PEYTO

Exploration & Development Corp.

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Interim Report
for the three and six months ended June 30, 2014

	3 Months Ended June 30		%	6 Months Ended June 30		%
	2014	2013	Change	**2014**	2013	Change
Operations						
Production						
Natural gas (mcf/d)	**388,407**	310,621	*25%*	**388,703**	303,943	*28%*
Oil & NGLs (bbl/d)	**7,568**	6,374	*19%*	**7,472**	6,109	*22%*
Thousand cubic feet equivalent (mcfe/d @ 1:6)	**433,812**	348,868	*24%*	**433,533**	340,595	*27%*
Barrels of oil equivalent (boe/d @ 6:1)	**72,302**	58,145	*24%*	**72,256**	56,766	*27%*
Production per million common shares (boe/d)*	**470**	391	*20%*	**473**	382	*24%*
Product prices						
Natural gas ($/mcf)	**4.37**	3.72	*17%*	**4.41**	3.61	*22%*
Oil & NGLs ($/bbl)	**77.30**	67.82	*14%*	**78.86**	71.65	*10%*
Operating expenses ($/Mcfe)	**0.36**	0.35	*3%*	**0.37**	0.33	*12%*
Transportation ($/Mcfe)	**0.13**	0.12	*8%*	**0.13**	0.12	*8%*
Field netback ($/Mcfe)	**4.32**	3.77	*15%*	**4.36**	3.72	*17%*
General & administrative expenses ($/Mcfe)	**0.01**	0.05	*(80)%*	**0.03**	0.04	*(25)%*
Interest expense ($/Mcfe)	**0.22**	0.25	*(12)%*	**0.22**	0.23	*(4)%*
Financial ($000, except per share*)						
Revenue	**207,519**	144,614	*43%*	**416,837**	277,816	*50%*
Royalties	**17,689**	9,849	*80%*	**35,551**	20,440	*74%*
Funds from operations	**161,577**	109,987	*47%*	**322,362**	212,844	*51%*
Funds from operations per share	**1.05**	0.74	*42%*	**2.11**	1.43	*48%*
Total dividends	**43,033**	32,727	*31%*	**79,538**	59,493	*34%*
Total dividends per share	**0.28**	0.22	*27%*	**0.52**	0.40	*30%*
Payout ratio	**27**	30	*(10)%*	**25**	28	*(11)%*
Earnings	**62,159**	37,773	*65%*	**124,288**	74,179	*68%*
Earnings per diluted share	**0.41**	0.25	*64%*	**0.81**	0.50	*62%*
Capital expenditures	**151,290**	73,809	*105%*	**330,668**	242,908	*36%*
Weighted average common shares outstanding	**153,690,808**	148,758,923	*3%*	**152,763,770**	148,716,032	*3%*
As at June 30						
End of period shares outstanding				**153,690,808**	148,758,923	*3%*
Net debt				**880,386**	746,094	*18%*
Shareholders' equity				**1,392,911**	1,227,842	*13%*
Total assets				**2,781,258**	2,328,117	*19%*

**all per share amounts using weighted average*

	3 Months Ended June 30		6 Months Ended June 30	
($000)	**2014**	2013	**2014**	2013
Cash flows from operating activities	**152,170**	96,700	**298,624**	189,243
Change in non-cash working capital	**2,560**	8,946	**10,523**	17,730
Change in provision for future compensation	**6,847**	4,341	**13,215**	5,871
Funds from operations	**161,577**	109,987	**322,362**	212,844
Funds from operations per share*	**1.05**	0.74	**2.11**	1.43

(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 Canadian generally accepted accounting principles ("GAAP") and does not have a standardized meaning prescribed by GAAP. 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 GAAP. Funds from operations cannot be assured and future distributions 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 2014 fiscal year. Profitable growth continued in the quarter with operating[(1)] and profit margins[(2)] of 78% and 30%, respectively. Additional highlights included:

- **Production per share up 20%.** Second quarter 2014 production increased 24% (20% per share) to 434 MMcfe/d (72,302 boe/d) from 349 MMcfe/d (58,145 boe/d) in Q2 2013.

- **Funds from operations per share up 42%.** Generated a record $162 million in Funds from Operations ("FFO") in Q2 2014, up 47% (42% per share) from $110 million in Q2 2013, due to increased production volumes and improved commodity prices.

- **Cash costs of $1.17/Mcfe.** Total cash costs, including royalties, operating costs, transportation, G&A and interest, were $1.17/Mcfe ($6.99/boe) up 7% from $1.09/Mcfe in Q2 2013, due primarily to higher royalties, driven by higher commodity prices. Excluding royalties, cash costs were 6% lower at $0.72/Mcfe ($4.30/boe) than Q2 2013. Higher revenues, combined with total cash costs, resulted in a Q2 2014 cash netback of $4.09/Mcfe ($24.56/boe) or a 78% operating margin.

- **Capital investment of $151 million**. A total of 31 gross wells were drilled in the second quarter, with traditional spring breakup causing little interruption to field operations. New wells brought on production over the last 12 months accounted for 36,300 boe/d at the end of the quarter, which, when combined with trailing twelve month capital of $665.8 million, equates to an annualized capital efficiency of $18,340/boe/d.

- **Earnings of $0.41/share, dividends of $0.28/share.** Earnings of $62 million were generated in the quarter while dividends of $43 million were paid to shareholders, representing a before tax payout ratio of 27% of FFO. The monthly dividend was increased 25% to $0.10/share effective May 2014.

- **Drilling milestone achieved.** On August 13, 2014 the Company spud its 1,000th well at 16-28-54-21W5 in Sundance.

Second Quarter 2014 in Review

Peyto had a very active second quarter despite spring breakup, which is the traditional period of reduced activity. Pad drilling, combined with active road maintenance in the Greater Sundance area, allowed for continuous drilling operations with an average of 8 rigs running throughout the quarter. This allowed the Company to maintain the industry leading capital efficiencies that have been achieved over the last few years, again adding new production for approximately $18,000/boe/d. While new production additions offset the base well declines, overall production growth was partially impeded by downtime and unscheduled disruptions caused by higher sales line pressures and power outages. Second quarter production averaged 72,302 boe/d, up slightly from the first quarter. Peyto also expanded its owned and operated gas plant capacity in the quarter, adding an aggregate of 7,000 boe/d at the Wildhay, Swanson, and Brazeau River gas plants. This additional capacity will accommodate new production volumes resulting from the balance of the 2014 drilling program. Both natural gas and propane prices were slightly lower than the previous quarter, but so were Peyto's cash costs, resulting in cash netbacks that were approximately the same. The realized cash netbacks for the first half of 2014 are still up substantially (19%) from the previous year. These higher cash netbacks, combined with record production levels, lead to quarterly FFO of $162 million, or $1.05/share. The strong financial and operating performance delivered in the quarter resulted in an annualized 19% Return on Equity (ROE) and 14% 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, particularly 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's second quarter 2014 activity continued to focus on the many stacked resource plays in the Alberta Deep Basin, with all zones yielding liquids rich, sweet natural gas. A total of 31 wells were drilled across the land base, targeting the many prospective zones, as shown in the following table:

Zone	Field							Total Wells Drilled
	Sundance	Nosehill	Wildhay	Ansell	Berland	Kisku/ Kakwa	Brazeau	
Cardium	2							2
Notikewin	3	1						4
Falher	4	5		1				10
Wilrich	8		4	1			1	14
Bluesky	1							1
Total	18	6	4	2			1	31

The majority of the activity in the quarter focused within the greater Sundance area where access to existing roads and leases was available.

Capital Expenditures

Over the course of the second quarter, Peyto spent $68.5 million to drill 31 gross (28.2 net) horizontal wells and $48.0 million to complete 30 gross (28.0 net) wells. Additionally, 32 gross (29.8 net) wells were brought onstream with $10.3 million of wellsite equipment and gathering pipelines. Major facility capital investment amounted to $16.3 million and included the installation and commissioning of an eighth compressor at the Wildhay gas plant (adding 10 MMcf/d capacity), the twinning of the Wildhay sales pipeline (providing 35 MMcf/d of additional sales gas transmission capacity), the installation of a large gathering line between the Oldman and Nosehill plants to take advantage of spare Nosehill plant capacity, and the commissioning of a fourth compressor at the Swanson Plant (adding 18 MMcf/d). A refrigeration plant and an additional compressor was also installed at the Brazeau River gas plant (adding 10 MMcf/d). Lastly, $1.0 million was directed towards preparation and fabrication for the planned Oldman North plant expansion (adding 40 MMcf/d with expected start-up in October).

