

# PEYTO

Energy Trust

2



*Interim Report  
for the three months ended June 30, 2006*

## Highlights

	3 Months Ended June 30		%	6 Months Ended June 30		%
	2006	2005	Change	2006	2005	Change
<b>Operations</b>						
Production						
Natural gas (mcf/d)	112,484	106,866	5%	111,685	104,965	6%
Oil & NGLs (bbl/d)	4,145	4,653	(11)%	4,144	4,495	(8)%
Barrels of oil equivalent (boe/d @ 6:1)	22,892	22,464	2%	22,758	21,990	3%
Product prices						
Natural gas (\$/mcf)	7.96	8.00	(1)%	8.60	7.91	9%
Oil & NGLs (\$/bbl)	66.94	51.03	31%	62.06	53.18	17%
Operating expenses (\$/boe)	2.26	1.30	74%	2.03	1.26	61%
Transportation (\$/boe)	0.59	0.68	(13)%	0.61	0.68	(10)%
Field netback (\$/boe)	39.64	33.97	17%	39.83	34.71	15%
General & administrative expenses (\$/boe)	0.43	0.10	330%	0.25	0.08	213%
Interest expense (\$/boe)	2.00	1.25	60%	1.69	1.11	52%
<b>Financial (\$000, except per unit)</b>						
Revenue	106,751	99,427	7%	220,468	193,496	14%
Royalties (net of ARTC)	18,236	25,954	(30)%	45,494	47,626	(4)%
Funds from operations	77,507	66,548	16%	156,124	133,184	17%
Funds from operations per unit	0.74	0.69	7%	1.50	1.38	9%
Total distributions	43,921	33,898	30%	85,439	64,370	33%
Total distributions per unit	0.42	0.35	20%	0.82	0.665	23%
Payout ratio	57	51	12%	55	48	15%
Cash distributions (net of DRIP)	38,315	31,023	24%	72,980	61,005	20%
Payout ratio	49	47	4%	47	46	2%
Earnings	56,768	25,690	121%	102,061	63,121	62%
Earnings per diluted unit	0.54	0.27	100%	0.98	0.65	51%
Capital expenditures	67,195	58,730	14%	212,289	157,805	35%
Weighted average trust units outstanding	104,472,570	96,848,988	8%	104,333,091	96,757,110	8%
<b>As at June 30</b>						
Net debt (before future compensation expense)				399,963	304,165	
Unitholders' equity				467,978	212,395	
Total assets				1,073,338	726,064	

	3 Months Ended June 30		6 Months Ended June 30	
	2006	2005	2006	2005
Net Earnings	<b>56,768</b>	25,690	<b>102,061</b>	63,121
Items not requiring cash:				
Non-cash provision for (recovery of) performance based compensation	<b>(2,626)</b>	21,118	<b>2,196</b>	25,045
Future income tax expense	<b>2,878</b>	5,261	<b>11,555</b>	17,730
Depletion, depreciation and accretion	<b>20,487</b>	14,479	<b>40,370</b>	27,288
Funds from operations <sup>(1)</sup>	<b>77,507</b>	66,548	<b>156,124</b>	133,184

<sup>(1)</sup> **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. We believe 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 Energy Trust (“Peyto”) is pleased to present the operating and financial results for the second quarter of the 2006 fiscal year. Peyto has a solid foundation made up of high quality, long life, natural gas assets, and a business with an eight year track record of successfully achieving premium returns on the capital we invest. We continue to design, drill and build our own assets in Alberta’s premier gas exploration area, the Deep Basin.

The following summarizes the Trust’s foundation.

- Long reserve life - Proved 13.6 years, Proved Plus Probable 18.9 years at the end of 2005
- Low operating costs - \$2.26/boe, three months ending June 30, 2006
- Low base general and administrative costs - \$0.43/boe, three months ending June 30, 2006
- High revenue per boe - \$45.93/boe, before hedging, \$51.24/boe, after hedging, three months ending June 30, 2006
- High field netback – \$39.64/boe, three months ending June 30, 2006
- High operatorship – we operate over 95% of our production
- Low cash distribution payout ratio – cash distributions were 49% of funds from operations for the three months ended June 30, 2006
- Low debt to funds from operations ratio – 1.3 (net debt, before provision for future compensation, divided by annualized second quarter 2006 funds from operations)
- Distribution growth – distributions have been increased 5 times and are now 87% higher than when the trust was formed in July 2003.
- Since inception, Peyto has raised a total of \$387 million issuing units from treasury, accumulated earnings of \$438 million, and distributed \$357 million to unitholders
- Transparent capital structure - no convertible debentures, no exchangeable shares, no stock options, no warrants

The following summarizes performance highlights of the business for the second quarter of 2006.

- Production growth - production increased 2% from 22,464 boe/d in the second quarter of 2005 to 22,892 boe/d in the second quarter of 2006
- Production per unit - decreased 8% per trust unit from the second quarter of 2005, after adjusting for debt and future unrealized performance based compensation
- Per unit funds from operations growth – grew 8% from the previous year to \$0.74/unit
- Hedging – we had an \$11.1 million gain for the second quarter versus a \$5.8 million loss in the first quarter of 2006 based on financial instruments
- Capital expenditures – \$67.2 million was invested into finding and developing new natural gas reserves
- Distributions per unit increased by 20% from the second quarter of 2005 while the cash payout ratio remained low at 49% compared to 47% in the second quarter of 2005. A total of \$43.9 million or \$0.42 per unit was distributed to unitholders in the second quarter of 2006.

*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).*

### Quarterly Review

In the second quarter, \$67.2 million of capital was invested in building new gas assets. Well related activity in the quarter accounted for \$59.2 million or 88% of the total. Seismic and land acquisitions made up \$4.5 million bringing the total investment in future drilling inventory to \$20.2 million for the first six months of 2006. We will begin to capitalize on this inventory over the next 12 months. Costs associated with the new 20 mmcf/d Nosehill Gas Plant were \$3.5 million of the total capital spent in the quarter.

Peyto drilled and cased 15 gross (13.4 net) gas wells and completed 26 gross (20.5 net) gas zones in the quarter. A normal spring breakup restricted access and thus, limited the number of new zones brought on production to 30 gross (19.7 net). Average production was 22,892 boe/d for the quarter.

Peyto’s operating costs were \$2.26/boe for the quarter, up from \$1.81/boe in the prior quarter. The average cost for the first six months of the year was \$2.03/boe. Although operating costs are higher than historic levels, the reason for the increase is primarily due to inflation which is driven by higher commodity prices.

Some of the increase in operating costs is due to the natural stabilization of our asset base which is more than offset by a reduction in royalties. We believe Peyto's operating costs continue to lead the industry by a wide margin.

The average price of natural gas quoted on the AECO monthly index declined by 17% from the first quarter to the second quarter. Peyto's marketing program resulted in a strong commodity price for gas of \$7.96/mcf and \$66.94/bbl for oil and NGLs. These prices combined with our low operating costs and lower royalties yielded field netbacks of \$39.64/boe, which were 17% higher than a year ago and effectively the same as the first quarter of 2006.

### Activity Update

To date in 2006, Peyto has drilled 62 gross (49 net) wells and brought on production 95 gross (77 net) zones accounting for approximately 6,000 boe/d of new working interest production. The following table shows a breakdown of Peyto's working interest production by area as compared to the same period for the previous year.

<b>Peyto Working Interest Sales (boe/d)</b>			
<b>Area</b>	<b>July 2006</b>	<b>July 2005</b>	<b>% Change</b>
Sundance/Wildhay	<b>18,690</b>	14,830	26%
Kakwa/Cutbank	<b>3,330</b>	5,750	(42%)
Other	<b>1,760</b>	920	91%
<b>Total</b>	<b>23,780</b>	21,500	11%

Over the past year, production in the Northern areas, Kakwa and Cutbank, has declined significantly resulting in a more stable producing base. The production decline in the Northern areas has masked the amount of production growth that we have achieved in the greater Sundance area.

