# PEYTO

## Exploration & Development Corp.

# 2001

*Annual Report*

PEYTO Exploration & Development Corp. is an oil and gas company with a track record of successful strategies, teamwork and action. We are proud of our achievements and pleased to present this annual report on operating and financial results for the fourth quarter and the full fiscal year 2001.

Peyto was founded in November 1998 as an exploration and development company focused on generating value per share by finding, developing and producing long term gas reserves in west central Alberta. Maintaining this focus, at year end over 95% of Peyto's assets were long term and located in the Edson/Sundance area of Alberta, Canada.

## Year End Review

Production for the year averaged 20.5 mmcf of natural gas and 785 barrels of oil and natural gas liquids per day. Production gains and lower operating costs combined to increase cash flow from operations from $12.5 million in 2000 to $35.5 million in 2001. Earnings increased from $5.9 million in 2000 to $17.5 million in 2001. Product prices averaged $5.81 per mcf for gas and $30.52 per barrel for oil and natural gas liquids. Operating costs decreased from $3.76 to $2.01 per barrel of oil equivalent ("boe", natural gas converted on a 10:1 basis throughout). As a result of the lower average product prices, the field netback realized was down 9% to $37.79 per boe. Comparative operational and financial data is presented in the following table.

| | 3 Months Ended Dec. 31 | | % | 12 Months Ended Dec. 31 | | % |
|---|---|---|---|---|---|---|
| | **2001** | 2000 | Change | **2001** | 2000 | Change |
| **Operations** | | | | | | |
| Production | | | | | | |
| Oil & NGLs (bbl/d) | **1,222** | 348 | *251* | **785** | 248 | *217* |
| Natural gas (mcf/d) | **30,175** | 9,590 | *215* | **20,501** | 6,822 | *201* |
| Barrels of oil equivalent (boe/d @ 10:1) | **4,240** | 1,307 | *224* | **2,835** | 930 | *205* |
| Average product prices | | | | | | |
| Oil & NGLs ($/bbl) | **23.84** | 43.92 | *(46)* | **30.52** | 39.92 | *(24)* |
| Natural gas ($/mcf) | **4.32** | 9.16 | *(53)* | **5.81** | 6.56 | *(11)* |
| Average operating expenses ($/boe) | **2.31** | 3.81 | *(39)* | **2.01** | 3.76 | *(47)* |
| Field Netback ($/boe) | **29.08** | 56.63 | *(49)* | **37.79** | 41.41 | *(9)* |
| **Financial ($000)** | | | | | | |
| Revenue | **14,679** | 9,486 | *55* | **52,247** | 19,954 | *162* |
| Royalties (net of ARTC) | **2,437** | 2,219 | *10* | **11,066** | 4,614 | *140* |
| Funds from operations | **9,546** | 5,947 | *61* | **35,502** | 12,458 | *185* |
| Net earnings (loss) | **4,969** | 2,947 | *69* | **17,524** | 5,906 | *197* |
| Capital expenditures | **22,029** | 19,821 | *11* | **79,955** | 43,586 | *83* |
| **As at December 31** | | | | | | |
| Working capital deficiency ($000) | | | | **4,585** | 7,625 | *(40)* |
| Long term debt ($000) | | | | **58,945** | 13,200 | *347* |
| Common shares outstanding (000) | | | | **41,999** | 39,799 | *6* |
| Weighted average shares outstanding (000) | | | | **41,585** | 33,706 | *23* |
| **Per share data ($/share)** | | | | | | |
| Funds from operations | | | | | | |
| Basic | **0.23** | 0.17 | *35* | **0.85** | 0.37 | *130* |
| Diluted | **0.22** | 0.16 | *38* | **0.84** | 0.36 | *133* |
| Earnings | | | | | | |
| Basic | **0.12** | 0.09 | *33* | **0.42** | 0.18 | *133* |
| Diluted | **0.12** | 0.07 | *71* | **0.41** | 0.17 | *141* |

Proven developed reserves at year end increased to 18.8 million boes at a finding and development cost of $6.58 per boe. During 2001 we were successful in converting the majority of our 2000 probable reserves (ie. drilling locations) to the proven developed category. We have taken the proactive approach by not allocating any proven reserve designation to undeveloped property, and accordingly had no proven undeveloped reserves booked at year end 2000 or 2001. The percentage of proven producing reserves in the proven category increased year over year from 63% to 86%. Our company achieved an investment recycle ratio of 6:1 and a production replacement ratio of 17:1 for the proven developed reserves added during 2001. Proven developed reserves had a 12 year reserve life based on fourth quarter average production. Proven plus probable reserves increased 127% to 40.1 million boes at a finding and development cost of $3.40 per boe. The majority of the probable reserves booked at the end of 2001 were development gas locations in Sundance that we are currently drilling. The net present value of our proven plus probable additional petroleum and natural gas assets increased 58% from $289.2 million or $7.27 per share (discounted at 10%) in 2000 to $455.9 million or $10.85 per share in 2001. The following table summarizes the reserves and the discounted net present value of future cash flow before income tax, using variable pricing, at December 31, 2001.

| **Reserve Category** | **Gas (mmcf)** | **Oil & NGL (mstb)** | **BOE @ 10:1 (mstb)** | **Reserve Life Index (years)** | **NPV @ 10% ($000)** | **10% Cash Flow Index (years)** | **NPV @ 12% ($000)** | **12% Cash Flow Index (years)** |
|---|---|---|---|---|---|---|---|---|
| Total Proven Developed | 125,142 | 6,320 | 18,834 | 12 | 267,383 | 7 | 242,152 | 6 |
| Proven Undeveloped | - | - | - | - | - | - | - | - |
| Total Proven | 125,142 | 6,320 | 18,834 | 12 | 267,383 | 7 | 242,152 | 6 |
| Probable Additional | 143,459 | 6,882 | 21,228 | 14 | 188,523 | 5 | 160,803 | 5 |
| Proven + Probable Additional | 268,601 | 13,202 | 40,062 | 26 | 455,906 | 12 | 402,955 | 11 |

