

## Management's discussion and analysis

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements of Peyto Exploration & Development Corp. ("Peyto" or the "Company", successor issuer to Peyto Energy Trust, the "Trust") for the years ended December 31, 2010 and 2009. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

This discussion provides management's analysis of Peyto's historical financial and operating results and provides estimates of Peyto's future financial and operating performance based on information currently available. Actual results will vary from estimates and the variances may be significant. Readers should be aware that historical results are not necessarily indicative of future performance. This MD&A was prepared using information that is current as of March 8, 2011. Additional information about Peyto, including the most recently filed annual information form is available at [www.sedar.com](http://www.sedar.com).

### Corporate Conversion

Effective December 31, 2010, the Company completed a plan of arrangement (the "2010 Arrangement") pursuant to which it acquired all of the assets and assumed all of the liabilities, respectively, of the Trust. Prior to completion of the 2010 Arrangement, the Trust was a reporting issuer in all provinces of Canada and the Trust Units were listed for trading on the TSX. Following completion of the 2010 Arrangement, the Common Shares were listed for trading on the TSX concurrent with the delisting of the Trust Units, the Trust ceased to be a reporting issuer and Peyto became a reporting issuer as successor to the Trust. Pursuant to the terms of the 2010 Arrangement, former holders of Trust Units received one Common Share for each one Trust Unit held. The former Unitholders received an aggregate of 131,875,382 Common Shares in exchange for all of the outstanding Trust Units. The conversion of the Trust to a corporate structure was intended to be a tax deferred transaction for Canadian and United States federal income tax purposes. For more information, please refer to the Information Circular dated November 5, 2010 which is available on Peyto's website at [www.peyto.com](http://www.peyto.com) or on SEDAR at [www.sedar.com](http://www.sedar.com).

There were no changes in Peyto's underlying operations associated with the 2010 Arrangement. The consolidated financial statements and related financial information have been prepared on a continuity of interest basis, which recognizes Peyto as the successor entity and accordingly all comparative information presented for the preconversion period is that of the Trust. For the convenience of the reader, when discussing prior periods this MD&A refers to common shares, shareholders and dividends although for the pre-conversion period such items were trust units, unitholders and distributions, respectively.

Certain information set forth in this MD&A, including management's assessment of the Company's future plans and operations, contains forward-looking statements. By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond these parties' control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other industry participants, the lack of availability of qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. Readers are cautioned that the assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Peyto's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what benefits that Peyto will derive there from.

All references are to Canadian dollars unless otherwise indicated. Natural gas liquids and oil volumes are recorded in barrels of oil (bbl) and are converted to a thousand cubic feet equivalent (mcf) using a ratio of six (6) thousand cubic feet to one (1) barrel of oil (bbl). Natural gas volumes recorded in thousand cubic feet (mcf) are converted to barrels of oil equivalent (boe) using the ratio of six (6) thousand cubic feet to one (1) barrel of oil (bbl).

### OVERVIEW

Peyto is a Canadian energy company involved in the development and production of natural gas in Alberta's deep basin. As at December 31, 2010, the total Proved plus Probable reserves were 1,558 billion cubic feet equivalent (256.7 million barrels of oil equivalent) as evaluated by the independent petroleum engineers. Production is weighted approximately 86% to natural gas and 14% to natural gas liquids and oil.

The Peyto model is designed to deliver a superior total return and, over time, growth in value, assets, production and income, all on a debt adjusted per share basis. The model is built around three key principles:

- Use technical expertise to achieve the best return on capital employed, through the development of internally generated drilling projects.
- Build an asset base which is made up of high quality long life natural gas reserves.
- Balance dividends to shareholders and funding for the capital program with cash flow and available bank lines.

Operating results over the last twelve years indicate that these principles have been successfully implemented. This business model makes Peyto a truly unique energy company.

## ANNUAL FINANCIAL INFORMATION

The following is a summary of selected financial information of the Company for the periods indicated. Reference should be made to the audited consolidated financial statements of the Company, which are available at [www.sedar.com](http://www.sedar.com).

Year Ended December 31 (\$000 except per share amounts)	2010	2009	2008
Total revenue (before royalties)	<b>319,426</b>	273,517	418,885
Funds from operations	<b>234,077</b>	202,699	286,907
Per share – basic and diluted	<b>1.94</b>	1.83	2.71
Earnings	<b>121,838</b>	152,774	179,397
Per share – basic and diluted	<b>1.01</b>	1.38	1.69
Total assets	<b>1,454,575</b>	1,254,113	1,280,246
Total long-term debt	<b>355,000</b>	435,000	500,000
Distributions per unit	<b>1.44</b>	1.47	1.76

### Funds from Operations

“Funds from operations” is a non-GAAP measure which represents cash flows from operating activities before changes in non-cash operating working capital and provision for future performance based compensation. Management considers funds from operations and per share calculations of funds from operations to be key measures as they demonstrate the Company’s ability to generate the cash necessary to pay dividends, repay debt and make capital investments. Management believes that by excluding the temporary impact of changes in non-cash operating working capital, funds from operations provides a useful measure of Peyto’s ability to generate cash that is not subject to short-term movements in operating working capital. The most directly comparable GAAP measure is cash flows from operating activities.

## QUARTERLY FINANCIAL INFORMATION

(\$000 except per share amounts)	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Total revenue (net of royalties)	<b>80,921</b>	69,650	64,649	70,801	64,761	56,353	56,598	70,133
Funds from operations	<b>66,359</b>	56,743	52,415	58,559	53,302	45,263	45,527	58,607
Per share – basic and diluted	<b>0.53</b>	0.47	0.44	0.51	0.46	0.39	0.43	0.55
Earnings	<b>27,700</b>	32,567	24,696	36,874	33,035	26,976	29,189	63,574
Per share – basic and diluted	<b>0.22</b>	0.27	0.21	0.32	0.28	0.24	0.28	0.60
Distributions	<b>46,299</b>	43,875	43,622	41,470	41,371	41,371	39,211	41,309
Per unit – basic and diluted	<b>0.36</b>	0.36	0.36	0.36	0.36	0.36	0.37	0.39

## RESULTS OF OPERATIONS

### Production

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Natural gas (mmcf/d)	<b>148.6</b>	95.5	<b>122.0</b>	92.7
Oil & natural gas liquids (bbl/d)	<b>3,439</b>	3,222	<b>3,389</b>	3,027
Barrels of oil equivalent (boe/d)	<b>28,197</b>	19,133	<b>23,728</b>	18,481
Thousand cubic feet equivalent (mmcf/d)	<b>169.2</b>	114.8	<b>142.4</b>	110.9

Natural gas production averaged 148.6 mmcf/d in the fourth quarter of 2010, 56% higher than the 95.5 mmcf/d reported for the same period in 2009. Oil and natural gas liquids production averaged 3,439 bbl/d, up from 3,222 bbl/d reported in the prior year. Production for the year increased 28% from 110.9 mmcfe/d to 142.4 mmcfe/d (18,481 boe/d to 23,728 boe/d). The production increases are attributable to Peyto's increased capital program and resulting production additions.