Currently, 4 drilling rigs are active in our core areas of Wildhay, Sundance and Nosehill. Construction of the new Nosehill Gas Plant commenced in July with startup expected in early September. This new 100% Peyto owned and operated facility will provide processing capacity for the continued development of gas reserves on the east side of the greater Sundance area.

### Marketing

Peyto's marketing strategy, meant to be methodical and consistent, is designed to smooth out short term fluctuations in the price of both natural gas and natural gas liquids through future sales. Although second quarter natural gas prices were 16% lower than Q2 2005 and 30% lower than Q1 2006, Peyto's realized gas price, after hedging, was effectively the same as the second quarter 2005, and only 14% lower than the first quarter of 2006.

Forward sales for the second quarter of 2006 increased Peyto's combined gas and liquids price by \$5.32/boe, which resulted in a gain of \$11.1 million.

As of June 30, 2006, Peyto had committed to the forward sale of 211,000 barrels of crude oil at an average price of \$76.62 per barrel and 21,160,000 gigajoules (GJ) of natural gas at an average price of \$8.93 per GJ. Peyto's current forward sale volume for 2006 represents approximately 60% of current gas production net of royalties and 40% of current liquids production net of royalties. Based on the historical heating value of Peyto's natural gas, the price per mcf on the forward sale will be \$10.45, which is 31% higher than the price Peyto realized in the second quarter of 2006. This forward price averaging gives stability to both the monthly distributions and capital expenditure program.

## Management Succession

Don Gray, the Founder, President and Chief Executive Officer of Peyto, has announced his intention to step back from day to day involvement with Peyto. Darren Gee, Peyto's VP Engineering, will advance to the role of President. Don Gray will continue as the Chief Executive Officer until January 1, 2007, at which time Mr. Gee will assume the role of President and Chief Executive Officer. In addition, Scott Robinson, the current VP Operations, will assume the role of Executive VP and Chief Operating Officer. Mr. Gray will remain an active Director of Peyto, allowing him to contribute his perspective to both strategy and operations.

On behalf of all unitholders, the Board would like to thank Don for his leadership of Peyto. In commenting on the succession, Mr. Mottershead, Chairman of the Board said, "Over the past eight years Don's vision, leadership and empowerment of people has built a company known for its technical expertise and superior assets. I believe these attributes will allow Peyto to seamlessly transition to its next CEO."

Don Gray said, "It has truly been an honor to lead such an incredible company. When we embarked on this journey eight years ago we faced many hurdles. Today Peyto is known for having the best assets and the strongest business model in the trust sector. I take a lot of pride in knowing that we have not only built great assets but we have also empowered future leaders. I'm confident and excited about Peyto's future."

## Outlook

As the Peyto team continues to put more producing assets into the "reserve bank," the resources that fund our growing distributions and capital program continue to increase. In light of the higher service costs and lower summer gas prices we believe it is appropriate to temporarily slow down our pace of development. For the balance of 2006, we intend to "live within our means," utilizing cash flow after distributions and available bank lines to fund our capital program. The majority of our capital program will be focused on opportunities that can be quickly converted into proven producing reserves, production and cash flow. Visit the Peyto website at [www.peyto.com](http://www.peyto.com) where you will find a wealth of information designed to inform and educate investors.



Don T. Gray  
Chief Executive Officer  
August 9, 2006



Darren Gee  
President

## Management's discussion and analysis

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the unaudited interim consolidated financial statements for the period ended June 30, 2006 and the audited consolidated financial statements of Peyto Energy Trust ("Peyto" or the "Trust") for the year ended December 31, 2005. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

Certain information set forth in this Management's Discussion and Analysis, including management's assessment of the Trust'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. Peyto disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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All references are to Canadian dollars unless otherwise indicated. 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).

To the best of our knowledge, Peyto's foreign ownership level currently stands at approximately 26 percent, well below the level that would jeopardize Peyto's status as a mutual fund trust under current or proposed legislation.

### OVERVIEW

Peyto is a Canadian energy trust involved in the development and production of natural gas in Alberta's deep basin. As at December 31, 2005, we had total proved plus probable reserves of 153.4 million barrels of oil equivalent with a reserve life of 18.9 years as evaluated by our independent petroleum engineers. Our production is weighted as to approximately 83% natural gas and 17% natural gas liquids and oil.

The Peyto model is designed to deliver growth in its assets, production and income, all on a per unit basis. The model is built around three key principles:

- Using our technical expertise to achieve the best return on capital employed, through the development of internally generated drilling projects.
- A low payout ratio designed to efficiently fund our growing inventory of drilling projects.
- Having an asset base which is made up of high quality long life natural gas reserves.

Operating results over the last seven years indicate that we have successfully implemented these principles. Our business model makes Peyto a truly unique energy trust.

## QUARTERLY FINANCIAL INFORMATION

(\$000 except per unit amounts)	2006		2005			2004		
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Total revenue (net of royalties)	<b>88,515</b>	86,459	94,111	84,912	73,473	72,397	66,024	59,337
Funds from operations	<b>77,507</b>	78,617	86,607	77,179	66,548	66,636	60,334	54,211
Per unit – basic*	<b>0.74</b>	0.76	0.85	0.78	0.69	0.69	0.65	0.60
Per unit – diluted*	<b>0.74</b>	0.76	0.85	0.78	0.69	0.69	0.65	0.60
Earnings (loss)	<b>56,768</b>	45,293	60,745	37,702	25,690	37,431	(2,558)	21,650
Per unit – basic*	<b>0.54</b>	0.44	0.60	0.38	0.27	0.39	(0.03)	0.24
Per unit – diluted*	<b>0.54</b>	0.44	0.60	0.38	0.27	0.39	(0.03)	0.24

\*Note: prior periods restated for 2 for 1 split of trust units completed May 31, 2005.

## RESULTS OF OPERATIONS

### Production

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Natural gas (mmcf/d)	<b>112.5</b>	106.9	<b>111.7</b>	104.9
Oil & natural gas liquids (bbl/d)	<b>4,145</b>	4,653	<b>4,144</b>	4,495
Barrels of oil equivalent (boe/d)	<b>22,892</b>	22,464	<b>22,758</b>	21,990

Natural gas production averaged 112.5 mmcf/d in the second quarter of 2006, 5 percent higher than the 106.9 mmcf/d reported for the same period in 2005. Oil and natural gas liquids production averaged 4,145 bbl/d, a decrease of 11 percent from 4,653 bbl/d reported in the prior year. First half production increased 3 percent from 21,990 boe/d to 22,758 boe/d. The overall production increases are directly attributable to Peyto's ongoing drilling program offsetting natural production declines.

### Commodity Prices

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Natural gas (\$/mcf)	<b>6.80</b>	8.14	<b>8.22</b>	7.80
Hedging – gas (\$/mcf)	<b>1.16</b>	(0.13)	<b>0.38</b>	0.11
Natural gas – after hedging (\$/mcf)	<b>7.96</b>	8.00	<b>8.60</b>	7.91
Oil and natural gas liquids(\$/bbl)	<b>69.03</b>	54.88	<b>65.42</b>	56.29
Hedging – oil (\$/bbl)	<b>(2.09)</b>	(3.85)	<b>(3.36)</b>	(3.11)
Oil and natural gas liquids – after hedging (\$/bbl)	<b>66.94</b>	51.03	<b>62.06</b>	53.18
Total Hedging (\$/boe)	<b>5.32</b>	(1.44)	<b>1.27</b>	0.12

Our natural gas price before hedging averaged \$6.80/mcf during the second quarter of 2006, a decrease of 17 percent from \$8.14/mcf reported for the equivalent period in 2005. Oil and natural gas liquids prices averaged \$69.03/bbl up 26 percent from \$54.88/bbl a year earlier. Hedging activity for the second quarter of 2006 accounted for \$5.32/boe of Peyto's price achieved. Expectations are for commodity prices to remain strong relative to historical pricing.