*Cash flow Index: discounted net present value divided by annualized fourth quarter 2001 cash flow*
*Note: Based on the Paddock Lindstrom & Associates report effective December 31, 2001*

Net capital expenditures for 2001 totaled $79.9 million. Exploration and development related activity represented $51.0 million (64% of total), while expenditures on facilities, gathering systems and equipment totaled $16.6 million (21%). The following table summarizes capital expenditures and finding and development (F&D) costs for the year.

| **Capital Expenditures** | | | **F&D Costs, $/BOE @ 10:1** | | |
|---|---|---|---|---|---|
| **Category** | **($000)** | **% of Total** | **Proven Developed ($/BOE)** | **Proven + Risked Probable ($/BOE)** | **Proven + Probable ($/BOE)** |
| Land | 2,750 | *3* | 0.23 | 0.15 | 0.12 |
| Seismic | 2,340 | *3* | 0.19 | 0.13 | 0.10 |
| Drilling – Exploratory & Development | 48,664 | *61* | 4.01 | 2.73 | 2.07 |
| Production Equipment, Facilities & Pipelines | 16,642 | *21* | 1.37 | 0.93 | 0.71 |
| Acquisitions & Dispositions | 9,513 | *12* | 0.78 | 0.53 | 0.40 |
| Office Equipment | 46 | *0* | 0.00 | 0.00 | 0.00 |
| **Total** | **79,955** | ***100*** | **6.58** | **4.47** | **3.40** |

**Fourth Quarter Review**

Production for the fourth quarter increased 224% to 4,240 boe per day from 1,307 boe per day during the same period in 2000. Our company produced 30.2 mmcf of natural gas and 1,222 barrels of oil and natural gas liquids per day. Cash flow and earnings increased to $9.5 million ($0.23 per share) and $4.9 million ($0.12 per share), respectively. Product prices averaged $4.32 per mcf of gas and $23.84 per barrel of oil and natural gas liquids with associated operating costs of $2.31 per boe. Due to lower commodity prices, the field netback was down 49% to $29.08 per boe. Capital spending totaled $22.0 million for the quarter.

We acquired the remaining partner interest in the Sundance gas plant and associated production of 210 boe/d for a total purchase price of $8,973,321. This strategic acquisition brings our ownership in the Sundance gas plant to 100%. Production at the Sundance plant was interrupted for two days during the quarter to allow for the expansion of the gathering and sales pipelines.

**Activity Update**

At this time, our production is approximately double the average daily rate for 2001 and is limited by our existing plant capacity at Sundance. In order to allow for significant production growth in 2002, work is now underway to expand the Sundance gas plant by 50 mmcf per day by June 2002. This fourth expansion in the first two years of the facility's life will increase the gas processing capacity to 98 mmcf per day. Currently we have three drilling rigs operating in the Sundance area. Six successful gas wells, all with a total depth greater than 2,200 meters, have now been drilled, cased and completed since year end. These wells are categorized as probable additional reserves in our 2001 reserve report. We plan to keep the three drilling rigs active in the Sundance area throughout the year.

**Outlook**

Capital expenditures for 2002 are expected to be between $70,000,000 and $100,000,000 and will be limited only by cash flow and available bank lines, not by opportunities. In recognition of some of the value added in 2001, our company's bank lines have recently been expanded to $80,000,000. The majority of the 2002 capital program will be used to drill, complete and tie-in low risk development gas wells adjacent to existing infrastructure in the Sundance area. Production growth in the first half of the year will be limited by plant capacity. The balance of the year is expected to be similar to the production growth realized in the second half of 2001.

Our team is focused on generating long term value. We have now completed our third consecutive year of successful exploration and development activity which is evidenced by superior results in all of the parameters that measure oil and gas investments. Shareholders are encouraged to assess for themselves the value of what they own by looking at the parameters that define the assets we have developed; cost structure, reserve life, net back and return on investment. We are driven by shareholder value and continue to have an abundance of investment ideas and opportunities in keeping with this commitment. Our company is defined by past growth which focused on value first, a present asset base with superior netbacks and long term, low risk, predictable reserves, and a future with a team that understands how to find, develop and maintain the highest quality assets.

We encourage you to visit Peyto's website at www.peyto.com for more information on our Company.

Don T. Gray, P.Eng.
President and Chief Executive Officer
March 4, 2002

*This report, or any part of it, may include comments that do not refer strictly to historical results or actions and may constitute forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Corporation or of the industry to be materially different from any results, performance or achievements expressed or implied by such forward-looking statements. Such risks, uncertainties and other factors include general and industry economic and business conditions which, among other things, affect the demand for the commodities produced by the Corporation, competitive factors and industry capacity, the availability of personnel to manage the Corporation and manage and deliver the commodities produced, the ability of the Corporation to finance and implement its business strategy, changes in, or the failure to comply with, government law and regulations (especially relating to health, safety and environment), weather and other such risks as may be identified in this report or in other published documents. Accordingly, there is no certainty that the Corporation's plans will be achieved.*

