PEYTO

Exploration & Development Corp.

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Interim Report
for the six months ended June 30, 2012

Highlights

	Three Months ended June 30		%	Six Months ended June 30		%
	2012	2011	Change	2012	2011	Change
Operations						
Production						
Natural gas (mcf/d)	221,176	183,790	*20%*	220,994	175,297	*26%*
Oil & NGLs (bbl/d)	4,480	3,811	*18%*	4,291	3,779	*14%*
Thousand cubic feet equivalent (mcfe/d @ 1:6)	248,058	206,657	*20%*	246,737	197,970	*25%*
Barrels of oil equivalent (boe/d @ 6:1)	41,343	34,443	*20%*	41,123	32,995	*25%*
Product prices						
Natural gas ($/mcf)	2.86	4.43	*(35)%*	3.19	4.66	*(32)%*
Oil & NGLs ($/bbl)	71.27	84.06	*(15)%*	77.75	80.18	*(3)%*
Operating expenses ($/mcfe)	0.29	0.32	*(9)%*	0.31	0.35	*(11)%*
Transportation ($/mcfe)	0.12	0.13	*(8)%*	0.12	0.13	*(8)%*
Field netback ($/mcfe)	3.16	4.41	*(28)%*	3.45	4.57	*(25)%*
General & administrative expenses ($/mcfe)	0.07	0.07	-	0.06	0.08	*(25)%*
Interest expense ($/mcfe)	0.23	0.24	*(8)%*	0.22	0.25	*(8)%*
Financial ($000 except per share)						
Revenue	86,553	103,193	*(16)%*	189,049	202,770	*(7)%*
Royalties	6,082	12,007	*(49)%*	14,917	21,929	*(32)%*
Funds from operations	64,732	77,010	*(16)%*	142,377	151,706	*(6)%*
Funds from operations per share	0.47	0.58	*(19)%*	1.03	1.14	*(10)%*
Total dividends	24,927	23,951	*4%*	49,808	47,872	*4%*
Total dividends per share	0.18	0.18	-	0.36	0.36	-
Payout ratio	39	31	*26%*	35	32	*9%*
Earnings	18,201	32,718	*(44)%*	45,069	64,406	*(30)%*
Earnings per diluted share	0.13	0.25	*(48)%*	0.33	0.49	*(33)%*
Capital expenditures	45,924	69,017	*(33)%*	144,557	172,803	*(16)%*
Weighted average trust shares outstanding	138,485,956	133,061,301	*4%*	138,399,017	132,900,079	*4%*
As at June 30						
Net debt (before future compensation expense and unrealized hedging gains)				519,328	474,008	*10%*
Shareholders' equity				999,057	859,205	*16%*
Total assets				1,789,210	1,576,618	*13%*

	Three Months ended June 30		Six Months ended June 30	
($000)	2012	2011	2012	2011
Cash flows from operating activities	74,551	81,831	133,934	124,718
Change in non-cash working capital	(10,934)	(4,751)	5,433	22,834
Change in provision for performance based compensation	1,115	(70)	3,010	4,154
Funds from operations	64,732	77,010	142,377	151,706
Funds from operations per share	0.47	0.58	1.03	1.14

(1) Funds from operations - Management uses funds from operations to analyze the operating performance of its energy assets. In order to facilitate comparative analysis, funds from operations is defined throughout this report as earnings before performance based compensation, non-cash and non-recurring expenses. Management believes that funds from operations is an important parameter to measure the value of an asset when combined with reserve life. Funds from operations is not a measure recognized by International Financial Reporting Standards ("IFRS") and does not have a standardized meaning prescribed by IFRS. Therefore, funds from operations, as defined by Peyto, may not be comparable to similar measures presented by other issuers, and investors are cautioned that funds from operations should not be construed as an alternative to net earnings, cash flow from operating activities or other measures of financial performance calculated in accordance with IFRS. Funds from operations cannot be assured and future dividends may vary.

Report from the president

Peyto Exploration & Development Corp. ("Peyto" or "the Company") is pleased to present its operating and financial results for the second quarter of the 2012 fiscal year. Peyto's production per share grew for the eleventh consecutive quarter while second quarter operating margins of 75%(1) and profit margins of 21%(2) were generated. Second quarter 2012 highlights include:

- **Production per share up 15%.** Second quarter 2012 production increased 20% (15% per share) from 207 MMcfe/d (34,443 boe/d) in Q2 2011 to 248 MMcfe/d (41,343 boe/d) in Q2 2012.

- **Funds from operations of $0.47/share.** Generated $65 million in Funds from Operations ("FFO") in Q2 2012 down 16% (19% per share) from $77 million in Q2 2011. Increased production and lower costs helped offset the 30% year over year reduction in realized commodity prices.

- **Record low cash costs of less than $1/mcfe.** Total cash costs, including royalties, operating costs, transportation, G&A and interest were $0.97/mcfe ($5.84/boe), setting a new Company record. Industry leading operating costs of $0.29/mcfe ($1.76/boe) in Q2 2012 down from $0.32/mcfe ($1.90/boe) in Q2 2011 helped contribute to this new record low. Cash netbacks of $2.86/mcfe ($17.17/boe) represented a 75% operating margin.

- **Capital Investments of $46 million**. At the end of the second quarter, 12,000 boe/d of new production had been added with $145 million of cumulative 2012 capital for a total cost of $12,100/boe/d. The annualized cost to build new production (trailing twelve months) has averaged $17,600/boe/d. A total of 10 gross wells were drilled during the second quarter.

- **Earnings of $0.13/share, dividends of $0.18/share.** Earnings of $18.2 million were generated in the quarter ($45.1 million year-to-date) while dividends of $24.9 million ($49.8 million year-to-date) were paid to shareholders, representing a before tax payout ratio of 39% of FFO.

- **First significant corporate acquisition.** Subsequent to the second quarter, Peyto announced an agreement to purchase all of the issued and outstanding common shares of Open Range Energy Corp. ("Open Range") on the basis of a share exchange, pursuant to a statutory plan of arrangement. This represents the first significant corporate acquisition in the Company's thirteen year history. The acquisition is expected to close on August 14, 2012 subject to, among other things, the approval of Open Range shareholders.

Second quarter 2012 in Review

The second quarter of 2012 was a typical period of reduced activity due to spring break-up. Operations in the field were effectively shut down for a six week period which restricted new production additions from April to late June. Total production for the quarter was maintained at the same level as Q1 2012, although increased liquids production was realized through facility optimizations and new drilling that was focused on the more liquids rich formations in Peyto's inventory. Peyto's strict focus on cost control during the quarter resulted in record low cash costs of $0.97/mcfe ($5.84/boe), inclusive of all royalties, operating costs, transportation, G&A and interest. Financial flexibility was maintained, with quarter ending net debt of $519 million on expanded total debt capacity of $800 million (inclusive of $100 million of senior secured notes) which represented a net debt to annualized FFO ratio of 2.0 times. The strong financial and operating performance delivered in the quarter resulted in an annualized 9% Return on Equity (ROE) and 8% Return on Capital Employed (ROCE).

1. *Operating Margin is defined as funds from operations divided by revenue before royalties but including realized hedging gains/losses.*
2. *Profit Margin is defined as net earnings for the quarter divided by revenue before royalties but including realized hedging gains/losses.*

Natural gas volumes recorded in thousand cubic feet (mcf) are converted to barrels of oil equivalent (boe) using the ratio of six (6) thousand cubic feet to one (1) barrel of oil (bbl). Natural gas liquids and oil volumes in barrel of oil (bbl) are converted to thousand cubic feet equivalent (Mcfe) using a ratio of one (1) barrel of oil to six (6) thousand cubic feet. This could be misleading, particularily if used in isolation as it is based on an energy equivalency conversion method primarily applied at the burner tip and does not represent a value equivalency at the wellhead.

Exploration & Development

Peyto focused drilling efforts on the more liquids rich formations in the second quarter. Although all of the drilling was in the Greater Sundance core area, half of the new wells spud were targeting the Cardium formation. The most recent Greater Sundance Cardium wells have averaged 45 bbl/mmcf of natural gas liquid in their first month of production, with over 60% of that liquid production being condensate and pentanes while the remainder is split between propane and butane. This focused drilling has helped improve corporate liquid yields from 18 bbl/mmcf at the start of the year to 22 bbl/mmcf by the end of the second quarter.

Peyto's enhanced liquids recovery project for the Oldman plant continued to progress throughout the quarter, although minor delays in facility manufacturing has pushed the anticipated startup to early October from late September 2012. A similar project at Peyto's Nosehill gas plant remains on schedule for January 2013.

Early production data in Peyto's southern expansion areas of Edson and Ansell are providing confidence in the profitability of future locations there. These areas are expected to benefit from the Open Range acquisition and associated gas plant and gathering system infrastructure. Combined, these areas account for approximately 9 mmcfe/d of production that is currently processed by a third party. After the installation of 25 km of pipeline to connect these wells to the Open Range gathering system, Peyto expects to see a 60% reduction in operating costs for these and future volumes. This strategically located infrastructure also allows Peyto to aggressively pursue additional drilling opportunities in both areas.

