PEYTO Energy Trust

President's Monthly Report

May 2009 | From the desk of Darren Gee, President & CEO

The natural gas business in North America appears to have caught the swine flu; killing some companies, making others very ill, and leaving those who dodged it thanking their lucky stars. Spot natural gas prices across North America have been hovering in the $2-$3 range which is close to the average cash cost, meaning few producers are actually generating positive cashflow from their production. At this price, which hopefully won't last, it no longer matters what it costs to build new production because after operating costs, royalties, interest, G&A and taxes, there is nothing left to pay for it anyway.

The evidence of supply reductions; not just reduced drilling activity but of existing production being shut-in, should start to emerge and help ease the downward pressure on prices. The only problem is that the real production data is months behind. By the time we see it, the industry may have over-corrected the balance.

As in the past, this 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).

Capital Investment

*2008 Capital Summary (millions$ CND)**

	Q1	Q2	Q3	Oct	Nov	Dec	Q4	2008	Jan	Feb	Mar	Q1
Land & Seismic	1	2	2	0	2	0	2	6	0	0	0	0
Drilling	17	10	35	5	1	1	8	70	5	2	0	7
Completions	9	7	20	4	4	1	8	45	1	2	0	4
Tie ins	5	3	6	1	2	2	4	17	0	1	0	2
Facilities	0	0	0	0	0	0	1	2	0	0	0	1
Other	0	0	0	0	0	0	0	0	0	0	0	0
Total	**33**	**21**	**62**	**10**	**8**	**4**	**22**	**139**	**7**	**6**	**1**	**13**

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. Tables may not add due to rounding.

Production

*2008/2009 Production ('000 boe/d)**

	Jan	Feb	Mar	Q1 09	Apr	May	June
Sundance	16.1	15.8	15.7	15.9	15.6		
Kakwa	2.1	2.0	2.0	2.0	1.9		
Other	1.3	1.3	1.2	1.3	1.1		
Total	**19.5**	**19.0**	**18.8**	**19.1**	**18.6**	**-**	**-**

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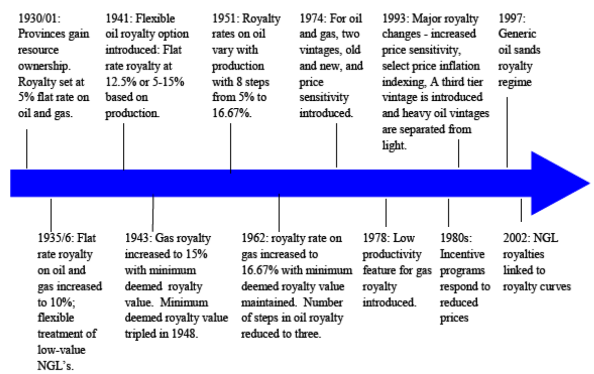
Alberta's Ever Changing Royalties

It used to be that we focused most of our attention on predicting well results in order to determine how profitable a capital investment would be. We (not just Peyto, but the whole Canadian industry) gravitated towards resource plays like the Deep Basin because there was lower geological and reservoir risks associated with exploration and development and therefore the variability in results could be managed.

Nowadays, it seems predicting royalty rates for a given investment is also something we must focus on, especially with the Alberta government changing the rules so often. That wasn't always the case. For the period from 1993 until 2007 (Figure 1) the royalty regime on gas drilling in Alberta was the essentially unchanged. Then the New Royalty Framework was announced in 2007, followed by transitional royalties in 2008 and now the new 3-point energy incentive plan for 2009.

Figure 3: Major Events in Alberta's Royalty History



Crystallizing any royalty incentives now becomes an important part of achieving the economic results. Peyto, for instance, lost close to $20 million in deep gas drilling credits as of January 1, 2009 when that program was cut off. Unfortunately, the Alberta government chose not to grandfather the old program but to completely abolish it and any outstanding claims you might still have had.

This new 3-point incentive plan at least lets you offset drilling credits against your existing corporate royalty base so that, in theory, you can crystallize those incentives faster (hopefully before the Crown decides to abolish this new program!). The speed at which the credits are recognized and netted off your total royalty bill will become an important part of the value of the incentive.