## Reserves Data

| As at December 31 | **2001** | 2000 | *% Change* |
|---|---|---|---|
| **Natural gas (millions of cubic feet)** | | | |
| Proven developed | **125,142** | 58,369 | *114* |
| Probable | **143,459** | 74,281 | *93* |
| Total | **268,601** | 132,650 | *102* |
| **Oil & natural gas liquids (thousands of barrels)** | | | |
| Proven developed | **6,320** | 1,907 | *231* |
| Probable | **6,882** | 2,433 | *183* |
| Total | **13,202** | 4,340 | *204* |
| **Barrels of oil equivalent @ 10:1 (thousands of barrels)** | | | |
| Proven developed | **18,834** | 7,744 | *143* |
| Probable | **21,228** | 9,861 | *115* |
| Total | **40,062** | 17,605 | *128* |

| **Net Present Value ($000)** | Discounted at | | | |
|---|---|---|---|---|
| | 0% | 10% | 12% | *NPV 12% % Change* |
| Proven Developed | 599,095 | 267,383 | 242,152 | *76* |
| Probable | 695,846 | 188,523 | 160,803 | *29* |
| Total | 1,294,940 | 455,906 | 402,955 | *54* |

*Note:*

*2001 Reserve & Net Present Value data based on Paddock Lindstrom & Associates Report Dated January 21, 2002.*

*2000 Reserve & Net Present Value data based on Paddock Lindstrom & Associates Report Dated February 27, 2001.*

**Management's discussion and analysis**

The following is a summary of the variations in Peyto's operating results for the periods indicated.

**Twelve Months Ended December 31, 2001 Compared to Twelve Months Ended December 31, 2000**

Gross revenues totaled $52.2 million for the year 2001, an increase of 162 percent from $19.9 million in 2000. This increase is a result of higher production volumes despite lower commodity prices. The price of natural gas averaged $5.81 per mcf for the year 2001 down 11 percent from $6.56 per mcf in 2000. Oil and natural gas liquids prices averaged $30.52 per barrel in 2001 down 24 percent from $39.92 per barrel in 2000.

Natural gas production for the year increased by 201 percent to 20.5 mmcf per day from 6.8 mmcf per day in 2000. Oil and natural gas liquids production increased by 217 percent to 785 bbl/d in 2001 from 248 bbl/d in 2000. Production for the year averaged 2,835 barrels of oil equivalent ("boe", natural gas converted on a 10:1 basis) per day up 205 percent from 930 boe per day for 2000.

2001 royalties, net of Alberta Royalty Tax Credit (ARTC), increased by 140 percent to $11.1 million from $4.6 million in 2000 due to higher gross revenues associated with increased production volumes. The 2001 average royalty rate, before ARTC, was 22 percent compared to 26 percent for 2000.

Due to increased production volumes, operating costs rose to $2.1 million in 2001 from $1.3 million in 2000. On a barrel of oil equivalent basis, operating costs declined by 47 percent to $2.01 per boe in 2001 from $3.76 per boe in 2000. Operating costs are comprised of field expenses and natural gas transportation costs net of income generated by the processing and gathering of joint venture gas. On a per boe basis, field expenses represent $1.87, transportation $1.10 and processing and gathering income a recovery of $0.96.

General and administrative expenses increased by 70 percent to $1,589,000 for 2001 from $932,000 in 2000. The Corporation does not capitalize general and administrative expenses. Operator overhead recoveries related to capital expenditures and well operations totaling $1.2 million have been netted from 2001 general and administrative expenses. On a boe basis, general and administrative expenses decreased by 44 percent to $1.54 per boe in 2001 from $2.74 per boe in 2000. This reduction was the result of the increase in production volumes while maintaining a similar level of staff. Fourth quarter G&A expenses included bonuses to employees and consultants totaling $873,500. The bonuses are awarded based on incremental cash flow per share achieved by the Corporation. Recipients were given the option to receive their bonus in the form of cash or flow-through shares of the Corporation at a price of $4.50 per share (25% premium to 10 day weighted average price) with 82 percent choosing to increase their stake in the Corporation by selecting the share option.

Financing charges for 2001 were $1.8 million up from $605,000 in 2000. The increase was due to higher debt levels associated with Peyto's 2001 capital expenditures totaling $79.9 million compared with $43.6 in 2000.

Depreciation, depletion and site restoration expenses were $6.5 million for 2001 compared to $1.9 million for 2000 as a direct result of Peyto's increased asset base and production volumes. On a per boe basis, the average depreciation, depletion and site restoration rate increased to $6.26 in 2001 from $5.45 in 2000.

The provision for future income tax increased to $11.5 million in 2001 from $4.7 million in 2000. The increase in the tax provision in 2001 is a direct result of Peyto's increased profitability due to significantly higher production volumes.

Funds from operations for 2001 were $35.5 million compared with $12.5 million in 2000. This 185 percent increase was the result of increased production volumes and lower operating costs on a per boe basis. On a per share basis, 2001 resulted in funds from operations of $0.85 per share versus $0.37 per share in 2000. Due to lower average commodity prices, Peyto's field netback for the period decreased from $41.41 per boe in 2000 to $37.79 per boe in 2001. Earnings for 2001 were $17.5 million or $0.42 per share compared with $5.9 million in 2000 or $0.18 per share.

**Twelve Months Ended December 31, 2000 Compared to Twelve Months Ended December 31, 1999**

During 2000 Peyto experienced significant growth and achieved major increases in revenue, production, cash flow and net income. Gross revenues for 2000 increased by 2,078 percent to $19.9 million from $0.9 million in 1999. Natural gas revenues rose by 2,701 percent to $16.3 million in 2000 from $0.6 million in 1999. Natural gas production for the year increased by 1,251 percent to 6.8 mmcf per day from 0.5 mmcf per day in 1999. The price for natural gas also rose significantly to $6.56 per mcf in 2000 up 108 percent from $3.16 per mcf in 1999. Revenues from oil and natural gas liquids increased by 1,041 percent in 2000 to $3.6 million from $0.3 million in 1999 primarily as a result of an increase in production of 945 percent to 930 bbl/d in 2000 from 89 bbl/d in 1999. The price received for oil and natural gas liquids was $39.92 per barrel in 2000 an increase of 79 percent from $22.32 per barrel in 1999.

