PEYTO

Exploration & Development Corp.

2002

Annual Report

PEYTO Exploration & Development Corp. is a gas exploration and production company that was founded in November 1998 with a clear strategy to build shareholder value by efficiently finding and developing long term gas reserves in Alberta's Deep Basin area. The successful execution of this strategy has provided us with significant competitive advantages. These advantages include:

- long life reserves which provide us with a stable production base to build on and which have no production hazards such as water or sour gas;
- low total cost structure combined with high heating value gas which gives us the most efficient cash flow generator in the industry; and
- a team that is aligned to the shareholders and has a proven track record of finding and developing high quality assets.

We are pleased with the success of this strategy and proud to present our operating and financial results for the fourth quarter and full fiscal year 2002.

Year End Review

Production for the year was up 111% for an average of 42.2 mmcf of natural gas and 1,823 barrels of light oil and natural gas liquids per day. This production gain resulted in an increase in cash flow from operations from $36.3 million in 2001 to $62.5 million in 2002. Earnings increased 63% from $17.5 million in 2001 to $28.6 million in 2002. Product prices averaged $4.63 per mcf for gas and $32.06 per barrel for oil and natural gas liquids. Operating costs remained constant at $1.37 per barrel of oil equivalent ("boe", natural gas converted on a 6:1 basis throughout). The gas price realized was 20% lower resulting in a 20% reduction in field netbacks to $20.45 per boe. Even with the lower commodity prices, we were successful in achieving record cash flow in each of the four quarters of 2002. Comparative operational and financial data is presented in the following table.

	3 Months Ended Dec. 31		%	12 Months Ended Dec. 31		%
	2002	2001	Change	**2002**	2001	Change
Operations						
Production						
Natural gas (mcf/d)	**50,556**	30,175	*68*	**42,254**	20,501	*106*
Oil & NGLs (bbl/d)	**2,349**	1,222	*92*	**1,823**	785	*132*
Barrels of oil equivalent (boe/d @ 6:1)	**10,775**	6,251	*72*	**8,865**	4,201	*111*
Average product prices						
Natural gas ($/mcf)	**5.90**	4.32	*37*	**4.63**	5.81	*(20)*
Oil & NGLs ($/bbl)	**36.52**	23.84	*53*	**32.06**	30.52	*5*
Average operating expenses ($/boe)	**1.12**	1.57	*(29)*	**1.37**	1.36	*1*
Field Netback ($/boe)	**25.15**	19.72	*28*	**20.45**	25.50	*(20)*
Financial ($000)						
Revenue	**35,354**	14,679	*141*	**92,709**	52,247	*77*
Royalties (net of ARTC)	**9,311**	2,437	*282*	**22,101**	11,066	*100*
Funds from operations	**23,746**	10,370	*129*	**62,503**	36,326	*72*
Net earnings	**10,310**	4,969	*107*	**28,554**	17,524	*63*
Capital expenditures	**37,627**	22,029	*71*	**112,551**	79,955	*41*
As at December 31						
Debt, including working capital deficit				**110,985**	63,530	*75*
Common shares outstanding (000)				**43,418**	41,999	*3*
Weighted average shares outstanding				**42,978**	41,585	*3*

	3 Months Ended Dec. 31		%	12 Months Ended Dec. 31		%
	2002	2001	Change	**2002**	2001	Change
Per share data ($/share)						
Funds from operations						
Basic	**0.55**	0.25	*120*	**1.45**	0.87	*67*
Diluted	**0.52**	0.24	*117*	**1.41**	0.86	*64*
Earnings						
Basic	**0.24**	0.12	*100*	**0.66**	0.42	*57*
Diluted	**0.23**	0.12	*92*	**0.64**	0.41	*56*

Proved developed reserves at year end increased by 63% to 44.4 million boes from 27.2 million boes in 2001. Peyto has continued its practice of not allocating a proved reserve designation to undeveloped property and accordingly had no proved undeveloped reserves booked at year end 2002. During the year, Peyto was successful in converting the majority of its probable reserves to the proved developed category by use of the drill bit. Proved plus probable additional reserves increased by 27.3 million boes to 85.2 million boes. As in previous years, most of the probable reserves booked at the end of 2002 represent development gas locations in the Sundance area. Our company achieved an investment recycle ratio of 4:1 and a production replacement ratio of 6:1 for the proved developed reserves added during 2002. Proved developed reserves had an 11 year reserve life based on fourth quarter average production. Discounted at 10%, the net present value of Peyto's proved plus probable additional petroleum and natural gas assets increased 77% from $455.9 million or $10.85 per share in 2001 to $807.4 million or $18.60 per share in 2002. The following table summarizes Peyto's reserves and the discounted net present value of future cash flow before income tax, using variable pricing, at December 31, 2002.

