Peyto Exploration & Development Corp.
President's Monthly Report

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

June was a busy month. We now have six drilling rigs running full force, making Peyto tied for the number one deep driller in Alberta (rigs that drill beyond 3000m). That comes with mixed feelings. Pride that our business model works so well at these prices but concern for Alberta that the rest of the industry doesn't. Or maybe I shouldn't be so surprised. According to Oilweek, Peyto is also the 10th largest natural gas company in Canada (as far as Proved gas reserves go), right behind ARC and Talisman. So maybe we should be the number one deep driller when you considering the cost advantage we enjoy right now.

All this drilling in June will now start to show up as production growth in July which is also just as natural gas prices have started to rally. The last few hedges we've done are all north of $3/GJ. Our 2012 plan is coming together nicely.

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

*2011/12 Capital Summary (millions$ CND)**

	Q1	Q2	Q3	Q4	2011	Jan	Feb	Mar	Q1 '12	Apr	May	Jun	Q2 '12
Land & Seismic	6	1	14	7	28	2	0	0	3	1	1		
Drilling	51	32	46	49	178	20	19	13	52	6	0		
Completions	33	18	26	28	104	10	11	11	31	4	0		
Tie ins	7	5	10	10	32	2	4	3	8	2	1		
Facilities	8	16	16	0	40	1	3	1	4	1	1		
Drilling Credit Used	0	-3	0	0	-3	0	0	0	0	0	0		
Total	**104**	**69**	**112**	**95**	**379**	**35**	**36**	**28**	**99**	**14**	**4**		

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	Q4 11	Jan	Feb	Mar	Q1 12	Apr	May	June	Q2 12
Sundance	28.0	30.2	32.3	35.1	35.7	35.7	34.8	35.4	34.6	34.1	34.2	34.3
Kakwa	2.6	3.2	3.0	3.4	3.6	3.7	4.0	3.8	4.4	4.1	4.0	4.2
Other	1.1	1.1	1.0	1.3	1.7	1.8	2.5	2.0	2.7	2.7	3.0	2.8
Total	**31.7**	**34.4**	**36.4**	**39.8**	**41.0**	**41.2**	**41.3**	**41.2**	**41.7**	**41.0**	**41.2**	**41.3**

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Sustainability of ~~Dividends~~ Earnings

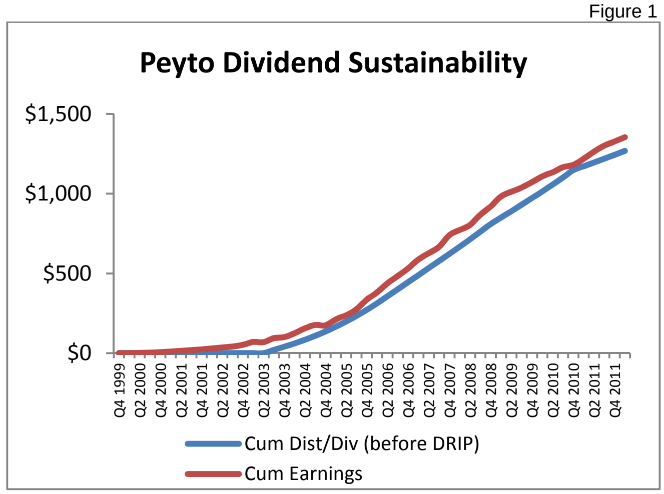
Sustainability. Wow, there's a word we haven't heard for a while. Surprising how a big dividend cut from one of the E&P Trusts-come-Dividend paying growth corps has the market focused on the sustainability of income again. But should investors really be that surprised by the cuts? I mean, how can you possibly think that a sustainable dividend structure can exist in the absense of any earnings or profitability? With cost structures and commodity prices where they are today, earnings are pretty hard to come by.

Without earnings, dividends have to come from either debt, which is not sustainable. Or from equity, which is not sustainable (and dilutive). Or at the expense of a company's future by selling assets or doing JVs to pay them (again unsustainable). And that last one is exactly where many are predicting the dividends are going to come from for the majority of the dividend paying E&Ps in our industry.