### Commodity Prices

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Natural gas (\$/mcf)	3.89	4.79	4.36	4.58
Hedging – gas (\$/mcf)	1.04	1.38	1.00	1.86
Natural gas – after hedging (\$/mcf)	4.93	6.17	5.36	6.44
Oil and natural gas liquids (\$/bbl)	67.06	60.77	65.31	50.18
Total Hedging (\$/mcf)	0.91	1.14	0.85	1.56
Total Hedging (\$/boe)	5.48	6.86	5.12	9.34

Peyto's natural gas price, before hedging gains, averaged \$3.89/mcf during the fourth quarter of 2010, a 19% decrease from \$4.79/mcf reported for the equivalent period in 2009. Oil and natural gas liquids prices averaged \$67.06/bbl, an increase of 10% from \$60.77/bbl a year earlier. Average natural gas price for the year was down 5% at \$4.36/mcf while oil and natural gas liquids prices were up 30% at \$65.31/bbl compared to 2009. Hedging activity accounted for 16% of Peyto's achieved price for the fourth quarter and 14% of the annual price.

### Revenue

(\$000)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Natural gas	53,196	42,127	194,293	155,072
Oil and natural gas liquids	21,216	18,013	80,788	55,458
Hedging gain	14,221	12,078	44,345	62,987
Total revenue	88,633	72,218	319,426	273,517

For the three months ended December 31, 2010, gross revenue increased 23% to \$88.6 million from \$72.2 million for the equivalent period in 2009. Revenue for 2010 increased 17% to \$319.4 million from \$273.5 million in 2009. The increase in revenue for the period was a result of increased production volumes and higher realized oil and NGL prices offset by lower realized natural gas prices as detailed in the following table:

	Three Months ended Dec. 31			Twelve Months ended Dec. 31		
	2010	2009	\$million	2010	2009	\$million
Total Revenue, December 31, 2009			72.2			273.5
Revenue change due to:						
<b>Natural gas</b>						
Volume (mmcf)	13,667	8,783	30.1	44,541	33,842	68.9
Price (\$/mcf)	\$4.93	\$6.17	(16.9)	\$5.36	\$6.44	(48.1)
<b>Oil &amp; NGL</b>						
Volume (mbbl)	316	296	1.2	1,237	1,105	6.5
Price (\$/bbl)	\$67.06	\$60.77	2.0	\$65.31	\$50.18	18.6
Total Revenue, December 31, 2010			88.6			319.4

### Royalties

Royalties are paid to the owners of the mineral rights with whom leases are held, including the provincial government of Alberta. Alberta gas crown royalties are invoiced on the Crown's share of production based on a monthly established Alberta Reference Price. The Alberta Reference Price is a monthly weighted average price of gas consumed in Alberta and gas exported from Alberta reduced for transportation and marketing allowances.

(\$000 except per share amounts)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Royalties	7,712	7,457	33,405	25,671
% of sales before hedging	10	12	12	12
% of sales after hedging	9	10	10	9
\$/mcf	0.50	0.71	0.64	0.63
\$/boe	2.97	4.24	3.86	3.81

For the fourth quarter of 2010, royalties averaged \$0.50/mcfe or approximately 9% of Peyto's total petroleum and natural gas sales. Royalties for the year were essentially flat at \$0.64/mcfe.

Substantially all of the Trust's production is in Province of Alberta. Under the Alberta Royalty Framework ("ARF") the Crown royalty rate varies with production rates and commodity prices. The royalty rate expressed as a percentage of sales revenue will fluctuate from period to period due to the fact that the Alberta Reference Price can differ significantly from the commodity prices realized by the Trust and that hedging gains and losses are not subject to royalties.

In addition to the basic underlying royalty structure (the ARF); Alberta has instituted additional features that impact the royalty paid on gas, particularly for newly drilled wells. These additional features include:

1. A drilling royalty credit program that is presently active but will terminate on March 31, 2011. Under this program credits are earned at a rate of \$200 per meter of newly drilled well depth and can be applied with certain limitations to the earning company's corporate royalty bill. For the twelve months ending December 31, 2010 \$18.2 million in Alberta drilling credits have been recognized as a reduction to capital spending.
2. A one year flat 5% royalty period (18 months for horizontal wells) for each new well but capped at a cumulative production level of 500 MMcf for each new well, and
3. A Natural Gas Deep Drilling Holiday program that provides a royalty holiday value for new wells based on meterage drilled. This holiday feature further reduces the royalty for new wells to a minimum of 5% for a maximum 5 year period from on-stream date. This benefit sequentially follows the benefit under point (2) above.

From the combination of these royalty programs, Peyto has experienced a decrease in overall corporate royalty rates. This, in part, can be attributed to a decline in commodity prices and the dependence of royalty rates on commodity prices. In its 12 year history, Peyto has invested over \$1.9 billion in capital projects, found and developed 1.2 TCFe of gas reserves, and paid over \$532 million in royalties.

### Operating Costs & Transportation

The Company's operating expenses include all costs with respect to day-to-day well and facility operations. Processing and gathering income related to joint venture and third party production reduces operating expenses.

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Operating costs (\$000)				
Field expenses	7,395	6,525	28,960	27,487
Processing and gathering income	(2,614)	(2,528)	(10,545)	(10,751)
Total operating costs	4,781	3,997	18,415	16,736
\$/mcf	0.31	0.38	0.35	0.41
\$/boe	1.84	2.27	2.13	2.48
Transportation	2,157	1,172	6,954	4,541
\$/mcf	0.14	0.11	0.13	0.11
\$/boe	0.83	0.67	0.80	0.67

Operating costs were \$4.8 million in the fourth quarter of 2010 compared to \$4.0 million for the equivalent period in 2009. On a unit-of-production basis, operating costs averaged \$0.31/mcfe in the fourth quarter of 2010 compared to \$0.38/mcfe for

the equivalent period in 2009. Operating costs for the year averaged \$0.35/mcfe in 2010 compared to \$0.41/mcfe in 2009. Transportation expense increased on a per mcfe basis due to an increase in pipeline tariffs effective January 1, 2010.