### Revenue

(\$000)	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Natural gas	<b>69,634</b>	79,130	<b>166,153</b>	147,206
Oil and natural gas liquids	<b>26,036</b>	23,236	<b>49,064</b>	45,803
Hedging gain (loss)	<b>11,081</b>	(2,939)	<b>5,251</b>	487
Total revenue	<b>106,751</b>	99,427	<b>220,468</b>	193,496

For the three months ended June 30, 2006, gross revenue increased 7 percent to \$106.7 million from \$99.4 million for the same period in 2005. The increase in revenue for the period was a result of stronger



commodity prices for liquids, our hedging program and increased production volumes for natural gas, as detailed in the following table:

	Three Months ended June 30				Six Months ended June 30			
	2006	2005	Change	\$million	2006	2005	Change	\$million
<b>Natural gas</b>								
Volume (mcf/d)	112,484	106,866	5,618		111,685	104,965	6,720	
Volume (mmcf)	10,236	9,725	511	4	20,215	18,999	1,216	10
Price (\$/mcf)	\$7.96	\$8.00	\$(0.04)	(1)	\$8.60	\$7.91	\$0.69	13
<b>Oil &amp; NGL</b>								
Volume (bbl/d)	4,145	4,653	(508)		4,144	4,496	(352)	
Volume (mmbbl)	377	423	(46)	(2)	750	813	(63)	(3)
Price (\$/bbl)	\$66.94	\$51.03	\$15.91	7	\$62.06	\$53.18	\$8.88	7
<b>Total revenue (\$million)</b>	<b>107</b>	<b>99</b>	<b>8</b>	<b>8</b>	<b>220</b>	<b>193</b>	<b>27</b>	<b>27</b>

## Royalties

We pay royalties to the owners of the mineral rights with whom we hold leases, 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	
	2006	2005	2006	2005
Royalties, net of ARTC (\$000)	18,236	25,954	45,494	47,626
% of sales	17	26	21	25
\$/boe	8.75	12.69	10.47	11.19

For the second quarter of 2006, royalties averaged \$8.75/boe or approximately 17 percent of Peyto's total petroleum and natural gas sales. The royalty rate expressed as a percentage of sales, will fluctuate from period to period due to the fact that the Alberta Reference Price can differ significantly from the commodity prices obtained by the Trust. In addition, royalties paid in the second quarter of 2006 were reduced by a larger than anticipated annual adjustment to the 2005 Gas Cost Allowance while sales were increased by a significant realized hedging gain of \$11.1 million. It is management's expectation that royalties as a percentage of sales for future periods will remain at historical levels.

## Operating Costs & Transportation

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

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Operating costs (\$000)				
Field expenses	6,252	4,235	11,260	8,061
Processing and gathering income	(1,546)	(1,583)	(2,878)	(3,045)
Total operating costs	4,706	2,652	8,382	5,016
\$/boe	2.26	1.30	2.03	1.26
Transportation				
\$/boe	0.59	0.68	0.61	0.68

Operating costs were \$4.7 million in the second quarter of 2006 compared to \$2.6 million during the same period a year earlier. On a unit-of-production basis, operating costs averaged \$2.26/boe in the second quarter of 2006 compared to \$1.30/boe for the second quarter of 2005. The increased cost is attributable to both year-over-year inflationary effects as well as new infrastructure related costs associated with the new Wildhay plant. Furthermore, the producing well count has increased over the year adding additional fixed costs.

## Netbacks

Operating netbacks represent the profit margin associated with the production and sale of petroleum and natural gas. The primary factors that produce Peyto's strong netbacks are a low cost structure and the high heat content of our natural gas that results in higher commodity prices.

(\$/boe)	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Sale Price	<b>51.24</b>	48.64	<b>53.50</b>	47.84
Less:				
Royalties	<b>8.75</b>	12.69	<b>10.47</b>	11.97
Operating costs	<b>2.26</b>	1.30	<b>2.03</b>	1.26
Transportation	<b>0.59</b>	0.68	<b>0.61</b>	0.68
Operating netback	<b>39.64</b>	33.97	<b>40.39</b>	34.71
General and administrative	<b>0.43</b>	0.10	<b>0.25</b>	0.08
Interest on long-term debt	<b>2.00</b>	1.25	<b>1.69</b>	1.11
Capital tax	-	0.06	-	0.06
Cash netback	<b>37.21</b>	32.56	<b>38.45</b>	33.46

## General and Administrative Expenses

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
G&A expenses (\$000)	<b>2,362</b>	1,529	<b>4,415</b>	2,940
Overhead recoveries	<b>(1,473)</b>	(1,320)	<b>(3,400)</b>	(2,620)
Net G&A expenses	<b>889</b>	209	<b>1,015</b>	320
\$/boe	<b>0.43</b>	0.10	<b>0.25</b>	0.08

General and administrative expenses before overhead recoveries increased to \$2.4 million in the second quarter of 2006, as compared to \$1.5 million for the same period in 2005 primarily due to staffing increases required to manage our active drilling program and increasing property base. Net of overhead recoveries associated with our capital expenditures program, general and administrative costs increased to \$0.43 per boe. Our capital program was reduced quarter over quarter, causing related overhead recoveries to decline.

## Interest Expense

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Interest expense (\$000)	<b>4,175</b>	2,552	<b>6,942</b>	4,422
\$/boe	<b>2.00</b>	1.25	<b>1.69</b>	1.11

Second quarter 2006 interest expense was \$4.2 million or \$2.00/boe compared to \$2.5 million or \$1.25/boe a year earlier. During 2006, average debt levels have increased to partially fund Peyto's capital expenditure program. Interest rates continue to be favourable and are not expected to increase substantially in the short-term.

## Depletion, Depreciation and Accretion

The 2006 second quarter provision for depletion, depreciation and accretion totaled \$20.5 million as compared to \$14.5 million in 2005. On a unit-of-production basis, depletion, depreciation and accretion costs averaged \$9.86/boe as compared to \$7.08/boe in 2005. The increase in the provision for depletion, depreciation and accretion costs is attributable to the increased cost of finding and developing new reserves.

## Income Taxes

The current provision for future income tax decreased to \$11.6 million for the first half of 2006 from \$17.7 million for the same period in 2005. This decrease is primarily due to increased capital activity year over year generating higher tax pools and to reflect the reduction in federal and provincial income tax rates being phased in over the next four years.

## MARKETING

### Commodity Price Risk Management

The Trust is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. The Trust enters into these contracts with well established counter-parties for the purpose of protecting a portion of its future revenues from the volatility of oil and natural gas prices. During the second quarter of 2006, we recorded a hedging gain of \$11.1 million as compared to a hedging loss of \$2.7 million in the second quarter of 2005. As set out under the section "Critical Accounting Estimates", we adopted, effective January 1, 2004, the CICA Accounting Guideline 13 with respect to Hedging Relationships. A summary of contracts outstanding in respect of the hedging activities are as follows:

<b>Crude Oil Period Hedged</b>	<b>Type</b>	<b>Daily Volume</b>	<b>Price (CAD)</b>
July 1 to September 30, 2006	Fixed price	200 bbl	\$70.00/bbl
July 1 to September 30, 2006	Fixed price	200 bbl	\$72.15/bbl
July 1 to September 30, 2006	Fixed price	300 bbl	\$75.40/bbl
July 1 to September 30, 2006	Fixed price	200 bbl	\$80.10/bbl
July 1 to September 30, 2006	Fixed price	200 bbl	\$80.20/bbl
August 1 to September 30, 2006	Fixed price	100 bbl	\$85.75/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$69.40/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$71.10/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$79.00/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$81.10/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$87.10/bbl
October 1 to December 31, 2006	Fixed price	200 bbl	\$87.13/bbl
January 1 to March 31, 2007	Fixed price	200 bbl	\$82.82/bbl
January 1 to March 31, 2007	Fixed price	200 bbl	\$87.35/bbl
January 1 to March 31, 2007	Fixed price	200 bbl	\$88.00/bbl
April 1 to June 30, 2007	Fixed price	200 bbl	\$82.39/bbl
April 1 to June 30, 2007	Fixed price	200 bbl	\$87.10/bbl
April 1 to June 30, 2007	Fixed price	200 bbl	\$88.05/bbl
July 1 to September 30, 2007	Fixed price	200 bbl	\$87.61/bbl
July 1 to September 30, 2007	Fixed price	200 bbl	\$88.20/bbl

<b>Natural Gas Period Hedged</b>	<b>Type</b>	<b>Daily Volume</b>	<b>Price (CAD)</b>
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.10/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.20/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.30/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.35/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.45/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.61/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$7.75/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$9.30/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$10.60/GJ
April 1 to October 31, 2006	Fixed price	5,000 GJ	\$10.60/GJ
April 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.27/GJ
July 1 to October 31, 2006	Fixed price	5,000 GJ	\$6.53/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$8.71/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.00/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.05/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$10.06/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$10.28/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$11.40/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$11.60/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.65/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$10.25/GJ

Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.00/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$8.65/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.23/GJ
April 1 to October 31, 2007	Fixed price	5,000 GJ	\$8.60/GJ
April 1 to October 31, 2007	Fixed price	5,000 GJ	\$7.50/GJ
Apr. 1, 2007 to March 31, 2008	Fixed price	5,000 GJ	\$8.90/GJ

### Commodity Price Sensitivity

Our low operating costs, low distribution ratio, marketing program and long reserve life reduce our sensitivity to changes in commodity prices.

### Currency Risk Management

The Trust is exposed to fluctuations in the Canadian/US dollar exchange ratio since our natural gas and oil sales are effectively priced in US dollars and converted to Canadian dollars. In the short term, this risk is mitigated indirectly as a result of our commodity hedging strategy as we hedge at Canadian prices. Over the long term, the Canadian dollar tends to rise as oil prices rise. There is a similar correlation between oil and gas prices. Currently we have not entered into any agreements to further manage this specific risk.

### Interest Rate Risk Management

The Trust is exposed to interest rate risk in relation to interest expense on its revolving demand facility. Currently we have not entered into any agreements to manage this risk. At June 30, 2006, the increase or decrease in earnings for each 100 bps change in interest rate paid on the outstanding revolving demand loan amounts to approximately \$3.2 million per annum.

## LIQUIDITY AND CAPITAL RESOURCES

### Funds from Operations

(\$000)	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Net earnings	<b>56,768</b>	25,690	<b>102,061</b>	63,121
Items not requiring cash:				
Non-cash provision for performance based compensation	<b>(2,626)</b>	21,118	<b>2,196</b>	25,045
Future income tax expense	<b>2,878</b>	5,261	<b>11,555</b>	17,730
Depletion, depreciation & accretion	<b>20,487</b>	14,479	<b>40,312</b>	27,288
Funds from operations	<b>77,507</b>	66,548	<b>156,124</b>	133,184

For the three months ended June 30, 2006, funds from operations totaled \$77.5 million or \$0.74 per unit, representing a 16 percent increase from the \$66.5 million, or \$0.69 per unit during the same period in 2005. Peyto's policy is to distribute approximately 50% of funds from operations to unitholders while retaining the balance to fund its growth oriented capital expenditures program. Our earnings and cash flow are sensitive to changes in commodity prices, exchange rates and other factors that are beyond our control. Current volatility in commodity prices creates uncertainty as to our funds from operations and capital expenditure budget. Accordingly, we assess results throughout the year and revise our operational plans as necessary to reflect the most current information.

Our revenues will be impacted by drilling success and production volumes as well as external factors such as the market prices for natural gas and crude oil and the exchange rate of the Canadian dollar relative to the US dollar.

### Bank Debt

We have an extendible revolving term credit facility with a syndicate of financial institutions in the amount of \$450 million which includes a \$430 million revolving facility and a \$20 million operating facility. Available borrowings are limited by a borrowing base, which is based on the value of petroleum and natural

gas assets as determined by the lenders. The loan is reviewed annually and may be extended at the option of the lender for an additional 364 day period. If not extended, the revolving facility will automatically convert to a one year and one day non-revolving term loan. The loan has therefore been classified as long-term on the balance sheet. The average borrowing rate for the second quarter of 2006 was 4.41% (2005 – 4.04%).

At June 30, 2006, \$390 million was drawn under the facility. Working capital liquidity is maintained by drawing from and repaying the unutilized credit facility as needed. At June 30, 2006, we had a working capital deficit of \$21.1 million.

We believe that funds generated from our operations, together with borrowings under our credit facility and proceeds from equity issued through our DRIP and Optional Trust Unit Purchase Plan will be sufficient to finance our current operations and planned capital expenditure program. The total amount of capital we ultimately invest in 2006 will be driven by the number and quality of projects we generate. Capital will only be invested if it meets the long term objectives of the trust. The majority of our capital program will involve drilling, completion and tie-in of low risk development gas wells. Peyto has the flexibility to match planned capital expenditures to actual cash flow.

## Capital

Peyto implemented a Distribution Reinvestment Plan (“DRIP”) effective with the March 2005 distribution whereby eligible unitholders may elect to reinvest their monthly cash distributions in additional trust units at a 5% discount to market price. On November 21, 2005 the DRIP plan was amended to incorporate an Optional Trust Unit Purchase Plan (“OTUPP”) which provides unitholders enrolled in the DRIP with the opportunity to purchase additional trust units from treasury using the same pricing as the DRIP.

Subsequent to June 30, 2006 60,819 trust units (58,018 pursuant to the DRIP and 2,801 pursuant to the OTUPP) were issued for net proceeds of \$1.4 million. Subsequent to the issuance of these units, 104,710,005 trust units were outstanding (June 30, 2006 – 104,649,186).

Authorized: Unlimited number of voting trust units  
 Issued and Outstanding:

Trust Units (no par value)	Number of Shares/Units	Amount \$
<b>Balance, December 31, 2004</b>	47,725,272	138,953,026
Trust units issued by private placement	670,000	31,586,375
Trust unit issue costs	-	(103,010)
Trust units issued pursuant to DRIP	28,645	1,356,148
Trust units issued pursuant to 2 for 1 split	48,423,917	-
Trust units issued by public offering	5,000,000	152,750,000
Trust unit issue costs	-	(8,054,775)
Trust units issued pursuant to DRIP	279,561	7,448,146
Trust units issued pursuant to OTUPP	206,452	4,800,000
<b>Balance, December 31, 2005</b>	102,333,847	328,735,910
Trust units issued by private placement	1,393,940	34,378,613
Trust units issued pursuant to DRIP	490,563	11,903,158
Trust units issued pursuant to OTUPP	430,836	10,207,682
<b>Balance, June 30, 2006</b>	<b>104,649,186</b>	<b>385,225,363</b>

## Performance Based Compensation

The Trust 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 3% of the incremental increase in value, if any, as adjusted to reflect changes in debt, equity and distributions, 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. No provision for the reserve value based component was recorded for the second quarter of 2006.

Under the market based component, rights with a three year vesting period 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 trust units 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 distributions of a trust unit for that period. A tax factor of 1.333 is then applied to determine the amount to be paid.

Based on the five day weighted average trading price of the trust units for the period ended June 30, 2006, compensation costs related to 4.5 million non-vested rights, with an average grant price of \$22.84, total \$2.2 million. The Trust records a non-cash provision for future compensation expense over the life of the rights. The cumulative provision totals \$12.3 million of which a recovery of \$2.6 million was recorded in the three months ending June 30, 2006.