Capital Expenditures

Peyto spent $23 million to spud 10 gross (8.3 net) wells in the second quarter 2012. Completion of 10 gross (8.7 net) zones and the wellsite equipment and connection of 12 gross (10.7 net) wells cost $14.3 million and $4.8 million, respectively. New facilities accounted for $2.5 million in the quarter, while $1.2 million was invested into new land and seismic.

Peyto's drilling efficiency continues to improve in 2012, evidenced by the average Cardium well in Greater Sundance now taking 17 days from spud to rig release, down 25% from 23 days in 2011. Second quarter drilling costs are also starting to reflect this improvement in drilling times. The average drilling cost of a Cardium well was $2.1 million in Q2 2012 as compared to $2.5 million in 2011. This reduced drilling time allows for more wells to be drilled with fewer rigs, also enabling Peyto to accomplish more with its small and efficient team of technical professionals.

Financial Results

Alberta natural gas prices averaged $1.74/GJ in the second quarter 2012, resulting in a Peyto unhedged realized price of $1.98/mcf before hedging gains of $0.88/mcf. Meanwhile, Edmonton light oil prices averaged $84.02/bbl from which Peyto realized $71.27/bbl for its natural gas liquids blend of Condensate, Pentane, Butane and Propane. Combined, Peyto's unhedged revenues totaled $3.05/mcfe ($3.83/mcfe including hedging gains), or 175% of the dry gas price, illustrating the benefit of high heat content, liquids rich natural gas production.

Royalties of $0.26/mcfe, operating costs of $0.29/mcfe, transportation costs of $0.12/mcfe, G&A of $0.07/mcfe and interest costs of $0.23/mcfe, combined for total cash costs of $0.97/mcfe. These are the lowest total cash costs achieved in the Company's thirteen year history and resulted in a cash netback of $2.86/mcfe or a 75% operating margin.

Depletion, depreciation and amortization charges of $1.73/mcfe, along with a provision for future tax and market based bonus payments reduced the cash netback to earnings of $0.81/mcfe, or a 21% profit margin.

During the quarter, Peyto increased its credit facility with its syndicate of lenders from $625 million to $700 million. Including the $100 million of senior secured notes, Peyto's total borrowing capacity has increased to $800 million.

Marketing

The natural gas price in North America bottomed out in the quarter with both Henry Hub and AECO daily prices averaging $1.95/MMBTU and $1.58/GJ in April 2012. This was the lowest natural gas price seen in over a decade and was caused by an abundance of natural gas in storage due, in part, to the fourth warmest winter on record. Since then, natural gas prices have recovered as this low price drove increased demand and consumption for power generation, as well as reduced drilling activity for new natural gas production. Much of Peyto's natural gas production was protected from this volatile price drop due to forward sales that were layered in over the previous year. Approximately 41% of Peyto's natural gas production was pre-sold for the quarter at an average fixed price of $3.59/GJ.

Natural gas liquids prices were similarly affected by weather and storage levels, most significantly Propane, with Conway Propane prices dropping 47% from US$1.02/gallon in January 2012 to US$0.54/gallon in June. The quarter over quarter comparison of Peyto's realized liquids prices is shown in the table below.

Oil & Natural Gas Liquids Prices by Component

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Condensate ($/bbl)	**90.14**	98.66	**95.22**	93.46
Propane ($/bbl)	**18.61**	42.96	**24.42**	42.26
Butane ($/bbl)	**61.10**	66.52	**64.69**	62.11
Pentane ($/bbl)	**93.44**	99.76	**97.97**	94.75
Total Oil and NGLs ($/bbl)	**71.27**	84.06	**77.75**	80.18

Peyto's hedging practice of layering in fixed price swaps for future production, in order to smooth out the volatility in natural gas and natural gas liquids prices, continued in the quarter. By the end of the second quarter, Peyto had committed to the future sale of 49,000 bbls of Propane and Butane at an average price of $61.56/bbl, and 51,510,000 gigajoules (GJ) of natural gas at an average price of $3.29/GJ or $3.84/mcf (based on Peyto's historical heat content). Had these contracts been closed on June 30, 2012, Peyto would have realized a gain in the amount of $26.1 million.

Activity Update

Peyto has maintained a very active pace since the end of breakup in early June, with six drilling rigs working throughout the Company's Deep Basin core areas. Drilling continues to be focused on the more liquids rich formations including the Cardium, Falher and Bluesky, with only selective locations being drilled in the Notikewin and Wilrich. New production additions for the year have grown to 14,000 boe/d, contributing to total current production of 44,000 boe/d. Natural gas liquids make up approximately 5,000 bbl/d of this total.

The first compressors are starting to arrive at the Oldman gas plant as part of the enhanced liquids recovery project. All new equipment is expected to be set by the end of August with startup expected for early October.

Peyto's natural gas fueling station at its Oldman gas plant also remains on schedule to be operational by November 2012. This will allow for the conversion of both drilling rigs and field trucks to run off natural gas rather than diesel, contributing to both capital and operating cost savings.

ONR Acquisition Update

On July 3, 2012, Peyto announced it had entered into an agreement to acquire Open Range on the basis of 0.0696 of a Peyto common share for each Open Range common share pursuant to a statutory plan of arrangement (for an aggregate of 5.2 million Peyto common shares). On August 6, 2012, Peyto announced it had amended the arrangement and increased the exchange ratio in favour of Open Range to 0.0723 (for an aggregate of 5.4 million Peyto common shares) in response to an unsolicited bid for Open Range by a third party. A copy of the amended Arrangement Agreement was filed by Open Range will be available for viewing on SEDAR at www.sedar.com.

This acquisition represents the first significant corporate acquisition in Peyto's thirteen year history. It is a unique opportunity that is consistent with Peyto's strategy of being geographically focused, controlling the infrastructure, and pursuing low-cost, long-life production.

The Open Range properties are a natural fit with Peyto's Greater Sundance core area. Open Range's plant and pipeline infrastructure can be interconnected with Peyto's existing infrastructure and provides a bridge to other proven Peyto lands on the outskirts of the main Sundance area. This will allow for the accelerated development of these Peyto step-out areas and reduce the operating costs of the operated production from both asset bases.

Upon completion of the Arrangement, Peyto intends to aggressively develop the numerous drilling opportunities identified on the Open Range lands by deploying two additional drilling rigs, beyond the six that are currently running on Peyto lands. It is anticipated that up to 55 gross (45 net) wells will be drilled over the next three years for a cumulative capital investment that is currently estimated at $245 million. Recent gains in Peyto's drilling efficiency are expected to reduce this estimate and further enhance the value of the Open Range acquisition for Peyto shareholders.

Much like Peyto's Greater Sundance area where successful drilling activity has generated years of additional development opportunities, Peyto expects the Open Range lands to ultimately yield many more locations beyond those currently identified. Integration of the acquired properties is not anticipated to displace any of Peyto's existing growth plans.

Highlights of the acquisition are as follows:

- Approximately 31 mmcf/d and 460 bbl/d of long life, natural gas and liquids production.
- Of this production over 98% will be operated by Peyto and processed in Peyto owned and operated facilities.
- Over 125 gross (110 net) sections of land primarily in the Sundance/Ansell area of the Alberta Deep Basin.
- Ownership and control of two strategically positioned gas plants in the Sundance/Ansell area with the option to install deep cut processing facilities. These plants have approximately 25 MMcf/d of unutilized processing capacity that adds immediate value to existing and future Peyto wells.
- Peyto has identified over 100 high rate of return, drilling locations offering sweet, liquids-rich potential in the five main formations that Peyto has already been actively developing (Cardium, Notikewin, Falher, Wilrich and Bluesky). These will complement Peyto's existing inventory of over 900 drilling locations.
- Over 115 square miles of three dimensional seismic data covering the Open Range lands.

Completion of the arrangement is expected to occur on August 14, 2012, subject to, among other things, the approval of at least 66⅔% of the votes cast at a meeting of Open Range shareholders.

Outlook

The bulk of Peyto's expanded drilling program of $450 million will be executed in the second half of 2012. This will be the most active period in Peyto's history. At an annualized rate of almost $600 million per year, this pace of capital investment represents one of the largest, natural gas directed capital programs currently in Alberta and sets Peyto apart as a leader in the development of Alberta's natural gas resources. Peyto's advantage as the lowest cost producer in the industry makes this level of capital investment possible during a period of lower natural gas prices and allows Peyto to take advantage of reduced natural gas activity and lower service costs.

With approximately $400 million of the capital program directed to Peyto's existing assets and $50 million towards opportunities that Peyto has identified on the Open Range lands, production is expected to reach 57,000 boe/d by year end. At the same time, Alberta natural gas prices are forecast to recover to over $3/GJ by December 2012, allowing Peyto to fund this capital investment through growing Funds from Operations and available bank lines.

As always, Peyto will maintain its financial flexibility with a healthy balance sheet and remain positioned to take advantage of future opportunities to maximize returns for shareholders.

Shareholders and interested investors are encouraged to visit the Peyto website at www.peyto.com where a monthly president's report allows you to follow the progress of the capital program and ensuing production growth.