					Net Present Value ($000) Discounted at		
Reserve Category	**Gas (mmcf)**	**Oil & NGL (mstb)**	**BOE 6:1 (mstb)**	**Reserve Life Index (years)**	**8%**	**10%**	**12%**
Proved Producing	195,918	8,641	41,294	10.5	546,024	492,809	450,345
Proved Non-producing	14,965	571	3,065		27,887	24,593	22,156
Proved Undeveloped	-	-	-		-	-	-
Total Proved	210,883	9,212	44,359	11.3	573,911	517,402	472,501
Probable Additional	195,334	8,304	40,860		339,845	290,043	251,456
Proved + Probable Additional	406,217	17,516	85,219	21.7	913,756	807,445	723,957

Note: Based on the Paddock Lindstrom & Associates report effective December 31, 2002

Net capital expenditures for 2002 totaled $112.6 million. Exploration and development related activity represented $78.1 million or 70% of the total, while expenditures on facilities, gathering systems and equipment totaled $24.1 million or 21% of the total. The following table summarizes capital expenditures and finding and development (F&D) costs for the year.

Capital Expenditures			F&D Costs, $/BOE @ 6:1		
Category	**($000)**	**% of Total**	**Proven Developed ($/BOE)**	**Proven + Risked Probable ($/BOE)**	**Proven + Probable ($/BOE)**
Land	3,388	*3*	0.17	0.13	0.11
Seismic	1,677	*2*	0.08	0.07	0.06
Drilling – Exploratory & Development	76,350	*68*	3.74	3.00	2.50
Production Equipment, Facilities & Pipelines	24,101	*21*	1.18	0.95	0.79
Acquisitions & Dispositions	6,971	*6*	0.34	0.27	0.23
Office Equipment	64	*0*	0.00	0.00	0.00
Total	**112,551**	***100***	**5.51**	**4.42**	**3.69**

Fourth Quarter Review

For the three months ended December 31, 2002, Peyto achieved corporate records for production, cash flow and earnings. Daily production averaged 51 mmcf of natural gas and 2,349 barrels of oil and natural gas liquids. Gas and liquids production per share for the quarter increased 62% and 86% respectively, over the same period in 2001. Our production gains increased cash flow from $10.4 million in 2001 to a record $23.7 million in 2002. Earnings increased from $5.0 million in 2001 to $10.3 million in 2002. Natural gas prices increased by 37%, averaging $5.90 per mcf while oil and natural gas liquids prices increased 53% averaging $36.52 per barrel. The high heating value of our gas resulted in a 17% premium when converted from gigajoules at the AECO price hub to mcf at the plantgate. Operating costs averaged $1.12 per boe. Capital expenditures for the quarter totaled $37.6 million with drilling projects continuing at record levels.

Activity Update

Our level of activity is 70% higher than it was a year ago. We currently have five drilling rigs operating in the Deep Basin area which have drilled and cased fifteen gas wells since year end, all with a total depth greater than 2,200 meters. All of these wells are categorized in our 2002 reserve report as probable additional reserves. We plan to keep up to five drilling rigs active in the core areas throughout the year. In March 2003, Peyto commenced production from a 100% well in our new area with initial production rates of 1.6 mmcf per day. Actual well capability was tested at a much higher rate, however, facility capacity constraints at the third party processing plant prevent us from seeing the full potential of this well at this time. Plans are under way to alleviate this constraint.

Outlook

Capital expenditures for 2003 are expected to be between $110 million and $160 million and will be funded primarily by cash flow. The majority of the 2003 capital program will involve drilling, completion and tie-in of low risk development gas wells adjacent to existing infrastructure in the Sundance area.