During the second quarter, Peyto invested $5.9 million at Alberta Crown land sales on highly prospective Wilrich lands adjacent to the company's existing Deep Basin land position. A total of 11 net sections (containing 34 internally identified new drilling locations) were added for $833/acre. Additionally, $2.3 million was spent on the acquisition of trade seismic data to support ongoing technical work in the Brazeau and Sundance areas.

By the end of the quarter, the 32 gross (29.8 net) wells brought onstream in Q2 2014 were contributing 14,850 boe/d to the quarter end exit rate of 73,000 boe/d.

Financial Results

Daily natural gas prices in Alberta (AECO) averaged $4.44/GJ in Q2 2014, while monthly AECO prices averaged $4.43/GJ. As Peyto had committed 88% of its production to the monthly price, Peyto realized a volume weighted average natural gas price of $4.44/GJ or $5.02/mcf, prior to a $0.65/mcf hedging loss.

Peyto realized a blended oil and natural gas liquids price of $77.58/bbl in Q2 2014, prior to a $0.28/bbl hedging loss, for its blend of condensate, pentane, butane and propane, which represented 74% of the $104.30/bbl average Edmonton light oil price.

Combining realized natural gas and liquids prices, Peyto's unhedged revenues totaled $5.85/Mcfe ($5.26/Mcfe including hedging losses), or 132% of the dry gas price, illustrating the benefit of high heat content, liquids rich natural gas production.

Royalties of $0.45/Mcfe, operating costs of $0.36/Mcfe, transportation costs of $0.13/Mcfe, G&A of $0.01/Mcfe and interest costs of $0.22/Mcfe, combined for total cash costs of $1.17/Mcfe ($6.99/boe). These industry leading total cash costs resulted in a cash netback of $4.09/Mcfe ($24.52/boe) or a 78% operating margin.

Royalties per Mcfe were up 40% due to higher natural gas and liquids prices while operating costs were in line with the previous year but down from the previous quarter as methanol and maintenance costs were lower.

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 $1.57/Mcfe, or a 30% profit margin, which funded dividends of $1.09/Mcfe.

Subsequent to the second quarter, Peyto issued CDN $50 million of senior unsecured notes pursuant to a note purchase and private shelf agreement. The notes have a coupon rate of 3.79% and mature on July 3, 2022. As the notes rank equally with Peyto's obligations under its bank facility and existing note purchase agreements, Peyto's aggregate borrowing capacity increased by $50 million to $1.32 billion.

Marketing

For the quarter, approximately 63% of Peyto's natural gas production received a fixed price of $3.53/GJ from hedges that were put in place over the previous 16 months, while the balance received the blended daily and monthly price of $4.44/GJ, resulting in an after-hedge price of $3.87/GJ or $4.37/mcf.

Peyto's practice of layering in future sales in the form of fixed price swaps, and thus smoothing out the volatility in gas prices, continued throughout the quarter. The following table summarizes the remaining hedged volumes and prices for the upcoming years, as of August 1, 2014.

	Future Sales		Average Price (CAD)	
	GJ	Mcf	$/GJ	$/Mcf
2014	42,155,000	36,656,522	3.66	4.21
2015	53,955,000	46,917,391	3.78	4.34
2016	5,005,000	4,352,174	3.79	4.35
Total	101,115,000	87,926,087	3.73	4.29

**prices and volumes in mcf use Peyto's historic heat content premium of 1.15.*

As illustrated in the following table, Peyto's realized natural gas liquids prices (1) were up 14% year over year but down 4% from the previous quarter.

	Three Months ended June 30		Q1
	2014	2013	2014
Condensate ($/bbl)	**103.73**	88.18	100.68
Propane ($/bbl) (includes hedging)	**23.05**	22.60	36.65
Butane ($/bbl) (includes hedging)	**59.47**	45.90	55.98
Pentane ($/bbl)	**106.58**	95.74	105.37
Total oil and natural gas liquids ($/bbl)	**77.30**	67.82	80.49
Canadian Light Sweet postings ($/bbl)	**104.30**	88.27	99.91

(1) liquids prices are Peyto realized prices in Canadian dollars adjusted for fractionation and transportation.

As a fixed offset to benchmark pricing can no longer be obtained for Propane and Butane prices, Peyto has discontinued the practice of forward selling these components of its natural gas liquids.

Activity Update

Continuous operations, through break-up and into the summer months, has been very successful in accelerating the 2014 capital plans resulting in strong production growth over the past two months. Well results throughout all geographic areas and across all zones, particularly the Notikewin, Falher and Wilrich formations in Sundance, Obed and Ansell areas, have provided steady growth from an average of 71,500 boe/d in April to an average of 74,800 boe/d in July. Most recently, August daily production has averaged 78,500 boe/d. Peyto remains on track to meet or exceed previous guidance of $625 million of capital and exit production of 81,500 boe/d.

Currently, the Company has all 9 of its drilling rigs active, with four completion spreads following up, and anticipates maintaining this activity level through to year end. One rig is currently drilling at Brazeau but will be accompanied by a second rig this fall. A major 23 km gathering line linking the Peyto Brazeau Gas Plant to the Company's south acreage is in progress and is expected to be completed by early October which will connect a 6 well program to be drilled in that area. Focused drilling in the heart of Sundance for Notikewin, Falher, Wilrich and Bluesky targets is also programmed and will serve to fill the 40 MMcf/d of new Oldman North Plant capacity.

On August 13, 2014, Peyto celebrated the spudding of its 1,000th gas well in the Alberta Deep Basin at 16-28-54-21W5M in Sundance. Remarkably, this location is directly adjacent to Peyto's original recompletion in Sundance at 15-30-54-21W5M, which continues to produce some 15 years later. Over the last five years Peyto has drilled over 400 natural gas wells, making Peyto the most active Alberta Deep Basin gas driller. While there are many stories told of the significant resource potential in the Alberta Deep Basin, Peyto has been the one turning that potential into reality and the Company continues to be an industry leader when it comes to profitable resource development.

Outlook

Natural gas prices in both Canada and the US have recently softened as record US production and mild summer weather has refilled storage reservoirs faster than expected. This brings future natural gas prices in Canada back into Peyto's "sweet spot" where significant profitable development can occur in Peyto's many Deep Basin resource plays without the risk of increased activity driving cost inflation and eroding returns.

At no point in Peyto's history has the Company had more opportunities than it does today and yet the team at Peyto continues to find additional new lands and drilling locations faster than they can be harvested. As demand for natural gas in North America continues to expand, Peyto is well positioned to keep applying its low cost advantage and delivering superior returns on invested capital.

(Signed) "*Darren Gee*"

Darren Gee
President and CEO
August 13, 2014

Management’s discussion and analysis

This Management's Discussion and Analysis (“MD&A”) should be read in conjunction with the audited financial statements of Peyto Exploration & Development Corp. (“Peyto” or the “Company”) for the years ended December 31, 2013 and 2012. The financial statements have been prepared in accordance with the International Accounting Standards Board (“IASB”) most current International Financial Reporting Standards (“IFRS” or “GAAP”) 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 12, 2014. 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 the Company's future plans and operations, contains forward-looking statements. By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond these parties' control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other industry participants, the lack of availability of qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. Readers are cautioned that the assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Peyto's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what benefits that Peyto will derive there from. Other than is required pursuant to applicable securities legislation, Peyto does not undertake to update forward looking statements at any particular time.

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).

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, 2013, the total Proved plus Probable reserves were 2,807 billion cubic feet equivalent (467.8 million barrels of oil equivalent) as evaluated by the independent petroleum engineers. Production is weighted approximately 90% to natural gas and 10% 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 with earnings, and cash flow, and balance funding for the capital program with cash flow, equity and available bank lines.