### Capital Expenditures

Net capital expenditures for the second quarter of 2006 totaled \$67.2 million. Exploration and development related activity represented \$52.3 million or 78% of the total, while expenditures on facilities, gathering systems and equipment totaled \$10.3 million or 15% of the total. The following table summarizes capital expenditures for the quarter.

(\$000)	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Land	2,047	2,916	12,678	5,292
Seismic	2,434	1,507	7,571	2,502
Drilling – Exploratory & Development	52,330	46,369	153,317	119,896
Production Equipment, Facilities & Pipelines	10,332	7,910	38,574	30,094
Acquisitions & Dispositions	-	-	-	-
Office Equipment	52	28	149	21
<b>Total Capital Expenditures</b>	<b>67,195</b>	<b>58,730</b>	<b>212,289</b>	<b>157,805</b>

### Distributions

	Three Months ended June 30		Six Months ended June 30	
	2006	2005	2006	2005
Funds from operations (\$000)	77,507	66,548	156,124	133,184
Total distributions (\$000)	43,921	33,898	85,439	64,370
Total distributions per unit (\$)*	0.42	0.35	0.82	0.665
Payout ratio (%)	57	51	55	48
Cash distributions (\$000) (net of DRIP)	38,315	31,023	72,980	61,005
Payout ratio (%)	49	47	47	46

Peyto's strategy is to distribute approximately 50 percent of funds from operations to our unitholders on a monthly basis with the balance being withheld to fund capital expenditures. As participation in the DRIP is optional and fluctuates monthly, the payout ratio of 50 percent is based on total distributions including those settled in units pursuant to the DRIP. The Board is prepared to adjust the payout levels to balance desired distributions with our requirement to maintain an appropriate capital structure. For Canadian income tax purposes distributions made are considered a combination of income and return of capital. The portion that is return of capital reduces the adjusted cost base of the units.

### Contractual Obligations

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

	\$
2006	476,742
2007	953,484
2008	1,096,641
2009	1,096,641

2010	1,096,641
2011	1,096,641
	<hr/> 5,816,790 <hr/>

## GUARANTEES/OFF-BALANCE SHEET ARRANGEMENTS

The Trust is a party to certain off balance sheet derivative financial instruments, including fixed price contracts as discussed further in the Hedging section.

## RELATED PARTY TRANSACTIONS

During the first quarter of 2006, the Trust paid \$620,218 to a company with a director who was also a director of the Trust until May 16, 2006. This payment related to a joint venture capital project.

An officer of the Trust is a partner of a law firm that provides legal services to the Trust. The fees charged are based on standard rates and time spent on matters pertaining to the Trust and its subsidiaries. For the first six months of 2006, the accrued and actual legal fees totaled \$181,445.

## INCOME TAXES

The following sets out a general discussion of the Canadian and US tax consequences of holding Peyto units as capital property. The summary is not exhaustive in nature and is not intended to provide legal or tax advice. Unitholders or potential Unitholders should consult their own legal or tax advisors as to their particular tax consequences.

### Canadian Taxpayers

The Trust qualifies as a mutual fund trust under the *Income Tax Act* (Canada) and, accordingly, Trust units are qualified investments for RRSPs, RRIFs, RESPs and DPSPs. Each year, the Trust is required to file an income tax return and any taxable income of the Trust is allocated to unitholders.

Unitholders are required to include in computing income their pro-rata share of any taxable income earned by the Trust in that year. An investor's adjusted cost base (ACB) in a trust unit equals the purchase price of the unit less any non-taxable cash distributions received from the date of acquisition. To the extent the unitholders' ACB is reduced below zero, such amount will be deemed to be a capital gain to the unitholder and the unitholders' ACB will be brought to nil.

During the first half of 2006, the Trust paid distributions to the unitholders in the amount of \$85.4 million (2005 - \$64.4 million) in accordance with the following schedule:

<u>Production Period</u>	<u>Record Date</u>	<u>Distribution Date</u>	<u>Per Unit</u>
January 2006	January 31, 2006	February 15, 2006	\$0.12
February 2006	February 28, 2006	March 15, 2006	\$0.14
March 2006	March 31, 2006	April 13, 2006	\$0.14
April 2006	April 30, 2006	May 15, 2006	\$0.14
May 2006	May 31, 2006	June 15, 2006	\$0.14
June 2006	June 30, 2006	July 14, 2006	\$0.14

### US Taxpayers

US unitholders who receive cash distributions are subject to a 15 percent Canadian withholding tax, applied to the taxable portion of the distributions as computed under Canadian tax law. US taxpayers may be eligible for a foreign tax credit with respect to Canadian withholding taxes paid.

The taxable portion of the cash distributions, if any, is determined by the Trust in relation to its current and accumulated earnings and profit using US tax principles. The taxable portion so determined, is considered to be a dividend for US tax purposes.

The non-taxable portion of the cash distributions is a return of the cost (or other basis). The cost (or other basis) is reduced by this amount for computing any gain or loss from disposition. However, if the full

amount of the cost (or other basis) has been recovered, any further non-taxable distributions should be reported as a gain.

US unitholders are advised to seek legal or tax advice from their professional advisors.

## **RISK MANAGEMENT**

Investors who purchase our units are participating in the net funds from operations from a portfolio of western Canadian crude oil and natural gas producing properties. As such, the funds from operations paid to investors and the value of the units are subject to numerous risks inherent in the oil and natural gas industry.

Our expected funds from operations depends largely on the volume of petroleum and natural gas production and the price received for such production, along with the associated costs. The price we receive for our 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 we receive for our 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 both natural gas and natural gas liquids through future sales. It is meant to be methodical and consistent and to avoid speculation.

Although our focus is on internally generated drilling programs, any acquisition of oil and natural gas assets depends on our assessment of value at the time of acquisition. Incorrect assessments of value can adversely affect distributions to unitholders and the value of the units. We employ experienced staff on our team and perform appropriate levels of due diligence on our 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 unitholders.

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, we employ experienced staff to evaluate and operate wells and utilize appropriate technology in our operations. In addition, we use prudent work practices and procedures, safety programs and risk management principles, including insurance coverage against certain potential losses.

The value of our Trust units 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 our oil and gas property investments. In order to mitigate this risk, our 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.

Our access to markets may be restricted at times by pipeline or processing capacity. We minimize these risks by controlling as much of our processing and transportation activities as possible and ensuring transportation and processing contracts are in place with reliable cost efficient counter-parties.

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. We have no control over the level of government intervention or taxation in the petroleum and natural gas industry. However, we operate in such a manner to ensure, to the best of our knowledge that we are 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. We have reviewed our environmental risks and are, to the best of our knowledge, in compliance with the appropriate environmental legislation and have determined that there is no current material impact on our operations.

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



## **DISCLOSURE CONTROLS AND PROCEDURES**

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the Chief Executive Officer ("CEO") and Vice President, Finance ("VPF"), on a timely basis so that appropriate decisions can be made regarding public disclosure.

As of the end of the period covered by this report, Peyto's management evaluated the effectiveness of the design and operation of its disclosure controls and procedures, under the supervision of, and with the participation of the CEO and VPF. Based on this evaluation, the CEO and VPF have concluded that Peyto's disclosure controls and procedures, as defined in Multilateral Instrument 52-109, Certification of Disclosure in Issuers Annual and Interim Filings are effective to ensure that material information relating to Peyto is made known to management on a timely basis and is included in this report.

## **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 Trust'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 Trust's reserves will likely vary from estimates, and such variances may be material.

The Trust's estimated quantities of proved and probable reserves at December 31, 2005 were audited by independent petroleum engineers Paddock Lindstrom & Associates Ltd. Paddock has been evaluating reserves in this area for Peyto for 7 consecutive years.