Darren Gee
President and CEO
August 8, 2012

Management’s discussion and analysis

This Management's Discussion and Analysis (“MD&A”) should be read in conjunction with the unaudited condensed financial statements for the period ended June 30, 2012 and the audited consolidated financial statements of Peyto Exploration & Development Corp. (“Peyto” or the “Company”) for the year ended December 31, 2011. The financial statements have been prepared in accordance with the International Accounting Standards Board (“IASB”) most current International Financial Reporting Standards (“IFRS”) and International Accounting Standards (“IAS”).

This discussion provides management's analysis of Peyto's historical financial and operating results and provides estimates of Peyto's future financial and operating performance based on information currently available. Actual results will vary from estimates and the variances may be significant. Readers should be aware that historical results are not necessarily indicative of future performance. This MD&A was prepared using information that is current as of August 7, 2012. Additional information about Peyto, including the most recently filed annual information form is available at www.sedar.com and on Peyto’s website at www.peyto.com.

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

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

Subsequent to the second quarter, Peyto announced an agreement to purchase all of the issued and outstanding common shares of Open Range Energy Corp.”) on the basis of a share exchange, pursuant to a statutory plan of arrangement. This represents the first corporate acquisition in the Company’s thirteen year history. The acquisition is expected to close on August 14, 2012 subject to, among other things, the approval of Open Range shareholders. A copy of the amended Arrangement Agreement was filed by Open Range and is available for viewing on SEDAR at www.sedar.com.

OVERVIEW

Peyto is a Canadian energy company involved in the development and production of natural gas in Alberta’s deep basin. As at December 31, 2011, the total Proved plus Probable reserves were 1,935 billion cubic feet equivalent (322.4 million barrels of oil equivalent) as evaluated by Peyto’s independent petroleum engineers. Production is weighted approximately 89% to natural gas and 11% to natural gas liquids and oil.

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

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

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

QUARTERLY FINANCIAL INFORMATION

	2012		2011				2010	
($000 except per share amounts)	**Q2**	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Total revenue (net of royalties)	**86,553**	93,661	104,394	98,261	91,186	89,655	80,921	69,650
Funds from operations	**64,732**	77,645	80,410	82,506	77,010	74,696	69,201	56,341
Per share – basic and diluted	**0.47**	0.56	0.60	0.62	0.58	0.56	0.55	0.46
Earnings	**18,201**	26,868	26,036	37,741	32,718	31,688	95,419	33,983
Per share – basic and diluted	**0.13**	0.19	0.19	0.28	0.25	0.24	0.76	0.28
Dividends	**24,927**	24,912	24,245	23,951	23,951	23,921	46,299	43,875
Per share – basic and diluted	**0.18**	0.18	0.18	0.18	0.18	0.18	0.36	0.36

Funds from Operations

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

RESULTS OF OPERATIONS

Production

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Natural gas (mmcf/d)	**221.2**	183.8	**221.0**	175.3
Oil & natural gas liquids (bbl/d)	**4,480**	3,811	**4,291**	3,779
Barrels of oil equivalent (boe/d)	**41,343**	34,443	**41,123**	32.995
Thousand cubic feet equivalent (mmcfe/d)	**248.1**	206.7	**246.7**	198.0

Natural gas production averaged 221.2 mmcf/d in the second quarter of 2012, 20 percent higher than the 183.8 mmcf/d reported for the same period in 2011. Oil and natural gas liquids production averaged 4,480 bbl/d, an increase of 18 percent from 3,811 bbl/d reported in the prior year. Second quarter production increased 20 percent from 206.7 mmcfe/d to 248.1 mmcfe/d. The production increases are attributable to Peyto's capital program and resulting production additions.

Oil & Natural Gas Liquids Production by Component

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Condensate (bbl/d)	**1,544**	1,448	**1,577**	1,461
Propane (bbl/d)	**858**	690	**763**	647
Butane (bbl/d)	**868**	739	**782**	696
Pentane (bbl/d)	**1,090**	885	**1,047**	869
Other NGL's (bbl/d)	**120**	49	**122**	106
Oil & natural gas liquids (bbl/d)	**4,480**	3,811	**4,291**	3,779
Thousand cubic feet equivalent (mmcfe/d)	**26.9**	22.9	**25.7**	22.7

Commodity Prices

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Oil and natural gas liquids ($/bbl)	**71.27**	84.06	**77.75**	80.18
Natural gas ($/mcf)	**1.98**	4.03	**2.32**	4.04
Hedging – gas ($/mcf)	**0.88**	0.40	**0.87**	0.62
Natural gas – after hedging ($/mcf)	**2.86**	4.43	**3.19**	4.66
Total Hedging ($/mcfe)	**0.78**	0.35	**0.78**	0.55

Total Hedging ($/boe)	**4.70**	2.10	**4.67**	3.30

Peyto's natural gas price, before hedging gains, averaged $1.98/mcf during the second quarter of 2012, a decrease of 51 percent from $4.03/mcf reported for the equivalent period in 2011. Oil and natural gas liquids prices averaged $71.27/bbl, a decrease of 15 percent from $84.06/bbl a year earlier. Hedging activity increased Peyto's achieved price/mcfe by 25% from $2.86 to $3.83.

Oil & Natural Gas Liquids Prices by Component

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Condensate ($/bbl)	**90.14**	98.66	**95.22**	93.46
Propane ($/bbl)	**18.61**	42.96	**24.42**	42.26
Butane ($/bbl)	**61.10**	66.52	**64.69**	62.11
Pentane ($/bbl)	**93.44**	99.76	**97.97**	94.75

Revenue

	Three Months ended June 30		Six Months ended June 30	
($000)	**2012**	2011	**2012**	2011
Natural gas	**39,823**	67,452	**93,388**	128,223
Oil and natural gas liquids	**29,056**	29,155	**60,711**	54,842
Hedging gain	**17,674**	6,586	**34,949**	19,705
Total revenue	**86,553**	103,193	**189,048**	202,770

For the three months ended June 30, 2012, revenue decreased 16 percent to $86.6 million from $103.2 million for the same period in 2011. The decrease in revenue for the period was a result of lower realized natural gas, oil and NGL prices offset with increases in volumes as detailed in the following table:

	Three Months ended June 30			Six Months ended June 30		
	2012	2011	**$million**	2012	2011	**$million**
Total Revenue, June 30, 2011			**103.2**			**202.8**
Revenue change due to:						
Natural gas						
Volume (mmcf)	20,127	16,725	**15.1**	40,221	31,729	**39.5**
Price ($/mcf)	$2.86	$4.43	**(31.6)**	$3.19	$4.66	**(59.1)**
Oil & NGL						
Volume (mbbl)	408	347	**5.1**	781	684	**7.8**
Price ($/bbl)	$71.27	$84.06	**(5.2)**	$77.75	$80.18	**(1.9)**
Total Revenue, June 30, 2012			**86.6**			**189.1**

Royalties

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

	Three Months ended June 30		Six Months ended June 30	
($000 except per share amounts)	**2012**	2011	**2012**	2011
Royalties	**6,082**	12,007	**14,917**	21,929
% of sales before hedging	**8.8**	12.4	**9.7**	12.0
% of sales after hedging	**7.0**	11.6	**7.9**	10.8
$/mcfe	**0.26**	0.64	**0.33**	0.61
$/boe	**1.56**	3.84	**1.99**	3.67

For the second quarter of 2012, royalties averaged $0.26/mcfe or approximately 7% of Peyto's total petroleum and natural gas sales.

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

In addition to the basic underlying royalty structure (the ARF), Alberta has instituted additional features that impact the royalty paid on gas and gas liquids for new wells drilled subsequent to Janaury 1, 2009. These additional features include:

1. A drilling royalty credit program that terminated on March 31, 2011. Under this program credits were earned at a rate of $200 per meter of newly drilled well depth and could be applied with certain limitations to the earning company's corporate royalty bill,
2. A one year flat 5% royalty period (18 months for horizontal wells) for each new well but capped at a cumulative production level of 500 MMcf for each new well, and
3. A Natural Gas Deep Drilling Holiday program that provides a royalty holiday value for new wells based on meterage drilled. This holiday feature further reduces the royalty for new wells to a minimum of 5% for a maximum 5 year period from on-stream date. This benefit sequentially follows the benefit under point (2) above.

From the combination of these royalty programs, Peyto has experienced a decrease in overall corporate royalty rates. This, in part, can be attributed to a decline in commodity prices and the dependence of royalty rates on commodity prices. In its 13 year history, Peyto has invested $2.4 billion in capital projects, found and developed 1.4 TCFe of gas reserves, and paid over $588 million in royalties.

Operating Costs & Transportation

Peyto's operating expenses include all costs with respect to day-to-day well and facility operations.

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Total operating costs	**6,603**	5,945	**13,904**	12,516
$/mcfe	**0.29**	0.32	**0.31**	0.35
$/boe	**1.76**	1.90	**1.66**	2.10
Transportation	**2,645**	2,371	**5,251**	4,535
$/mcfe	**0.12**	0.13	**0.12**	0.13
$/boe	**0.70**	0.76	**0.70**	0.76

Operating costs increased to $6.6 million in the second quarter of 2012 from $5.9 million for the equivalent period in 2011 due to increased production volumes. On a unit-of-production basis, operating costs decreased 7% averaging $0.29/mcfe in the second quarter of 2012 compared to $0.32/mcfe for the equivalent period in 2011. Transportation expense remained unchanged on a per mcfe basis.