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

QUARTERLY FINANCIAL INFORMATION

	2014		2013				2012	
($000 except per share amounts)	**Q2**	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Total revenue (net of royalties)	**189,830**	191,457	154,167	123,851	134,765	122,612	111,105	95,409
Funds from operations	**161,577**	160,785	125,164	99,736	109,987	102,856	90,078	76,555
Per share – basic and diluted	**1.05**	1.06	0.84	0.67	0.74	0.69	0.62	0.54
Earnings	**62,159**	62,129	37,989	30,461	37,773	36,405	25,823	23,058
Per share – basic and diluted	**0.41**	0.41	0.26	0.21	0.25	0.25	0.18	0.16
Dividends	**43,033**	36,505	35,702	35,702	32,727	26,766	26,178	25,576
Per share – basic and diluted	**0.28**	0.24	0.24	0.24	0.22	0.18	0.18	0.18

** per share amounts using weighted average common*

Funds from Operations

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

RESULTS OF OPERATIONS

Production

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
Natural gas (mmcf/d)	**388.4**	310.6	**388.7**	303.9
Oil & natural gas liquids (bbl/d)	**7,568**	6,374	**7,472**	6,109
Barrels of oil equivalent (boe/d)	**72,302**	58,145	**72,256**	56,766
Thousand cubic feet equivalent (mmcfe/d)	**433.3**	348.9	**433.5**	340.6

Natural gas production averaged 388.4 mmcf/d in the second quarter of 2014, 25 percent higher than the 310.6 mmcf/d reported for the same period in 2013. Oil and natural gas liquids production averaged 7,568 bbl/d, an increase of 19 percent from 6,374 bbl/d reported in the prior year. Second quarter production increased 24 percent from 348.9 mmcfe/d to 433.8 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	
	2014	2013	**2014**	2013
Condensate (bbl/d)	**2,783**	2,362	**2,877**	2,206
Propane (bbl/d)	**1,722**	1,410	**1,663**	1,258
Butane (bbl/d)	**1,451**	1,235	**1,405**	1,161
Pentane (bbl/d)	**1,442**	1,189	**1,343**	1,280
Other NGL's (bbl/d)	**170**	178	**184**	204
Oil & natural gas liquids (bbl/d)	**7,568**	6,374	**7,472**	6,109
Thousand cubic feet equivalent (mmcfe/d)	**45.4**	38.2	**44.8**	36.7

Commodity Prices

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
Oil and natural gas liquids ($/bbl)	**77.58**	68.08	**81.04**	71.71
Hedging – ngls ($/bbl)	**(0.28)**	(0.26)	**(2.18)**	(0.06)
Oil and natural gas liquids – after hedging ($/bbl)	**77.30**	67.82	**78.86**	71.65
Natural gas ($/mcf)	**5.02**	3.85	**5.13**	3.59
Hedging – gas ($/mcf)	**(0.65)**	(0.13)	**(0.72)**	0.02
Natural gas – after hedging ($/mcf)	**4.37**	3.72	**4.41**	3.61
Total Hedging ($/mcfe)	**(0.59)**	(0.12)	**(0.68)**	0.02
Total Hedging ($/boe)	**(3.57)**	(0.72)	**(4.10)**	0.12

Peyto's natural gas price, before hedging, averaged $5.02/mcf during the second quarter of 2014, an increase of 30 percent from $3.85/mcf reported for the equivalent period in 2013. Oil and natural gas liquids prices before hedging averaged $81.04/bbl, an increase of 13 percent from $71.71/bbl a year earlier.

Oil & Natural Gas Liquids Prices by Component

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
Condensate ($/bbl)	**103.73**	88.18	**101.57**	90.02
Propane ($/bbl) (includes hedging)	**23.05**	22.60	**30.70**	23.88
Butane ($/bbl) (includes hedging)	**59.47**	45.90	**54.91**	51.83
Pentane ($/bbl)	**106.58**	95.74	**105.45**	99.24

liquids prices are Peyto realized prices in Canadian dollars adjusted for fractionation and transportation.

Revenue

	Three Months ended June 30		Six Months ended June 30	
($000)	**2014**	2013	**2014**	2013
Natural gas	**177,575**	108,970	**360,821**	197,597
Oil and natural gas liquids	**53,420**	39,496	**109,594**	79,292
Hedging gain (loss)	**(23,476)**	(3,852)	**(53,578)**	927
Total revenue	**207,519**	144,614	**416,837**	277,816

For the three months ended June 30, 2014, revenue increased 43 percent to $207.5 million from $144.6 million for the same period in 2013. The increase in revenue for the period was a result of increased production volumes and commodity prices as detailed in the following table:

	Three Months ended June 30			Six Months ended June 30		
	2014	2013	**$million**	2014	2013	**$million**
Total Revenue, June 30, 2013			**144.6**			**277.8**
Revenue change due to:						
Natural gas						
Volume (mmcf)	35,345	28,267	**26.2**	70,355	55,014	**55.3**
Price ($/mcf)	$4.37	$3.72	**22.9**	$4.41	$3.61	**56.2**
Oil & NGL						
Volume (mbbl)	689	580	**7.3**	1,352	1,106	**17.7**
Price ($/bbl)	$77.30	$67.82	**6.5**	$78.86	$71.65	**9.8**
Total Revenue, June 30, 2014			**207.5**			**416.8**

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)	**2014**	2013	**2014**	2013
Royalties	**17,689**	9,849	**35,551**	20,440
% of sales before hedging	**7.7**	6.6	**7.6**	7.4
% of sales after hedging	**8.5**	6.8	**8.5**	7.4
$/mcfe	**0.45**	0.32	**0.45**	0.34
$/boe	**2.69**	1.92	**2.72**	2.04

For the second quarter of 2014, royalties averaged $0.45/mcfe or approximately 8.5% 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 January 1, 2009. These additional features include:

1. 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

2. 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 (1) above.

In its 15 years history, Peyto has invested $3.8 billion in capital projects, found and developed 2.1 TCFe of gas reserves, and paid over $709 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	
	2014	2013	**2014**	2013
Operating costs ($000)	**14,059**	11,242	**29,289**	20,548
$/mcfe	**0.36**	0.35	**0.37**	0.33
$/boe	**2.14**	2.10	**2.24**	1.98
Transportation ($000)	**5,100**	3,796	**10,244**	7,455
$/mcfe	**0.13**	0.12	**0.13**	0.12
$/boe	**0.78**	0.72	**0.78**	0.72

Operating costs increased to $14.1 million in the second quarter of 2014 from $11.2 million for the equivalent period in 2013 due to increased production volumes and well count. On a unit-of-production basis, operating costs increased 3% averaging $0.36/mcfe in the second quarter of 2014 compared to $0.35/mcfe for the equivalent period in 2014.

Transportation expenses increased 8% from 0.12/mcfe in the second quarter 2013 to $0.13/mcfe in the second quarter 2014 due to increased TCPL tolls beginning in September 2013.

General and Administrative Expenses

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
G&A expenses ($000)	**3,668**	3,690	**8,012**	7,014
Overhead recoveries	**(3,086)**	(1,973)	**(5,874)**	(4,817)
Net G&A expenses	**582**	1,717	**2,138**	2,197
$/mcfe	**0.01**	0.05	**0.03**	0.04
$/boe	**0.09**	0.30	**0.16**	0.24

For the second quarter, general and administrative expenses before overhead recoveries remained unchanged from the same quarter in 2013. Capital overhead recoveries increased 56 percent for the second quarter from $2.0 million to $3.1 million due to increased capital spending**.** General and administrative expenses averaged $0.01/mcfe in the second quarter of 2014 compared to $0.05/mcfe for the equivalent period in 2013 due to higher levels of production.

Interest Expense

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
Interest expense ($000)	**8,512**	8,022	**17,252**	14,332
$/mcfe	**0.22**	0.25	**0.22**	0.23
$/boe	**1.29**	1.50	**1.32**	1.38
Average interest rate	**4.2%**	4.2%	**4.3%**	4.1%

Second quarter 2014 interest expense was $8.5 million or $0.22/mcfe compared to $8.0 million or $0.25/mcfe for the second quarter 2013.

Netbacks

	Three Months ended June 30		Six Months ended June 30	
($/mcfe)	**2014**	2013	**2014**	2013
Gross Sale Price	**5.85**	4.68	**5.99**	4.49
Hedging gain (loss)	**(0.59)**	(0.12)	**(0.68)**	0.02
Net Sale Price	**5.26**	4.56	**5.31**	4.51
Less: Royalties	**0.45**	0.32	**0.45**	0.34
Operating costs	**0.36**	0.35	**0.37**	0.33
Transportation	**0.13**	0.12	**0.13**	0.12
Field netback	**4.32**	3.77	**4.36**	3.72
General and administrative	**0.01**	0.05	**0.03**	0.04
Interest on long-term debt	**0.22**	0.25	**0.22**	0.23
Cash netback ($/mcfe)	**4.09**	3.47	**4.11**	3.45
Cash netback ($/boe)	**24.56**	20.82	**24.65**	20.70

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 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. Hedging activity decreased Peyto's achieved price/mcfe by 10% from $5.85 to $5.26 per mcfe for the quarter.