### **Depletion and Depreciation Estimate**

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

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

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

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

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

#### **Asset Retirement Obligation**

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

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

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

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

The reserve value based compensation is calculated using the 2005 year end independent reserves evaluation which was completed in January 2006. A quarterly provision for the reserve value based compensation is calculated using estimated proved producing reserve additions adjusted for changes in debt, equity and distributions. 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 Trust'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.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

#### **Comprehensive Income, Financial Instruments and Hedges**

The CICA issued new standards in early 2005 for Comprehensive Income (CICA 1530), Financial Instruments (CICA 3855) and Hedges (CICA 3865) which will be effective for the reporting year end 2007. The new standards will bring Canadian rules in line with current rules in the US. The standards will introduce the concept of "Comprehensive Income" to Canadian GAAP and will require that an enterprise (a) classify items of comprehensive income by their nature in a financial statement and (b) display the accumulated balance of comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the statement of financial position. Derivative contracts will be carried on the balance sheet at their mark-to-market value, with the change in value flowing to either net income or comprehensive income. Gains and losses on instruments that are identified as hedges will flow initially to comprehensive income and be brought into net income at the time the underlying hedged item is settled. It is expected that this standard will be effective for the Trust's 2007 reporting. Any instruments that do not qualify for hedge accounting will be marked-to-market with the adjustment (tax effected) flowing through the income statement.

### **ADDITIONAL INFORMATION**

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

## Quarterly information

	2006			2005		
	Q2	Q1	Q4	Q3	Q2	Q1
<b>Operations</b>						
Production						
Natural gas (mcf/d)	<b>112,484</b>	110,878	108,356	108,460	106,866	103,043
Oil & NGLs (bbl/d)	<b>4,145</b>	4,143	4,185	4,569	4,653	4,337
Barrels of oil equivalent (boe/d @ 6:1)	<b>22,892</b>	22,622	22,245	22,646	22,464	21,511
Average product prices						
Natural gas (\$/mcf)	<b>7.96</b>	9.26	10.55	8.67	8.00	7.81
Oil & natural gas liquids (\$/bbl)	<b>66.94</b>	57.12	58.43	57.22	51.03	55.52
Average operating expenses (\$/boe)	<b>2.26</b>	1.81	1.95	1.70	1.30	1.22
Average transportation costs (\$/boe)	<b>0.59</b>	0.63	0.70	0.66	0.68	0.68
Field netback (\$/boe)	<b>39.64</b>	40.02	43.33	38.39	33.97	35.50
General & administrative expense (\$/boe)	<b>0.43</b>	0.06	0.05	0.13	0.10	0.06
Interest expense (\$/boe)	<b>2.00</b>	1.36	0.91	1.16	1.25	0.97
<b>Financial (\$000 except per unit)</b>						
Revenue	<b>106,751</b>	113,717	127,633	110,566	99,427	94,069
Royalties (net of ARTC)	<b>18,236</b>	27,258	33,522	25,654	25,954	21,672
Funds from operations	<b>77,507</b>	78,617	86,607	77,179	66,548	66,636
Funds from operations per unit*	<b>0.74</b>	0.76	0.85	0.78	0.69	0.69
Total distributions	<b>43,921</b>	41,517	36,773	35,505	33,898	30,472
Total distributions per unit*	<b>0.42</b>	0.40	0.36	0.36	0.35	0.315
Payout ratio	<b>57%</b>	53%	42%	46%	51%	46%
Cash distributions (net of DRIP)	<b>38,315</b>	34,665	33,771	32,318	31,023	29,982
Payout ratio	<b>49%</b>	44%	39%	42%	47%	45%
Earnings	<b>56,768</b>	45,293	60,745	37,702	25,690	37,431
Earnings per diluted unit*	<b>0.54</b>	0.44	0.60	0.38	0.27	0.39
Capital expenditures	<b>67,195</b>	145,094	107,647	93,001	58,730	99,074
Weighted average trust units outstanding*	<b>104,472,570</b>	103,910,640	102,148,411	98,584,597	96,848,988	96,664,210

\*Note: prior periods restated for 2 for 1 split of trust units completed May 31, 2005.

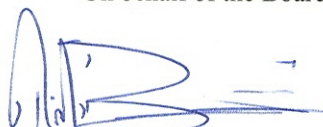
## Peyto Energy Trust

### Consolidated Balance Sheets (unaudited)

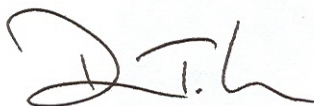
	June 30, 2006 \$	December 31, 2005 \$
<b>Assets</b>		
<b>Current</b>		
Cash	3,839,181	-
Accounts receivable (Note 4)	57,800,266	82,793,463
Due from private placements	-	27,450,247
Prepaid expenses and deposits	6,207,115	1,795,540
	<b>67,846,562</b>	112,039,250
<b>Property, plant and equipment (Note 2)</b>	<b>1,005,491,420</b>	832,887,287
	<b>1,073,337,982</b>	944,926,537
<b>Liabilities and Unitholders' Equity</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	64,354,041	208,284,019
Capital taxes payable	110,412	110,412
Cash distributions payable	13,345,463	11,529,973
Provision for future performance based compensation	11,118,639	8,748,198
	<b>88,928,555</b>	228,672,602
Long-term debt (Note 3)	390,000,000	180,000,000
Provision for future performance based compensation	1,227,007	1,400,970
Asset retirement obligations	5,355,379	4,729,098
Future income taxes	119,848,622	108,292,966
	<b>516,431,008</b>	294,423,034
<b>Unitholders' equity</b>		
Unitholders' capital (Note 4)	385,225,363	328,735,910
Units to be issued (Note 4)	1,368,438	28,332,345
Accumulated earnings	437,986,515	335,925,837
Accumulated distributions (Note 5)	(356,601,897)	(271,163,191)
	<b>467,978,419</b>	421,830,901
	<b>1,073,337,982</b>	944,926,537

See accompanying notes

On behalf of the Board:



Director



Director

(signed) "Michael MacBean"  
Director

(signed) "Donald T. Gray"  
Director

**Peyto Energy Trust**

**Consolidated Statements of Earnings and Accumulated Earnings**  
(unaudited)

	<b>Three Months Ended June 30</b>		<b>Six Months Ended June 30</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
	\$	\$	\$	\$
<b>Revenue</b>				
Petroleum and natural gas sales, net	<b>88,514,997</b>	73,472,840	<b>174,974,213</b>	145,869,788
<b>Expenses</b>				
Operating (Note 6)	<b>4,705,710</b>	2,652,209	<b>8,381,676</b>	5,015,582
Transportation	<b>1,237,147</b>	1,386,829	<b>2,510,980</b>	2,702,996
General and administrative (Note 7)	<b>889,272</b>	209,031	<b>1,015,205</b>	319,674
Future market and reserves based bonus provision	<b>(2,625,718)</b>	21,117,684	<b>2,196,478</b>	25,044,723
Interest	<b>4,175,384</b>	2,551,745	<b>6,941,964</b>	4,422,402
Depletion, depreciation and accretion (Note 2)	<b>20,487,037</b>	14,479,191	<b>40,311,576</b>	27,288,487
	<b>28,868,832</b>	42,396,689	<b>61,357,879</b>	64,793,864
Earnings before taxes	<b>59,646,165</b>	31,076,151	<b>113,616,334</b>	81,075,924
<b>Taxes</b>				
Future income tax expense	<b>2,878,656</b>	5,260,992	<b>11,555,656</b>	17,729,992
Capital tax expense	-	125,000	-	225,000
	<b>2,878,656</b>	5,385,992	<b>11,555,656</b>	17,954,992
Net earnings for the period	<b>56,767,509</b>	25,690,159	<b>102,060,678</b>	63,120,932
Accumulated earnings, beginning of period	<b>381,219,006</b>	211,788,866	<b>335,925,837</b>	174,358,093
<b>Accumulated earnings, end of period</b>	<b>437,986,515</b>	237,479,025	<b>437,986,515</b>	237,479,025
<b>Earnings per unit (Note 4)</b>				
Basic	<b>0.54</b>	0.27	<b>0.98</b>	0.65
Diluted	<b>0.54</b>	0.27	<b>0.98</b>	0.65

