for the Group, which is engaged in oil and gas exploration, operating in the Republic of Algeria.

This preliminary results announcement is for the year ended 31 December 2006. While the financial information contained in this preliminary results announcement has been computed in accordance with International Financial Reporting Standards (“IFRS”), this announcement does not itself contain sufficient information to comply with IFRS. For these purposes, IFRS comprise the Standards issued by the International Accounting Standards Board (“IASB”) and Interpretations issued by the International Financial Reporting Interpretations Committee (“IFRIC”).

The financial information set out above does not constitute the company’s Annual Report for the years ended 31 December 2006 or 2005, but is derived from those accounts and is consistent with the accounting policies described therein. The auditors have reported on those accounts; their reports were unqualified.

**Basis of accounting**

The financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”).

The financial statements have been prepared under the historical cost accounting rules, except for the valuation of share options and contingent deferred consideration, and on a going concern basis. The principal accounting policies adopted are set out below.

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

IFRS 7	Financial instruments: Disclosures; and the related amendment to IAS 1 on capital disclosures
IFRS 8	Operating Segments
IFRIC 8	Scope of IFRS 2 Share –based Payment
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 11	IFRS-2 Group and Treasury Share Transactions
IFRIC 12	Service Concession Arrangements

The Directors anticipate that the adoption of these Standards and Interpretations in future periods will have no material impact on the financial statements of the Group when the relevant standards come into effect for periods commencing on or after 1 January 2007 (IFRS 8: 1 January 2008).



**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Basis of consolidation**

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

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

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

**Leasing**

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

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

**Foreign currencies**

The functional and presentation currency of the Company is US Dollars.

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

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

**Taxation**

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

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

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if



**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

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 tax profit nor the accounting profit.

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

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that 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. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

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

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

Fixtures and equipment - 20% straight line

**Intangible assets other than oil and gas**

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

Computer software - 33% straight line

**Intangible and tangible non current assets - oil and gas interests**

The Group adopts the full cost method of accounting for its oil and gas interests. Under the full cost method of accounting all costs relating to the exploration for and development of oil and gas exploration and evaluation interests, whether productive or not, are accumulated and capitalised as non-current assets within geographic costs pools. Exploration and evaluation costs are generally classified as intangible non-current assets during the exploration and evaluation phase and are carried forward where activities in an area have not yet reached a stage which permits reasonable assessment of the existence of economically recoverable reserves, and subject to there being no impairment.

Costs dealt with in this way include seismic data, licence acquisition costs, technical work, exploration and appraisal drilling, general technical support and directly attributable administrative and overhead costs.

Exploration and evaluation costs are transferred to property, plant and equipment upon declaration of commerciality and amortised, together with development costs, over the life of the area, generally the field.

Upon cessation of exploration on each licence, or otherwise when an impairment of an exploration and evaluation asset arises, an impairment test is performed for the pool and any balance of unsuccessful exploration and evaluation costs carried forward in the pool is amortised over the life of the pool.

Depreciation, depletion and amortisation is provided under the unit of production method which uses the estimated remaining commercial reserves and the net book value and any further anticipated costs to develop such reserves.



**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**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 considered is the pool. 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, generally the field.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have been adjusted.

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

**Disposals of oil and gas interests**

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

**Carry of expenditures and farm-in arrangements**

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

**Inventories**

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

**Warrants**

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

**Capitalisation of Interest**

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



**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Financial instruments**

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

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

*Trade receivables*

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

*Contingent deferred consideration*

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

*Financial liabilities and equity*

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

*Borrowings*

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

*Trade payables*

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

*Cash and Cash Equivalents*

Cash and cash equivalents comprise of 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.

*Equity instruments*

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

**Provisions**

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

**Decommissioning provision**



The decommissioning provision represents management's best estimate of the Group's liability for restoring the sites of drilled wells to their original status, discounted where the effect is material.