Depletion, Depreciation and Amortization

Under IFRS, Peyto uses proved plus probable reserves as its depletion base to calculate depletion expense. The 2014 second quarter provision for depletion, depreciation and amortization totaled $68.4 million as compared to $53.3 million in 2013 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 $1.68/mcfe in 2013.

Income Taxes

The deferred income tax expense is $20.7 million for the three months ended June 30, 2014 (2013 - $12.0 million). Resource pools are generated from the capital program, which are available to offset income tax liabilities.

Income Tax Pool type ($ millions)	**June 30, 2014**	December 31, 2013	**Annual deductibility**
Canadian Oil and Gas Property Expense	241.4	245.1	10% declining balance
Canadian Development Expense	757.5	668.5	30% declining balance
Canadian Exploration Expense	118.2	208.7	100%
Undepreciated Capital Cost	349.1	312.3	25% declining balance
Non-capital loss carry forward	-	19.7	100%
Other	35.8	32.5	7% declining balance to 20%
Total Federal Tax Pools	**1,502.0**	1,486.8	
Additional Alberta Tax Pools	44.9	44.9	100% and 30% declining balance

MARKETING

Commodity Price Risk Management

The Company is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. The Company enters into these forward contracts with well-established counterparties for the purpose of protecting a portion of its future revenues from the volatility of oil and natural gas prices. In order to minimize counterparty risk, these marketing contracts are executed with financial institutions that are members of Peyto's banking syndicate. During the second quarter of 2014, a realized hedging loss of $23.5 million was recorded as compared to a loss of $3.8 million for the equivalent period in 2013. Prices for propane contracts are listed in USD at Conway. The price Peyto realizes is less: i) a market-basis differential from Conway to Edmonton, ii) currency exchange, and iii) a pipeline and fractionation fee, to get to Peyto's plant gate price. A summary of contracts outstanding in respect of the hedging activities are as follows:

Propane Period Hedged	**Type**	**Monthly Volume**	**Price (USD)**
January 1, 2014 to December 31, 2014	Fixed Price	4,000 bbl	$35.70/bbl
January 1, 2014 to December 31, 2014	Fixed Price	4,000 bbl	$37.485/bbl
April 1, 2014 to September 30, 2014	Fixed Price	4,000 bbl	$41.79/bbl
April 1, 2014 to September 30, 2014	Fixed Price	4,000 bbl	$42.63/bbl
April 1, 2014 to September 30, 2014	Fixed Price	4,000 bbl	$44.31/bbl
April 1, 2014 to September 30, 2014	Fixed Price	4,000 bbl	$46.20/bbl
October 1, 2014 to December 31, 2014	Fixed Price	4,000 bbl	$42.84/bbl

Natural Gas Period Hedged	**Type**	**Daily Volume**	**Price (CAD)**
November 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.0575/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.25/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.30/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.33/GJ
April 1, 2013 to October 31, 2014	Fixed Price	7,500 GJ	$3.20/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.22/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.20/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.1925/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.25/GJ
April 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.30/GJ
November 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.50/GJ
November 1, 2013 to October 31, 2014	Fixed Price	5,000 GJ	$3.53/GJ
November 1, 2013 to March 31, 2015	Fixed Price	5,000 GJ	$3.6025/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.505/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.555/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.48/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.335/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.10/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.80/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.825/GJ

April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.95/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$3.98/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$4.07/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$4.32/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$4.35/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$4.55/GJ
April 1, 2014 to October 31, 2014	Fixed Price	5,000 GJ	$4.42/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.82/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.44/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.52/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.4725/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.525/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.60/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.27/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.41/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.5575/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.465/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.43/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.54/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.50/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.25/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.25/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.23/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.23/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.23/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.31/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.3525/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.40/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.49/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.54/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.61/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.70/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.75/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.81/GJ
April 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.83/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.81/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.95/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.05/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.12/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.20/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.44/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.585/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.78/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.60/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.58/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.68/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.68/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.80/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.87/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.50/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.57/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.69/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.50/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.285/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.30/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.35/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.40/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.47/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.48/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.52/GJ

April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.70/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.75/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.78/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.79/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.91/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.865/GJ
April 1, 2015 to October 31, 2015	Fixed Price	5,000 GJ	$3.75/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.9175/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.93/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$4.00/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$4.05/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.915/GJ

As at June 30, 2014, Peyto had committed to the future sale of 120,000 barrels of propane at an average price of $43.81 CAD ($41.03 USD) per barrel and 94,362,500 gigajoules (GJ) of natural gas at an average price of $3.71 per GJ or $4.26 per mcf. Had these contracts been closed on June 30, 2014, Peyto would have realized a loss in the amount of $43.2 million.

Subsequent to June 30, 2014 Peyto entered into the following contracts:

Natural Gas Period Hedged	**Type**	**Daily Volume**	**Price (CAD)**
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.26/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$4.10/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.86/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.85/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.90/GJ
November 1, 2014 to March 31, 2015	Fixed Price	5,000 GJ	$3.70/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.73/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.70/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.56/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.57/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$3.62/GJ
April 1, 2015 to March 31, 2016	Fixed Price	5,000 GJ	$4.00/GJ

Commodity Price Sensitivity

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

Currency Risk Management

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

Interest Rate Risk Management

The Company is exposed to interest rate risk in relation to interest expense on its revolving credit facility while interest rates on the senior notes are fixed. Currently there are no agreements to manage the risk on the credit facility. At June 30 2014, 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 $1.4 million per quarter. Average debt outstanding under the credit facility for the quarter was $546.0 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)	**2014**	2013	**2014**	2013
Cash flows from operating activities	**152,170**	96,700	**298,624**	189,243
Change in non-cash working capital	**2,560**	8,946	**10,523**	17,730
Change in provision for future compensation	**6,847**	4,341	**13,215**	5,871
Funds from operations	**161,577**	109,987	**322,362**	212,844
Funds from operations per share	**1.05**	0.74	**2.11**	1.43

** per share amounts using weighted average common*

For the second quarter ended June 30, 2014, funds from operations totaled $161.6 million or $1.05 per share, as compared to $110.0 million, or $0.74 per share during the same quarter in 2013 due to increases in commodity prices and production. 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. Peyto's policy is to balance dividends to shareholders with earnings and cash flow, and balance funding for the capital program with cash flow, equity and available bank lines.

Revenue 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.

Long Term Debt

($000)	**June 30, 2014**	December 31, 2013
Bank credit facility	**555,000**	605,000
Senior unsecured notes	**270,000**	270,000
Balance, end of the period	**825,000**	875,000

As at June 30, 2014, the Company had a syndicated $1 billion extendible revolving credit facility with a stated term date of April 25, 2017. The bank facility is made up of a $30 million working capital sub-tranche and a $970 million production line. The facilities are available on a revolving basis for a three year period. Borrowings under the facility bear interest at Canadian bank prime or US base rate, or, at Peyto's option, Canadian dollar bankers' acceptances or US dollar LIBOR loan rates, plus applicable margin and stamping fees. The total stamping fees range between 50 basis points and 215 basis points on Canadian bank prime and US base rate borrowings and between 150 basis points and 315 basis points on Canadian dollar bankers' acceptance and US dollar LIBOR borrowings. The undrawn portion of the facility is subject to a standby fee in the range of 30 to 63 basis points.

Peyto is subject to the following financial covenants as defined in the credit facility and note purchase agreements:

- Long-term debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 3.0 times trailing twelve month net income before non-cash items, interest and income taxes;
- Long-term debt and subordinated debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 4.0 times trailing twelve month net income before non-cash items, interest and income taxes;
- Trailing twelve months net income before non-cash items, interest and income taxes to exceed 3.0 times trailing twelve months interest expense;
- Long-term debt and subordinated debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 55 per cent of the book value of shareholders' equity and long-term debt and subordinated debt.

Peyto is in compliance with all financial covenants at June 30, 2014 and at the date of this MD&A.

Peyto's total borrowing capacity is $1.27 billion consisting of a $1.0 billion credit facility and $270 million in senior unsecured notes.