### General and Administrative Expenses

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
G&A expenses (\$000)	3,819	2,445	11,063	9,797
Overhead recoveries	(1,735)	(813)	(4,545)	(2,505)
Net G&A expenses	2,084	1,632	6,518	7,292
\$/mcfe	0.13	0.15	0.12	0.18
\$/boe	0.80	0.93	0.75	1.08

For the fourth quarter, general and administrative expenses before overhead recoveries were up 56% over the same quarter of 2009 and 13% on an annual basis due primarily to costs of \$0.7 million incurred in 2010 associated with the 2010 Arrangement. Capital overhead recoveries increased 113% for the fourth quarter from \$0.8 million to \$1.7 million and 81% on an annual basis as a result of the increased capital program in 2010.

### Interest Expense

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Interest expense (\$000)	5,540	4,608	20,057	16,527
\$/mcfe	0.36	0.44	0.39	0.41
\$/boe	2.14	2.62	2.32	2.45
Average interest rate	5.0%	4.2%	4.6%	3.5%

Fourth quarter 2010 interest expense was \$5.5 million or \$0.36/mcfe compared to \$4.6 million or \$0.44/mcfe for the equivalent period in 2009. 2010 interest expense was \$20.1 million or \$0.39/mcfe compared to \$16.5 million or \$0.41/mcfe a year earlier due to an increase in interest rates.

### Netbacks

(\$/mcfe)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Gross Sale Price	4.79	5.70	5.29	5.19
Hedging gain	0.91	1.14	0.85	1.56
Net Sale Price	5.70	6.84	6.14	6.75
Less: Royalties	0.50	0.71	0.64	0.63
Operating costs	0.31	0.38	0.35	0.41
Transportation	0.14	0.11	0.13	0.11
Field netback	4.75	5.64	5.02	5.60
General and administrative	0.13	0.15	0.12	0.18
Interest on long-term debt	0.36	0.44	0.39	0.41
Cash netback (\$/mcfe)	4.26	5.05	4.51	5.01
Cash netback (\$/boe)	25.58	30.31	27.03	30.06

Netbacks are a non-GAAP measure that represents the profit margin associated with the production and sale of petroleum and natural gas. Netbacks are per unit of production measures used to assess the Company's performance and efficiency. The primary factors that produce Peyto's strong netbacks and high margins are a low cost structure and the high heat content of its natural gas that results in higher commodity prices.

### Depletion, Depreciation and Accretion

The 2010 provision for depletion, depreciation and accretion totaled \$94.2 million compared to \$73.3 million in 2009. On a unit-of-production basis, depletion, depreciation and accretion costs for 2010 averaged \$1.81/mcfe; the same as in 2009.

### Income Taxes

The current provision for future income tax recovery is \$15.8 million (2009 – \$31.4 million). Resource pools are generated from the capital program, which are available to offset current and future income tax liabilities. On December 31, 2010, the

Company converted from a publicly traded income trust to a publicly traded corporation by way of a plan of arrangement. As a result, for the year ended December 31, 2010, the Company's future income tax recovery was calculated on the basis of it being a corporation. For the year ended December 31, 2009, the Company's future income tax recovery was calculated on the basis of it being a publicly traded income trust in accordance with legislation applicable to certain income trusts. This recovery is attributable to the following items: i) distribution of taxable income of the Trust in excess of net income, decreasing the required tax pool claims, ii) recognition of the value of certain tax assets not previously recognized as they could not be used under the trust structure, and iii) reduction in corporate income tax rates.

Canada Revenue Agency ("CRA") conducted an audit of Peyto's restructuring costs incurred in the 2003 trust conversion. On September 25, 2008, the CRA reassessed on the basis that \$41 million of these costs were not deductible and treated them as an eligible capital amount. Peyto filed a notice of objection and the CRA confirmed the reassessment. Examinations for discovery have been completed. A trial date has not been set. The Tax Court of Canada has agreed to both parties' request to hold Peyto's appeal in abeyance pending a decision of the Federal Court of Appeal in another taxpayer's appeal. The other appeal raises issues that are similar in principle to those raised in Peyto's appeal.

## MARKETING

### Commodity Price Risk Management

The Company is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. The Company enters into these forward contracts with well established counterparties for the purpose of protecting a portion of its future revenues from the volatility of oil and natural gas prices. In order to minimize counterparty risk, these marketing contracts are executed with financial institutions that are members of Peyto's loan syndicate. During 2010, a realized hedging gain of \$44.3 million was recorded as compared to \$63.0 million in 2009. A summary of contracts outstanding in respect of the hedging activities are as follows:

<b>Natural Gas Period Hedged</b>	<b>Type</b>	<b>Daily Volume</b>	<b>Price (CAD)</b>
November 1, 2009 to March 31, 2011	Fixed Price	5,000 GJ	\$6.20/GJ
November 1, 2009 to March 31, 2011	Fixed price	5,000 GJ	\$5.81/GJ
April 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$5.28/GJ
April 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$5.29/GJ
April 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$5.555/GJ
April 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$5.70/GJ
April 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$4.55/GJ
April 1, 2010 to March 31, 2012	Fixed Price	5,000 GJ	\$5.67/GJ
April 1, 2010 to March 31, 2012	Fixed Price	5,000 GJ	\$5.82/GJ
November 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$8.91/GJ
November 1, 2010 to March 31, 2011	Fixed Price	5,000 GJ	\$9.15/GJ
November 1, 2010 to March 31, 2012	Fixed Price	5,000 GJ	\$4.10/GJ
April 1, 2011 to October 31, 2011	Fixed Price	5,000 GJ	\$3.50/GJ
April 1, 2011 to March 31, 2012	Fixed Price	5,000 GJ	\$6.20/GJ
April 1, 2011 to March 31, 2012	Fixed Price	5,000 GJ	\$5.00/GJ
April 1, 2011 to March 31, 2012	Fixed Price	5,000 GJ	\$5.12/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	\$4.05/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	\$4.15/GJ
November 1, 2011 to March 31, 2012	Fixed Price	5,000 GJ	\$4.50/GJ

As at December 31, 2010, the Trust had committed to the future sale of 24,010,000 gigajoules (GJ) of natural gas at an average price of \$5.07 per GJ or \$5.93 per mcf. Had these contracts been closed on December 31, 2010, the Trust would have realized a gain in the amount of \$27.9 million.

Subsequent to December 31, 2010 the Trust entered into the following contract:

<b>Natural Gas Period Hedged</b>	<b>Type</b>	<b>Daily Volume</b>	<b>Price (CAD)</b>
April 1, 2011 to October 31, 2011	Fixed Price	5,000 GJ	\$3.80/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	\$4.10/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	\$4.00/GJ

### Commodity Price Sensitivity

Peyto's earnings are largely determined by commodity prices for crude oil and natural gas including the US/Canadian dollar exchange rate. Volatility in these oil and gas prices can cause fluctuations in Peyto's earnings over which the Company has no control. Low operating costs and a long reserve life reduce Peyto's sensitivity to changes in commodity prices.