See accompanying notes

**Peyto Energy Trust**

**Consolidated Statements of Cash Flows**  
(unaudited)

	<b>Three Months Ended June 30</b>		<b>Six Months Ended June 30</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
	\$	\$	\$	\$
<b>Cash provided by (used in)</b>				
<b>Operating Activities</b>				
Net earnings for the period	<b>56,767,509</b>	25,690,159	<b>102,060,678</b>	63,120,932
Items not requiring cash:				
Future income tax expense	<b>2,878,656</b>	5,260,992	<b>11,555,656</b>	17,729,992
Depletion, depreciation and accretion	<b>20,487,037</b>	14,479,191	<b>40,311,576</b>	27,288,487
Change in non-cash working capital related to operating activities	<b>2,267,844</b>	10,854,377	<b>27,534,260</b>	1,153,941
	<b>82,401,046</b>	56,284,719	<b>181,462,170</b>	109,293,352
<b>Financing Activities</b>				
Issue of trust units, net of costs and DRIP	<b>112,015</b>	-	<b>17,067,064</b>	4,430,515
Cash distributions paid (net of DRIP)	<b>(38,315,010)</b>	(31,022,916)	<b>(72,980,224)</b>	(61,005,127)
Increase in bank debt	<b>90,000,000</b>	70,000,000	<b>210,000,000</b>	100,000,000
Change in non-cash working capital related to financing activities	<b>9,610,088</b>	470,546	<b>29,265,737</b>	28,639,566
	<b>61,407,093</b>	39,447,630	<b>183,352,577</b>	72,064,954
<b>Investing Activities</b>				
Additions to property, plant and equipment	<b>(67,195,003)</b>	(58,730,387)	<b>(212,289,431)</b>	(157,804,797)
Change in non-cash working capital related to investing activities	<b>(72,773,955)</b>	(30,585,401)	<b>(148,686,135)</b>	(17,136,948)
	<b>(139,968,958)</b>	(89,315,788)	<b>(360,975,566)</b>	(174,941,745)
<b>Net increase (decrease) in cash</b>	<b>3,839,181</b>	6,416,561	<b>3,839,181</b>	6,416,561
Cash, beginning of period	-	-	-	-
<b>Cash, end of period</b>	<b>3,839,181</b>	6,416,561	<b>3,839,181</b>	6,416,561

## Peyto Energy Trust

### Notes to Consolidated Financial Statements (unaudited)

June 30, 2006 and 2005

#### 1. Summary of Significant Accounting Policies

The unaudited interim consolidated financial statements of Peyto Energy Trust (the "Trust") follow the same accounting policies as the most recent annual audited financial statements. The interim consolidated financial statement note disclosures do not include all of those required by Canadian generally accepted accounting principles applicable for annual financial statements. Accordingly, these interim financial statements should be read in conjunction with the 2005 audited consolidated financial statements.

These financial statements include the accounts of Peyto Energy Trust and its wholly owned subsidiaries, Peyto Exploration & Development Corp. and Peyto Operating Trust.

Certain comparative figures have been reclassified to ensure consistency with current period presentation.

#### 2. Property, Plant and Equipment

	June 30, 2006 \$	December 31, 2005 \$
Property, plant and equipment	1,188,749,944	976,005,103
Accumulated depletion and depreciation	(183,258,524)	(143,117,816)
	<b>1,005,491,420</b>	<b>832,887,287</b>

At June 30, 2006 costs of \$39,529,264 (June 30, 2005 - \$28,663,020) related to undeveloped land have been excluded from the depletion and depreciation calculation.

#### 3. Long-Term Debt

The Trust has a syndicated \$450 million extendible revolving credit facility. The facility is made up of a \$20 million working capital sub-tranche and a \$430 million production line. The facilities are available on a revolving basis for a period of at least 364 days and upon the term out date may be extended for a further 364 day period at the request of the Trust, subject to approval by the lenders. In the event that the revolving period is not extended, the facility is available on a non-revolving basis for a one year term, at the end of which time the facility would be due and payable. Outstanding amounts on this facility bear interest at rates determined by the Trust's debt to cash flow ratio that range from prime to prime plus 0.75% for debt to cash flow ratios ranging from less than 1:1 to greater than 2.5:1. A General Security Agreement with a floating charge on land registered in Alberta is held as collateral by the bank.

#### 4. Unitholders' Capital

**Authorized:** Unlimited number of voting trust units

##### Issued and Outstanding

Trust Units (no par value)	Number of Shares/Units	Amount \$
<b>Balance, December 31, 2004</b>	47,725,272	138,953,026
Trust units issued by private placement	670,000	31,586,375
Trust unit issue costs	-	(103,010)
Trust units issued pursuant to DRIP	28,645	1,356,148

Trust units issued pursuant to 2 for 1 split	48,423,917	-
Trust units issued by public offering	5,000,000	152,750,000
Trust unit issue costs	-	(8,054,775)
Trust units issued pursuant to DRIP	279,561	7,448,146
Trust units issued pursuant to OTUPP	206,452	4,800,000
<b>Balance, December 31, 2005</b>	<b>102,333,847</b>	<b>328,735,910</b>
Trust units issued by private placement	1,393,940	34,378,613
Trust units issued pursuant to DRIP	490,563	11,903,158
Trust units issued pursuant to OTUPP	430,836	10,207,682
<b>Balance, June 30, 2006</b>	<b>104,649,186</b>	<b>385,225,363</b>

### Units to be Issued

On March 2, 2005, Peyto implemented a Distribution Reinvestment Plan ("DRIP"). On November 21, 2005 the DRIP plan was amended to incorporate an Optional Trust Unit Purchase Plan ("OTUPP") which provides unitholders enrolled in the DRIP with the opportunity to purchase additional trust units from treasury subject to certain limitations, using the same pricing as the DRIP. On July 14, 2006, at a price of \$22.50 per trust unit, 58,018 trust units were issued from treasury pursuant to the DRIP, and 2,801 trust units were issued from treasury pursuant to the OTUPP. \$63,015 (December 31, 2005 - \$132,000) was included in accounts receivable for the funds due Peyto under the OTUPP.

### Per Unit Amounts

Earnings per unit have been calculated based upon the weighted average number of units outstanding during the period of 104,472,570 (2005 – 96,848,988). There are no dilutive instruments outstanding.

## 5. Accumulated Distributions

Peyto's strategy is to distribute approximately 50 percent of funds from operations to our unitholders on a monthly basis with the balance being withheld to fund capital expenditures. Management and the Board are prepared to adjust the payout levels to balance desired distributions with our requirement to maintain an appropriate capital structure. During the quarter, the Trust paid total distributions to the unitholders in the aggregate amount of \$43.9 million of which \$38.3 million was settled in cash and \$5.6 million was settled by the issuance of trust units pursuant to the DRIP (2005 – total \$33.9 million; cash \$31 million and DRIP \$2.9 million) in accordance with the following schedule:

<b>Production Period</b>	<b>Record Date</b>	<b>Distribution Date</b>	<b>Per Unit</b>
January 2006	January 31, 2006	February 15, 2006	\$0.12
February 2006	February 28, 2006	March 15, 2006	\$0.14
March 2006	March 31, 2006	April 13, 2006	\$0.14
April 2006	April 30, 2006	May 15, 2006	\$0.14
May 2006	May 31, 2006	June 15, 2006	\$0.14
June 2006	June 30, 2006	July 14, 2006	\$0.14

## 6. Operating Expenses

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30</b>		<b>June 30</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Field expenses	<b>6,251,633</b>	4,235,214	<b>11,260,132</b>	8,060,981
Processing and gathering income	<b>(1,545,923)</b>	(1,583,005)	<b>(2,878,456)</b>	(3,045,399)
<b>Total operating costs</b>	<b>4,705,710</b>	2,652,209	<b>8,381,676</b>	5,015,582



## 7. General and Administrative Expenses

General and administrative expenses are reduced by operating and capital overhead recoveries from operated properties.