On July 3, 2014, Peyto issued CDN $50 million of senior unsecured 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 3.79% and mature on July 3, 2022. Interest is paid semi-annually in arrears. The issuance of these notes increases Peyto's borrowing capacity to $1.32 billion.

Peyto believes funds generated from operations, together with borrowings under the credit facility will be sufficient to maintain dividends, finance current operations, and fund the planned capital expenditure program of $575 to $625 million for 2014. The total amount of capital invested in 2014 will be driven by the number and quality of projects generated. Capital will only be invested if it meets the long term objectives of the Company. The majority of the capital program will involve drilling, completion and tie-in of lower risk development gas wells. Peyto's rapidly scaleable business model has the flexibility to match planned capital expenditures to actual cash flow.

Net Debt

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

($000)	**As at June 30, 2014**	As at December 31, 2013	As at June 30, 2013
Bank credit facility	**555,000**	605,000	600,000
Senior unsecured notes	**270,000**	270,000	150,000
Working capital deficit	**117,703**	103,247	(2,497)
Financial derivative instruments	**(44,000)**	(26,606)	7,139
Provision for future performance based compensation	**(18,317)**	(5,100)	(8,548)
Net debt	**880,386**	946,541	746,094

Capital

Authorized: Unlimited number of voting common shares

Issued and Outstanding

Common Shares (no par value)	**Number of Common Shares**	**Amount $**
Balance, December 31, 2013	**148,758,923**	**1,130,069**
Common shares issued by private placement	211,885	6,997
Equity offering	4,720,000	160,480
Common share issuance costs, (net of tax)	-	(5,162)
Balance, June 30, 2014	**153,690,808**	**1,292,384**

On December 31, 2013, Peyto completed a private placement of 190,525 common shares to employees and consultants for net proceeds of $6.2 million ($32.78 per share). These common shares were issued January 8, 2014

On February 5, 2014, Peyto closed an offering for 4,720,000 common shares at a price of $34.00 per common share, receiving net proceeds of $153.6 million.

On March 17, 2014, Peyto completed a private placement of 21,360 common shares to employees and consultants for net proceeds of $ 0.8 million ($35.20 per common share).

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 and dividends, of proved producing reserves calculated using a constant price at December 31 of the current year and a discount rate of 8%. This methodology can generate interim results which vary significantly from the final compensation paid. Compensation expense of $6.2 million was recorded for the period ended June 30, 2014.

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 a weighted average trading price of the common shares of $41.30 per share for the period ended June 30, 2014, compensation costs related to 5.1 million non-vested rights (3.3% of the total number of common shares outstanding), with an average grant price of $28.49, are $6.9 million for the second quarter of 2014. 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 7 of the condensed financial statements for the more details). This methodology can generate interim results which vary significantly from the final compensation paid. The cumulative provision totals $26.7 million.

Stock Appreciation Rights Outstanding

	Valued but Not Vested			To be Valued December 31, 2014	
Vesting Date	**Number of Rights**	**Value ($)**		**Number of Rights**	**Average Grant Price ($)**
December 31, 2014	71,667	174,000	*	1,017,718	32.27
	971,340	10,009,300	**		
December 31, 2015	971,340	10,009,300	**	1,017,718	32.27
December 31, 2016	-	-		1,017,718	32.27

*Valued on December 31, 2012 at $22.58
**Valued on December 31, 2013 at $32.27

Capital Expenditures

Net capital expenditures for the second quarter of 2014 totaled $151.3 million. Exploration and development related activity represented $116.5 million (77% of total), while expenditures on facilities, gathering systems and equipment totaled $26.5 million (18% of total) and land, seismic and acquisitions/dispositions totaled $8.3 million (5% of total). The following table summarizes capital expenditures for the period:

	Three Months ended June 30		Six Months ended June 30	
($000)	**2014**	2013	**2014**	2013
Land	**5,882**	3,211	**8,738**	3,968
Seismic	**2,322**	667	**6,260**	1,689
Drilling	**68,464**	32,257	**148,711**	107,802
Completions	**48,014**	10,117	**84,101**	51,320
Equipping & Tie-ins	**10,254**	7,264	**25,967**	21,828
Facilities & Pipelines	**16,282**	18,478	**56,665**	54,486
Acquisitions	**72**	1,815	**226**	1,815
Total Capital Expenditures	**151,290**	73,809	**330,668**	242,908

Dividends

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	2014	2013
Funds from operations ($000)	**161,577**	109,987	**322,362**	212,844
Total dividends ($000)	**43,033**	32,727	**79,538**	59,493
Total dividends per share ($)	**0.28**	0.22	**0.52**	0.40
Payout ratio (%)	**27**	30	**25**	28

* per share amounts using weighted average common

Peyto's policy is to balance dividends to shareholders with earnings and cash flow, and balance funding for the capital program with cash flow, equity 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

In addition to those recorded on the Company's balance sheet, the following is a summary of Peyto's contractual obligations and commitments as at June 30, 2014:

	2014	2015	2016	2017	2018	Thereafter
Interest payments[1]	6,115	12,230	12,230	12,230	12,230	22,755
Transportation commitments	9,002	19,785	19,431	15,631	11,917	15,793
Operating leases	1,209	2,380	1,863	1,654	1,295	10,356
Total	16,326	34,395	33,524	29,515	25,442	318,904

[1] Fixed interest payments on senior unsecured notes

LITIGATION

On October 1, 2013, two shareholders (the "Plaintiffs") of Poseidon Concepts Corp. ("Poseidon") filed an application to seek leave of the Alberta Court of Queen's Bench (the "Court") to pursue a class action lawsuit against the Corporation, as a successor to new Open Range Energy Corp. ("New Open Range"). The proposed action contains various claims relating to alleged misrepresentations in disclosure documents of Poseidon (not New Open Range), which claims are also alleged in class action lawsuits filed in Alberta, Ontario, and Quebec earlier in 2013 against Poseidon and certain of its current and former directors and officers, and underwriters involved in the public offering of common shares of Poseidon completed in February 2012. The proposed class action seeks various declarations and damages including compensatory damages which the Plaintiffs estimate at $651 million and punitive damages which the Plaintiffs estimate at $10 million, which damage amounts appear to be duplicative of damage amounts claimed in the class actions against Poseidon, certain of its current and former directors and officers, and underwriters.

New Open Range was incorporated on September 14, 2011 solely for purposes of participating in a plan of arrangement with Poseidon (formerly named Open Range Energy Corp. ("Old Open Range")), which was completed on November 1, 2011. Pursuant to such arrangement, Poseidon completed a corporate reorganization resulting in two separate publicly-traded companies: Poseidon, which continued to carry on the energy service and supply business; and New Open Range, which carried on Poseidon's former oil and gas exploration and production business. Peyto acquired all of the issued and outstanding common shares of New Open Range on August 14, 2012. On April 9, 2013, Poseidon obtained creditor protection under the Companies' Creditor Protection Act.

On October 31, 2013, Poseidon filed a lawsuit with the Court naming the Company as a co-defendant along with the former directors and officers of Poseidon, the former directors and officers of Old Open Range and the former directors and officers of New Open Range. Poseidon claims, among other things, that the Company is vicariously liable for the alleged wrongful acts and breaches of duty of the directors, officers and employees of New Open Range.

On July 3, 2014, the Plaintiffs filed a lawsuit with the Court against KPMG LLP, Poseidon's and Old Open Range's former auditors, making allegations substantially similar to those in the other claims. On July 29, 2014, KPMG LLP filed a statement of defense and a third party claim against Poseidon, the Company and the former directors and officers of Poseidon. The third party claim seeks, among other things, an indemnity, or alternatively contribution, from the third party defendants with respect to any judgment awarded against KPMG LLP.

The allegations against New Open Range contained in the claims described above are based on factual matters that pre-existed the Company's acquisition of New Open Range. The Company has not yet been required to defend either of the actions. When it is required to defend the actions, the Company intends to aggressively protect its interests and the interests of its Shareholders and will seek all available legal remedies in defending the actions.

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 the Company against certain potential losses.

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

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

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

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

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

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

Internal Control over Financial Reporting

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

Peyto is required to disclose herein any change in Peyto's internal control over financial reporting that occurred during the period ended June 30, 2014 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 the Company's disclosure and internal controls and procedures, no matter how well conceived, can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

CRITICAL ACCOUNTING ESTIMATES

Reserve Estimates

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

The Company's estimated quantities of proved and probable reserves at December 31, 2013 were audited by independent petroleum engineers InSite Petroleum Consultants Ltd. InSite has been evaluating reserves in this area and for Peyto for 15 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 credit adjusted risk free rate. The liability is adjusted each reporting period to reflect the passage of time and for revisions to the estimated future cash flows, with the accretion charged to earnings. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material.