### Currency Risk Management

The Company is exposed to fluctuations in the Canadian/US dollar exchange ratio since commodities are effectively priced in US dollars and converted to Canadian dollars. In the short term, this risk is mitigated indirectly as a result of a commodity hedging strategy that is conducted in a Canadian dollar currency. Over the long term, the Canadian dollar tends to rise as commodity prices rise. There is a similar correlation between oil and gas prices. Currently Peyto has not entered into any agreements to further manage its currency risks.

### Interest Rate Risk Management

The Company is exposed to interest rate risk in relation to interest expense on its revolving demand facility. Currently there are no agreements to manage this risk. At December 31, 2010, the increase or decrease in earnings for each 100 bps (1%) change in interest rate paid on the outstanding revolving demand loan amounts to approximately \$1.0 million per quarter or \$4.2 million per annum. Average debt outstanding for the fourth quarter of 2010 was \$438.6 million.

## LIQUIDITY AND CAPITAL RESOURCES

Funds from operations is reconciled to cash flows from operating activities below:

(\$000)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Cash flows from operating activities	<b>65,545</b>	46,567	<b>222,532</b>	198,688
Change in non-cash working capital	<b>(21,594)</b>	389	<b>(22,297)</b>	(4,111)
Change in provision for (recovery of) performance based compensation	<b>(7,456)</b>	1,266	<b>3,978</b>	3,042
Market and reserve value performance based compensation	<b>29,864</b>	5,080	<b>29,864</b>	5,080
Funds from operations	<b>66,359</b>	53,302	<b>234,077</b>	202,699
Funds from operations per share	<b>0.53</b>	0.46	<b>1.94</b>	1.83

For the fourth quarter ended December 31, 2010, funds from operations totaled \$66.4 million or \$0.53 per share, as compared to \$53.3 million, or \$0.46 per share during the same quarter in 2009. Funds from operation for the year was up 13% to \$234.1 million. Peyto's policy is to balance dividends to shareholders and funding for a capital program with cash flow and available bank lines. Earnings and cash flow are sensitive to changes in commodity prices, exchange rates and other factors that are beyond Peyto's control. Current volatility in commodity prices creates uncertainty as to the funds from operations and capital expenditure budget. Accordingly, results are assessed throughout the year and operational plans revised as necessary to reflect the most current information.

Revenues will be impacted by drilling success and production volumes as well as external factors such as the market prices for commodities and the exchange rate of the Canadian dollar relative to the US dollar.

### Bank Debt

Peyto has a syndicated \$625 million extendible revolving credit facility with a stated term date of April 30, 2011. The facility is made up of a \$20 million working capital sub-tranche and a \$605 million production line. The facilities are available on a revolving basis for a period of at least 364 days and upon the term out date may be extended for a further 364 day period at the request of Peyto, subject to approval by the lenders. In the event that the revolving period is not extended, the facility is available on a non-revolving basis for a one year term, at the end of which time the facility would be due and payable. The loan has therefore been classified as long-term on the balance sheet. The average borrowing rate for the three months ended December 31, 2010 was 5.0% (2009 – 4.2%). Outstanding amounts on this facility will bear interest at rates determined by Peyto's debt to cash flow ratio that range from prime plus 1.25% to prime plus 2.75% for debt to earnings

before interest, taxes, depreciation, depletion and amortization (EBITDA) ratios ranging from less than 1:1 to greater than 2.5:1. A General Security Agreement with a floating charge on land registered in Alberta is held as collateral by the bank.

At December 31, 2010, \$355 million was drawn under the facility. Working capital liquidity is maintained by drawing from and repaying the unutilized credit facility as needed. At December 31, 2010, the working capital deficit was \$30.3 million (including a non-cash current asset for an unrealized mark to market future hedging gain of \$25.2 million).

Peyto believes funds generated from operations, together with borrowings under the credit facility will be sufficient to maintain dividends, finance current operations, and fund the planned capital expenditure program of \$300 to \$325 million for 2011. The total amount of capital invested in 2011 will be driven by the number and quality of projects generated. Capital will only be invested if it meets the long term objectives of the Company. The majority of the capital program will involve drilling, completion and tie-in of lower risk development gas wells. Peyto's rapidly scaleable business model has the flexibility to match planned capital expenditures to actual cash flow.

### Net Debt

"Net debt" is a non-GAAP measure that is the sum of long-term debt and working capital excluding the current financial derivative instruments and current provision for future performance based compensation. It is used by management to analyze the financial position and leverage of the Company. Net debt is reconciled below to long-term debt which is the most directly comparable GAAP measure:

(\$000)	As at December 31, 2010	As at December 31, 2009
Long-term debt	355,000	435,000
Current liabilities	134,984	71,681
Current assets	(104,720)	(73,503)
Financial derivative instruments	25,247	8,683
Provision for future performance based compensation	(5,567)	(2,001)
Net debt	404,944	439,860

### Capital

**Authorized:** Unlimited number of voting common shares

### Issued and Outstanding

Trust Units (no par value) (\$000)	Number of Units	Amount
<b>Balance, December 31, 2008</b>	<b>105,920,194</b>	<b>410,233</b>
Trust units issued	9,000,000	94,500
Trust units issuance costs (net of tax)	-	(4,326)
<b>Balance, December 31, 2009</b>	<b>114,920,194</b>	<b>500,407</b>
Trust units issued by private placement	196,420	2,728
Trust units issued	13,880,500	218,704
Trust units issuance costs (net of tax)	-	(8,206)
Trust units issued pursuant to DRIP	746,079	10,558
Trust units issued pursuant to OTUPP	2,132,189	30,302
Exchange for common shares pursuant to the Arrangement	(131,875,382)	(754,493)
<b>Balance, December 31, 2010</b>	<b>-</b>	<b>-</b>

### Issued and Outstanding

Common shares (no par value) (\$000)	Number of Units	Amount
Issue common shares for trust units pursuant to the Arrangement	131,875,382	754,493
<b>Balance, December 31, 2010</b>	<b>131,875,382</b>	<b>754,493</b>

On June 26, 2009, Peyto closed an offering of 9,000,000 trust units at a price of \$10.50 per trust unit, receiving net proceeds of \$90.2 million (net of issuance costs).

On December 31, 2009 the Trust completed a private placement of 196,420 trust units to employees and consultants for net proceeds of \$2.7 million (\$13.89 per unit). These trust units were issued on January 6, 2010.