General and Administrative Expenses

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
G&A expenses ($000)	**2,810**	2,635	**5,744**	5,699
Overhead recoveries	**(1,171)**	(1,287)	**(3,134)**	(2,745)
Net G&A expenses	**1,639**	1,348	**2,610**	2,954
$/mcfe	**0.07**	0.07	**0.06**	0.08
$/boe	**0.44**	0.41	**0.35**	0.48

For the second quarter, general and administrative expenses before overhead recoveries were up 7% over the same quarter of 2011. Capital overhead recoveries decreased 9% for the second quarter from $1.3 million to $1.2 million due to decreased gross capital spending**.** General and administrative expenses averaged $0.07/mcfe in the second quarter of 2012 unchanged from the same period in 2011.

Interest Expense

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Interest expense ($000)	**4,996**	4,512	**10,134**	9,130
$/mcfe	**0.23**	0.24	**0.22**	0.25
$/boe	**1.38**	1.44	**1.32**	1.53
Average interest rate	**4.1%**	4.1%	**4.3%**	4.4%

Second quarter 2012 interest expense was $5.0 million or $0.23/mcfe compared to $4.5 million or $0.24/mcfe for the second quarter 2011.

Netbacks

	Three Months ended June 30		Six Months ended June 30	
($/mcfe)	**2012**	2011	**2012**	2011
Gross Sale Price	**3.05**	5.15	**3.43**	5.11
Hedging gain	**0.78**	0.35	**0.78**	0.55
Net Sale Price	**3.83**	5.50	**4.21**	5.66
Less: Royalties	**0.26**	0.64	**0.33**	0.61
Operating costs	**0.29**	0.32	**0.31**	0.35
Transportation	**0.12**	0.13	**0.12**	0.13
Field netback	**3.16**	4.41	**3.45**	4.57
General and administrative	**0.07**	0.07	**0.06**	0.08
Interest on long-term debt	**0.23**	0.24	**0.22**	0.25
Cash netback ($/mcfe)	**2.86**	4.10	**3.17**	4.24
Cash netback ($/boe)	**17.17**	24.60	**19.02**	25.44

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

Depletion, Depreciation and Amortization

Under IFRS, Peyto uses proved plus probable reserves as its depletion base to calculate depletion expense. The 2012 second quarter provision for depletion, depreciation and amortization totaled $39.1 million as compared to $30.9 million in 2011 due to higher levels of production and a larger asset base. On a unit-of-production basis, depletion and depreciation costs averaged $1.73/mcfe as compared to $1.64/mcfe in 2011.

Income Taxes

The current provision for deferred income tax expense is $15.0 million (2011 - $10.9 million). Peyto paid no cash taxes or tax installments for the three months ended June 30, 2012 or for the comparative period in 2011. Resource pools are generated from the capital program, which are available to offset current and deferred income tax liabilities.

Income Tax Pool type ($ millions)	**June 30, 2012**	December 31, 2011	**Annual deductibility**
Canadian Oil and Gas Property Expense	173.6	179.5	10% declining balance
Canadian Development Expense	479.4	457.3	30% declining balance
Canadian Exploration Expense	153.0	163.0	100%
Undepreciated Capital Cost	156.2	156.8	Primarily 25% declining balance
Other	38.5	41.5	Various rates, 7% declining balance to 20%
Total Federal Tax Pools	**1,000.7**	998.1	
Additional Alberta Tax Pools	58.0	56.5	Various rates, 25% declining balance to 100%

MARKETING

Commodity Price Risk Management

Peyto is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. Peyto enters into these forward contracts with well established counterparties for the purpose of protecting a portion of its future revenues from the volatility of oil and natural gas prices. In order to minimize counterparty risk, these marketing contracts are executed with financial institutions that are members of Peyto's loan syndicate. During the second quarter of 2012, a realized hedging gain of $17.7 million was recorded as compared to $6.6 million for the equivalent period in 2011. A summary of contracts outstanding in respect of the hedging activities are as follows:

Propane **Period Hedged**	**Type**	**Monthly** **Volume**	**Price** **(CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$49.56/BBL
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$44.10/BBL

Butane **Period Hedged**	**Type**	**Monthly** **Volume**	**Price** **(CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$80.64/BBL

Iso-Butane **Period Hedged**	**Type**	**Monthly** **Volume**	**Price** **(CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	1,000 BBL	$82.32/BBL

Natural Gas Period Hedged	Type	Daily Volume	Price (CAD)
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.05/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.15/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.10/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.055/GJ
April 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$3.80/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.17/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.10/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.10/GJ
November 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to December 31, 2012	Fixed Price	5,000 GJ	$3.3125/GJ
April 1, 2012 to December 31, 2012	Fixed Price	5,000 GJ	$3.395/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to March 31, 2013	Fixed Price	5,000 GJ	$2.20/GJ
April 1, 2012 to March 31, 2013	Fixed Price	5,000 GJ	$2.31/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.52/GJ
April 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
May 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.30/GJ
June 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$1.83/GJ
July 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$2.32/GJ
July 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$2.35/GJ
August 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.10/GJ
November 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.60/GJ
November 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$2.81/GJ
November 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
November 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.0575/GJ
April 1, 2013 to March 31, 2014	Fixed Price	5,000 GJ	$3.105/GJ

As at June 30, 2012, Peyto had committed to the future sale of 49,000 barrels of propane at an average price of $61.56 per barrel and 51,510,000 gigajoules (GJ) of natural gas at an average price of $3.29 per GJ or $3.84 per mcf. Had these contracts closed on June 30, 2012, Peyto would have realized a gain in the amount of $26.1 million.

Subsequent to June 30, 2012 Peyto entered into the following contracts:

Propane **Period Hedged**	**Type**	**Monthly Volume**	**Price (CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$32.34/BBL

Butane **Period Hedged**	**Type**	**Monthly Volume**	**Price (CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$58.38/BBL

Iso-Butane **Period Hedged**	**Type**	**Monthly Volume**	**Price (CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	1,000 BBL	$60.48/BBL

Natural Gas **Period Hedged**	**Type**	**Daily Volume**	**Price (CAD)**
August 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
January 1, 2013 to December 31, 2013	Fixed Price	5,000 GJ	$3.105/GJ

Commodity Price Sensitivity

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

Currency Risk Management

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

Interest Rate Risk Management

Peyto is exposed to interest rate risk in relation to interest expense on its revolving demand facility. Currently there are no agreements to manage this risk. At June 30, 2012, the increase or decrease in earnings for each 100 bps (1%) change in interest rate paid on the outstanding revolving demand loan amounts to approximately $1.0 million per quarter. Average debt outstanding for the second quarter of 2012 was $495.0 million.

LIQUIDITY AND CAPITAL RESOURCES

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

	Three Months ended June 30		Six Months ended June 30	
($000)	**2011**	2011	**2011**	2011
Cash flows from operating activities	**74,551**	81,831	**133,934**	124,718
Change in non-cash working capital	**(10,934)**	(7,169)	**5,433**	20,416
Change in provision for performance based compensation	**1,115**	2,348	**3,010**	6,572
Funds from operations	**64,732**	77,010	**142,377**	151,706
Funds from operations per share	**0.47**	0.58	**1.03**	1.14

For the second quarter ended June 30, 2012, funds from operations totaled $64.7 million or $0.47 per share, as compared to $77.0 million, or $0.58 per share during the same quarter in 2011. Peyto's policy is to balance dividends to shareholders and funding for a capital program with cash flow and available bank lines. Earnings and cash flow are sensitive to changes in commodity prices, exchange rates and other factors that are beyond Peyto's control. Current volatility in commodity prices creates uncertainty as to the funds from operations and capital expenditure budget. Accordingly, results are assessed throughout the year and operational plans revised as necessary to reflect the most current information.

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

Bank Debt

Peyto has a syndicated $700 million extendible revolving credit facility with a stated term date of April 29, 2013. The facility is made up of a $30 million working capital sub-tranche and a $670 million production line. The facilities are available on a revolving basis for a period of at least 364 days and upon the term out date may be extended for a further 364 day period at the request of Peyto, subject to approval by the lenders. In the event that the revolving period is not extended, the facility is available on a non-revolving basis for a one year term, at the end of which time the facility would be due and payable. The loan has therefore been classified as long-term on the balance sheet. The average borrowing rate for the three months ended June 30, 2012 was 4.0% (2011 – 4.1%). Outstanding amounts on this facility will bear interest at rates determined by Peyto's debt to cash flow ratio that range from prime plus 1.25% to prime plus 2.75% for debt to earnings before interest, taxes, depreciation, depletion and amortization (EBITDA) ratios ranging from less than 1:1 to greater than 2.5:1. A General Security Agreement with a floating charge on land registered in Alberta is held as collateral by the bank.

At June 30, 2012, $395 million was drawn under the facility. Working capital liquidity is maintained by drawing from and repaying the unutilized credit facility as needed. At June 30, 2012, the working capital deficit was $3.5 million (including a non-cash current asset for an unrealized mark to market future hedging gain of $27.4 million).