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
G&A expenses	2,362,174	1,529,543	4,414,855	2,940,164
Overhead recoveries	(1,472,902)	(1,320,512)	(3,399,650)	(2,620,490)
Net G&A expenses	889,272	209,031	1,015,205	319,674

## 8. Financial Instruments

The Trust is a party to certain off balance sheet derivative financial instruments, including fixed price contracts. The Trust enters into these contracts with well established counterparties for the purpose of protecting a portion of its future earnings and cash flows from operations from the volatility of petroleum and natural gas prices. The Trust believes the derivative financial instruments are effective as hedges, both at inception and over the term of the instrument, as the term and notional amount do not exceed the Trust's firm commitment or forecasted transaction and the underlying basis of the instrument correlates highly with the Trust's exposure. A summary of contracts outstanding in respect of the hedging activities at June 30, 2006 is as follows:

Crude Oil Period Hedged	Type	Daily Volume	Weighted Average Price (CAD)
July 1 to September 30, 2006	Fixed price	1,100 bbl	\$75.55/bbl
October 1 to December 31, 2006	Fixed price	800 bbl	\$75.15/bbl
January 1 to March 31, 2007	Fixed price	200 bbl	\$82.82/bbl
April 1 to June 30, 2007	Fixed price	200 bbl	\$82.39/bbl

Natural Gas Period Hedged	Type	Daily Volume	Weighted Average Price (CAD)
April 1 to October 31, 2006	Fixed price	50,000 GJ	\$8.23/GJ
April 1, 2006 to March 31, 2007	Fixed price	5,000 GJ	\$9.27/GJ
July 1 to October 31, 2006	Fixed price	5,000 GJ	\$6.53/GJ
Nov. 1, 2006 to March 31, 2007	Fixed price	60,000 GJ	\$9.74/GJ
April 1 to October 31, 2007	Fixed price	10,000 GJ	\$8.05/GJ
April 1, 2007 to March 31, 2008	Fixed price	5,000 GJ	\$8.90/GJ

As at June 30, 2006, the Trust had committed to the future sale of 211,000 barrels of crude oil at an average price of \$76.62 per barrel and 21,160,000 gigajoules (GJ) of natural gas at an average price of \$8.93 per GJ or \$10.45 per mcf based on the historical heating value of Peyto's natural gas. These contracts will generate revenue totaling \$205.2 million. Based on the market's estimate of the future commodity prices as at June 30, 2006 the fair value of these contracts would be \$174.7 million.

Subsequent to June 30, 2006 the Trust entered into the following contracts:

Crude Oil Period Hedged	Type	Daily Volume	Price (CAD)
August 1 to September 30, 2006	Fixed price	100 bbl	\$85.75/bbl
October 1 to December 31, 2006	Fixed price	400 bbl	\$87.12/bbl
January 1 to March 31, 2007	Fixed price	400 bbl	\$87.68/bbl

April 1 to June 30, 2007	Fixed price	400 bbl	\$87.58/bbl
July 1 to September 30, 2007	Fixed price	400 bbl	\$87.91/bbl

### Fair Values of Financial Assets and Liabilities

The Trust's financial instruments include accounts receivable, current liabilities, provision for future performance based compensation and long term debt. At June 30, 2006, the carrying value of accounts receivable, current liabilities and provision for future performance based compensation approximate their value due to their short term nature or method of determination. The carrying value of the long term debt approximates its fair value due to the floating rate of interest charged under the facilities.

### Credit Risk

A substantial portion of the Trust's accounts receivable is with petroleum and natural gas marketing entities. The Trust generally extends unsecured credit to these companies, and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions and may accordingly impact the Trust's overall credit risk. Management believes the risk is mitigated by the size, reputation and diversified nature of the companies to which they extend credit. The Trust has not previously experienced any material credit losses on the collection of accounts receivable. Of the Trust's significant individual accounts receivable at June 30, 2006, approximately 50% was due from two companies (December 31, 2005 – 42%).

The Trust may be exposed to certain losses in the event of non-performance by counter-parties to commodity price contracts. The Trust mitigates this risk by entering into transactions with counter-parties that have investment grade credit ratings.

### Interest rate risk

The Trust is exposed to interest rate risk in relation to interest expense on its revolving demand facility. At June 30, 2006, the increase or decrease in earnings for each 1% change in interest rate paid on the outstanding revolving demand loan amounts to approximately \$3.2 million per annum.

## 9. Supplemental Cash Flow Information

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Cash interest paid	4,175,384	2,551,745	6,941,964	4,422,402
Cash taxes paid	-	125,000	-	225,000

## 10. Contingencies and Commitments

### a) Contingent Liability

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

Peyto has been named in a Statement of Claim issued by Canadian Natural Resources Limited and affiliates ("CNRL"), claiming \$13M in damages for alleged breaches of duty as operator of jointly owned properties, and an interim and permanent injunction to prevent Peyto from proceeding with the completion of a well on those properties. CNRL alleges that Peyto failed to take proper steps as operator of a joint well (the "Well") on lands that offset 100% Peyto owned lands. Peyto has filed a Statement of Defence defending the allegations set forth in the Statement of Claim. The injunction claimed by CNRL was to prevent Peyto from completing the Well at a target location which had

been agreed upon by both parties. Although claimed in the Statement of Claim, CNRL did not apply for an interim injunction, and Peyto completed the Well as planned, but no commercial production was obtained. Accordingly, it remains to be seen whether CNRL will proceed with the action. If the action goes ahead, Peyto intends to defend itself vigorously. Although the outcome of this matter is not determinable at this time, Peyto believes that this claim will not have a material adverse effect on Peyto's financial position or results of operations.

**b) Commitments**

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

	\$
2006	476,742
2007	953,484
2008	1,096,641
2009	1,096,641
2010	1,096,641
2011	1,096,641
	<u>5,816,790</u>

**11. Related Party Transactions**

During the period ended March 31, 2006, the Trust paid \$620,218 to a company with a shareholder who was also a director of the Trust until May 16, 2006, related to a joint venture capital project. Costs associated with this joint venture capital project are billed and paid in accordance with normal business operations.

An officer of the Trust is a partner of a law firm that provides legal services to the Trust. The fees charged are based on standard rates and time spent on matters pertaining to the Trust and its subsidiaries. For the first half of 2006, legal fees totaled \$181,445 (2005 - \$49,988).

## **Peyto Exploration & Development Corp. Information**

### **Officers**

Don Gray  
Chief Executive Officer

Darren Gee  
President

Scott Robinson  
Executive Vice President &  
Chief Operating Officer

Kathy Turgeon  
Vice President, Finance

Glenn Booth  
Vice President, Land

Ken Veres  
Vice-President, Exploration

Stephen Chetner  
Corporate Secretary

### **Directors**

Ian Mottershead, Chairman  
Rick Braund  
Don Gray  
Brian Craig  
John Boyd  
Michael MacBean

### **Auditors**

Deloitte & Touché LLP

### **Solicitors**

Burnet, Duckworth & Palmer LLP

### **Bankers**

Bank of Montreal  
Union Bank of California  
Royal Bank of Canada  
BNP Paribas  
Société Générale  
ATB Financial

### **Transfer Agent**

Valiant Trust Company

### **Head Office**

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Stock Listing Symbol: PEY.un  
Toronto Stock Exchange