Future Market Performance Based Compensation

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

Reserve Value Performance Based Compensation

The reserve value based compensation is calculated using the year end independent reserves evaluation which was completed in February 2014. A quarterly provision for the reserve value based compensation is calculated using estimated proved producing reserve additions adjusted for changes in debt, equity and dividends. Actual proved producing reserves additions and forecasted commodity prices could vary significantly from those estimated and may have a material effect on the calculation.

Income Taxes

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

Accounting Changes

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

CHANGES IN ACCOUNTING POLICIES

Presentation of Financial Statements

Peyto adopted the following standards on January 1, 2014:

IAS 36 "Impairment of Assets" has been amended to reduce the circumstances in which the recoverable amount of cash generating units "CGUs" is required to be disclosed and clarify the disclosures required when an impairment loss has been recognized or reversed in the period. The retrospective adoption of these amendments will only impact Peyto's disclosures in the notes to the financial statements in periods when an impairment loss or impairment reversal is recognized.

IFRIC 21 "Levies" was developed by the IFRS Interpretations Committee ("IFRIC") and is applicable to all levies imposed by governments under legislation, other than outflows that are within the scope of other standards (e.g., IAS 12 "Income Taxes") and fines or other penalties for breaches of legislation. The interpretation clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. It also clarifies that a levy liability is accrued progressively only if the activity that triggers payment occurs over a period of time, in accordance with the relevant legislation. Lastly, the interpretation clarifies that a liability should not be recognized before the specified minimum threshold to trigger that levy is reached. The retrospective adoption of this interpretation does not have any impact on Peyto's financial statements

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 period ended June 30, 2014.

IFRS 9, as issued, reflects part of the IASB's work on the replacement of IAS 39 "Financial Instruments: Recognition and Measurement" and applies to classification and measurement of financial assets and financial liabilities as defined in IAS 39 and hedging transactions. The standard has no effective date. In subsequent phases, the IASB will address impairment of financial assets. The adoption of IFRS 9 may have an effect on the classification and measurement of the company's financial assets and financial liabilities. The Company will quantify the effect in conjunction with the other phases, when the final standard including all phases is issued with an effective date.

In May 2014, the IASB issued IFRS 15 "Revenue from Contracts with Customers," which replaces IAS 18 "Revenue" IAS 11 "Construction Contracts," and related interpretations. The standard is required to be adopted either retrospectively or using a modified transition approach for fiscal years beginning on or after January 1, 2017, with earlier adoption permitted. IFRS 15 will be applied by Peyto on January 1, 2017 and the Company is currently evaluating the impact of the standard on Peyto's financial statements.

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

	2014		2013		
	Q2	Q1	Q4	Q3	Q2
Operations					
Production					
Natural gas (mcf/d)	388,407	389,002	361,870	300,286	310,621
Oil & NGLs (bbl/d)	7,568	7,375	6,984	6,295	6,374
Barrels of oil equivalent (boe/d @ 6:1)	72,302	72,209	67,296	56,343	58,145
Thousand cubic feet equivalent (mcfe/d @ 6:1)	433,812	433,252	403,774	338,058	348,868
Average product prices					
Natural gas ($/mcf)	4.37	4.45	3.59	3.35	3.72
Oil & natural gas liquids ($/bbl)	77.30	80.49	69.84	70.91	67.82
$/MCFE					
Average sale price ($/mcfe)	5.26	5.37	4.43	4.29	4.56
Average royalties paid ($/mcfe)	0.45	0.46	0.28	0.31	0.32
Average operating expenses ($/mcfe)	0.36	0.39	0.35	0.37	0.35
Average transportation costs ($/mcfe)	0.13	0.13	0.13	0.12	0.12
Field netback ($/mcfe)	4.32	4.39	3.67	3.49	3.77
General & administrative expense ($/mcfe)	0.01	0.04	0.06	0.02	0.05
Interest expense ($/mcfe)	0.22	0.23	0.24	0.25	0.25
Cash netback ($/mcfe)	4.09	4.12	3.37	3.22	3.47
Financial ($000 except per share)					
Revenue	207,519	209,318	164,455	133,573	144,614
Royalties	17,689	17,861	10,288	9,722	9,849
Funds from operations	161,577	160,785	125,164	99,736	109,987
Funds from operations per share	1.05	1.06	0.84	0.67	0.74
Total dividends	43,033	36,505	35,702	35,702	32,727
Total dividends per share	0.28	0.24	0.24	0.24	0.22
Payout ratio	27%	23%	29%	36%	30%
Earnings	62,159	62,129	37,989	30,461	37,773
Earnings per diluted share	0.41	0.41	0.26	0.21	0.25
Capital expenditures	151,290	179,378	154,295	180,801	73,809
Weighted average shares outstanding	153,690,808	151,826,431	148,758,923	148,758,923	148,758,923

** per share amounts using weighted average common*

Peyto Exploration & Development Corp.

Condensed Balance Sheet *(unaudited)*

(Amount in $ thousands)

	June 30 2014	December 31 2013
Assets		
Current assets		
Accounts receivable	96,864	83,714
Due from private placement *(Note 6)*	-	6,245
Prepaid expenses	18,322	5,666
	115,186	95,625
Property, plant and equipment, net *(Note 3)*	2,665,253	2,459,531
Long-term derivative financial instruments *(Note 8)*	819	-
	2,666,072	2,459,531
	2,781,258	2,555,156
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	155,203	155,265
Dividends payable *(Note 6)*	15,369	11,901
Derivative financial instruments *(Note 8)*	44,000	26,606
Provision for future performance based compensation *(Note 7)*	18,317	5,100
	232,889	198,872
Long-term debt *(Note 4)*	825,000	875,000
Long-term derivative financial instruments *(Note 8)*	-	5,180
Provision for future performance based compensation *(Note 7)*	8,382	3,200
Decommissioning provision *(Note 5)*	74,125	61,184
Deferred income taxes	247,951	211,082
	1,155,458	1,155,646
Equity		
Share capital *(Note 6)*	1,292,384	1,130,069
Shares to be issued *(Note 6)*	-	6,245
Retained earnings	131,725	86,975
Accumulated other comprehensive loss *(Note 6)*	(31,198)	(22,651)
	1,392,911	1,200,638
	2,781,258	2,555,156

See accompanying notes to the financial statements.

Peyto Exploration & Development Corp.

Condensed Income Statement *(unaudited)*

(Amount in $ thousands except earnings per share amount)

	Three months ended June 30		Six months ended June 30	
	2014	2013	**2014**	2013
Revenue				
Oil and gas sales	230,995	148,466	470,415	276,889
Realized (loss) gain on hedges *(Note 8)*	(23,476)	(3,852)	(53,578)	927
Royalties	(17,689)	(9,849)	(35,551)	(20,440)
Petroleum and natural gas sales, net	**189,830**	134,765	**381,286**	257,376
Expenses				
Operating	14,059	11,242	29,289	20,548
Transportation	5,100	3,796	10,244	7,455
General and administrative	582	1,717	2,138	2,197
Future performance based compensation *(Note 7)*	9,803	6,559	18,399	9,097
Interest	8,512	8,022	17,252	14,332
Accretion of decommissioning provision *(Note 5)*	476	369	974	737
Depletion and depreciation *(Note 3)*	68,410	53,287	137,262	104,912
	106,942	84,992	**215,558**	159,278
Earnings before taxes	**82,888**	49,773	**165,728**	98,098
Income tax				
Deferred income tax expense	20,729	12,000	41,440	23,919
Earnings for the period	**62,159**	37,773	**124,288**	74,179

Earnings per share *(Note 6)*				
Basic and diluted	**$0.41**	$0.25	**$0.81**	$ 0.50

See accompanying notes to the financial statements.

Peyto Exploration & Development Corp.

Condensed Statement of Comprehensive Income *(unaudited)*

(Amount in $ thousands)

	Three months ended June 30		Six months ended June 30	
	2014	2013	**2014**	2013
Earnings for the period	**62,159**	37,773	**124,288**	74,179
Other comprehensive income				
Change in unrealized gain (loss) on cash flow hedges	14,942	30,204	(64,971)	2,076
Deferred tax (expense) recovery	(9,694)	(8,514)	2,846	(287)
Realized loss (gain) on cash flow hedges	23,476	3,852	53,578	(927)
Comprehensive income	**90,883**	63,315	**115,741**	75,041

See accompanying notes to the financial statements.