On January 3, 2012, Peyto issued CDN $100 million of senior secured notes pursuant to a note purchase and private shelf agreement with Prudential Investment Management, Inc. The notes were issued by way of private placement and rank equally with Peyto's obligations under its credit facility. The notes have a coupon rate of 4.39% and mature on January 3, 2019. Interest will be paid semi-annually in arrears. Proceeds from the notes were used to repay a portion of Peyto's outstanding bank debt.

Upon the issuance of the senior secured notes January 3, 2012, Peyto became subject to the following financial covenants as defined in the credit facility and note purchase and private shelf agreements:

- Senior Debt to EBITDA Ratio will not exceed 3.0 to 1.0.
- Total Debt to EBITDA Ratio will not exceed 4.0 to 1.0.
- Interest Coverage Ratio will not be less than 3.0 to 1.0
- Total Debt to Capitalization Ratio will not exceed 0.55:1.0

Peyto is in compliance with all financial covenants.

The private shelf agreement with Prudential was amended on June 25, 2012 to provide for the issuance, on an uncommitted basis, of an additional US $50 million of senior notes on or prior to January 3, 2015.

Peyto believes funds generated from operations, together with borrowings under the credit facility will be sufficient to maintain dividends, finance current operations, and fund the planned capital expenditure program. The total amount of capital invested in 2012 will be driven by the number and quality of projects generated. Capital will only be invested if it meets the long term objectives of Peyto. The majority of the capital program will involve drilling, completion and tie-in of lower risk development gas wells. Peyto's rapidly scaleable business model has the flexibility to match planned capital expenditures to actual cash flow.

Net Debt

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

($000)	**As at June 30, 2012**	As at December 31, 2011	As at June 30, 2011
Long-term debt	**495,000**	470,000	455,000
Working capital deficit (surplus)	**3,492**	(38,818)	10,651
Financial derivative instruments	**27,409**	38,530	18,448
Provision for future performance based compensation	**(6,573)**	(4,321)	(10,091)
Net debt	**519,328**	465,391	474,008

Capital
Authorized: Unlimited number of voting common shares

Issued and Outstanding

Common shares (no par value) ($000)	**Number of Shares**	**Amount**
Balance, December 31, 2010	**131,875,382**	**755,831**
Common shares issued by private placement	906,196	17,150
Common shares issued pursuant to DRIP	113,527	1,973
Common shares issued pursuant to OTUPP	166,196	2,889
Common shares issued	4,899,000	115,126
Common shares issuance costs (net of tax)	-	(3,854)
Balance, December 31, 2011	**137,960,301**	**889,115**
Common shares issued by private placement	525,655	11,926
Balance, June 30, 2012	**138,485,956**	**901,041**

Peyto reinstated its amended distribution reinvestment and optional trust unit purchase plan (the "Amended DRIP Plan") effective with the January 2010 distribution whereby eligible unitholders could elect to reinvest their monthly cash distributions in additional trust units at a 5 percent discount to market price. The DRIP plan incorporated an Optional Trust Unit Purchase Plan (“OTUPP”) which provided unitholders enrolled in the DRIP with the opportunity to purchase additional trust units from treasury using the same pricing as the DRIP. The DRIP and the OTUPP plans were cancelled December 31, 2010.

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

On January 14, 2011, 279,723 common shares (113,527 pursuant to the DRIP and 166,196 pursuant to the OTUPP) were issued for net proceeds of $4.9 million.

On March 25, 2011, Peyto completed a private placement of 250,615 common shares to employees and consultants for net proceeds of $4.6 million ($18.86 per share). Subsequent to the issuance of these shares, 133,061,301 common shares were outstanding.

On December 31, 2011, Peyto completed a private placement of 397,235 common shares to employees and consultants for net proceeds of $9.7 million ($24.52 per share). These shares were issued on January 13, 2012.

On March 23, 2012, Peyto completed a private placement of 128,420 common shares to employees and consultants for net proceeds of $2.2 million ($17.22 per share). Subsequent to the issuance of these shares, 138,485,956 common shares were outstanding.

Performance Based Compensation
Peyto awards performance based compensation to employees and key consultants annually. The performance based compensation is comprised of market and reserve value based components.

The reserve value based component is 4% of the incremental increase in value, if any, as adjusted to reflect changes in debt, equity, dividends, general and administrative expenses and interest expense, of proved producing reserves calculated using a constant price at December 31 of the current year and a discount rate of 8%. This methodology can generate interim results which vary significantly from the final compensation paid. Compensation expense of $0.5 million was recorded for the period ended June 30, 2012.

Under the market based component, rights vesting over three years are allocated to employees and key consultants. The number of rights outstanding at any time is not to exceed 6% of the total number of common shares outstanding. At

December 31 of each year, all vested rights are automatically cancelled and, if applicable, paid out in cash. Compensation is calculated as the number of vested rights multiplied by the total of the market appreciation (over the price at the date of grant) and associated dividends of a share for that period.

Based on the weighted average trading price of the common shares for the period ended June 30, 2012, compensation costs related to 4.0 million non-vested rights (3% of the total number of common shares outstanding), with an average grant price of $21.42, are $1.2 million for the second quarter of 2012. Peyto records a non-cash provision for future compensation expense over the life of the rights calculated using a Black-Scholes valuation model (refer to Note 12 of the Condensed Interim Financial Statements for the more details). The cumulative provision totals $8.1 million.

Capital Expenditures

Net capital expenditures for the second quarter of 2012 totaled $45.9 million. Exploration and development related activity represented $37.4 million (82% of total), while expenditures on facilities, gathering systems and equipment totaled $7.3 million (16% of total) and land, seismic and acquisitions/dispositions totaled $1.2 million (2% of total). The following table summarizes capital expenditures for the period:

	Three Months ended June 30		Six Months ended June 30	
($000)	**2012**	2011	**2012**	2011
Land	**1,172**	678	**3,337**	1,932
Seismic	**24**	663	**660**	751
Drilling – Exploratory & Development	**37,422**	47,111	**120,391**	130,568
Production Equipment, Facilities & Pipelines	**7,310**	20,557	**20,173**	35,196
Acquisitions	**-**	8	**-**	5,054
Dispositions	**(4)**	-	**(4)**	(698)
Total Capital Expenditures	**45,924**	69,017	**144,557**	172,803

Dividends

	Three Months ended June 30		Six Months ended June 30	
	2012	2011	**2012**	2011
Funds from operations ($000)	**64,732**	77,010	**142,377**	151,706
Total dividends ($000)	**24,927**	23,951	**49,808**	47,872
Total dividends per share ($)	**0.18**	0.18	**0.36**	0.36
Payout ratio (%)	**39**	31	**35**	32

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

Contractual Obligations

Peyto has contractual obligations and commitments as follows:

	2012	**2013**	**2014**	**2015**	**2016**	**Thereafter**
Note repayment(1)	-	-	-	-	-	100,000
Interest payments(2)	2,195	4,390	4,390	4,390	4,390	10,975
Transportation commitments	5,492	10,973	10,056	7,492	3,187	1,314
Operating lease	536	1,071	1,071	-	-	-
Total	8,223	16,434	15,517	11,882	7,577	112,289

(1) Long-term debt repayment on senior secured notes

(2) Fixed interest payments on senior secured notes

RELATED PARTY TRANSACTIONS

An officer and director of Peyto is a partner of a law firm that provides legal services to Peyto. The fees charged are based on standard rates and time spent on matters pertaining to Peyto.

RISK MANAGEMENT

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

Expected returns depend largely on the volume of petroleum and natural gas production and the price received for such production, along with the associated costs. The price received for oil depends on a number of factors, including West Texas Intermediate oil prices, Canadian/US currency exchange rates, quality differentials and Edmonton par oil prices. The price received for natural gas production is primarily dependent on current Alberta market prices. Peyto's marketing strategy is designed to smooth out short term fluctuations in the price of natural gas through future sales. It is meant to be methodical and consistent and to avoid speculation.

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

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

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

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

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

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

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

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

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

Peyto is required to disclose herein any change in Peyto's internal control over financial reporting that occurred during the period ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, Peyto's internal control over financial reporting. No material changes in Peyto's internal control over financial reporting were identified during such period that has materially affected, or are reasonably likely to materially affect, Peyto's internal control over financial reporting.

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

CRITICAL ACCOUNTING ESTIMATES

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

Peyto's estimated quantities of proved and probable reserves at December 31, 2011 were audited by independent petroleum engineers InSite Petroleum Consultants Ltd. InSite has been evaluating reserves in this area and for Peyto for 13 consecutive years.

Depletion and Depreciation Estimate
All costs of exploring for and developing petroleum and natural gas reserves, together with the costs of production equipment, are capitalized and then depleted and depreciated on the unit-of-production method based on estimated gross proven reserves. Petroleum and natural gas reserves and production are converted into equivalent units based upon estimated relative energy content (6 mcf to 1 barrel of oil). Costs for gas plants and other facilities are capitalized and depreciated on a declining balance basis.

Impairment of Long-Lived Assets
Impairment is indicated if the carrying value of the long-lived asset or oil and gas cash generating unit exceeds its recoverable amount under IFRS. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings. The determination of the recoverable amount for impairment purposes under IFRS involves the use of numerous assumptions and judgments including future net cash flows from oil and gas reserves, future third-party pricing, inflation factors, discount rates and other uncertainties. Future revisions to these assumptions impact the recoverable amount.