By definition a dividend is *"a sum of money paid to shareholders of a corporation out of **earnings.**"* Which is why it surprises me that investors would think there should be sustainable dividends in the absence of earnings. Or why analysts would focus on leverage ratios as any kind of key to sustainabilty.

Let's use Peyto as an example. Figure 1 shows the cumulative earnings and cumulative dividends/distributions over time.

Figure 1



In Peyto's case it is easy to see that as earnings are generated over time, they are passed along to shareholders in the form of income (distibutions/dividends). One could then conclude that as long as Peyto continues to generate earnings, we should be able to continue to distribute those profits.

It's a pretty simple analysis that uses readily available information. But when we look at many others in our industry the same way, oftentimes it doesn't add up. See these next few slides as example.

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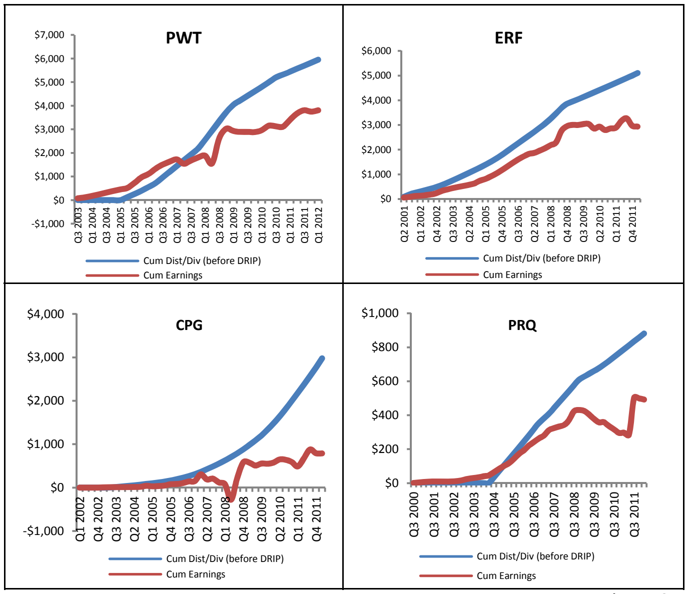


Figure 2

For many companies, earnings are not accumulating nearly as fast as dividends are flowing. If cumulative earnings over time *were* keeping up with cumulative dividends/distributions, you might gain some confidence in their ultimate sustainability, but if earnings are not accumulating but dividends keep going out the door, they have to be coming from somewhere, that means debt, equity or asset sales (in this analysis I've used dividends before any Dividend Re-Investment Program because that is really just funding them with equity).

There is another way to look at sustainability of dividends (or earnings as is the case I'm making). That is to look at costs. Since there is only so much revenue to go around, where it goes might also give you a clue.

In 2011, for example, Peyto generated revenue of $32.80/boe from the sale of it's oil and natural gas. From that, we need to deduct the cash costs; royalties, opex, transportation, G&A and interest, as well as the cost to replace the production. For 2011, Peyto's cash costs were $8.10/boe while it's PDP FD&A was $12.73/boe (I like PDP FD&A rather than depletion). That leaves $12/boe for dividend or distribution (assuming no taxes), out of which Peyto dividended $7.42/boe. See the math in table 1.

Even after all the costs and dividends, there was money left over to re-invest into growth. If this is the math every year, then sustainability in the income stream is probable.

But what about the rest of the dividend payers? Table 1 summarizes what's "left over" in 2011 for those companies.

