PEYTO Energy Trust

President's Monthly Report

January 2007 From the desk of Darren Gee, President

Happy New Year! Welcome to the beginning of another exciting year at Peyto. Like an *"auld acquaintance,"* we have not forgotten our business strategy; profitably **"design, drill and build"** our own producing gas assets to further increase per unit value. As with most successful businesses, we accomplish this by re-investing funds from our operation and by using available leverage to enhance the rate of return, rather than continued dilution through the issuance of trust units.

This month's report includes an estimate of monthly capital spending, as well as our field estimate of production for the most recent month (see Capital Investment and Production tables below). In addition, comments on commodity outlook, industry activity and our ongoing operation should continue to help frame our discussion of where Peyto is today and where we are going.

Capital Investment

*2006 Capital Summary (millions$ CND)**

	Q1	Q2	Jul	Aug	Sept	Q3	Oct	Nov	Dec	Q4	2006
Land & Seismic	16	4	1	1	0	1	0	0		0	22
Drilling	67	30	8	9	12	29	7	4		12	137
Completions	34	22	11	6	6	23	4	3		7	86
Tie ins	16	7	3	2	4	9	2	0		3	35
Facilities	12	4	5	3	1	9	1	0		1	25
Other	0	0	0	0	0	0	0	0		0	0
Total	**145**	**67**	**27**	**22**	**22**	**71**	**14**	**8**		**22**	**305**

This is an estimate based on real field data, not a forecast, and the actual numbers will vary from the estimate due to accruals and adjustments. Such variance may be material.

Production

*2006 Production ('000 boe/d)**

	Q1	Q2	Q3	Oct	Nov	Dec	Q4	2006
Sundance	17.7	17.8	18.4	18.5	17.8	17.4	17.9	18.0
Kakwa	3.3	3.0	2.7	2.3	2.3	2.4	2.3	2.8
Other	1.6	2.1	2.2	2.1	2.4	2.5	2.3	2.0
Total	**22.6**	**22.9**	**23.3**	**22.9**	**22.5**	**22.2**	**22.5**	**22.8**

This is an estimate based on real field data, not a forecast, and the actual numbers will vary from the estimate due to accruals and adjustments. Such variance may be material.

As mentioned in my last report, Peyto has adopted a near term business strategy that provides for re-investment of retained cash flow (funds from operations less cash distributions) without increasing available bank lines or issuing a significant amount of new units. This strategy has been in place since the spring of 2006 and I believe it will allow us to effectively offset our declines while we await a return to more favorable business conditions, in the form of reduced service costs and/or increased natural gas prices.

We have now completed our 8th year of building tight gas assets and, as shown Figure 1, the combined production from the 2006 drills initially represents approximately 30% of

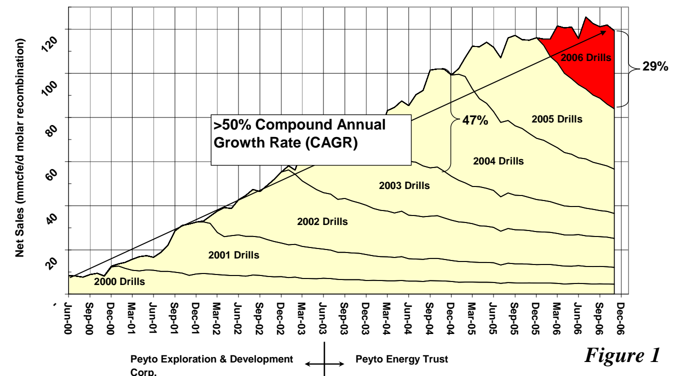

Figure 1

the total production. This is in contrast to past years where the new drilling made up closer to half of our total production and created steep corporate declines. We estimate that the total corporate decline will be shallower as a smaller percentage of production is in the initial steep decline phase.

We await our year end reserve report to determine the value of these newly constructed assets in relation to the capital invested in them.