We have now completed our fourth consecutive year of successful exploration and development activity which is illustrated by our superior results in all performance parameters. We continue to have an abundance of investment ideas and opportunities to pursue. In order to learn more about the company we encourage you to visit Peyto's website at www.peyto.com where you will find a current presentation, financial and historical news releases and an updated insider trading summary.

Don T. Gray, P.Eng.
President and Chief Executive Officer
March 6, 2003

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	**2002**	2001	*% Change*
Natural gas (millions of cubic feet)			
Proved developed	**210,883**	125,142	*69*
Probable	**195,334**	143,459	*36*
Total	**406,217**	268,601	*51*
Oil & natural gas liquids (thousands of barrels)			
Proved developed	**9,212**	6,320	*46*
Probable	**8,304**	6,882	*21*
Total	**17,516**	13,202	*33*
Barrels of oil equivalent @ 6:1 (thousands of barrels)			
Proved developed	**44,359**	27,177	*63*
Probable	**40,860**	30,792	*33*
Total	**85,219**	57,969	*47*

Net Present Value ($000)	Discounted at			
	0%	10%	12%	*NPV 12% % Change*
Proved Developed	1,100,506	517,402	472,501	*95*
Probable	905,514	290,043	251,456	*56*
Total	2,006,020	807,445	723,957	*80*

Note:

2002 Reserve & Net Present Value data based on Paddock Lindstrom & Associates Report Dated January 27, 2003.

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

Management's Discussion and Analysis

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

Twelve Months Ended December 31, 2002 Compared to Twelve Months Ended December 31, 2001

Gross revenues totaled $92.7 million for the year 2002, an increase of 77 percent from $52.2 million in 2001. This increase is a result of higher production volumes despite lower natural gas prices. The price of natural gas averaged $4.63 per mcf for the year 2002 down 20 percent from $5.81 per mcf in 2001. Oil and natural gas liquids prices averaged $32.06 per barrel in 2002 up 5 percent from $30.52 per barrel in 2001.

A successful drilling program resulted in natural gas production for the year increasing by 106 percent to 42.2 mmcf per day in 2002 from 20.5 mmcf per day in 2001. Oil and natural gas liquids production increased by 132 percent to 1,823 barrels per day in 2002 from 785 barrels per day in 2001. Production for the year averaged 8,865 barrels of oil equivalent ("boe", natural gas converted on a 6:1 basis) per day, an increase of 111 percent from 4,201 boe per day for 2001.

2002 royalties, net of Alberta Royalty Tax Credit (ARTC), increased by 100 percent to $22.1 million from $11.1 million in 2001 due to higher gross revenues associated with increased production volumes. The 2002 average royalty rate was 24 percent compared to 22 percent for 2001.

Increased production volumes caused operating costs to rise to $4.4 million in 2002 from $2.1 million in 2001. On a barrel of oil equivalent basis, operating costs were $1.37 per boe in 2002 compared to $1.36 per boe in 2001. 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 $1.45, transportation $0.58 and processing and gathering income a recovery of $0.66.

General and administrative expenses increased by 7 percent to $1,694,000 for 2002 from $1,589,000 in 2001. The Corporation does not capitalize general and administrative expenses. Operator overhead recoveries related to capital expenditures and well operations totaling $1.7 million have been netted from 2002 general and administrative expenses. On a boe basis, general and administrative expenses decreased by 50 percent to $0.52 per boe in 2002 from $1.04 per boe in 2001. 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 $1,047,500. 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 $11.70 per share (25% premium to 10 day weighted average price) with 98 percent choosing to increase their stake in the Corporation by selecting the share option.

Financing charges for 2002 were $2.7 million up from $1.8 million in 2001. The increase was the result of higher debt levels associated with Peyto's 2002 capital expenditure program which totaled $112.6 million compared with $79.9 million in 2001.

Depreciation, depletion and site restoration expenses were $12.2 million for 2002 compared to $6.5 million for 2001 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 decreased to $3.78 in 2002 from $4.22 in 2001.

The provision for future income tax increased to $20.6 million in 2002 from $11.5 million in 2001. The increase in the tax provision in 2002 is a direct result of Peyto's increased profitability due to significantly higher production volumes.