Decommissioning Provision
The decommissioning provision is estimated based on existing laws, contracts or other policies. The fair value of the obligation is based on estimated future costs for abandonment and reclamation discounted at a risk free rate. The liability is adjusted each reporting period to reflect the passage of time and for revisions to the estimated future cash flows, with the

accretion charged to earnings. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material.

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

Reserve Value Performance Based Compensation
The reserve value based compensation is calculated using the year end independent reserves evaluation which was completed in February 2012. A quarterly provision for the reserve value based compensation is calculated using estimated proved producing reserve additions adjusted for changes in debt, equity, dividends, general and administrative expenses and interest expense. Actual proved producing reserves additions and forecasted commodity prices could vary significantly from those estimated and may have a material effect on the calculation.

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

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

CHANGES IN ACCOUNTING POLICIES

Presentation of Financial Statements
As of January 1, 2012, Peyto adopted IAS 1, "Presentation of Items of OCI: Amendments to IAS 1 Presentation of Financial Statements." The amendments stipulate the presentation of net earnings and OCI and also require Peyto to group items within OCI based on whether the items may be subsequently reclassified to profit or loss.

STANDARDS ISSUED BUT NOT YET EFFECTIVE

The IASB issued the following standards and amendments which are not yet effective for Peyto and discussed in further detail in Note 2 to the Financial Statements for the fiscal year ended December 31, 2011. The IASB did not issue any standards, interpretations or amendments during the second quarter of 2012.

- IFRS 11, "Joint Arrangements," requires retrospective application and will be adopted by Peyto on January 1, 2013. The adoption of the standard is not expected to have a material impact on Peyto's financial statements.

- IFRS 12, "Disclosure of Interest in Other Entities," requires retrospective application and will be adopted by Peyto on January 1, 2013. The adoption of the standard is not expected to have a material impact on Peyto's financial statements.

- Amendments to IAS 28, "Investment in Associates and Joint Ventures," require retrospective application and will be adopted by Peyto on January 1, 2013. The adoption of the amended standard is not expected to have a material impact on Peyto's financial statements.

- IFRS 13, "Fair Value Measurement," requires prospective application and will be adopted by Peyto on January 1, 2013. The impact of adoption of IFRS 13 has not yet been determined.

- Amendments to IFRS 7, "Financial Instruments: Disclosures," require retrospective application and will be adopted by Peyto on January 1, 2013. The adoption of this standard is not expected to have a material impact on Peyto's financial statements.

- Amendments to IAS 32, "Financial Instruments: Presentation," require retrospective application and will be adopted by Peyto on January 1, 2014. The adoption of this standard is not expected to have a material impact on Peyto's financial statements.

- IFRS 9, "Financial Instruments," requires retrospective application and will be adopted by Peyto on January 1, 2015. The impact of the adoption of this standard has not yet been determined.

ADDITIONAL INFORMATION

Additional information relating to Peyto Exploration & Development Corp. can be found on SEDAR at www.sedar.com and www.peyto.com.

Quarterly information

	2012		2011		
	Q2	Q1	Q4	Q3	Q2
Operations					
Production					
Natural gas (mcf/d)	221,176	220,811	212,715	194,832	183,790
Oil & NGLs (bbl/d)	4,480	4,101	3,947	3,918	3,811
Barrels of oil equivalent (boe/d @ 6:1)	41,343	40,903	39,399	36,390	34,443
Thousand cubic feet equivalent (mcfe/d @ 6:1)	248,058	245,417	236,394	218,338	206,657
Average product prices					
Natural gas ($/mcf)	2.86	3.53	4.21	4.43	4.43
Oil & natural gas liquids ($/bbl)	71.27	84.83	88.04	78.07	84.06
$/MCFE					
Average sale price ($/mcfe)	3.83	4.59	5.25	5.35	5.50
Average royalties paid ($/mcfe)	0.26	0.39	0.46	0.45	0.64
Average operating expenses ($/mcfe)	0.29	0.33	0.35	0.36	0.32
Average transportation costs ($/mcfe)	0.12	0.12	0.12	0.13	0.13
Field netback ($/mcfe)	3.16	3.75	4.32	4.41	4.41
General & administrative expense ($/mcfe)	0.07	0.04	0.05	0.04	0.07
Interest expense ($/mcfe)	0.23	0.23	0.35	0.26	0.24
Cash netback ($/mcfe)	2.86	3.48	3.92	4.11	4.10
Financial ($000 except per share)					
Revenue	86,553	102,496	114,263	107,526	103,193
Royalties	6,082	8,835	9,870	9,265	12,007
Funds from operations	64,732	77,645	80,410	82,506	77,010
Funds from operations per share	0.47	0.56	0.60	0.62	0.58
Total dividends	24,927	24,912	24,245	23,951	23,951
Total dividends per share	0.18	0.18	0.18	0.18	0.18
Payout ratio	39%	32%	30%	29%	31%
Earnings	18,201	26,868	26,036	37,341	32,718
Earnings per diluted share	0.13	0.19	0.19	0.28	0.25
Capital expenditures	45,924	98,632	94,688	111,570	69,017
Weighted average shares outstanding	138,485,956	138,312,078	133,913,301	133,061,301	133,061,301

Peyto Exploration & Development Corp.

Condensed Balance Sheet *(unaudited)*

(Amount in $ thousands)

	June 30 2012	December 31 2011
Assets		
Current assets		
Cash	-	57,224
Accounts receivable	39,793	53,829
Due from private placement *(Note 6)*	-	9,740
Financial derivative instruments *(Note 8)*	27,409	38,530
Prepaid expenses	11,454	3,991
	78,656	**163,314**
Long-term financial derivative instruments *(Note 8)*	-	6,304
Prepaid capital	6,923	1,414
Property, plant and equipment, net *(Note 3)*	1,703,631	1,629,220
	1,710,554	**1,636,938**
	1,789,210	**1,800,252**
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	67,265	110,483
Dividends payable *(Note 6)*	8,309	8,278
Provision for future performance based compensation *(Note 7)*	6,573	4,321
	82,147	**123,082**
Long-term financial derivative instruments *(Note 8)*	1,331	-
Long-term debt *(Note 4)*	495,000	470,000
Provision for future performance based compensation *(Note 7)*	1,993	1,235
Decommissioning provision *(Note 5)*	47,154	38,037
Deferred income taxes	162,527	152,190
	708,005	**661,462**
Shareholders' equity		
Shareholders' capital *(Note 6)*	901,041	889,115
Shares to be issued *(Note 6)*	-	9,740
Retained earnings	78,119	82,889
Accumulated other comprehensive income *(Note 6)*	19,898	33,964
	999,058	**1,015,708**
	1,789,210	**1,800,252**

Approved by the Board of Directors

(signed) *"Michael MacBean"*
Director

(signed) *"Darren Gee"*
Director

Peyto Exploration & Development Corp.

Condensed Income Statement *(unaudited)*

(Amount in $ thousands)

	Three months ended June 30		Six months ended June 30	
	2012	**2011**	**2012**	**2011**
Revenue				
Oil and gas sales	68,879	96,607	154,100	183,065
Realized gain on hedges	17,674	6,586	34,949	19,705
Royalties	(6,082)	(12,007)	(14,917)	(21,929)
Petroleum and natural gas sales, net	**80,471**	**91,186**	**174,132**	**180,841**
Expenses				
Operating	6,603	5,945	13,904	12,516
Transportation	2,645	2,371	5,251	4,535
General and administrative	1,639	1,348	2,610	2,954
Future performance based compensation *(Note 7)*	1,115	2,348	3,010	6,572
Interest	4,996	4,512	10,134	9,130
Accretion of decommissioning provision	232	234	489	465
Depletion and depreciation *(Note 3)*	39,101	30,850	78,774	59,876
Gain on disposition of assets *(Note 3)*	(144)	-	(144)	(818)
	56,187	**47,608**	**114,028**	**95,230**
Earnings before taxes	**24,284**	**43,578**	**60,104**	**85,611**
Income tax				
Deferred income tax expense	6,083	10,860	15,035	21,205
Earnings for the period	**18,201**	**32,718**	**45,069**	**64,406**
Earnings per share *(Note 6)*				
Basic and diluted	**$ 0.13**	**$ 0.25**	**$ 0.33**	**$ 0.49**
Weighted average number of common shares outstanding *(Note 6)*				
Basic and diluted	**138,485,956**	**133,061,301**	**138,399,017**	**132,900,079**

Peyto Exploration & Development Corp.

Condensed Statement of Comprehensive Income (Loss) *(unaudited)*

(Amount in $ thousands)

	Three months ended June 30		Six months ended June 30	
	2012	**2011**	**2012**	**2011**
Earnings for the period	**18,201**	**32,718**	**45,069**	**64,406**
Other comprehensive income (loss)				
Change in unrealized gain (loss) on cash flow hedges	(10,923)	6,522	16,194	10,431
Deferred tax recovery	7,149	69	4,689	2,510
Realized (gain) loss on cash flow hedges	(17,674)	(6,586)	(34,949)	(19,705)
Comprehensive Income (Loss)	**(3,247)**	**32,723**	**31,003**	**57,642**

Peyto Exploration & Development Corp.

