Peyto Exploration & Development Corp.
President's Monthly Report

February 2012 — From the desk of Darren Gee, President & CEO

Wow. I feel a little like Ben Johnson. We just won the gold medal for the fastest growth, only to have it stripped away for using a banned substance, natural gas. Peyto seems to have been "the baby tossed out with the bath water" these days, as investors flee natural gas in fear that the lack of winter weather is going to leave us with a glut of natural gas in North America. Even with a big producer like Chesapeake announcing it will shut in up to 1.0 BCF/d of production in support of higher prices, natural gas prices continue to head lower. As gassy names go, Peyto is easily one of the most defensive, with its industry leading low costs, high natural gas liquids content and solid hedge book. Add to that a strong balance sheet and we more than weather the storm of low gas prices.

So far, our winter weather has been like the treatment for a pulled hamstring: ice and heat. A frigid week of -35C in Alberta resulted in significant production "freezing off" (temporarily knocked out over a thousand boes/d of our production too) while relatively hot temps in the US have resulted in little natural gas demand. It's a tough start to the New Year but, as hardy Canadians, I suppose we're used to it.

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

*2011 Capital Summary (millions$ CND)**

	2010	Q1 '11	Q2 '11	July	Aug	Sept	Q3 '11	Oct	Nov	Dec	Q4	2011
Land & Seismic	18.5	6	1	1	7	6	14	6	0	1	7	28
Drilling	140.5	51	32	17	14	15	46	15	19	15	49	178
Completions	65.3	33	18	8	10	8	26	11	9	8	28	104
Tie ins	30.3	7	5	4	3	4	10	4	2	5	10	32
Facilities	19	8	16	4	6	6	16	0	0	0	0	40
Drilling Credit Used	-7.6	0	-3	0	0	0	0	0	0	0	0	-3
Total	**262**	**104**	**69**	**33**	**40**	**39**	**112**	**35**	**30**	**29**	**95**	**379**

**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

*2011/2012 Production ('000 boe/d)**

	Q1 11	Q2 11	Q3 11	Oct	Nov	Dec	Q4 11	Jan	Feb	Mar	Q1 12
Sundance	28.0	30.2	32.3	34.5	34.9	35.9	35.1	35.7			
Kakwa	2.6	3.2	3.0	3.1	3.2	3.9	3.4	3.6			
Other	1.1	1.1	1.0	1.0	1.4	1.5	1.3	1.7			
Total	**31.7**	**34.4**	**36.4**	**38.6**	**39.5**	**41.3**	**39.8**	**41.0**	-	-	

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How Low Can You Go

I wasn't so fortunate to get away to the islands this winter, but these natural gas prices remind me of the fire dancers at the luau trying to limbo under an impossibly low "flaming" bar. Especially as we start to approach the $2 mark. No longer is the market concerned with what price is required to make a return on future capital investment, now it's more about what is required to keep the lease operating statements in the black and cashflow positive.

Of course, everyone knows these are not sustainable natural gas prices. But the question now becomes, who blinks first. Logically, the higher cost, leaner gas production should be the first to shut in. Coalbed methane, with its de-watering costs and large compression requirement is likely first. Then low pressure, dry gas. Then sour gas with its high cost for removal and disposal. Then gas reservoirs that produce water but have risks associated with re-starting and reserves recovery. And lastly, natural gas with significant associated natural gas liquids. Especially condensate that attracts a premium to oil. I supposed solution gas associated with oil production is really the last to turn out the lights, but those volumes are really tied to oil prices more than gas prices.

And companies are going to have to be honest with themselves about what their true costs are. A snapshot of Canadian producers with greater than 50% gas is shown in Figure 1, along with their cash costs. As you can see, Peyto is the only company with cash costs below the $2 mark.

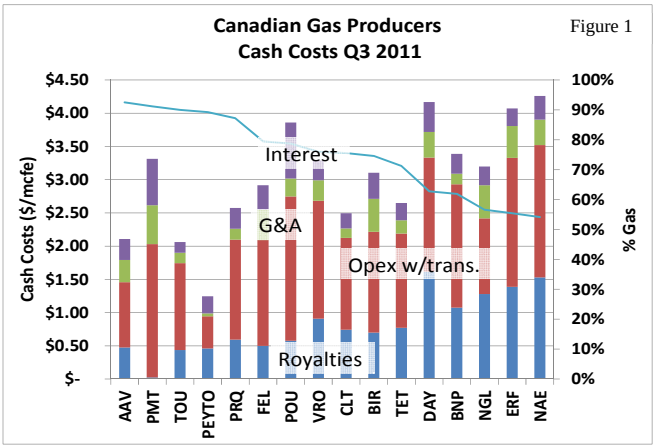

Figure 1

The US gas producers are not faring much better, even though many quote costs that are lower. In the comparison above, I've included both royalty costs and volumes. In the US, however, the costs are calculated net of royalties. So for instance, Peyto's Q3 costs of $1.24/mcfe become $0.83/mcfe, net of royalty costs and using net volumes. In Figure 2 I've compared Peyto's cash costs, calculated the US way, against a few of the more efficient and well known gas producers in the US.