The 111% increase in production volumes caused funds from operations for 2002 to increase to $62.5 million compared with $36.3 million in 2001. Lower average natural gas prices caused Peyto's field netback for the period to decrease from $25.50 per boe in 2001 to $20.45 per boe in 2002. Earnings for 2002 were $28.6 million or $0.66 per share compared with $17.5 million in 2001 or $0.42 per share.

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 4,202 barrels of oil equivalent ("boe", natural gas converted on a 6:1 basis) per day up 204 percent from 1,381 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 $1.36 per boe in 2001 from $2.58 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 $1.26, transportation $0.75 and processing and gathering income a recovery of $0.65.

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 $1.04 per boe in 2001 from $1.85 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 $4.22 in 2001 from $3.77 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 $36.3 million compared with $12.5 million in 2000. This 190 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 $0.87 per share versus $0.37 per share in 2000. Due to lower average commodity prices, Peyto's field netback for the period decreased from $27.82 per boe in 2000 to $25.50 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.

Liquidity and Capital Resources

For the year ended December 31, 2002, the Corporation incurred net capital expenditures of $112.6 million. Capital expenditures during 2002 were comprised of $78.1 million for exploration and development, $24.1 million for facilities, gathering systems and equipment and $10.4 million for acquisitions and land. At December 31, 2002, the Corporation had a working capital deficiency, including the revolving demand loan, of $110.9 million, resulting in a net debt to running cash flow ratio of 1.2:1 based on annualized fourth quarter cash flow.

Capital expenditures for 2002 and 2001 were funded primarily by cash flow and bank debt, with equity issues limited to the exercise of stock options and the issuance of flow through shares pursuant to the Corporation's employee bonus plan.

Outlook

Peyto's 2003 capital expenditure program is budgeted to be between $110 million and $160 million and will be financed from available bank lines and the cash flow expected to be generated in 2003. In 2003, 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 $105 million revolving demand loan facility that bears interest at prime and does not require any principal repayments in 2003. 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, product marketing , 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, a low cost structure, 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 2002 oil prices strengthened but continued to be volatile. Peyto believes that oil prices will continue to be volatile in 2003. Natural gas prices have become increasingly favourable in recent months. Given this outlook, Peyto believes that capital investment and competition for land, acquisitions and services will increase in 2003. Peyto anticipates relative stability with respect to exchange and interest rates, although Peyto has a low sensitivity to these matters.

Recent Pronouncement

The CICA issued Accounting Guideline 13 "Hedging Relationships" which deals with the identification, designation, documentation and effectiveness of hedging relationships for the purpose of applying hedge accounting. The guideline establishes conditions for applying hedge accounting, but does not specify hedge accounting methods. The guideline is effective for fiscal years beginning on or after July 1, 2003. The Corporation anticipates that adoption of Accounting Guideline 13 will not have a material effect on its consolidated financial statements.

Quarterly information

	2002				2001
	Q4	Q3	Q2	Q1	Q4
Operations					
Production					
Natural gas (mcf/d)	**50,556**	45,018	38,194	35,049	30,175
Oil & NGLs (bbl/d)	**2,349**	2,009	1,512	1,409	1,222
Barrels of oil equivalent (boe/d @ 6:1)	**10,775**	9,512	7,878	7,250	6,251
Average product prices					
Natural gas ($/mcf)	**5.90**	3.49	4.43	4.46	4.32
Oil & natural gas liquids ($/bbl)	**36.52**	33.67	29.95	24.42	23.84
Average operating expenses ($/boe)	**1.12**	1.36	1.67	1.44	1.57
Field netback ($/boe)	**25.15**	16.42	19.72	19.52	19.72
Financial ($000)					
Revenue	**35,354**	20,676	19,530	17,150	14,679
Royalties (net of ARTC)	**9,311**	5,122	4,197	3,472	2,437
Funds from operations	**23,746**	13,474	13,185	12,098	10,370
Net earnings	**10,310**	5,957	6,362	5,925	4,969
Capital expenditures	**37,627**	24,105	28,270	22,549	22,029
Common shares outstanding (000)	**43,418**	43,321	43,143	42,976	41,999
Per share data ($/share)					
Funds from operations					
Basic	**0.55**	0.31	0.31	0.29	0.25
Diluted	**0.52**	0.30	0.30	0.28	0.24
Earnings					
Basic	**0.24**	0.14	0.15	0.14	0.12
Diluted	**0.23**	0.13	0.14	0.14	0.12

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, 2002 and 2001 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, 2002 and 2001 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 28, 2003

Chartered Accountants

PEYTO Exploration & Development Corp.