In 2000, royalties, net of Alberta Royalty Tax Credit (ARTC), increased by 1,464 percent to $4.6 million from $0.3 million in 1999 due to higher gross revenues associated with increased production volumes. The average royalty rate, before ARTC, decreased to 25 percent in 2000 from 33 percent in 1999. This reduction was due to fewer encumbrances on Peyto's 2000 production.

Due to increased production volumes, operating costs rose to $1.3 million in 2000 from $0.2 million in 1999. On a barrel of oil equivalent basis ("boe", natural gas converted on a 10:1 basis), operating costs declined by 41 percent to $3.76 per boe in 2000 from $6.33 per boe in 1999. The decrease in operating costs was primarily the result of the Peyto operated processing plant coming onto production in April 2000 thereby eliminating the reliance on third party facilities.

Net general and administrative expenses increased by 148 percent to $0.9 million in 2000 from $0.4 million in 1999. This variance was primarily due to the increase in the overall size of operations of Peyto. On a boe basis, net general and administrative expenses decreased by 76 percent to $2.74 per boe in 2000 from $11.50 per boe in 1999. This reduction was the result of the significant increase in production volumes.

Financing charges for 2000 were $603,000 up from $13,000 in 1999. The increase was due to higher debt levels associated with Peyto's fiscal 2000 capital expenditure program of $43.6 million compared with $6.8 million in 1999.

Depreciation, depletion and site restoration expenses rose by 1,451% to $1.8 million in 2000 from $0.1 in 1999 as a direct result of Peyto's increased asset base and production volumes. On a per boe basis, the average depreciation, depletion and site restoration rate increased to $5.45 in 2000 from $3.66 in 1999 as a result of significant facilities, processing plant and pipeline expenditures incurred during 2000.

The provision for future income tax increased to $4.7 million in 2000 from a recovery of $5,000 in 1999. Due to the increased capital structure of Peyto, the Company became subject to Large Corporations Tax in 2000 and recorded capital taxes of $69,000. The increase in the tax provision in 2000 is a direct result of the increased profitability in Peyto due to significantly higher production volumes.

Cash flow for 2000 was $12.5 million compared with $23,000 in 1999. This 54,065% increase was the result of increased production volumes, higher commodity prices and lower operating costs. On a per share basis, 2000 resulted in cash flow of $0.37 per share versus $0.00 per share in 1999. Peyto's field netback improved significantly from $12.61 per boe in 1999 to $41.41 per boe in 2000. Net income in 2000 was $5.9 million or $0.18 per share compared with a loss of $91,000 in 1999 or $0.01 per share.

During the year, Peyto acquired all of the issued and outstanding common shares of Largo Petroleum Inc. This transaction was accounted for using the purchase method of accounting whereby assets acquired and liabilities assumed are recorded at fair values. The fair values of the net assets acquired are as follows:

| | 2000<br>$ |
|---|---|
| Assets acquired: | |
| Current assets, including cash of $543,148 | 861,145 |
| Property, plant and equipment | 1,184,063 |
| Due from shareholder | 125,000 |
| Current liabilities | (143,772) |
| Future site restoration costs | (45,309) |
| Fair value of net assets acquired | 1,981,127 |

**Liquidity and Capital Resources**

***Historic Review***

For the year ended December 31, 2001, the Corporation incurred net capital expenditures of $79.9 million (year ended December 31, 2000 - $43.6 million, year ended December 31, 1999 - $6.8 million, year ended December 31, 1998 - $0.6 million). Capital expenditures during 2001 were comprised of $51.0 million for exploration and development, $16.6 million for facilities, gathering systems and equipment and $12.3 million for acquisitions and land. At December 31, 2001, long term debt stood at $58.9 million and the Corporation had a working capital deficiency of $4.6 million resulting in a net debt to running cash flow ratio of 1.6:1.

**Outlook**

Peyto's 2002 capital expenditure program is budgeted to be between $70 million and $100 million and will be financed from available bank lines and the cash flow expected to be generated in 2002. In 2002, primarily all of Peyto's capital expenditures are discretionary focused on exploration, development and acquisition activity. The majority of these expenditures will be employed to drill, complete and tie-in low risk development gas wells adjacent to Peyto's existing infrastructure. Peyto has the flexibility to match planned capital expenditures to actual cash flow.

Peyto currently has a $80 million revolving demand loan facility that bears interest at prime and does not require any principal repayments in 2002. The Corporation settles sales receivables and trade payables in accordance with normal industry practices. Working capital liquidity is maintained through drawing and repaying the bank facilities.

**Business Risks**

All companies in the Canadian oil and natural gas industry are exposed to a number of business risks, some of which are beyond their control. These risks can be categorized as operational, financial and regulatory.

Operational risks include finding and developing oil and natural gas reserves on an economic basis, reservoir production performance, marketing production, hiring and retaining employees and accessing contract services on a cost effective basis. By employing a team of highly qualified staff, providing a compensation system that rewards above average performance and developing strong long-term relationships with contract service providers, these risks are mitigated. The Corporation maintains an insurance program consistent with industry practice to protect against destruction of assets, well blowouts, pollution and other business interruptions. We also maintain a geologically diverse, but geographically concentrated prospect inventory, undertake a large drilling program and use proven technology where appropriate to minimize the cost of finding and developing oil and natural gas reserves.

Financial risks include commodity prices, interest rates and the CDN/US exchange rate, all of which are largely beyond Peyto's control. Peyto's approach to management of these risks is to maintain a prudent level of debt, enter into certain fixed price, physical delivery, commodity-based contracts and use its strong financial position to fund exploration and development activities and acquisitions through fluctuations in these variables.

Peyto is also subject to various regulatory risks, many of which are beyond our control. We take a proactive approach with respect to environmental and safety matters such as maintaining an environmental and safety program whereby major facilities are regularly audited. An operational emergency response plan is in place and is in compliance with current environmental legislation.