Peyto reinstated its amended distribution reinvestment and optional trust unit purchase plan (the "Amended DRIP Plan") effective with the January 2010 distribution whereby eligible unitholders may elect to reinvest their monthly cash distributions in additional trust units at a 5 percent discount to market price. The DRIP plan incorporates an Optional Trust Unit Purchase Plan ("OTUPP") which provides unitholders enrolled in the DRIP with the opportunity to purchase additional trust units from treasury using the same pricing as the DRIP.

On April 27, 2010, Peyto closed an offering of 5,566,000 trust units at a price of \$13.45 per trust unit, receiving net proceeds of \$71.7 million (net of issuance costs).

On November 30, 2010, Peyto closed an offering of 8,314,500 trust units at a price of \$17.30 per trust unit, receiving net proceeds of \$138.8 million (net of issuance costs).

On December 31, 2010, Peyto converted all outstanding trust units into common shares on a one share per trust unit basis. At December 31, 2010 there were 131,875,382 shares outstanding. The DRIP and the OTUPP plans were cancelled December 31, 2010.

### Shares to be Issued

On December 31, 2010 Peyto completed a private placement of 655,581 common shares to employees and consultants for net proceeds of \$12.4 million (\$18.95 per unit). These shares were issued on January 6, 2011.

Subsequent to December 31, 2010, 279,723 common shares (113,527 pursuant to the DRIP and 166,196 pursuant to the OTUPP) were issued for net proceeds of \$4.9 million. Subsequent to the issuance of these shares, 132,810,686 common shares were outstanding.

### Performance Based Compensation

The Company awards performance based compensation to employees and key consultants annually. The performance based compensation is comprised of market and reserve value based components.

The reserve value based component is 4% of the incremental increase in value, if any, as adjusted to reflect changes in debt, equity and dividends, of proved producing reserves calculated using a constant price at December 31 of the current year and a discount rate of 8%. This methodology can generate interim results which vary significantly from the final compensation paid. Compensation expense of \$8.6 million was recorded for the year ended December 31, 2010.

(\$millions except share values)	2010	2009	Change
Net present value of proved producing reserves @ 8% based on constant InSite 2011 price forecast	1,254.0	1,178.0	
Net debt before performance based compensation	(392.4)	(439.9)	
2010 distributions, G&A and interest		(201.8)	
Net value	861.6	536.3	
Shares/units outstanding	131.875	115.117	
Net value per unit	6.532	4.658	<b>1.874</b>
Units outstanding at beginning of year			<b>115.117</b>
Equity adjusted increase in value			<b>215.7</b>
<b>2010 reserve value based compensation @ 4%</b>			<b>8.6</b>

Under the market based component, rights vesting over three years are allocated to employees and key consultants. The number of rights outstanding at any time is not to exceed 6% of the total number of common shares outstanding. At December 31 of each year, all vested rights are automatically cancelled and, if applicable, paid out in cash. Compensation is calculated as the number of vested rights multiplied by the total of the market appreciation (over the price at the date of grant) and associated dividends of a share for that period. The 2010 market based component was based on i) 1.5 million vested rights at an average grant price of \$16.45, average cumulative distributions of \$4.67, ii) 0.5 million vested rights at an average grant price of \$9.53, average cumulative distributions of \$2.91 and a five day weighted average closing price of \$18.95 and iii) 0.7 million vested rights at an average grant price of \$13.49, average cumulative distributions of \$1.44 and a ten day weighted average price of \$18.83.

The total amount expensed under these plans was as follows:

(\$000)	2010	2009
Market based compensation	21,236	4,540
Reserve value based compensation	8,628	540
<b>Total</b>	<b>29,864</b>	<b>5,080</b>

For the future market based component, compensation costs for the year ended December 31, 2010 were \$4.0 million, which related to 0.5 million non-vested rights with an average grant price of \$9.56 and 1.3 million non-vested rights with an average grant price of \$13.49. The cumulative provision as at December 31, 2010 was \$7.0 million.

### Capital Expenditures

Net capital expenditures for the fourth quarter of 2010 totaled \$110.6 million. Exploration and development related activity net of drilling royalty credits represented \$82.6 million (75% of total), while expenditures on facilities, gathering systems and equipment totaled \$14.8 million (13% of total) and land, seismic and acquisitions totaled \$13.2 million (12% of total). Capital expenditures of \$261.5 million for 2010 were 259% higher than 2009 capital expenditures. The following table summarizes capital expenditures for the year:

(\$000)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Land	8,049	1,150	12,600	4,115
Seismic	92	644	224	1,470
Drilling – Exploratory & Development	82,561	27,449	205,567	66,926
Production Equipment, Facilities & Pipelines	14,766	4,993	49,100	11,417
Acquisitions	5,024	-	5,724	-
Drilling Royalty Credit	69	(7,942)	(11,731)	(11,342)
Office Equipment	-	13	-	153
<b>Total Capital Expenditures</b>	<b>110,561</b>	<b>26,307</b>	<b>261,484</b>	<b>72,739</b>

### Distributions

	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Funds from operations (\$000)	66,359	53,302	234,077	202,699
Total distributions (\$000)	46,299	41,371	175,268	163,263
Total distributions per unit (\$)	0.36	0.36	1.44	1.47
Payout ratio (%)	70	78	75	81
Total cash distributions (net of DRIP) (\$000)	40,900	41,371	162,736	163,263
Payout ratio (net of DRIP) (%)	62	78	70	81

Peyto's policy is to balance dividends to shareholders and funding for a capital program with cash flow and available bank lines. The Board of Directors is prepared to adjust the payout ratio levels (dividends declared divided by funds from operations) to achieve the desired dividends while maintaining an appropriate capital structure.

### Retained Earnings and Distributions

(\$000)	Three Months ended Dec. 31		Twelve Months ended Dec. 31	
	2010	2009	2010	2009
Opening retained earnings (before distributions)	1,166,347	1,039,174	1,072,209	919,435
Earnings for the period	27,700	33,035	121,838	152,774
Total retained earnings (before distributions)	1,194,047	1,072,209	1,194,047	1,072,209
Total accumulated distributions	(1,147,728)	(972,460)	(1,147,728)	(972,460)
<b>Retained earnings (after distributions)</b>	<b>46,319</b>	<b>99,749</b>	<b>46,319</b>	<b>99,749</b>

Since inception, Peyto has accumulated earnings of \$1.2 billion and distributed \$1.1 billion to unitholders while a trust.

### Taxation of Distributions and Dividends

Distributions comprise a return of capital portion (tax deferred) and a return on capital portion (taxable). The return of capital component reduces the cost basis of the trust units held. Effective January 1, 2011, Peyto will pay dividends to its shareholders. Dividends taxed differently than distributions of the Trust in that dividends do not comprise a return of capital and thus are fully taxable.