BALANCE SHEETS

As at December 31,

	2002	2001
	$	$
ASSETS		
Current		
Cash	**205,558**	1,220
Accounts receivable *[note 8]*	**18,860,110**	8,245,973
Prepaids and deposits	**894,553**	526,291
	19,960,221	8,773,484
Property, plant and equipment *[notes 3 and 5]*	**222,206,233**	121,700,469
	242,166,454	130,473,953
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	**50,778,415**	13,113,286
Capital taxes payable	**166,922**	245,360
Revolving demand loan *[note 5]*	**80,000,000**	58,945,472
	130,945,337	72,304,118
Future site restoration and abandonment	**380,914**	202,322
Future income taxes *[note 7]*	**39,773,845**	18,349,387
	40,154,759	18,551,709
Shareholders' equity		
Share capital *[note 6]*	**19,230,677**	16,336,504
Retained earnings	**51,835,681**	23,281,622
	71,066,358	39,618,126
	242,166,454	130,473,953

See accompanying notes

Approved on behalf of the Board:

Director Director

Don T. Gray Rick Braund

PEYTO Exploration & Development Corp.

STATEMENTS OF EARNINGS AND RETAINED EARNINGS

For the year ended December 31,

	2002 $	**2001** $
REVENUE		
Petroleum and natural gas sales, net	**70,607,767**	41,181,322
Interest and other income	**—**	12,422
	70,607,767	41,193,744
EXPENSES		
Operating *[note 4]*	**4,433,686**	2,082,511
General and administrative	**1,694,074**	1,588,903
Interest	**2,668,964**	1,779,212
Depletion, depreciation and site restoration	**12,223,429**	6,475,181
	21,020,153	11,925,807
Earnings before taxes	**49,587,614**	29,267,937
Future income tax expense *[note 7]*	**(20,626,612)**	(11,503,696)
Capital tax expense	**(406,943)**	(240,670)
Earnings for the year	**28,554,059**	17,523,571
Retained earnings, beginning of year	**23,281,622**	5,758,051
Retained earnings, end of year	**51,835,681**	23,281,622
Earnings per share *[note 6]*		
Basic	**0.66**	0.42
Diluted	**0.64**	0.41

See accompanying notes

PEYTO Exploration & Development Corp.

STATEMENTS OF CASH FLOWS

For the year ended December 31,

	2002 $	2001 $
Cash provided by (used in)		
OPERATING ACTIVITIES		
Earnings for the year	**28,554,059**	17,523,571
Items not requiring cash		
Non-cash expenses	**1,098,630**	823,500
Future income tax expense	**20,626,612**	11,503,696
Depletion, depreciation and site restoration	**12,223,429**	6,475,181
Funds from operations	**62,502,730**	36,325,948
Change in non-cash working capital related to operating activities *[note 9]*	**1,940,682**	1,595,406
	64,443,412	37,921,354
FINANCING ACTIVITIES		
Issue of common shares, net of costs	**2,593,389**	923,557
Increase in revolving demand loan	**21,054,528**	45,745,744
	23,647,917	46,669,301
INVESTING ACTIVITIES		
Additions to property, plant and equipment	**(112,550,601)**	(79,955,081)
Change in non-cash working capital related to investing activities *[note 9]*	**24,663,610**	(4,687,381)
	(87,886,991)	(84,642,462)
Net increase (decrease) in cash	**204,338**	(51,807)
Cash, beginning of year	**1,220**	53,027
Cash, end of year	**205,558**	1,220

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001

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 development and production of petroleum and natural gas in Western Canada.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared by management 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 and production of petroleum and natural gas reserves are capitalized in one Canadian cost center and charged to earnings as set out below. Costs include lease acquisition, geological and geophysical costs and costs of drilling and equipping 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. For purposes of the depletion and depreciation calculation, 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. Costs of acquiring and evaluating unproved properties are excluded from the depletion calculation until it is determined whether or not proved reserves are attributable to the properties or impairment occurs.