Condensed Statement of Changes in Equity *(unaudited)*

(Amount in $ thousands)

	Six months ended June 30	
	2012	**2011**
Shareholders' capital, beginning of period	**889,115**	755,831
Common shares issued	-	-
Common shares issued by private placement	11,952	17,150
Common shares issuance costs (net of tax)	(26)	(75)
Common shares issued pursuant to DRIP	-	1,973
Common shares issued pursuant to OTUPP	-	2,889
Shareholders' capital, end of period	**901,041**	777,768

Common shares to be issued, beginning of period	**9,740**	17,285
Common shares issued	(9,740)	(17,285)
Common shares to be issued	-	-
Common shares to be issued, end of period	**-**	-

Retained earnings, beginning of period	**82,889**	50,774
Earnings for the period	45,069	64,406
Dividends *(Note 6)*	(49,839)	(47,872)
Retained earnings, end of period	**78,119**	67,308

Accumulated other comprehensive income, beginning of period	**33,964**	20,893
Other comprehensive income (loss)	(14,066)	(6,764)
Accumulated other comprehensive income, end of period	**19,898**	14,129

Total shareholders' equity	**999,058**	859,205

Peyto Exploration & Development Corp.

Condensed Statement of Cash Flows *(unaudited)*

(Amount in $ thousands)

	Three months ended June 30		Six months ended June 30	
	2012	**2011**	**2012**	**2011**
Cash provided by (used in) operating activities				
Earnings	**18,201**	32,718	**45,069**	64,406
Items not requiring cash:				
Deferred income tax	**6,083**	10,860	**15,035**	21,205
Depletion and depreciation	**39,101**	30,850	**78,774**	59,876
Accretion of decommissioning provision	**232**	234	**489**	465
Change in non-cash working capital related to operating activities	**10,934**	7,169	**(5,433)**	(20,416)
	74,551	81,831	**133,934**	125,536
Financing activities				
Issuance of common shares	**-**	-	**11,952**	4,628
Issuance costs	**-**	(13)	**(35)**	-
Cash dividends paid	**(24,927)**	(23,951)	**(49,808)**	(43,291)
Increase (decrease) in bank debt	**25,000**	30,000	**(75,000)**	100,000
Issuance of long term notes	**-**	-	**100,000**	-
	73	6,036	**(12,891)**	61,337
Investing activities				
Additions to property, plant and equipment	**(74,624)**	(86,258)	**(178,267)**	(182,418)
Net increase (decrease) in cash	**-**	1,609	**(57,224)**	4,455
Cash, Beginning of Period	**-**	10,740	**57,224**	7,894
Cash, End of Period	**-**	12,349	**-**	12,349

The following amounts are included in cash flows from operating activities:

Cash interest paid	**4,122**	4,228	**8,435**	8,541
Cash taxes paid	**-**	-	**-**	-

Peyto Exploration & Development Corp.

Notes to Condensed Financial Statements *(unaudited)*

As at June 30, 2012 and 2011

(Amount in $ thousands, except as otherwise noted)

1. Nature of operations

Peyto Exploration & Development Corp. ("Peyto" or the "Company") is a Calgary based oil and natural gas company. Peyto conducts exploration, development and production activities in Canada. Peyto is incorporated and domiciled in the Province of Alberta, Canada. The address of its registered office is 1500, 250 – 2nd Street SW, Calgary, Alberta, Canada, T2P 0C1.

These financial statements were approved and authorized for issuance by the Audit Committee of Peyto on August 7, 2012.

2. Basis of presentation

The condensed financial statements have been prepared by management and reported in Canadian dollars in accordance with International Accounting Standard ("IAS") 34, "Interim Financial Reporting". These condensed financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the Company's Financial Statements for the year ended December 31, 2011.

The timely preparation of the condensed financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingencies, if any, as at the date of the financial statements and the reported amounts of revenue and expenses during the period. By their nature, estimates are subject to measurement uncertainty and changes in such estimates in future years could require a material change in the condensed financial statements.

All accounting policies and methods of computation followed in the preparation of these financial statements are the same as those disclosed in Note 2 of Peyto's audited Financial Statements as at and for the years ended December 31, 2011 and 2010.

3. Property, plant and equipment, net

Cost	
At December 31, 2011	1,843,766
Additions	153,185
Dispositions	-
At June 30, 2012	1,996,951
Accumulated depletion and depreciation	
At December 31, 2011	(214,546)
Depletion and depreciation	(78,774)
Dispositions	-
At June 30, 2012	(293,320)
Carrying amount at June 30, 2012	**1,703,631**

Proceeds received for assets disposed of during the three and six month periods ended June 30, 2012 were $0.1 million and $0.1 million (2011 - $nil and $1.5 million).

During the three and six month periods ended June 30 2012, Peyto capitalized $0.8 million and $2.5 million (2011 - $1.0 million and $2.3 million) of general and administrative expense directly attributable to production and development activities.

4. Long-term debt

Peyto has a syndicated $700 million extendible revolving credit facility with a stated term date of April 28, 2013.

The bank facility is made up of a $30 million working capital sub-tranche and a $670 million production line. The facilities are available on a revolving basis for a period of at least 364 days and upon the term out date may be extended for a further 364 day period at the request of Peyto, subject to approval by the lenders. In the event that the revolving period is not extended, the facility is available on a non-revolving basis for a further one year term, at the end of which time the facility would be due and payable. Outstanding amounts on this facility will bear interest at rates ranging from prime plus 1.25% to prime plus 2.75% determined by Peyto's debt to earnings before interest, taxes, depreciation, depletion and amortization (EBITDA) ratios ranging from less than 1:1 to greater than 2.5:1. A General Security Agreement with a floating charge on land registered in Alberta is held as collateral by the bank.

On January 3, 2012, Peyto issued CDN $100 million of senior secured notes pursuant to a note purchase and private shelf agreement. The notes were issued by way of private placement and rank equally with Peyto's obligations under its bank facility. The notes have a coupon rate of 4.39% and mature on January 3, 2019. Interest will be paid semi-annually in arrears.

Upon the issuance of the senior secured notes January 3, 2012, Peyto became subject to the following financial covenants as defined in the credit facility and note purchase and private shelf agreements:

- Senior Debt to EBITDA Ratio will not exceed 3.0 to 1.0.
- Total Debt to EBITDA Ratio will not exceed 4.0 to 1.0.
- Interest Coverage Ratio will not be less than 3.0 to 1.0
- Total Debt to Capitalization Ratio will not exceed 0.55:1.0

Peyto is in compliance with all financial covenants at June 30, 2012.

The private shelf agreement was amended on June 25, 2012 to provide for the issuance, on an uncommitted basis, of an additional US $50 million of senior notes on or prior to January 3, 2015.

Peyto's total borrowing capacity remains at $800 million; however Peyto's net credit facility is $700 million.

Total interest expense for the three and six month periods ended June 30, 2012 was $5.0 million and $10.1 million (2011 - $4.5 million and $9.1 million) and the average borrowing rate for the three and six month periods was 4.1% and 4.3% (2011 – 4.1% and 4.4%).

5. Decommissioning provision

Peyto makes provision for the future cost of decommissioning wells, pipelines and facilities on a discounted basis based on the commissioning of these assets.

The decommissioning provision represents the present value of the decommissioning costs related to the above infrastructure, which are expected to be incurred over the economic life of the assets. The provisions have been based on Peyto's internal estimates of the cost of decommissioning, the discount rate, the inflation rate and the economic life of the infrastructure. Assumptions, based on the current economic environment, have been made which management believes are a reasonable basis upon which to estimate the future liability. These estimates are reviewed regularly to take into account any material changes to the assumptions. However, actual decommissioning costs will ultimately depend upon the future market prices for the necessary decommissioning work required which will reflect market conditions at the relevant time. Furthermore, the timing of the decommissioning is likely to depend on when production activities ceases to be economically viable. This in turn will depend and be directly related to the current and future commodity prices, which are inherently uncertain.

The following table reconciles the change in decommissioning provision:

Balance, December 31, 2011	**38,037**
New or increased provisions	2,508
Accretion of decommissioning provision	489
Change in discount rate and estimates	6,120
Balance, June 30, 2012	**47,154**
Current	-
Non-current	47,154

Peyto has estimated the net present value of its total decommissioning provision to be $47.2 million as at June 30, 2012 ($38.0 million at December 31, 2011) based on a total future undiscounted liability of $109.0 million ($101.2 million at December 31, 2011). At June 30, 2012 management estimates that these payments are expected to be made over the next 50 years with the majority of payments being made in years 2040 to 2061. The Bank of Canada’s long term bond rate of 2.33 per cent (2.49 per cent at December 31, 2011) and an inflation rate of two per cent (two per cent at December 31, 2011) were used to calculate the present value of the decommissioning provision.