For 2010, Peyto paid distributions to unitholders in the amount of \$175.3 million (2009 - \$163.3 million) in accordance with the following schedule:

<b>Production Period</b>	<b>Record Date</b>	<b>Distribution Date</b>	<b>Per Unit <sup>(1)</sup></b>
January 2010	January 31, 2010	February 15, 2010	\$0.12
February 2010	February 28, 2010	March 15, 2010	\$0.12
March 2010	March 31, 2010	April 15, 2010	\$0.12
April 2010	April 30, 2010	May 14, 2010	\$0.12
May 2010	May 31, 2010	June 15, 2010	\$0.12
June 2010	June 30, 2010	July 15, 2010	\$0.12
July 2010	July 31, 2010	August 13, 2010	\$0.12
August 2010	August 31, 2010	September 15, 2010	\$0.12
September 2010	September 30, 2010	October 15, 2010	\$0.12
October 2010	October 31, 2010	November 15, 2010	\$0.12
November 2010	November 30, 2010	December 15, 2010	\$0.12
December 2010	December 31, 2010	January 14, 2011	\$0.12

<sup>(1)</sup> Distributions per trust unit reflect the sum of the per trust unit amounts declared monthly to unitholders.

### Contractual Obligations

The Company is committed to payments under operating leases for office space as follows:

<b>(\$000)</b>	<b>December 31, 2010</b>
2011	1,043
2012	1,043
2013	1,043
2014	1,043
	<b>4,172</b>

### RELATED PARTY TRANSACTIONS

An officer and director of the Company is a partner of a law firm that provides legal services to the Company. The fees charged are based on standard rates and time spent on matters pertaining to the Company and its subsidiaries. For the year ended December 31, 2010, legal fees totaled \$1.4 million (2009 - \$0.6 million). As at December 31, 2010, an amount due to this firm of \$1.3 million was included in accounts payable (2009 - \$0.5 million)

During the year ended December 31, 2010, a private company controlled by a director of the Company was paid \$10,000 (2009 - \$nil) for consulting services. The transaction with the related party occurred within normal course of business and has been measured at its exchange amount which is the amount of consideration established and agreed to with the related party.

### RISK MANAGEMENT

Investors who purchase shares are participating in the total returns from a portfolio of western Canadian natural gas producing properties. As such, the total returns earned by investors and the value of the shares are subject to numerous risks inherent in the oil and natural gas industry.

Expected returns depend largely on the volume of petroleum and natural gas production and the price received for such production, along with the associated costs. The price received for oil depends on a number of factors, including West Texas Intermediate oil prices, Canadian/US currency exchange rates, quality differentials and Edmonton par oil prices. The price received for natural gas production is primarily dependent on current Alberta market prices. Peyto's marketing strategy is

designed to smooth out short term fluctuations in the price of natural gas through future sales. It is meant to be methodical and consistent and to avoid speculation.

Although Peyto's focus is on internally generated drilling programs, any acquisition of oil and natural gas assets depends on an assessment of value at the time of acquisition. Incorrect assessments of value can adversely affect dividends to shareholders and the value of the shares. Peyto employs experienced staff and performs appropriate levels of due diligence on the analysis of acquisition targets, including a detailed examination of reserve reports; if appropriate, re-engineering of reserves for a large portion of the properties to ensure the results are consistent; site examinations of facilities for environmental liabilities; detailed examination of balance sheet accounts; review of contracts; review of prior year tax returns and modeling of the acquisition to attempt to ensure accretive results to the shareholders.

Inherent in development of the existing oil and gas reserves are the risks, among others, of drilling dry holes, encountering production or drilling difficulties or experiencing high decline rates in producing wells. To minimize these risks, Peyto employs experienced staff to evaluate and operate wells and utilize appropriate technology in operations. In addition, prudent work practices and procedures, safety programs and risk management principles, including insurance coverage protect the Company against certain potential losses.

The value of Peyto's shares is based on among other things, the underlying value of the oil and natural gas reserves. Geological and operational risks can affect the quantity and quality of reserves and the cost of ultimately recovering those reserves. Lower oil and gas prices increase the risk of write-downs on oil and gas property investments. In order to mitigate this risk, proven and probable oil and gas reserves are evaluated each year by a firm of independent reservoir engineers. The reserves committee of the Board of Directors reviews and approves the reserve report.

Access to markets may be restricted at times by pipeline or processing capacity. These risks are minimized by controlling as much of the processing and transportation activities as possible and ensuring transportation and processing contracts are in place with reliable cost efficient counterparties.

The petroleum and natural gas industry is subject to extensive controls, regulatory policies and income and resource taxes imposed by various levels of government. These regulations, controls and taxation policies are amended from time to time. Peyto has no control over the level of government intervention or taxation in the petroleum and natural gas industry. The Company operates in such a manner to ensure, to the best of its knowledge that it is in compliance with all applicable regulations and are able to respond to changes as they occur.

The petroleum and natural gas industry is subject to both environmental regulations and an increased environmental awareness. Peyto has reviewed its environmental risks and is, to the best of its knowledge, in compliance with the appropriate environmental legislation and have determined that there is no current material impact on operations. Peyto employs environmentally responsible business operations, and looks to both Alberta provincial authorities and Canada's federal authorities for direction and regulation regarding environmental and climate change legislation.

Peyto is subject to financial market risk. In order to maintain substantial rates of growth, the Company must continue reinvesting in, drilling for or acquiring petroleum and natural gas. The capital expenditure program is funded primarily through funds from operations, debt and, if appropriate, equity.

## **CONTROLS AND PROCEDURES**

### **Disclosure Controls and Procedures**

The Company's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that: (i) material information relating to the Company is made known to the Company's Chief Executive Officer and Chief Financial Officer by others, particularly during the period in which the annual and interim filings are being prepared; and (ii) information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time period specified in securities legislation. Such officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of the Company's disclosure controls and procedures at the year end of the Company and have concluded that the Company's disclosure controls and procedures are effective at the financial period end of the Company for the foregoing purposes.

### **Internal Control over Financial Reporting**

The Company's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, internal control over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes in accordance with the Canadian GAAP. Such officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of the Company's internal control over financial reporting at the financial period end of the Company and concluded that the Company's internal control over financial reporting is effective, at the financial period end of the Company, for the foregoing purpose.