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 less estimated future production costs, general and administrative expenses, financing costs, site restoration and abandonment costs and income taxes. Future net revenues are estimated using prices and costs without escalation or discounting and the income tax legislation in effect at the period end. 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 estimated life of the 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 are 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

In certain circumstances, fixed price commodity contracts are used to reduce the Corporation's exposure to adverse fluctuations in commodity prices to protect future cash flow used to finance the Corporation's capital expenditure program. Gains and losses relating to fixed price contracts that meet hedge criteria are recognized as part of natural gas sales concurrently with the hedged transaction. The Corporation does not enter into financial instruments for trading or speculative purposes.

The Corporation's policy is to formally designate each derivative financial instrument as a hedge of a specifically identified future revenue stream. The Corporation believes the derivative financial instruments are effective as hedges, both at inception and over the term of the instrument, as the term to maturity, the notional amount and the commodity price basis in the instruments all match the terms of the future revenue stream being hedged.

Realized and unrealized gains or losses associated with the fixed price commodity contracts, which have been terminated or cease to be effective prior to maturity, are deferred as other current, or non-current, assets or liabilities on the balance sheet, as appropriate and recognized in earnings in the period in which the underlying hedged transaction is recognized. In the event a designated hedged item is sold, extinguished or matures prior to the termination of the related derivative instrument, any realized or unrealized gain or loss on such derivative instrument is recognized in earnings.

f) Measurement uncertainty

The amount recorded for depletion and depreciation 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 6. 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.

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001

3. PROPERTY, PLANT AND EQUIPMENT

	2002 $	2001 $
Property, plant and equipment	**243,180,014**	130,693,300
Office furniture and equipment	**284,236**	220,347
	243,464,250	130,913,647
Accumulated depletion and depreciation	**(21,258,017)**	(9,213,178)
	222,206,233	121,700,469

At December 31, 2002, costs of $20,122,240 (2001 - $13,575,000) related to undeveloped land have been excluded from the depletion and depreciation calculation.

For the year ended December 31, 2002, the Corporation charged $178,592 (2001 - $84,477) to expense for future site restoration.

4. 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.

	2002 $	2001 $
Field expenses	**4,680,319**	1,938,831
Transmission	**1,874,546**	1,135,728
Processing and gathering income	**(2,121,179)**	(992,048)
Total operating costs	**4,433,686**	2,082,511

5. REVOLVING DEMAND LOAN

The Corporation has a revolving credit facility to a maximum of $105,000,000 of which $80,000,000 was drawn at December 31, 2002 ($58,945,472 at December 31, 2001). Outstanding amounts on this facility bear interest at bank prime and are due immediately on demand. A General Security Agreement with a floating charge on land registered in Alberta is held as collateral by the bank. For the year ended December 31, 2002, the effective interest rate on amounts outstanding on this facility was 3.6% (December 31, 2001 – 5.0%). Under the terms of the facility the Corporation is subject to certain non-financial covenants all of which had been met at December 31, 2002.

Effective January 1, 2002 the Corporation adopted the recommendations of the Emerging Issues Committee of the Canadian Institute of Chartered Accountants ("CICA") concerning the presentation of revolving demand loans. These new recommendations require that the classification of debt on the balance sheet be based upon the facts existing at the balance sheet date rather than expectations. Prior to the adoption of the new recommendations, the Corporation presented the demand loan as long-term on the basis that the bank had indicated it was not its intention to call for repayment within one year provided there was no adverse change in the financial position of the Corporation.

While the bank has confirmed that it is not its intention to call for repayment of this loan provided there is no adverse change in the financial position of the Corporation, this loan is demand in nature and pursuant to the CICA pronouncement is presented as a current liability.

6. 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, 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
Exercise of stock options	1,324,557	2,631,074
Flow-through shares issued	93,900	1,098,630
Tax benefits transferred to shareholders	—	(813,719)
Share issue costs, net of associated tax benefits	—	(21,812)
Balance, December 31, 2002	43,418,188	19,230,677

During the year, the Corporation issued 93,900 flow-through shares at a price of $11.70 per share (2001 – 183,000 shares at $4.50 per share) as settlement of its bonus commitment to its employees and consultants.