**Business Prospects**

Oil and natural gas are commodities affected by global and regional events of an economic, political and environmental nature. Such events can impact the price of the commodity in that either security of supply or demand for the product is affected to varying degrees. The outlook for prices, in turn, has a major influence on levels of competition and capital investment in the business. In 2001 oil prices weakened and continued to be volatile and Peyto believes that oil prices will continue to fluctuate in 2002. Natural gas prices have dropped significantly with prospects looking more favourable in the coming months. Given this outlook, Peyto believes that capital investment and competition for land, acquisitions and services will decrease in 2002. Peyto anticipates relative stability with respect to exchange and interest rates, although Peyto has a low sensitivity to these matters.

**Quarterly information**

| | 2001 | | | | 2000 |
|---|---|---|---|---|---|
| | **Q4** | Q3 | Q2 | Q1 | Q4 |
| **Operations** | | | | | |
| Production | | | | | |
| Oil & NGLs (bbl/d) | **1,222** | 815 | 621 | 472 | 348 |
| Natural gas (mcf/d) | **30,175** | 22,431 | 15,502 | 13,694 | 9,590 |
| Barrels of oil equivalent (boe/d @ 10:1) | **4,240** | 3,058 | 2,171 | 1,842 | 1,307 |
| Average product prices | | | | | |
| Oil & NGLs ($/bbl) | **23.84** | 30.48 | 36.82 | 39.89 | 43.92 |
| Natural gas ($/mcf) | **4.32** | 4.32 | 7.02 | 10.30 | 9.16 |
| Average operating expenses ($/boe) | **2.31** | 1.38 | 2.29 | 2.06 | 3.81 |
| Field netback ($/boe) | **29.08** | 31.02 | 44.88 | 61.33 | 56.63 |
| **Financial ($000)** | | | | | |
| Revenue | **14,679** | 11,195 | 11,987 | 14,386 | 9,486 |
| Royalties (net of ARTC) | **2,437** | 2,082 | 2,667 | 3,880 | 2,219 |
| Funds from operations | **9,546** | 8,115 | 8,160 | 9,681 | 5,947 |
| Net earnings | **4,969** | 3,486 | 4,450 | 4,618 | 2,946 |
| Capital expenditures | **22,029** | 18,472 | 18,641 | 20,813 | 19,821 |
| Common shares outstanding (000) | **41,999** | 41,816 | 41,813 | 41,646 | 39,799 |
| **Per share data ($/share)** | | | | | |
| Funds from operations | | | | | |
| Basic | **0.23** | 0.19 | 0.20 | 0.24 | 0.17 |
| Diluted | **0.22** | 0.19 | 0.19 | 0.23 | 0.15 |
| Earnings | | | | | |
| Basic | **0.12** | 0.08 | 0.11 | 0.11 | 0.09 |
| Diluted | **0.12** | 0.08 | 0.10 | 0.11 | 0.07 |

# AUDITORS' REPORT

To the Shareholders of
**PEYTO Exploration & Development Corp.**

We have audited the balance sheets of **PEYTO Exploration & Development Corp.** as at December 31, 2001 and 2000 and the statements of earnings and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Calgary, Canada
February 8, 2002

Ernst & Young (signed) Chartered Accountants

**PEYTO Exploration & Development Corp.**

# BALANCE SHEETS

As at December 31,

| | 2001<br>$ | 2000<br>$ |
|---|---|---|
| **ASSETS** | | |
| **Current** | | |
| Cash | **1,220** | 53,027 |
| Accounts receivable | **8,245,973** | 11,620,928 |
| Prepaids | **526,291** | 247,053 |
| | **8,773,484** | 11,921,008 |
| **Property, plant and equipment *[notes 4, 5 and 7]*** | **121,700,469** | 48,136,090 |
| | **130,473,953** | 60,057,098 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities | **13,113,286** | 19,477,534 |
| Capital taxes payable | **245,360** | 68,804 |
| | **13,358,646** | 19,546,338 |
| **Long-term debt *[note 7]*** | **58,945,472** | 13,199,728 |
| **Future site restoration** | **202,322** | 117,845 |
| **Future income taxes *[note 9]*** | **18,349,387** | 6,884,091 |
| | **77,497,181** | 20,201,664 |
| **Shareholders' equity** | | |
| Share capital *[note 8]* | **16,336,504** | 14,551,045 |
| Retained earnings | **23,281,622** | 5,758,051 |
| | **39,618,126** | 20,309,096 |
| | **130,473,953** | 60,057,098 |

*See accompanying notes*

Approved on behalf of the Board:

Director　　　　Director

Steve Chetner (signed)　　　　Don Gray (signed)

**PEYTO Exploration & Development Corp.**

# STATEMENTS OF EARNINGS AND RETAINED EARNINGS

For the year ended December 31,

| | 2001<br>$ | 2000<br>$ |
|---|---|---|
| **REVENUE** | | |
| Petroleum and natural gas sales, net | **41,181,322** | 15,339,262 |
| Interest and other income | **12,422** | 2,335 |
| | **41,193,744** | 15,341,597 |
| **EXPENSES** | | |
| Operating *[note 6]* | **2,082,511** | 1,276,749 |
| General and administrative | **1,588,903** | 932,185 |
| Interest | **1,779,212** | 605,334 |
| Depletion, depreciation and site restoration | **6,475,181** | 1,851,170 |
| | **11,925,807** | 4,665,438 |
| Earnings before taxes | **29,267,937** | 10,676,159 |
| Future income tax expense *[note 9]* | **(11,503,696)** | (4,701,141) |
| Capital tax expense | **(240,670)** | (68,804) |
| Earnings for the year | **17,523,571** | 5,906,214 |
| Retained earnings (deficit), beginning of year | **5,758,051** | (148,163) |
| **Retained earnings, end of year** | **23,281,622** | 5,758,051 |
| Earnings per share *[notes 3 and 8]* | | |
| Basic | **0.42** | 0.18 |
| Diluted | **0.41** | 0.17 |