**CONSOLIDATED FINANCIAL STATEMENTS  
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Share-based payments**

The Group has applied the requirements of IFRS 2 to bonus shares and share option schemes allowing certain employees within the Group to acquire or receive shares of the Company. For all grants of bonus shares and share options, the fair value as at the date of grant is calculated using an appropriate option pricing model and the corresponding cost is recognised over the expected life of the option. The fair value of the bonuses granted is recognised as an employee expense with a corresponding increase in equity. The fair value of the bonuses granted is measured using the standard methodology applied by the Company taking into account the terms and conditions upon which the bonuses were granted.

**Critical accounting estimates and judgements**

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The Group makes estimates and assumptions concerning the future. The resulting accounting estimates and assumptions will, by definition, seldom equal related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

*Decommissioning costs*

The Group has estimated that decommissioning costs for wells will now be \$550,000 per well discounted to money of the day. It has provided for this amount for GKS-3, RDL-1, GRJ-1, GRJ-2 and GKS-3. The total amount provided in the balance sheet as at 31 December 2006 at net present value is \$2,050,000.

*Impairment review of GKN and GKS*

The Group employs an economist to calculate the net present value of GKN and GKS based on, and with sensitivities associated with, a gross production profile of 4 thousand barrels per day, an oil price of \$45 - \$60/bbl and a discount rate of 10%. The positive net present value from this model exceeded the carrying value as at 31 December 2006 of \$26.8 million which was, therefore, retained as tangible assets.

*Contingent deferred consideration from HBH sale*

As part of the HBH agreement with the BG group ("BG"), if gas reserves of the HBH field are agreed (in accordance with the agreement) to be greater than 800 bcf BG will pay the Group an additional \$4,000,000 for every 100 bcf over 800 bcf from a minimum of 900 bcf up to a maximum of 1,300 bcf. The Group estimates, based on an independent review of potential reserves that the Group will receive \$8,000,000 contingent deferred income, which discounted to money of the day at 10% per annum results in an estimated receivable contingent deferred income of \$5,597,000 at 31 December 2006.

*Carry value of intangible exploration and evaluation assets*

The outcome of ongoing exploration, and therefore whether the carrying value of intangible exploration and evaluation assets will ultimately be recovered, is inherently uncertain. Management makes the judgments 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 IFRS6.

**NOTES**

1 EARNINGS PER SHARE

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

<i>Earnings</i>	2006 \$'000	2005 \$'000
Profit/(Loss) for the purposes of basic and diluted loss per share	46,309	(40,786)
<i>Number of shares</i>	2006 Number	2005 Number
Weighted average number of ordinary shares for the purposes of basic profit/(loss) per share	261,769,050	253,677,757
Adjustments for:		
-bonus shares	1,669,707	-
-share options	13,240,500	-
Weighted average number of ordinary shares for the purposes of diluted profit/(loss) per share	276,679,257	253,677,757

There is a dilutive effect from the options and bonus shares issued by the company.



2 PROPERTY, PLANT AND EQUIPMENT

	Oil & Gas Properties \$'000	Fixtures & Equipment \$'000	Total \$'000
<b>At 1 January 2005</b>			
Cost	-	119	119
Accumulated depreciation	-	(36)	(36)
Net book value	-	83	83
<b>Year ended 31 December 2005</b>			
Opening net book value	-	83	83
Additions	-	804	804
Transfer from intangible assets	24,849	-	24,849
Depreciation charge	-	(142)	(142)
Closing net book value	24,849	745	25,594
<b>At 31 December 2005</b>			
Cost	24,849	923	25,772
Accumulated depreciation	-	(178)	(178)
Net book value	24,849	745	25,594
<b>Year ended 31 December 2006</b>			
Opening net book value	24,849	745	25,594
Additions	1,233	167	1,400
Transfer from intangible assets	-	-	-
Depreciation charge	-	(212)	(212)
Closing net book value	26,082	700	26,782
<b>At 31 December 2006</b>			
Cost	26,082	1,090	27,172
Accumulated depreciation	-	(390)	(390)
Net book value	26,082	700	26,782