Peyto Exploration & Development Corp.

Condensed Statement of Changes in Equity *(unaudited)*

(Amount in $ thousands)

	Six months ended June 30	
	2014	**2013**
Share capital, beginning of period	**1,130,069**	1,124,382
Common shares issued by private placement	6,997	5,742
Equity offering	160,480	-
Common shares issuance costs (net of tax)	(5,162)	(55)
Share capital, end of period	**1,292,384**	1,130,069

Shares to be issued, beginning of period	**6,245**	3,459
Shares issued	(6,245)	(3,459)
Shares to be issued, end of period	**-**	-

Retained earnings, beginning of period	**86,975**	75,247
Earnings for the period	124,288	74,179
Dividends *(Note 6)*	(79,538)	(59,494)
Retained earnings, end of period	**131,725**	89,932

Accumulated other comprehensive income, beginning of period	**(22,651)**	6,979
Other comprehensive (loss) income	(8,547)	862
Accumulated other comprehensive (loss) income, end of period	**(31,198)**	7,841

Total equity	**1,392,911**	1,227,842

See accompanying notes to the financial statements.

Peyto Exploration & Development Corp.

Condensed Statement of Cash Flows (unaudited)

(Amount in $ thousands)

	Three months ended June 30		Six months ended June 30	
	2014	**2013**	**2014**	**2013**
Cash provided by (used in) operating activities				
Earnings	62,159	37,773	124,288	74,179
Items not requiring cash:				
Deferred income tax	20,729	12,000	41,440	23,919
Depletion and depreciation	68,410	53,287	137,262	104,912
Accretion of decommissioning provision	476	369	974	737
Long term portion of future performance based compensation	2,956	2,217	5,183	3,226
Change in non-cash working capital related to operating activities	(2,560)	(8,946)	(10,523)	(17,730)
	152,170	96,700	**298,624**	189,243
Financing activities				
Issuance of common shares	-	-	167,477	5,742
Issuance costs	-	-	(6,883)	(73)
Cash dividends paid	(39,960)	(29,752)	(76,070)	(56,504)
Increase (decrease) in bank debt	65,000	110,000	(50,000)	170,000
	25,040	80,248	**34,524**	119,165
Investing activities				
Additions to property, plant and equipment	(151,290)	(73,809)	(330,668)	(242,908)
Change in prepaid capital	(9,143)	-	(349)	3,714
Change in non-cash working capital relating to investing activities	(16,777)	(87,628)	(2,131)	(53,703)
	(177,210)	(161,437)	**(333,148)**	(292,897)
Net increase (decrease) in cash	**-**	15,511	**-**	15,511
Cash, beginning of period	**-**	-	**-**	-
Cash, end of period	**-**	15,511	**-**	15,511
The following amounts are included in cash flows from operating activities:				
Cash interest paid	**5,130**	6,646	**13,460**	14,514
Cash taxes paid	**-**	-	**-**	1,890

See accompanying notes to the financial statements

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 12, 2014.

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 consolidated financial statements as at and for the years ended December 31, 2013 and 2012.

Significant Accounting Policies

(a) Significant Accounting Judgments, Estimates and Assumptions

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.

Except as disclosed below, 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 financial statements as at and for the years ended December 31, 2013 and 2012.

(b) Recent Accounting Pronouncements

Certain new standards, interpretations, amendments and improvements to existing standards were issued by the International Accounting Standards Board (IASB) or International Financial Reporting Interpretations Committee (IFRIC) that are mandatory for accounting periods beginning January 1, 2014 or later periods. The affected standards are consistent with those disclosed in Peyto's financial statements as at and for the years ended December 31, 2013 and 2012.

Peyto adopted the following standards on January 1, 2014:
IAS 36 "Impairment of Assets" has been amended to reduce the circumstances in which the recoverable amount of cash generating units "CGUs" are required to be disclosed and clarify the disclosures required when an impairment loss has been recognized or reversed in the period. The retrospective adoption of these amendments will only impact Peyto's disclosures in the notes to the financial statements in periods when an impairment loss or impairment reversal is recognized.

IFRIC 21 "Levies" was developed by the IFRS Interpretations Committee ("IFRIC") and is applicable to all levies imposed by governments under legislation, other than outflows that are within the scope of other standards (e.g., IAS 12 "Income Taxes") and fines or other penalties for breaches of legislation. The interpretation clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. It also clarifies that a levy liability is accrued progressively only if the activity that triggers payment occurs over a period of time, in accordance with the relevant legislation. Lastly, the interpretation clarifies that a liability should not be recognized before the specified minimum threshold to trigger that levy is reached. The retrospective adoption of this interpretation does not have any impact on Peyto's financial statements

Standards issued but not yet effective

IFRS 9, as issued, reflects part of the IASB's work on the replacement of IAS 39 "Financial Instruments: Recognition and Measurement" and applies to classification and measurement of financial assets and financial liabilities as defined in IAS 39 and hedging transactions. The standard has no effective date. In subsequent phases, the IASB will address impairment of financial assets. The adoption of IFRS 9 may have an effect on the classification and measurement of the company's financial assets and financial liabilities. The Company will quantify the effect in conjunction with the other phases, when the final standard including all phases is issued with an effective date.

In May 2014, the IASB issued IFRS 15 "Revenue from Contracts with Customers," which replaces IAS 18 "Revenue," IAS 11 "Construction Contracts," and related interpretations. The standard is required to be adopted either retrospectively or using a modified transition approach for fiscal years beginning on or after January 1, 2017, with earlier adoption permitted. IFRS 15 will be applied by Peyto on January 1, 2017 and the Company is currently evaluating the impact of the standard on Peyto's financial statements.

3. Property, plant and equipment, net

Cost	
At December 31, 2013	3,071,245
Additions	330,668
Decommissioning provision additions	11,967
Prepaid capital	349
At June 30, 2014	3,414,229
Accumulated depletion and depreciation	
At December 31, 2013	(611,714)
Depletion and depreciation	(137,262)
At June 30, 2014	(748,976)
Carrying amount at December 31, 2013	2,459,531
Carrying amount at June 30, 2014	**2,665,253**

During the three and six month periods ended June 30, 2014, Peyto capitalized \$3.1 million and \$5.9 million (2013 - \$1.5 million and \$4.1 million) of general and administrative expense directly attributable to exploration and development activities.

4. Long-term debt

	June 30, 2014	December 31, 2013
Bank credit facility	555,000	605,000
Senior unsecured notes	270,000	270,000
Balance, end of the period	**825,000**	875,000

As at June 30, 2014, the Company had a syndicated \$1 billion extendible revolving credit facility with a stated term date of April 25, 2017. The bank facility is made up of a \$30 million working capital sub-tranche and a \$970 million production line. The facilities are available on a revolving basis for a three year period. Borrowings under the facility bear interest at Canadian bank prime or US base rate, or, at Peyto's option, Canadian dollar bankers' acceptances or US dollar LIBOR loan rates, plus applicable margin and stamping fees. The total stamping fees range between 50 basis points and 215 basis points on Canadian bank prime and US base rate borrowings and between 150 basis points and 315 basis points on Canadian dollar bankers' acceptance and US dollar LIBOR borrowings. The undrawn portion of the facility is subject to a standby fee in the range of 30 to 63 basis points.

On July 3, 2014, Peyto issued CDN \$50 million of senior unsecured 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 3.79% and mature on July 3, 2022. Interest is paid semi-annually in arrears.

Peyto is subject to the following financial covenants as defined in the credit facility and note purchase agreements:

- Long-term debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 3.0 times trailing twelve month net income before non-cash items, interest and income taxes;
- Long-term debt and subordinated debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 4.0 times trailing twelve month net income before non-cash items, interest and income taxes;
- Trailing twelve months net income before non-cash items, interest and income taxes to exceed 3.0 times trailing twelve months interest expense;
- Long-term debt and subordinated debt plus the average working capital deficiency (surplus) at the end of the two most recently completed fiscal quarters adjusted for non-cash items not to exceed 55 per cent of the book value of shareholders' equity and long-term debt and subordinated debt.