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001

Stock Options

The Corporation has a director, employee, and non-employee stock option plan. The number of common shares reserved for issuance at any one time shall not exceed 4,314,262 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:

Exercise Price	Number Outstanding at December 31, 2002	Weighted Average Exercise Price	Weighted Average Contractual Life (Years)
$0.48 - $1.40	71,000	$1.10	2.47
$2.60 - $2.70	1,531,443	$2.64	3.12
$3.00 - $3.10	383,333	$3.07	3.45
$4.03 - $5.51	1,236,224	$5.14	4.15
$6.00 - $6.40	323,333	$6.29	4.55
$7.70	20,000	$7.70	4.67
$9.10	50,000	$9.10	4.85
	3,615,333	$3.95	3.67

	2002		2001	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Opening	**3,310,333**	**$2.39**	2,987,000	$0.63
Granted	**1,679,557**	**$5.52**	3,095,334	$2.71
Exercised	**(1,324,557)**	**$1.99**	(2,017,667)	$0.48
Cancelled	**(50,000)**	**$5.51**	(754,334)	$1.82
Closing	**3,615,333**	**$3.95**	3,310,333	$2.39

As at December 31, 2002, the Corporation had 126,668 options that were exercisable at a weighted average exercise price of $2.01 (December 31, 2001 – 103,333 options at $1.22).

Per Share Amounts

Earnings per share have been calculated based upon the weighted average number of common shares outstanding during the year of 42,978,340 (2001 - 41,585,017). The weighted average number of common shares used to determine diluted earnings per share amounts in 2002 was 44,494,866 (2001 - 42,376,285). Excluded from the diluted earnings per share amounts are 70,000 options, the impact of which are anti-dilutive.

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001

Stock Based Compensation

Effective January 1, 2002 the Corporation adopted CICA Handbook section 3870 - Stock-based Compensation and Other Stock-based payments. As permitted by CICA 3870 the Corporation has applied this change prospectively for new awards granted on or after January 1, 2002. The Corporation has chosen to recognize no compensation when stock options are granted to employees and directors under stock option plans with no cash settlement features. However, direct awards of stock to employees and stock and stock option awards granted to non-employees have been accounted for in accordance with the fair value method of accounting for stock-based compensation. The fair value of direct awards of stock is determined by the quoted market price of the Corporation's stock and the fair value of stock options is determined using the Black Scholes option pricing model. In periods prior to January 1, 2002, the Corporation recognized no compensation when stock or stock options were issued to employees. Pro forma information regarding earnings is required and has been determined as if the Corporation had accounted for its employee stock options granted after December 31, 2001 under the fair value method.

The fair value for these options was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions for 2002: weighted-average risk-free interest rate of 3.0%; dividend yield of 0%; weighted-average volatility factors of the expected market price of the Company's Common Shares of 45%; and a weighted-average expected life of the options of 3 years. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the option vesting periods. The Company's pro forma net income under Canadian generally accepted accounting principles would be reduced by $735,000 for the year ended December 31, 2002. Basic and diluted earnings-per-share figures would have been reduced by $0.02 and $0.02 respectively. The weighted average fair value of stock options granted during 2002 was $1.94 per share.

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001

7. FUTURE 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:

	2002 $	**2001** $
Earnings before income taxes	**49,587,614**	29,267,937
Statutory income tax rate	**42.12%**	42.62%
Expected income taxes	**20,886,303**	12,473,995
Increase (decrease) in income taxes from:		
Non-deductible crown charges	**9,309,161**	4,531,513
Resource allowance	**(8,814,288)**	(5,002,401)
Corporate income tax rate change	**(215,990)**	(317,788)
Attributed Canadian royalty income (ACRI)	**(430,625)**	—
Other	**(107,949)**	(181,621)
Future income tax expense	**20,626,612**	11,503,696

The net future income taxes liability comprises:

	2002 $	**2001** $
Differences between tax base and reported amounts for depreciable assets	**41,939,500**	19,298,650
Resource allowance & crown lease rentals rate reductions	**(1,247,503)**	(564,370)
ACRI carryforwards recognized	**(612,104)**	(178,464)
Share and debt issue costs	**(145,607)**	(92,879)
Provision for future site restoration and abandonment	**(160,441)**	(86,230)
Tax loss carryforwards recognized	**—**	(144,203)
Other	**—**	116,883
	39,773,845	18,349,387

As at December 31, 2002, the Corporation has tax pools of $122,634,772 (December 31, 2001 - $77,235,409) available for deduction against future income.