*See accompanying notes*

**PEYTO Exploration & Development Corp.**

# STATEMENTS OF CASH FLOWS

For the year ended December 31,

| | 2001<br>$ | 2000<br>$ |
|---|---|---|
| **Cash provided by (used in)** | | |
| **OPERATING ACTIVITIES** | | |
| Earnings for the year | **17,523,571** | 5,906,214 |
| Items not requiring cash | | |
| Future income taxes | **11,503,696** | 4,701,141 |
| Depletion, depreciation and site restoration | **6,475,181** | 1,851,170 |
| Funds from operations | **35,502,448** | 12,458,525 |
| Change in non-cash working capital related to operating activities *[note 11]* | **1,595,406** | (5,804,009) |
| | **37,097,854** | 6,654,516 |
| **FINANCING ACTIVITIES** | | |
| Issue of common shares, net of costs | **1,747,057** | 7,430,474 |
| Increase in long-term debt | **45,745,744** | 12,049,728 |
| | **47,492,801** | 19,480,202 |
| **INVESTING ACTIVITIES** | | |
| Additions to property, plant and equipment | **(79,955,081)** | (39,460,559) |
| Net change in non-cash working capital related to investing activities *[note 11]* | **(4,687,381)** | 12,391,995 |
| Cash acquired in acquisition of Largo Petroleum Inc. *[note 4]* | **—** | 543,148 |
| | **(84,642,462)** | (26,525,416) |
| **Net decrease in cash** | **(51,807)** | (390,698) |
| Cash, beginning of year | **53,027** | 443,725 |
| **Cash, end of year** | **1,220** | 53,027 |
| Funds from operations per share *[notes 3 and 8]* | | |
| Basic | **0.85** | 0.37 |
| Diluted | **0.84** | 0.36 |

*See accompanying notes*

**PEYTO Exploration & Development Corp.**

# NOTES TO FINANCIAL STATEMENTS

December 31, 2001 and 2000

## 1. NATURE OF OPERATIONS

PEYTO Exploration & Development Corp. (hereafter "PEYTO" or the "Corporation") was incorporated under the Business Corporations Act of Alberta and its principal business activity is the exploration for and production of petroleum and natural gas in Western Canada. PEYTO is listed on the Toronto Stock Exchange under symbol "PEY".

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles and a summary of accounting policies follows:

### a) Joint operations

The Corporation conducts substantially all of its petroleum and natural gas exploration and production activities jointly with others and, accordingly, these financial statements reflect only the Corporation's proportionate interest in such activities.

### b) Property, plant and equipment

#### (i) Capitalization of costs

The Corporation follows the full cost method of accounting for its petroleum and natural gas operations. All costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses and costs of drilling both productive and non-productive wells. All general and administrative costs are expensed as incurred.

Proceeds from the disposal of properties would usually be applied against capitalized costs, without any gain or loss being realized, unless the disposal results in a change in the depletion rate of greater than 20% in which case a gain or loss on disposal will be recorded.

#### (ii) Depletion and depreciation

Depletion of petroleum and natural gas properties and depreciation of production equipment is provided using the unit-of-production method based upon estimated gross proved petroleum and natural gas reserves as determined by independent engineers. The costs of significant unevaluated properties are excluded from costs subject to depletion. For depletion and depreciation purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Depreciation of gas plants and related facilities is calculated on a straight-line basis over a 20 year term.

Office furniture and equipment are depreciated over their estimated useful lives at declining balance rates between 20% and 30%.

**(iii) Ceiling test**

In applying the full cost method, the Corporation calculates a ceiling test whereby the carrying value of petroleum and natural gas properties and production equipment, net of recorded future income taxes and the accumulated provision for site restoration and abandonment costs, is compared annually to an estimate of future net revenue from the production of gross proved reserves. Net revenue is estimated using year end prices, less estimated future general and administrative expenses, financing costs and income taxes. Any reduction in value as a result of the ceiling test will be charged to earnings as additional depletion and depreciation.

## c) Future site restoration and abandonment costs

Estimated future costs relating to site restoration and abandonment of petroleum and natural gas properties and related facilities are accrued on a unit of production basis over the life of gross proved reserves. Costs are estimated, net of expected recoveries, based upon current prices, technology and industry standards. The annual provision is accounted for as part of depletion, depreciation and site restoration expense. The accumulated provision is classified as a non-current liability and actual expenditures will be charged against the accumulated provision as incurred.

## d) Flow-through common shares

Resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. The estimated tax benefits transferred to shareholders are recorded as future income taxes and reduced share capital is recorded when the expenditures are incurred and renounced.

## e) Financial instruments

The Corporation utilizes commodity price derivative instruments to hedge its exposure to fluctuations in oil and gas pricing. Gains and losses relating to derivative instruments that meet hedge criteria are recognized as part of petroleum and natural gas sales concurrently with the hedged transaction. The fair value of these contracts is not reflected in the financial statements.

## f) Measurement uncertainty

The amount recorded for depletion of property, plant and equipment, the provision for site restoration costs and the ceiling test calculation are based on estimates of gross proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future years could be significant.

## g) Future income taxes

The Corporation follows the liability method of tax allocation. Under this method future income tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities, and are measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

## h) Stock based compensation plan

The Corporation has a stock based compensation plan, which is described in note 8. As options are issued at current market value, the option has no intrinsic value, therefore no compensation expense is recorded when the options are granted. Consideration paid by employees or directors on the exercise of stock options is credited to share capital.