The Company is required to disclose herein any change in the Company's internal control over financial reporting that occurred during the period ended December 31, 2010 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. No material changes in the Company's internal control over financial reporting were identified during such period that has materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

It should be noted that a control system, including the Company's disclosure and internal controls and procedures, no matter how well conceived, can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

### **CRITICAL ACCOUNTING ESTIMATES**

#### **Reserve Estimates**

Estimates of oil and natural gas reserves, by necessity, are projections based on geologic and engineering data, and there are uncertainties inherent to the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is an analytical process of estimating underground accumulations of oil and natural gas that can be difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Estimates of economically recoverable oil and natural gas reserves and future net cash flows necessarily depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effects of regulations by governmental agencies and assumptions governing future oil and natural gas prices, future royalties and operating costs, development costs and workover and remedial costs, all of which may in fact vary considerably from actual results. For these reasons, estimates of the economically recoverable quantities of oil and natural gas attributable to any particular group of properties, classifications of such reserves based on risk recovery, and estimates of the future net cash flows expected therefrom may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of the Company's oil and natural gas properties and the rate of depletion of the oil and natural gas properties as well as the calculation of the reserve value based compensation. Actual production, revenues and expenditures with respect to the Company's reserves will likely vary from estimates, and such variances may be material.

The Company's estimated quantities of proved and probable reserves at December 31, 2010 were audited by independent petroleum engineers InSite Petroleum Consultants Ltd. InSite has been evaluating reserves in this area and for Peyto for 12 consecutive years.

#### **Depletion and Depreciation Estimate**

The full cost method of accounting for petroleum and natural gas operations is followed whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, geological and geophysical costs, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells and overhead charges directly related to acquisition, exploration and development activities.

All costs of exploring for and developing petroleum and natural gas reserves, together with the costs of production equipment, are depleted and depreciated on the unit-of-production method based on estimated gross proven reserves. Petroleum and natural gas reserves and production are converted into equivalent units based upon estimated relative energy content (6 mcf to 1 barrel of oil).

Costs of acquiring unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

### **Full Cost Accounting Ceiling Test**

The carrying value of property, plant and equipment is reviewed at least annually for impairment. Impairment occurs when the carrying value of the assets is not recoverable by the future undiscounted cash flows. The ceiling test is based on estimates of proved reserves, production rates, estimated future petroleum and natural gas prices and costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material. Any impairment would be charged as additional depletion and depreciation expense.

### **Asset Retirement Obligation**

The asset retirement obligation is estimated based on existing laws, contracts or other policies. The fair value of the obligation is based on estimated future costs for abandonment and reclamation discounted at a credit adjusted risk free rate. The liability is adjusted each reporting period to reflect the passage of time and for revisions to the estimated future cash flows, with the accretion charged to earnings. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material.

### **Future Market Performance Based Compensation**

The provision for future market based compensation is estimated based on current market conditions, distribution history and on the assumption that all outstanding rights will be paid out according to the vesting schedule. The conditions at the time of vesting could vary significantly from the current conditions and may have a material effect on the calculation.

### **Reserve Value Performance Based Compensation**

The reserve value based compensation is calculated using the year end independent reserves evaluation which was completed in February 2011. A quarterly provision for the reserve value based compensation is calculated using estimated proved producing reserve additions adjusted for changes in debt, equity and dividends. Actual proved producing reserves additions and forecasted commodity prices could vary significantly from those estimated and may have a material effect on the calculation.

### **Income Taxes**

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded.

### **Accounting Changes**

Voluntary changes in accounting policy are made only if they result in financial statements which provide more reliable and relevant information. Accounting policy changes are applied retrospectively unless it is impractical to determine the period or cumulative impact of the change. Corrections of prior period errors are applied retrospectively and changes in accounting estimates are applied prospectively by including these changes in earnings. When the Company has not applied a new primary source of GAAP that has been issued, but is not effective, the Company will disclose the fact along with information relevant to assessing the possible impact that application of the new primary source of GAAP will have on the financial statements in the period of initial application.

## **CHANGES IN ACCOUNTING POLICIES**

### **International Financial Reporting Standards**

The Accounting Standards Board (AcSB) confirmed in February 2008 that International Financial Reporting Standards (IFRS) will replace Canadian GAAP for publicly accountable enterprises for financial periods beginning on or after January 1, 2011. Accordingly, the conversion from Canadian GAAP to IFRS will be applicable to the Trust's reporting for the first quarter of 2011 for which current and comparative information will be prepared under IFRS.

Peyto's project consists of three key phases:

- Scoping and diagnostic phase – this phase involves performing a high level impact analysis to identify areas that may be affected by the transition to IFRS. The results of this analysis are priority ranked according to complexity and the amount of time required assessing the impact of changes in transitioning to IFRS.
- Impact analysis and evaluation phase – during this phase, items identified in the diagnostic phase are addressed according to the priority levels assigned to them. This phase involves analysis of policy choices allowed under IFRS and their impact on the financial statements. In addition, certain potential differences are further investigated to

assess whether there may be a broader impact to Peyto's debt agreements, compensation arrangements or management reporting systems. The conclusion of the impact analysis and evaluation phase will require the Audit Committee of the Board of Directors to review all accounting policy choices as proposed by management.

- Financial implementation phase – involves implementation of all changes approved in the impact analysis phase and will include changes to information systems, business processes, modification of agreements and training of all staff who are impacted by the conversion.

Peyto has effectively completed all phases of its IFRS transition project and continues to review its draft IFRS financial statements and disclosures for completeness and quality assurance. The Audit Committee has reviewed all accounting policy choices proposed by management.

### **First Time Adoption of IFRS**

Most adjustments required on transition to IFRS will be made retrospectively against opening retained earnings as of the date of the first comparative balance sheet presented, based on standards applicable at that time. IFRS 1 provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions in certain areas to the general requirement for full retrospective application of IFRS. Management has analyzed the various accounting policy choices available under IFRS 1 and has implemented those determined to be the most appropriate for Peyto. The following IFRS 1 exemptions have been applied in the IFRS opening balance sheet:

- Property Plant and Equipment (“PP&E”) – IFRS 1 provides the option to retrospectively restate PP&E assets at their deemed cost being the Canadian GAAP net book value assigned to these assets as at the date of transition, January 1, 2010 rather than restating historical cost. Peyto has determined that it has one cash generating unit (CGU). The number of CGUs could change in the future as a result of significant acquisitions in other geographical areas or some other significant change in the nature of Peyto's operations.
- Business combinations – IFRS 1 provides an optional exemption to the requirement to retrospectively restate any business combinations recorded previously under Canadian GAAP. This exemption is not applicable as Peyto had no significant business combinations recorded previously under Canadian GAAP.