8. FINANCIAL INSTRUMENTS

a) Fair Value

The Corporation has financial instruments consisting of cash, accounts receivable, deposits, accounts payable and accrued liabilities, capital taxes payable and revolving demand loan. The carrying value of these instruments approximates fair value unless otherwise stated.

The Corporation is a party to certain off balance sheet derivative financial instruments in 2002 and 2001 consisting of fixed price forward sales contracts. A summary of contracts outstanding with respect to the hedging activities at December 31, 2002 is as follows:

Natural gas collar referenced to AECO monthly index

Period Hedged	Daily Volume	Floor	Ceiling
November 1, 2002 to March 31, 2003	8,000 GJ	$3.50/GJ	$7.00/GJ
November 1, 2002 to March 31, 2003	8,000 GJ	$3.50/GJ	$6.60/GJ
November 1, 2002 to March 31, 2003	6,000 GJ	$3.50/GJ	$6.70/GJ
April 1 to October 31, 2003	6,000 GJ	$3.50/GJ	$7.25/GJ
April 1 to October 31, 2003	8,000 GJ	$3.50/GJ	$6.85/GJ
April 1 to October 31, 2003	6,000 GJ	$3.50/GJ	$7.00/GJ

Based on dealer quotes, had these contracts been closed on December 31, 2002, no gain or loss would have been realized.

Subsequent to December 31, 2002, the Corporation entered into the following natural gas collars:

Period Hedged	Daily Volume	Floor	Ceiling
April 1 to October 31, 2003	5,000 GJ	$5.50/GJ	$7.61/GJ
November 1, 2003 to March 31, 2004	5,000 GJ	$5.50/GJ	$8.45/GJ

b) Credit Risk

A substantial portion of the Corporation's accounts receivable are with oil and gas marketing entities. The Corporation generally extends unsecured credit to these companies, and therefore, the collection of accounts receivables may be affected by changes in economic or other conditions and may accordingly impact the Corporation's overall credit risk. Management believes the risk is mitigated by the size, reputation and diversified nature of the companies to which they extend credit.

The Corporation has not previously experienced any material credit losses on the collection of receivables. Of the Corporation's significant individual accounts receivable at December 31, 2002, approximately 70% was owing from one company (December 31, 2001 – 58% from one company).

c) Interest rate risk

The Corporation is exposed to interest rate risk in relation to interest expense on its revolving demand facility. At December 31, 2002, the increase or decrease in earnings for each 1% change in interest rate paid on the outstanding revolving demand loan amounts to approximately $734,000 per annum (December 31, 2001 - $353,000).

9. CHANGE IN NON-CASH WORKING CAPITAL

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

	2002 **$**	**2001** **$**
Accounts receivable	**(10,614,137)**	3,374,955
Prepaids and deposits	**(368,262)**	(279,238)
Accounts payable and accrued liabilities	**37,665,129**	(6,364,248)
Capital taxes payable	**(78,438)**	176,556
	26,604,292	(3,091,975)
Attributable to investing activities	**24,663,610**	(4,687,381)
Attributable to operating activities	**1,940,682**	1,595,406
Cash interest paid during the year	**2,668,964**	1,779,212
Cash taxes paid during the year	**485,381**	64,114

Corporate information

Officers

Don Gray
President and Chief Executive Officer

Roberto Bosdachin
Vice-President, Exploration

Darren Gee
Vice President, Engineering

Lyle Skaien
Vice President, Operations

Sandra Brick
Vice President, Finance

Stephen Chetner
Corporate Secretary

Directors

Rick Braund

Don Gray

Mike Broadfoot

Brian Craig

Stephen Chetner

John Boyd

Auditors
Ernst & Young LLP

Solicitors
Burnet, Duckworth & Palmer LLP

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