6. Shareholders’ capital

Authorized: Unlimited number of voting common shares

Issued and Outstanding

Common Shares (no par value)	Number of Common Shares	Amount $
Balance, December 31, 2010	131,875,382	755,831
Common shares issued	4,899,000	115,126
Common share issuance costs (net of tax)	-	(3,854)
Common shares issued by private placement	906,196	17,150
Common shares issued pursuant to DRIP	113,527	1,973
Common shares issued pursuant to OTUPP	166,196	2,889
Balance, December 31, 2011	137,960,301	889,115
Common shares issued by private placement	525,655	11,952
Common share issuance costs (net of tax)	-	(26)
Balance, June 30, 2012	**138,485,956**	**901,041**

Peyto reinstated its amended distribution reinvestment and optional trust unit purchase plan (the "Amended DRIP Plan") effective with the January 2010 distribution whereby eligible unitholders could elect to reinvest their monthly cash distributions in additional trust units at a 5 percent discount to market price. The DRIP plan incorporated an Optional Trust Unit Purchase Plan (“OTUPP”) which provided unitholders enrolled in the DRIP with the opportunity to purchase additional trust units from treasury using the same pricing as the DRIP. The DRIP and the OTUPP plans were cancelled December 31, 2010.

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

On January 14, 2011, 279,723 common shares (113,527 pursuant to the DRIP and 166,196 pursuant to the OTUPP) were issued for net proceeds of $4.9 million.

On March 25, 2011, Peyto completed a private placement of 250,615 common shares to employees and consultants for net proceeds of $4.7 million ($18.86 per share).

On December 16, 2011, Peyto closed an offering of 4,899,000 common shares at a price of $23.50 per common share, receiving proceeds of $110.1 million (net of issuance costs).

On December 31, 2011 Peyto completed a private placement of 397,235 common shares to employees and consultants for net proceeds of $9.7 million ($24.52 per share). These common shares were issued on January 13, 2012.

On March 23, 2012 Peyto completed a private placement of 128,420 common shares to employees and consultants for net proceeds of $2.2 million ($17.22 per share).

Per share amounts
Earnings per share or unit have been calculated based upon the weighted average number of common shares outstanding for the three and six month periods ended June 30, 2012 were 138,485,956 and 138,399,017 (2011 - 133,061,301 and 132,900,079). There are no dilutive instruments outstanding.

Dividends
During the three and six month periods ended June 30, 2012, Peyto declared and paid dividends of $0.18 and $0.36 per

common share or $0.06 per common share per month, totaling $24.9 million and $49.8 million (2011 - $0.18 and $0.36 per share or $0.06 per share per month, $24.0 million and $47.9 million).

Comprehensive income
Comprehensive income consists of earnings and other comprehensive income ("OCI"). OCI comprises the change in the fair value of the effective portion of the derivatives used as hedging items in a cash flow hedge. "Accumulated other comprehensive income" is an equity category comprised of the cumulative amounts of OCI.

Accumulated hedging gains
Gains and losses from cash flow hedges are accumulated until settled. These outstanding hedging contracts are recognized in earnings on settlement with gains and losses being recognized as a component of net revenue. Further information on these contracts is set out in Note 8.

7. Future performance based compensation

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

Reserve based component
The reserves value based component is 4% of the incremental increase in value, if any, as adjusted to reflect changes in debt, equity, dividends, general and administrative costs and interest, of proved producing reserves calculated using a constant price at December 31 of the current year and a discount rate of 8%.

Market based component
Under the market based component, rights with a three year vesting period are allocated to employees. The number of rights outstanding at any time is not to exceed 6% of the total number of common shares outstanding. At December 31 of each year, all vested rights are automatically cancelled and, if applicable, paid out in cash over the three year vesting period. Compensation is calculated as the number of vested rights multiplied by the total of the market appreciation (over the price at the date of grant) and associated dividends of a common share for that period.

The fair values were calculated using a Black-Scholes valuation model. The principal inputs to the valuation model were:

	June 30 2012	**June 30 2011**
Share price	$18.83 - $24.75	$18.83 - $21.50
Exercise price	$12.06 - $24.55	$9.57 - $18.84
Expected volatility	0% - 36%	0% - 38%
Expected life	0.50 years	0.50 – 2.50 years
Risk-free interest rate	1.04%	1.58%

8. Risk management contracts

Peyto uses derivative instruments to reduce its exposure to fluctuations in commodity prices. Peyto considers all of these transactions to be effective economic hedges for accounting purposes.

Following is a summary of all risk management contracts in place as at June 30, 2012:

Propane Period Hedged	**Type**	**Monthly Volume**	**Price (CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$49.56/BBL
September 1, 2012 to March 31, 2013	Fixed Price	2,000 BBL	$44.10/BBL

Butane Period Hedged	**Type**	**Monthly Volume**	**Price (CAD)**
September 1, 2012 to March 31, 2013	Fixed Price	2,000 bbl	$80.64/bbl

Iso-Butane Period Hedged	Type	Monthly Volume	Price (CAD)
September 1, 2012 to March 31, 2013	Fixed Price	1,000 bbl	$82.32/bbl

Natural Gas Period Hedged	Type	Daily Volume	Price (CAD)
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.05/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.15/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.10/GJ
April 1, 2011 to October 31, 2012	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.055/GJ
April 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$3.80/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.17/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.10/GJ
June 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.10/GJ
November 1, 2011 to March 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to December 31, 2012	Fixed Price	5,000 GJ	$3.3125/GJ
April 1, 2012 to December 31, 2012	Fixed Price	5,000 GJ	$3.395/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2012 to March 31, 2013	Fixed Price	5,000 GJ	$2.20/GJ
April 1, 2012 to March 31, 2013	Fixed Price	5,000 GJ	$2.31/GJ
April 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.52/GJ
April 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
May 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.30/GJ
June 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$1.83/GJ
July 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$2.32/GJ
July 1, 2012 to October 31, 2012	Fixed Price	5,000 GJ	$2.35/GJ
August 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.10/GJ
November 1, 2012 to October 31, 2013	Fixed Price	5,000 GJ	$2.60/GJ
November 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$2.81/GJ
November 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
November 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.0575/GJ
April 1, 2013 to March 31, 2014	Fixed Price	5,000 GJ	$3.105/GJ

As at June 30, 2012, Peyto had committed to the future sale of 49,000 barrels of natural gas liquids at an average price of $61.56 per barrel and 51,510,000 gigajoules (GJ) of natural gas at an average price of $3.29 per GJ or $3.84 per mcf. Had these contracts been closed on June 30, 2012, Peyto would have realized a gain in the amount of $26.1 million. If the AECO gas price on June 30, 2012 were to increase by $1/GJ, the unrealized gain would decrease by approximately $51.5 million. An opposite change in commodity prices rates would result in an opposite impact on other comprehensive income.

Subsequent to June 30, 2012 Peyto entered into the following contracts:

Propane Period Hedged	Type	Monthly Volume	Price (CAD)
September 1, 2012 to March 31, 2013	Fixed Price	2,000 bbl	$32.34/bbl

Butane Period Hedged	Type	Monthly Volume	Price (CAD)
September 1, 2012 to March 31, 2013	Fixed Price	2,000 bbl	$58.38/bbl

Iso-Butane Period Hedged	Type	Monthly Volume	Price (CAD)
September 1, 2012 to March 31, 2013	Fixed Price	1,000 bbl	$60.48/bbl

Natural Gas Period Hedged	Type	Monthly Volume	Price (CAD)
August 1, 2012 to March 31, 2014	Fixed Price	5,000 GJ	$3.00/GJ
January 1, 2013 to December 31, 2013	Fixed Price	5,000 GJ	$3.105/GJ

9. Commitments and contingencies

Peyto has contractual obligations and commitments as follows:

	2012	2013	2014	2015	2016	Thereafter
Note repayment(1)	-	-	-	-	-	100,000
Interest payments(2)	2,195	4,390	4,390	4,390	4,390	10,975
Transportation commitments	5,044	9,265	7,746	5,462	2,270	285
Operating lease	536	1,071	1,071	-	-	-
Total	7,775	14,726	13,207	9,852	6,660	111,260

(1) Long-term debt repayment on senior secured notes
(2) Fixed interest payments on senior secured notes

Contingent liability
From time to time, Peyto is the subject of litigation arising out of its day-to-day operations. Damages claimed pursuant to such litigation may be material or may be indeterminate and the outcome of such litigation may materially impact Peyto's financial position or results of operations in the period of settlement. While Peyto assesses the merits of each lawsuit and defends itself accordingly, Peyto may be required to incur significant expenses or devote significant resources to defending itself against such litigation. These claims are not currently expected to have a material impact on Peyto's financial position or results of operations.

10. Subsequent Event

Subsequent to June 30, 2012, Peyto announced its intention to purchase all of the issued and outstanding common shares of Open Range Energy Corp. on the basis of a share exchange, pursuant to a statutory plan of arrangement. This transaction is subject to the approval of Open Range shareholders, among other things.

Officers

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Scott Robinson
Executive Vice President and Chief Operating Officer

Kathy Turgeon
Vice President, Finance and Chief Financial Officer

Stephen Chetner
Corporate Secretary

Tim Louie
Vice President, Land

David Thomas
Vice President, Exploration

Jean-Paul Lachance
Vice President, Exploitation

Directors

Don Gray, Chairman
Rick Braund
Stephen Chetner
Brian Davis
Michael MacBean, Lead Independent Director
Darren Gee
Gregory Fletcher
Scott Robinson

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Deloitte & Touche LLP

Solicitors

Burnet, Duckworth & Palmer LLP

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