## 3. CHANGE IN ACCOUNTIING FOR PER SHARE AMOUNTS

Effective January 1, 2001, the Corporation adopted the new Canadian Institute of Chartered Accountants' recommendations for determining per share amounts. The new standard utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted average number of shares is calculated assuming the proceeds that arise from the exercise of outstanding in the money options are used to purchase shares of the Corporation at their average market price for the period. Comparative per share amounts for 2000 have been restated.

Prior to the adoption of the new recommendation, diluted per share amounts were determined using the imputed earnings method.

## 4. BUSINESS ACQUISITIONS

During 2000, the Corporation acquired Largo Petroleum Inc. This transaction was accounted for using the purchase method of accounting whereby assets acquired and liabilities assumed are recorded at fair values. The investee's operating results were included in the financial statements from the closing date of purchase. The fair values of the net assets acquired are as follows:

| | **2000**<br>$ |
|---|---|
| **Assets acquired:** | |
| Current assets, including cash of $543,148 | 861,145 |
| Property, plant and equipment | 1,184,063 |
| Due from shareholder | 125,000 |
| Current liabilities | (143,772) |
| Future site restoration costs | (45,309) |
| **Fair value of net assets acquired** | 1,981,127 |
| **Consideration** | |
| 6,603,755 common shares | 1,981,127 |

On January 1, 2001 Largo Petroleum Inc. was amalgamated with the Corporation.

## 5. PROPERTY, PLANT AND EQUIPMENT

| | **2001**<br>$ | 2000<br>$ |
|---|---|---|
| Property, plant and equipment | **130,693,300** | 50,784,483 |
| Office furniture and equipment | **220,347** | 174,081 |
| | **130,913,647** | 50,958,564 |
| Accumulated depletion and depreciation | **(9,213,178)** | (2,822,474) |
| | **121,700,469** | 48,136,090 |

At December 31, 2001, costs of $13,575,000 (2000 - $8,250,000) related to undeveloped land have been excluded from the depreciation calculation.

For the year ended December 31, 2001, the Corporation charged $84,477 (2000 - $62,200) to expense for future site restoration.

## 6. OPERATING EXPENSES

The Corporation's operating expenses include all costs with respect to day-to-day well and facility operations and the cost of transportation of natural gas. Processing and gathering income related to joint venture and third party gas is included in operating expenses.

| | 2001<br>$ | 2000<br>$ |
|---|---|---|
| Field expenses | **1,938,831** | 927,382 |
| Transmission | **1,135,728** | 499,832 |
| Processing and gathering income | **(992,048)** | (150,465) |
| Total operating costs | **2,082,511** | 1,276,749 |

## 7. LONG-TERM DEBT

The Corporation has a revolving operating credit facility to a maximum of $60,000,000. Outstanding amounts on this facility bear interest at bank prime and are due on demand. At December 31, 2001, the Corporation had drawn $58,945,472 on the facility. As collateral, the Corporation has provided a general security agreement with a floating charge on land registered in Alberta. The bank has stated that provided there is no adverse change in the Corporation's financial position, it is not their intention to call for repayment of the loan prior to December 31,2002. Accordingly the loan is classified as long-term.

On January 31, 2002 the credit facility was increased to an operating line of $65,000,000.

## 8. SHARE CAPITAL

**Authorized**

Unlimited number of common voting shares
Unlimited number of preferred shares, issuable in series

**Issued - Common shares**

| | Number of Shares | Amount $ |
|---|---|---|
| **Balance, December 31, 1999** | 24,526,642 | 5,041,613 |
| Exercise of stock options | 370,667 | 101,667 |
| Flow-though shares issued | 2,100,000 | 4,630,000 |
| Redemption of debenture (b) | 4,500,000 | 2,700,000 |
| Issued for property acquisition (a) | 1,650,000 | 2,145,000 |
| Issued for shares in Largo Petroleum Inc. (note 4) | 6,603,755 | 1,981,127 |
| Issued for cash by private placement | 48,000 | 40,800 |
| Tax benefits transferred to shareholders | — | (2,065,906) |
| Share issue costs, net of associated tax benefits | — | (23,256) |
| **Balance, December 31, 2000** | 39,799,064 | 14,551,045 |
| Exercise of stock options | 2,017,667 | 1,013,657 |
| Flow-through shares issued | 183,000 | 823,500 |
| Share issue costs, net of associated tax benefits | — | (51,698) |
| **Balance, December 31, 2001** | 41,999,731 | 16,336,504 |

a) The Corporation purchased seven unconnected gas wells that it currently operates and some strategic undeveloped land for total consideration of $3,268,435, consisting of 1,650,000 common shares at a prescribed price of $1.30 per share and $1,123,435 cash.

b) On January 24, 2000 the Corporation issued a $2,700,000 convertible subordinated secured debenture due December 1, 2004 and bearing interest at 3.0% per annum. The debenture was subsequently converted into common shares on August 25, 2000 at a price of $0.60 per share.

## Stock Options

The Corporation has a director and employee stock option plan. The number of common shares reserved for issuance at any one time shall not exceed 4,178,005 shares subject to shareholder and regulatory approval. The exercise price of an option is set at the market price of the common shares at the date of grant. Options vest over three years and have terms of 5 years.