Table 1

2011 Annual Results

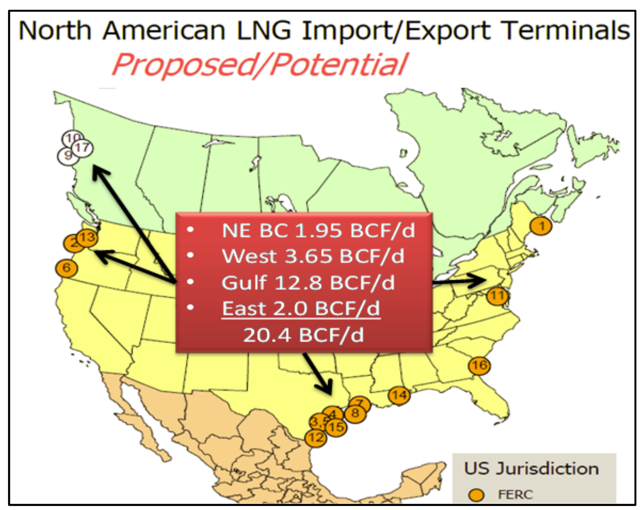
	PEYTO	PRQ	BTE	ARX	PGF	BNP	TET	VET	CPG	PWT
Revenue	$ 32.80	$ 29.46	$ 61.07	$ 48.99	$ 53.67	$ 41.45	$ 32.63	$ 77.43	$ 78.10	$ 60.33
Royalties	*$ (3.17)*	*$ (3.58)*	*$ (11.60)*	*$ (7.20)*	*$ (10.29)*	*$ (6.39)*	*$ (3.79)*	*$ (4.22)*	*$ (13.95)*	*$ (11.10)*
Op Costs	*$ (2.87)*	*$ (8.95)*	*$ (14.89)*	*$ (10.89)*	*$ (15.14)*	*$ (10.65)*	*$ (9.56)*	*$ (14.63)*	*$ (13.08)*	*$ (17.89)*
Transport	*$ -*	*$ -*	*$ -*	*$ -*	*$ -*	*$ -*		*$ -*	*$ -*	*$ -*
G&A	*$ (0.37)*	*$ (0.98)*	*$ (2.15)*	*$ (1.86)*	*$ (2.49)*	*$ (0.95)*	*$ (1.18)*	*$ (3.47)*	*$ (1.42)*	*$ (2.38)*
Interest	*$ (1.69)*	*$ (1.85)*	*$ (2.43)*	*$ (1.27)*	*$ (2.81)*	*$ (1.91)*	*$ (1.53)*	*$ (1.94)*	*$ (2.24)*	*$ (3.19)*
Cash Costs	$ (8.10)	$ (15.35)	$ (31.07)	$ (21.22)	$ (30.73)	$ (19.91)	$ (16.06)	$ (24.26)	$ (30.68)	$ (34.57)
PDP FD&A	$ (12.73)	$ (6.96)	$ (21.23)	$ (21.83)	$ (18.96)	$ (20.64)	$ (20.20)	$ (45.65)	$ (34.28)	$ (38.71)
Subtotal	$ 11.97	$ 7.15	$ 8.77	$ 5.94	$ 3.98	$ 0.90	$ (3.63)	$ 7.52	$ 13.13	$ (12.94)
Dividends	$ (7.42)	$ (5.86)	$ (13.42)	$ (11.30)	$ (10.28)	$ (8.52)	$ (4.74)	$ (16.18)	$ (28.64)	$ (8.46)
Total	$ 4.55	$ 1.29	$ (4.65)	$ (5.36)	$ (6.30)	$ (7.62)	$ (8.37)	$ (8.66)	$ (15.50)	$ (21.41)

Even with some companies disposing assets to lower FD&A costs, the math doesn't leave enough left over for dividends.

As I stated at the start, in this commodity price environment, generating enough revenue to cover all the costs and create some earnings is pretty tough. Which is why truly sustainable dividends are also hard to come by.

Activity Update and Commodity Prices

There is still a lot of talk of LNG exports solving the oversupply of natural gas in North America.



http://www.ferc.gov/industries/gas/indus-act/lng/LNG-proposed-potential.pdf

As of May 24, 2012 there were over 20 BCF/d of LNG export projects on the books. My money is on the ones in the Gulf of Mexico to be first up and running, but then I'm an optimist when it comes to American entrepreneurialism overriding federal protectionism (there's a mouthful).

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