Peyto is in compliance with all financial covenants at June 30, 2014.

Total interest expense for the three and six month periods ended June 30, 2014 was $8.5 million and $17.3 million (2013 - $8.0 million and $14.3 million) and the average borrowing rate for the period was 4.2% and 4.3% (2013 – 4.2% and 4.1%).

5. Decommissioning provision

The following table reconciles the change in decommissioning provision:

Balance, December 31, 2013	**61,184**
New or increased provisions	5,365
Accretion of decommissioning provision	974
Change in discount rate and estimates	6,602
Balance, June 30, 2014	**74,125**
Current	-
Non-current	74,125

Peyto has estimated the net present value of its total decommissioning provision to be $74.1 million as at June 30, 2014 ($61.2 million at December 31, 2013) based on a total future undiscounted liability of $185.4 million ($177.8 million at December 31, 2013). At June 30, 2014 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 2063. The Bank of Canada's long term bond rate of 2.78 per cent (3.24 per cent at December 31, 2013) and an inflation rate of two per cent (two per cent at December 31, 2013) were used to calculate the present value of the decommissioning provision.

6. Share capital

Authorized: Unlimited number of voting common shares

Issued and Outstanding

Common Shares (no par value)	Number of Common Shares	Amount $
Balance, December 31, 2013	**148,758,923**	**1,130,069**
Common shares issued by private placement	211,885	6,997
Equity offering	4,720,000	160,480
Common share issuance costs, (net of tax)	-	(5,162)
Balance, June 30, 2014	**153,690,808**	**1,292,384**

Earnings per common share was determined based on the following:

	Three Months ended June 30		Six Months ended June 30	
	2014	2013	**2014**	2013
Weighted average common shares basic and diluted	**153,690,808**	148,758,923	**152,763,770**	148,716,032

On December 31, 2013, Peyto completed a private placement of 190,525 common shares to employees and consultants for net proceeds of $6.2 million ($32.78 per share). These common shares were issued January 8, 2014

On February 5, 2014, Peyto closed an offering for 4,720,000 common shares at a price of $34.00 per common share, receiving net proceeds of $153.6 million.

On March 17, 2014, Peyto completed a private placement of 21,360 common shares to employees and consultants for net proceeds of $ 0.8 million ($35.20 per common share).

Dividends
During the three and six month periods ended June 30, 2014, Peyto declared and paid dividends of $0.28 and $0.52 per common share ($0.08 per common share per month for January to April and $0.10 per common share for the months of May and June), totaling $42.9 million and $79.5 million respectively (2013 - $0.22 and $0.40 or $0.06 per share for the months of January to April and $0.08 for the months of May and June, $32.7 million and $59.5 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. 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 option valuation model were:

	June 30, 2014	June 30, 2013
Share price	$22.58-$40.10	$22.58 - $30.40
Exercise price	$19.91-$31.75	$19.30 - $22.68
Expected volatility	0%-26%	0% - 26%
Option life	0.50 years	0.50 years
Dividend yield	0%	0%
Risk-free interest rate	1.09%	1.25%

8. Financial instruments

Financial instrument classification and measurement
Financial instruments of the Company carried on the condensed balance sheet are carried at amortized cost with the exception of cash and financial derivative instruments, specifically fixed price contracts, which are carried at fair value. There are no significant differences between the carrying amount of financial instruments and their estimated fair values as at June 30, 2014.

The Company's areas of financial risk management and risks related to financial instruments remained unchanged from December 31, 2013.

The fair value of the Company's cash and financial derivative instruments are quoted in active markets. The Company classifies the fair value of these transactions according to the following hierarchy.

- Level 1 – quoted prices in active markets for identical financial instruments.
- Level 2 – quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and value drivers are observable in active markets.
- Level 3 – valuations derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

The Company's cash and financial derivative instruments have been assessed on the fair value hierarchy described above and classified as Level 1.

Fair values of financial assets and liabilities
The Company's financial instruments include cash, accounts receivable, financial derivative instruments, due from private placement, current liabilities, provision for future performance based compensation and long term debt. At June 30, 2014, cash and financial derivative instruments are carried at fair value. Accounts receivable, due from private placement, current liabilities and provision for future performance based compensation approximate their fair value due to their short term nature. The carrying value of the long term debt approximates its fair value due to the floating rate of interest charged under the credit facility.

Commodity price risk management
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, 2014:

Propane Period Hedged	**Type**	**Monthly Volume**	**Price (USD)**
January 1, 2014 to December 31, 2014	Fixed Price	8,000 bbl	$35.70 to $37.485/bbl
April 1, 2014 to September 30, 2014	Fixed Price	16,000 bbl	$41.79/ to $46.20 /bbl
October 1, 2014 to December 31, 2014	Fixed Price	4,000 bbl	$42.84/bbl

Natural Gas Period Hedged	**Type**	**Daily Volume**	**Price (CAD)**
November 1, 2012 to October 31, 2014	Fixed Price	5,000 GJ	$3.0575/GJ
April 1, 2013 to October 31, 2014	Fixed Price	47,500 GJ	$3.1925- $3.33/GJ
November 1, 2013 to October 31, 2014	Fixed Price	15,000 GJ	$3.50- $3.6025/GJ
April 1, 2014 to October 31, 2014	Fixed Price	70,000 GJ	$3.10- $4.55/GJ
April 1, 2014 to March 31, 2015	Fixed Price	140,000 GJ	$3.20- $3.83/GJ
November 1, 2014 to March 31, 2015	Fixed Price	90,000 GJ	$3.81- $4.87GJ
April 1, 2015 to October 31, 2015	Fixed Price	70,000 GJ	$3.285- $3.91/GJ
April 1, 2015 to March 31, 2016	Fixed Price	25,000 GJ	$3.915-$ 4.05/GJ

As at June 30, 2014, Peyto had committed to the future sale of 120,000 barrels of propane at an average price of $43.81 CAD ($41.03 USD) per barrel and 94,362,500 gigajoules (GJ) of natural gas at an average price of $3.71 per GJ or $4.26 per mcf. Had these contracts been closed on June 30, 2014, Peyto would have realized a net loss in the amount of $43.2 million. If the AECO gas price on June 30, 2014 were to increase by $1/GJ, the unrealized loss would increase by approximately $94.4 million. An opposite change in commodity prices rates would result in an opposite impact on other comprehensive income.

Subsequent to June 30, 2014 Peyto entered into the following contracts:

Natural Gas Period Hedged	**Type**	**Daily Volume**	**Price (CAD)**
November 1, 2014 to March 31, 2015	Fixed Price	30,000 GJ	$3.70- $4.26/GJ
April 1, 2015 to March 31, 2016	Fixed Price	30,000 GJ	$3.56 -$4.00/GJ

9. Commitments

In addition to those recorded on the Company's balance sheet, the following is a summary of Peyto's contractual obligations and commitments as at June 30, 2014:

	2014	**2015**	**2016**	**2017**	**2018**	**Thereafter**
Interest payments [(1)]	6,115	12,230	12,230	12,230	12,230	22,755
Transportation commitments	9,002	19,785	19,431	15,631	11,917	15,793
Operating leases	1,209	2,380	1,863	1,654	1,295	10,356
Total	16,326	34,395	33,524	29,515	25,442	48,904

[(1)] Fixed interest payments on senior unsecured notes

10. Contingencies

On October 31, 2013, Peyto was named as a party to a statement of claim received with respect to transactions between Poseidon Concepts Corp. and Open Range Energy Corp. On July 3, 2014, the Plaintiffs filed a lawsuit with the Court against KPMG LLP, Poseidon's and Old Open Range's former auditors, making allegations substantially similar to those in the other claims. On July 29, 2014, KPMG LLP filed a statement of defense and a third party claim against Poseidon, the Company and the former directors and officers of Poseidon. The third party claim seeks, among other things, an indemnity, or alternatively contribution, from the third party defendants with respect to any judgment awarded against KPMG LLP. The allegations contained in these claims are based on factual matters that pre-existed Peyto's involvement with New Open Range. However, Peyto intends to aggressively protect its interests and the interests of its shareholders and will seek all available legal remedies in defending the action. Management continues to assess the nature of this claim, in conjunction with their legal advisors.

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
Stephen Chetner
Brian Davis
Michael MacBean, Lead Independent Director
Darren Gee
Gregory Fletcher
Scott Robinson

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Deloitte LLP

Solicitors

Burnet, Duckworth & Palmer LLP

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