The Corporation has the following options outstanding:

| Grant Date | Expiry Date | Price | 2001 |
|---|---|---|---|
| January 10, 2000 | January 10, 2005 | $0.48 | **10,000** |
| January 18, 2000 | January 18, 2005 | $0.52 | **210,000** |
| February 14, 2000 | February 14, 2005 | $0.56 | **60,000** |
| April 27, 2000 | April 27, 2005 | $0.76 | **166,667** |
| May 16, 2000 | May 16, 2005 | $0.90 | **15,000** |
| August 9, 2000 | August 9, 2005 | $1.16 | **30,000** |
| August 31, 2000 | August 31, 2005 | $1.40 | **60,000** |
| February 7, 2001 | February 7, 2006 | $2.60 | **1,347,334** |
| February 14, 2001 | February 14, 2006 | $2.70 | **451,333** |
| February 21, 2001 | February 21, 2006 | $2.70 | **400,000** |
| March 13, 2001 | March 13, 2006 | $3.00 | **120,000** |
| July 10, 2001 | July 10, 2006 | $3.09 | **440,000** |
| | | $2.39 | **3,310,334** |

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | **Options** | **Weighted – Average Exercise Price** | **Options** | **Weighted-Average Exercise Price** |
| Opening | **2,987,000** | **$0.63** | 1,305,000 | $0.19 |
| Granted | **3,095,334** | **$2.71** | 2,292,000 | $0.79 |
| Exercised | **(2,017,667)** | **$0.48** | (370,667) | $0.27 |
| Cancelled | **(754,333)** | **$1.82** | (239,333) | $0.33 |
| Closing | **3,310,334** | **$2.39** | 2,987,000 | $0.63 |

On January 14, 2002 the Corporation issued 310,000 options at an exercise price of $4.03 to employees of the Corporation with an expiration date of January 14, 2007.

## Per Share Amounts

Earnings per share and funds from operations per share have been calculated based upon the weighted average number of common shares outstanding during the year of 41,585,017 (2000 - 33,706,139). The weighted average number of common shares used to determine diluted per share amounts in 2001 was 42,376,285 (2000 – 34,953,915).

# NOTES TO FINANCIAL STATEMENTS

December 31, 2001 and 2000

## 9. INCOME TAXES

The actual income tax provision differs from the expected amount calculated by applying the Canadian combined federal and provincial corporate tax rates to earnings before income taxes. The majority of these differences are explained as follows:

| | **2001** $ | **2000** $ |
|---|---|---|
| Income before income taxes | **29,267,937** | 10,676,159 |
| Statutory income tax rate | **42.62%** | 44.62% |
| Expected income taxes | **12,473,995** | 4,763,702 |
| Increase (decrease) in income taxes from: | | |
| Non-deductible crown charges | **4,531,513** | 2,059,083 |
| Resource allowance | **(5,002,401)** | (1,914,739) |
| Corporate income tax rate change | **(317,788)** | (11,865) |
| Attributed Canadian royalty income | — | (183,231) |
| Other | **(181,621)** | (11,809) |
| **Income tax expense** | **11,503,696** | 4,701,141 |

The net future tax liability comprises:

| | **2001** $ |
|---|---|
| Differences between tax base and reported amounts of depreciable assets | **19,298,651** |
| Provision for future site restoration | **(86,230)** |
| Tax loss carryforwards recognized | **(144,203)** |
| ACRI carryforwards recognized | **(178,464)** |
| Resource Allowance & Crown Lease Rentals rate reductions | **(564,370)** |
| Share issue costs | **(92,879)** |
| Other | **116,883** |
| | **18,349,387** |

## 10. FINANCIAL INSTRUMENTS

Financial instruments of the Corporation consist of cash, accounts receivable, accounts payable and accrued liabilities and long term debt. As at December 31, 2001 there are no significant differences between their carrying values and their estimated market values.

The Corporation is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. The Corporation enters into these contracts for the purpose of protecting a portion of its future earnings and cash flows from operations from the volatility of natural gas commodity process by locking in a minimum and maximum forward price.

A summary of contracts outstanding with respect to the hedging activities at December 31, 2001 were as follows:

**Natural gas collar referenced to AECO index**

| Period Hedged | Daily Volume | Floor | Ceiling |
|---|---|---|---|
| November 1, 2001 to April 1, 2002 | 2,000 gigajoules | $6.00/gigajoule | $10.55/gigajoule |
| November 1, 2001 to April 1, 2002 | 2,000 gigajoules | $6.00/gigajoule | $10.80/gigajoule |
| November 1, 2001 to April 1, 2002 | 2,000 gigajoules | $6.00/gigajoule | $10.10/gigajoule |
| November 1, 2001 to April 1, 2002 | 2,500 gigajoules | $3.50/gigajoule | $5.80/gigajoule |
| April 1, 2002 to November 1, 2002 | 3,500 gigajoules | $3.50/gigajoule | $5.75/gigajoule |

Based on dealer quotes, had these contracts been closed on December 31,2001, the Corporation would have realized a gain of $1,368,290.

## 11. CHANGE IN NON-CASH WORKING CAPITAL

Changes in non-cash working capital balances are comprised of the following:

| | 2001<br>$ | 2000<br>$ |
|---|---|---|
| Accounts receivable | **3,374,955** | (10,329,860) |
| Prepaids | **(279,238)** | (166,707) |
| Accounts payable and accrued liabilities | **(6,364,248)** | 17,015,749 |
| Capital taxes payable | **176,556** | 68,804 |
| | **(3,091,975)** | 6,587,986 |
| Attributable to investing activities | **(4,687,381)** | 12,391,995 |
| | **1,595,406** | (5,804,009) |
| Cash interest paid during the year | **1,779,212** | 530,449 |
| Cash taxes paid during the year | **64,114** | — |

## Corporate information

### Officers

Don Gray
President and Chief Executive Officer

Roberto Bosdachin
Vice-President, Exploration

Lyle Skaien
Vice President, Operations

Darren Gee
Vice President, Exploitation

Sandra Brick
Vice President, Finance

Stephen Chetner
Corporate Secretary

### Directors

Rick Braund

Don Gray

Mike Broadfoot

Brian Craig

Jim Riddell

Stephen Chetner

**Auditors**
Ernst & Young LLP

**Solicitors**
Burnet, Duckworth & Palmer LLP

**Bankers**
Royal Bank of Canada

**Transfer Agent**
Computershare Trust Company of Canada

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