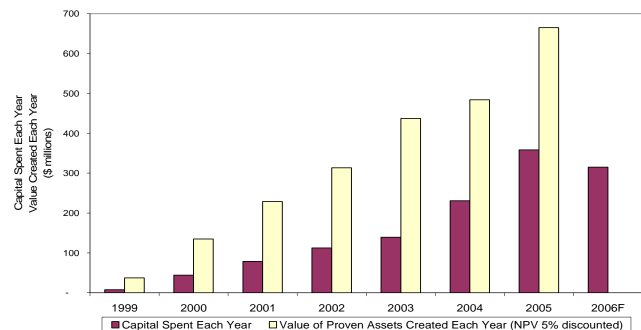

Figure 2

As shown in Figure 2, Peyto has historically created assets that are worth an average of 2.4 times the capital used to build them. Even more significant than the efficiency with which this capital was invested is the amount of incremental value that has been created. For example in 2005, $296 million of cash flow was extracted from our asset base, while $665 million of assets were added back through the creation of new producing gas wells. This equates to $369 million of incremental value or over $3 per unit, all while still delivering a distribution to unit holders. It is the accretive nature of these newly built assets that continues to deliver value growth to our unit holders.

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So How Can Flat Production Equal Growing Value?

So exactly how does the value of the asset base grow if production remains flat? This was a concept I introduced in my report last month but one that is not intuitive to most investors, or oil and gas analysts, for that matter.

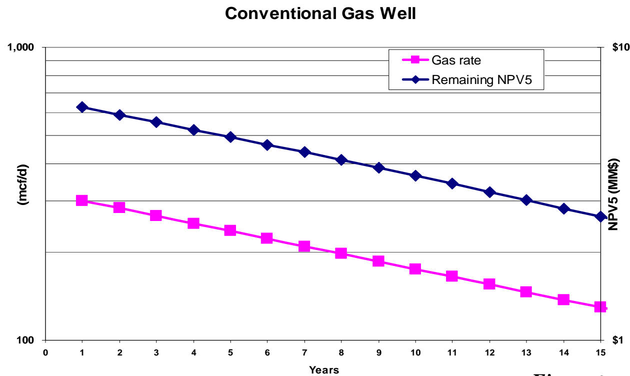

Figure 3

The reason it is not intuitive is that conventional oil and gas companies have been built on conventional oil and gas assets (ie. wells that produce at greater flow rate relative to their reserve base). Production from these conventional wells declines at approximately the same rate as the value that is extracted from them. So for conventional assets, there is a direct connection between production and value, as production declines so does the remaining value (Net Present Value at 5% discount factor). Figure 3 shows the production profile and value decline of a conventional gas reservoir with a conventional or exponential decline.

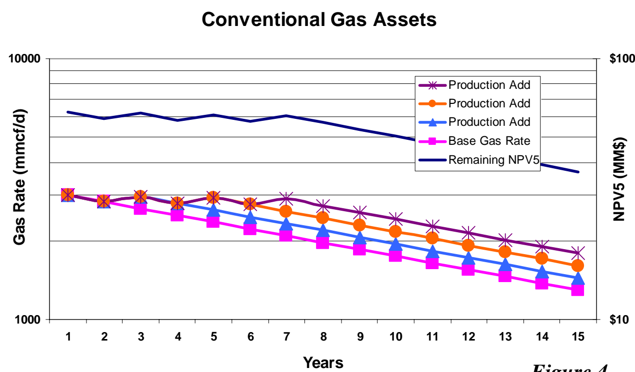

Figure 4

Figure 4 shows how, if you added additional conventional assets to replace the declining production, you also replace the value loss, thus production held flat equals value held flat.

Unlike most other oil and gas companies, Peyto's assets are all unconventional or tight gas assets (ie. wells that have lower stabilized flow rate relative to their reserve base). For these unconventional wells, the rate at which the production declines is initially greater than the rate at which the value is extracted.

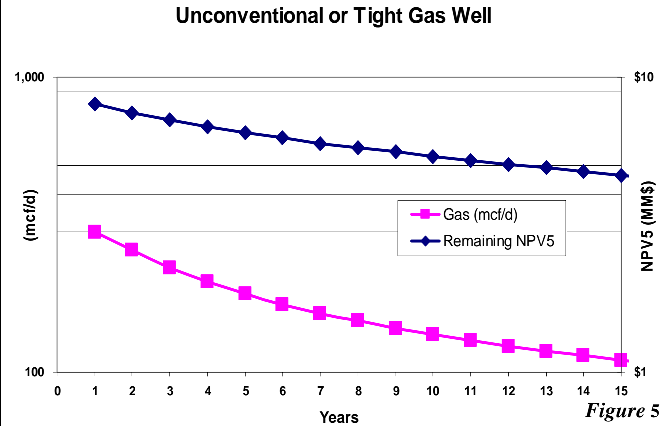

Figure 5

As shown in Figure 5, initially the production declines at a much greater rate than the value is extracted. In these early years, if the production is held flat by adding new, tight gas production, the total value actually grows. This relationship is shown in Figure 6.