In 2005, \$24.8 million was transferred from oil & gas exploration and evaluation costs to oil & gas properties within property, plant and equipment during the year. This transfer was triggered by the SONATRACH and Gulf Keystone Petroleum Limited joint venture management committee i) recognising the potential commerciality of the GKN field, which in turn is expected to lead to confirmation of commerciality by Sonatrach and then in turn to the Ministry of Energy and Mining in Algeria endorsing a production license and; ii) the anticipated declaration of commerciality of GKS and subsequent recommendation via SONATRACH to the Ministry of Energy and Mining in Algeria for the award of an early production license. The additions in 2006 represent the continuing expenditures on these assets.



3 INTANGIBLE ASSETS	Exploration & evaluation costs \$'000	Computer software \$'000	Total \$'000
<b>At 1 January 2005</b>			
Cost and net book value	41,708	-	41,708
<b>Year ended 31 December 2005</b>			
Opening net book value	41,708	-	41,708
Additions (restated)	35,008	156	35,164
Transferred to tangible assets	(24,849)	-	(24,849)
Impairment write off	(35,145)	-	(35,145)
Amortisation charge	-	(27)	(27)
Closing net book value	16,722	129	16,851
<b>At 31 December 2005</b>			
Cost (restated)	51,867	156	52,023
Accumulated amortisation	(35,145)	(27)	(35,172)
Net book value	16,722	129	16,851
<b>Year ended 31 December 2006</b>			
Opening net book value	16,722	129	16,851
Additions	3,330	61	3,391
Disposal of HBH	(223)	-	(223)
Amortisation charge	-	(64)	(64)
Closing net book value	19,829	126	19,955
<b>At 31 December 2006</b>			
Cost	54,974	217	55,191
Accumulated amortisation	(35,145)	(91)	(35,236)
Net book value	19,829	126	19,955

The expiry of the exploration license on Block 126a in April 2006 and the Group's decision only to focus on the GKN, GKS and GRJ fields within Block 126a triggered an impairment test under IFRS 6 and IAS 36 for Block 126a's group of cash generating units. This led to a \$35.1 million write off in 2005.

The additions to oil & gas exploration and evaluation costs in the period relate to the wells in the GRJ field on block 126a (see note 25) that was granted a licence extension until July 2007 and expenditures on the Group's other Bottena and Ben Guecha blocks whose exploration licences expire late in 2008 and early 2010 respectively

**Restatement of prior year exploration and evaluation costs:**

Under the terms of various of the Group's production sharing agreements, SONATRACH is entitled to receive an amount of any future production to the value of \$11.8m as cost recovery for past exploration expenditures. However, if no commercially exploitable deposits are discovered, the Group does not owe SONATRACH for the data acquired. In prior years, such obligations had been recorded as liabilities with the associated cost included in non-current assets. In these financial statements, the Group has restated non-current assets to derecognise this liability, on the basis that these amounts are more appropriately regarded as an integral part of the future production attributable to SONATRACH under the production sharing contract.



3 INTANGIBLE ASSETS (continued)

**Disposal of 36.75 per cent interest in HBH**

In August 2006, Gulf Keystone announced the introduction of BG North Sea Holdings Limited, a subsidiary of BG Group Plc, as strategic partner in the Hassi Ba Hamou Perimeter exploration, appraisal and exploitation contract. Under the joint venture agreement (“JV”), BG has acquired 49 per cent of Gulf Keystone's interest in HBH and assumed the role of Operator. Gulf Keystone holds a 38.25 per cent interest, BG a 36.75 per cent interest and SONATRACH a 25 per cent interest in HBH. In accordance with Article 14 of the HBH Contract, the rate of participation of the investors in the financing of the investment costs for exploration, evaluation, development, exploitation and operating costs is set at 25 per cent for SONATRACH, 38.25 per cent for Gulf Keystone and 36.75 per cent for BG. However, in the absence of the discovery of a commercially exploitable deposit, the JV partners may not claim any reimbursement or compensation from SONATRACH. As part of the joint venture agreement, BG carries Gulf Keystone for up to \$30 million of its share of exploitation expenditures on the block, which is repayable from Gulf Keystone's share of future production. As a result of the benefit of the cost carry under the HBH sale agreement, the Group carries no intangible assets on HBH, other than the expenditures incurred prior to entering the transaction with BG. The gain on sales of assets was principally comprised of funds received from the farm in deal with BG.