Based on the rules for the new program, a drilling royalty credit of $200/m can be earned, to be applied against your corporate royalty bill, for new wells drilled from April 1, 2009 until April 1, 2010. Any credits earned have to be used up by March 31, 2011.

As well, new wells brought on between April 1, 2009 and March 31, 2010 will be charged a maximum 5% royalty rate for their first year of production.

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Of course, there are limits. A maximum amount of credit claimable against 2009 royalties is to be based on the amount of 2008 Alberta production a company might have. In Peyto's case for instance, using the crown's 10 to 1 conversion factor for gas, Peyto is a 13,300 boe/d company and is eligible to claim up to 40% off.

If we assumed that we would be paying about $30 million in royalties in 2009, then working backwards from the eligible credit limit, we would be able to earn up to $12 million in credits. At $200/m that would require us to drill 60,000 m over the next 12 months. Based on 2008's average well depth of 2,813 m this would require us to drill approximately 21 net wells. If the average well cost is approximately $3 million, that works out to $63 million of capital spending. So in essence, we could invest $63 million, drilling 21 net wells and it would really only cost us $51 million. Not a bad deal.

So what does that incentive do to the economics of an average Peyto well? That assumes of course that we can take advantage of and realize the entire drilling credit, along with the 5% minimum royalty in the first 12 months.

Table 1 shows the economic comparison for a typical vertical Cardium well, valued at current, forward strip gas prices and at current $3.50/GJ pricing, under the two royalty scenarios:

Table 1 - Economic Comparison of Royalty Incentives

Typical Cardium Gas Well
Capital $2.0 million (drill, complete, equip, tiein, land, seismic)
Reserves 1.2 bcf, IP 600 mcf/d
Gas Price/GJ: $4.60, $6.40, $6.75, +2%

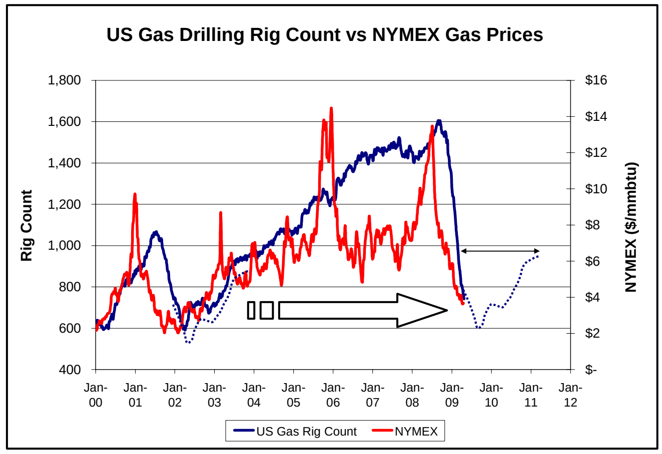
	Existing NRF		NRF plus 3 Point Incentive	
	Forward Strip Pricing	$3.50/GJ, esc Pricing	Forward Strip Pricing	$3.50/GJ, esc Pricing
Rate of Return (%)	34%	15%	55%	26%
NPV5 ($MM)	3.9	1.3	4.5	1.8
Payout (yrs)	2.8	5.3	1.8	3

As long as prices recover and we can actually realize the drilling credit, it offers a handsome improvement over the existing royalty regime.

It's unfortunate that the expected economic result now has to come with a qualifier on royalties in addition to well results and commodity prices. As if we didn't have enough variables to manage.

Activity Levels and Commodity Prices

The US gas rig count continues to slide; the rig count now stands at 741 down from 1600 in August 2008 (Figure 4). Based on the historical trends from 2002, it could take a year or two to see that rig count recover to over 1000 rigs.



In Canada, drilling has ground to a halt due to spring breakup with only 5% of rigs (31) working in Alberta. Comparably, that is very low, in spite of the fact that the new drilling incentives mean drilling in some plays is almost free! (A 500m gas well, for example, in eastern Alberta that can be drilled for $100k earns $100k of royalty credit).

Natural gas prices have hopefully bottomed out with the expectation that all of this slowdown in activity will drive less supply. Good thing if that's the case. Neither our industry nor our province can last long at these gas prices.

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