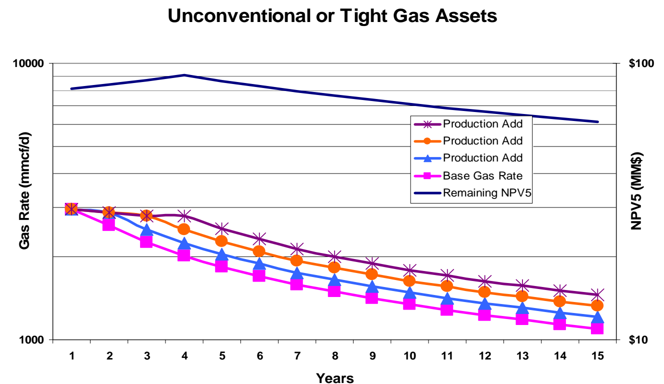

Figure 6

Commodity Prices and Activity Levels

This month, in Figure 7 below, I have displayed the natural gas price in $/boe (barrels of oil equivalent) where 8 mcf (thousand cubic feet) of natural gas is equal to 1 barrel of oil. In reality, the theoretical heat content relationship between the two is closer to 6 to 1 because 6 mcf of natural gas generates the same amount of energy as 1 barrel of oil. Historically oil and gas have averaged 8:1, not 6:1, because

oil is a global commodity while natural gas is more of a North American commodity. As natural gas becomes more widely used and Liquefied Natural Gas (LNG) infrastructure expands, the two energy sources should trade closer to 6:1.

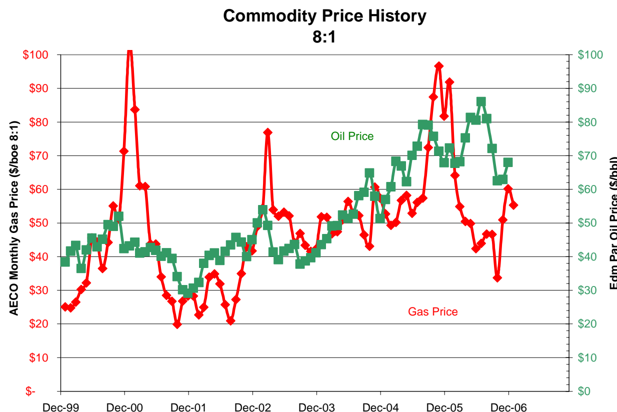

Figure 7

As we start the New Year, we see the spread between oil (Edmonton par) and natural gas prices (AECO monthly) moving closer to the historical 8:1 relationship. This is good for Peyto, as we are fundamentally a gas company with only 10% of our production linked to oil prices. This coming together of the commodity prices will, I believe, begin to bring service costs in line and create a more favorable business condition for gas development.

Our forward sales of natural gas have secured an average price of over $11/mcf for this winter, protecting against short term swings in winter prices.

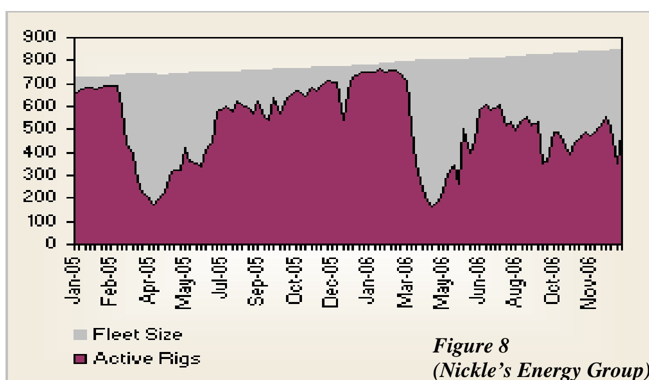

Figure 8
(Nickle's Energy Group)

Western Canadian drilling activity continues to slowdown, as does rig utilization, shown in Figure 8. Despite this slowdown, hourly service rig rates, as a barometer of service costs, have yet to show any reduction.

Peyto's activity remains curtailed until we see a reduction in service costs, at which time we can begin to accelerate our vast inventory of opportunities.

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