The following is a listing of key areas where accounting policies differ and where accounting policy decisions are necessary that will impact our reported financial position and results of operations:

- Re-classification of Exploration and Evaluation (“E&E”) expenditures from PP&E – Upon transition to IFRS, Peyto will reclassify any E&E expenditures that are currently included in PP&E on the Consolidated Balance Sheet. E&E assets will not be depleted and must be assessed for impairment when indicators suggest the possibility of impairment. Peyto does not have any significant E&E assets.
- Calculation of depletion expense for PP&E assets – Upon transition to IFRS, Peyto has the option to calculate depletion using a reserve base of proved reserves or both proved and probable reserves, as compared to the Canadian GAAP method of calculating depletion using only proved reserves. Peyto is currently assessing which method for calculating depletion will be used.
- Impairment of PP&E assets – Under IFRS, impairment of PP&E must be calculated at a more granular level than what is currently required under Canadian GAAP. Impairment calculations were performed at the cash generating unit level using total proved plus probable reserves. Impairment testing has been completed and no impairments were identified.
- Provisions for asset retirement costs – Under IFRS, Peyto is required to revalue its entire liability for asset retirement costs at each balance sheet date using a current liability-specific discount rate, which can generally be interpreted to mean the current risk-free rate of interest. Under Canadian GAAP, once recorded, asset retirement obligations are not adjusted for future changes in discount rates. As at January 1, 2010, Peyto's asset retirement obligations will increase \$8.3 million to \$18.8 million.
- Provision for future market based compensation - Peyto issues stock-based compensation awards which are valued at intrinsic value under Canadian GAAP. Upon the adoption of IFRS, this liability will be restated to fair value. At

January 1, 2010, Peyto's current liability for future performance based compensation will increase \$1.4 million to \$3.4 million while the long term liability will not change significantly.

- Deferred income taxes - Under IFRS, entities that are subject to different tax rates on distributed and undistributed income must calculate deferred taxes using the undistributed profits rate, which is the higher of the two. Canadian GAAP requires each individual tax rate to be applied to distributed and undistributed profits, respectively. As a result of using the undistributed profits rate, Peyto will record an increase in its deferred tax liability of \$71.5 million upon transition to IFRS, with the offset recorded as a reduction to retained earnings. Upon conversion to a corporation on December 31, 2010, tax rates used to calculate deferred taxes will be corporate income tax rates which will result in a deferred tax recovery of substantially all of this amount.

The following table summarizes Peyto's January 1, 2010 balance sheet under Canadian GAAP and the transitional entries required to present the opening balance sheet under IFRS. Peyto has not yet prepared a full set of annual financial statements under IFRS, therefore, amounts are unaudited.

(\$000)	Canadian GAAP	IFRS Adjustments	IFRS
Current assets	73,503	-	73,503
Long term assets	1,180,610	-	1,180,610
<b>Total assets</b>	<b>1,254,113</b>		<b>1,254,113</b>
Current liabilities	71,681	1,394	73,075
Long term liabilities	569,949	79,804	649,753
Equity	612,483	(81,198)	531,285
<b>Total liabilities and equity</b>	<b>1,254,113</b>		<b>1,254,113</b>

In addition to accounting policy differences, Peyto's transition to IFRS is expected to impact its internal controls over financial reporting, disclosure controls and procedures, information systems and certain of the Company's business activities as follows:

Internal controls over financial reporting ("ICFR") –Peyto is currently reviewing its ICFR documentation and assessing whether changes to controls are required to address accounting policy changes under IFRS. No material changes are expected as a result of the transition to IFRS.

Disclosure controls and procedures – Peyto has assessed the impact of transition to IFRS on its disclosure controls and procedures and has not identified any material changes required in its control environment. It is expected that there will be increased note disclosure around certain financial statement items than what is currently required under Canadian GAAP. Management is currently drafting its IFRS note disclosure in accordance with current IFRS standards and continues to monitor requirements put forth by the IASB in discussion papers and exposure drafts for future disclosure requirements. Throughout the transition process, Peyto has carefully considered its stakeholders' information requirements and will continue to ensure that adequate and timely information is provided to meet these needs.

Information systems – Peyto has assessed its systems capabilities and identified any changes required to support Canadian GAAP and IFRS reporting. Modifications have been made to track PP&E and E&E expenditures at the level required by IFRS. No significant modifications were required.

Business activities – Management has worked with its counterparties and lenders to ensure that any agreements that contain references to Canadian GAAP financial statements are modified to allow for IFRS statements. Based on the changes to Peyto's accounting policies, no issues are expected with the existing wording of debt covenants and related agreements as a result of the conversion to IFRS.

## **ADDITIONAL INFORMATION**

Additional information relating to Peyto Exploration & Development Corp. can be found on SEDAR at [www.sedar.com](http://www.sedar.com) and [www.peyto.com](http://www.peyto.com).

## Quarterly information

	2010				2009
	Q4	Q3	Q2	Q1	Q4
<b>Operations</b>					
Production					
Natural gas (mcf/d)	148,551	122,717	112,422	103,934	95,467
Oil & NGLs (bbl/d)	3,439	3,322	3,465	3,330	3,222
Barrels of oil equivalent (boe/d @ 6:1)	28,197	23,775	22,202	20,653	19,133
Thousand cubic feet equivalent (mcf/d @ 6:1)	169,184	142,651	133,211	123,916	114,798
Average product prices					
Natural gas (\$/mcf)	4.93	5.16	5.25	6.34	6.17
Oil & natural gas liquids (\$/bbl)	67.06	59.66	65.58	68.93	60.77
\$/MCFE					
Average sale price (\$/mcf)	5.70	5.83	6.14	7.17	6.84
Average royalties paid (\$/mcf)	0.50	0.52	0.81	0.82	0.71
Average operating expenses (\$/mcf)	0.31	0.34	0.38	0.41	0.38
Average transportation costs (\$/mcf)	0.14	0.14	0.13	0.13	0.11
Field netback (\$/mcf)	4.75	4.83	4.82	5.81	5.64
General & administrative expense (\$/mcf)	0.13	0.12	0.09	0.16	0.15
Interest expense (\$/mcf)	0.36	0.39	0.41	0.40	0.44
Cash netback (\$/mcf)	4.26	4.32	4.32	5.25	5.05
<b>Financial (\$000 except per share)</b>					
Revenue	88,633	76,450	74,370	79,974	72,218
Royalties	7,712	6,800	9,721	9,173	7,457
Funds from operations	66,359	56,743	52,415	58,559	53,302
Funds from operations per share	0.53	0.47	0.44	0.51	0.46
Total distributions	46,299	43,875	43,622	41,470	41,371
Total distributions per share	0.36	0.36	0.36	0.36	0.36
Payout ratio	70%	77%	83%	71%	78%
Earnings	27,700	32,567	24,696	36,874	33,035
Earnings per diluted share	0.22	0.27	0.21	0.32	0.28
Capital expenditures	110,561	64,123	37,439	49,361	26,307
Weighted average shares outstanding	125,726,450	121,765,712	119,419,799	115,153,667	114,920,194