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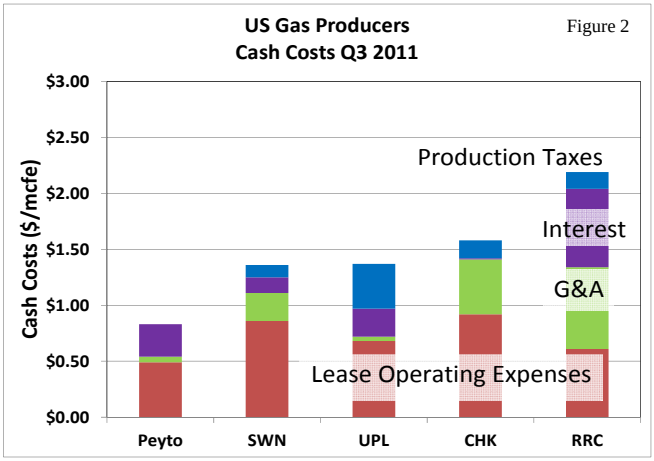
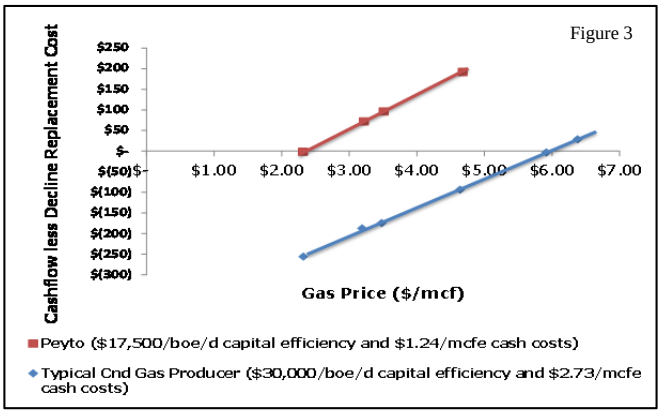


Effectively this analysis is suggesting that at the gas prices of today, most producers in Canada and the US are just keeping the lights on without any additional cash to reinvest to replace the producing reserves. As always, the question then becomes, what price do we need, to be able to replace and grow reserves? Or for that matter, just to offset declines.

For that analysis, you have to look at the true cost of replacement (which should be full cycle not half cycle), or you can look simply at a one year decline replacement analysis. In other words, what price do we need for natural gas so that cashflows provide sufficient capital to offset the declines?

In Figure 3, below, I've calculated that breakeven gas price (assuming $105/bbl oil and 30%/yr declines) and using Q3 2011 cash costs along with 2011 capital efficiencies. As you can see, for Peyto, that price is around $2.30/mcf, but for many of the "gassier" Canadian E&Ps (>70% gas) its closer to $6.00/mcf. That means that debt, equity or JV capital will be required to balance the scales, none of which are sustainable in the long term.

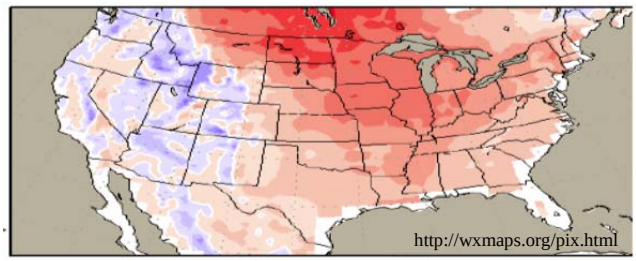


Interestingly, I recently read a similar analysis by ARC Financial's Chief Energy Economist, Peter Tertzakian. Peter and his team do an excellent job of tracking a myriad of metrics that measure the energy industry's activity and provide commentary on trends and developments. In his comments, he looked at the decline rate of US domestic gas production and suggested it had increased over the last five years from the old 20%/year rate to over 30%/year now, as a result of the shale gas boom. Using this new decline and the aveage costs to add a producing mcfe of natural gas, Peter calculated what price was needed in the US to do the same thing - hold production flat with cashflow. The required price there, he concluded, was approximately $5.80/mcf. Not that dissimilar from my analysis of a typical Canadian producer.

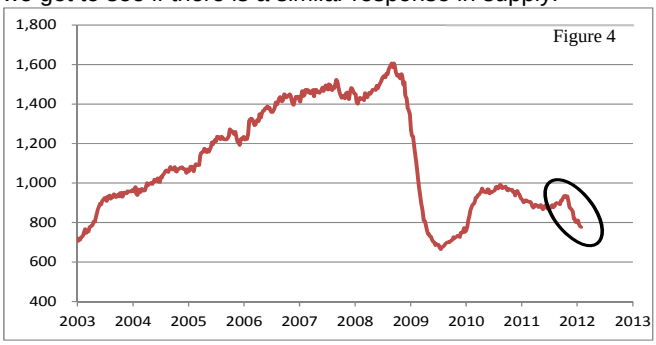
So if these are unsustainably low natural gas prices, there must be a limit to how much external capital can continue to pour in and balance the scales between cashflow and capital? ***When*** we reach that limit, will likely dictate just how low that limbo bar will actually go.

Activity Update and Commodity Prices

Natural gas prices, especially relative to oil prices, are all the talk these days. Especially with the winter weather we've been experiencing.



Current forecasts (above) continue to show weather patterns that are much warmer than usual, especially in those gas consuming areas where people live. This has caused a rapid drop in the futures price of natural gas which has then led to a response by the producers in the form of gas directed drilling (Baker Hughes US Gas directed rigs – Figure 4). Now we get to see if there is a similar response in supply.



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