4	<b>RECONCILIATION OF PROFIT/(LOSS) FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES</b>	2006 \$'000	2005 \$'000
	<b>Profit/(loss) from operations</b>	44,514	(42,864)
	<b>Adjustments for:</b>		
	Depreciation of property, plant & equipment	212	142
	Amortisation of intangible assets	64	27
	Impairment of intangible exploration assets	-	35,145
	Share based payment expense	3,033	394
	Increase in inventories	(1,239)	(987)
	Increase in provision	-	2,050
	Increase in receivables	(62,210)	(2,961)
	Increase/(decrease) in payables	2,208	(4,878)
	Net cash (used)/generated in operating activities	<u>(13,418)</u>	<u>(13,932)</u>



5 **BANK GUARANTEES**

As part of the contractual terms of the Algerian contracts, the Group has given bank guarantees to SONATRACH of \$21.6 million. These are cash backed guarantees which effectively reduce the free cash available that the Group has on its balance sheet. The US\$21.6 million total is comprised of, \$6 million for the Bottena (“129 Contract”) work programme and \$15.6 million for the Ben Guecha (“108/128b Contract”) work programme. These guarantees are for the exploration and evaluation work programmes stipulated in the contracts and are reduced as the work programmes are completed. A previous guarantee of \$13.1 million for the Hassi Be Hamou (Blocks 317b, 322b3, 347b, 348 and 349b) work programme was replaced by a BG guarantee as part of the JV agreement.

6 **SUBSEQUENT EVENTS**

On 13 April 2007 the board of directors of Gulf Keystone, RAK Petroleum and RAK Bermuda, a wholly owned subsidiary of RAK Petroleum, announced the terms of a recommended acquisition of Gulf Keystone by RAK Petroleum to be effected by way of an amalgamation of Gulf Keystone with RAK Bermuda. Under the terms of the proposed amalgamation Gulf Keystone shareholders will receive amalgamation consideration of 74 pence per Gulf Keystone share, which are to be cancelled pursuant to the amalgamation. The total consideration on a fully diluted basis including the cash cancellation consideration for in the money Gulf Keystone options and amounts due under the Gulf Keystone Executive bonus scheme is approximately £208 million (\$412 million).

On 13 January 2007 the Group repaid in full its outstanding debts to GIBCA Limited and Falcon Partners Trust, both related parties, who had provided an unsecured debt facility in aggregate of \$5 million at an interest rate of 7% and for a term of up to 12 months.

On 7th April 2007 Gulf Keystone commenced workover operations on well HEK-3 an oil and gas discovery well drilled by SONATRACH in 2004. At that time, the well was tested over the Cretaceous, Coniacian limestone interval and achieved, post acidisation, flow of 184 barrels of oil over a 4 hour period, prior to the well being suspended. Gulf Keystone re-entered the well and tested the same zone, over the measured interval 2,439 to 2,446 metres, employing an acid fracturing technique to improve connectivity between the reservoir and the wellbore. After cleaning up the well, a stabilised flow rate of 1,040 barrels per day of 31 degrees API oil was achieved through a 32/64 inch choke.

During April Gulf Keystone performed well test operations on well GRJ-2, no hydrocarbons flowed into the wellbore under test and this well is being plugged and abandoned. Whilst final expenditures on the GRJ field are forecast to be around US\$24 million, as at 31 December 2006 expenditures of US\$18.9 million are included in intangible assets. In accordance with the Group’s accounting policies for intangible oil and gas interests, these amounts will be subject to an impairment test in 2007.