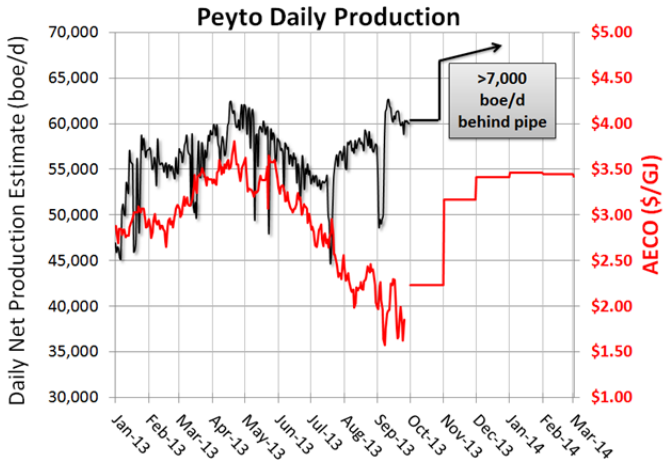
Peyto Exploration & Development Corp.
President's Monthly Report

October 2013 — From the desk of Darren Gee, President & CEO

Despite some very unattractive natural gas prices in Alberta over the last month, driven mostly by a temporary and avaricious TCPL transportation toll (causing triple the AECO-NYMEX basis differential), Peyto's operations are otherwise humming along nicely. Even though we are profitably adding incremental production, we are reluctant to turn it on and expose any flush volumes (above those that have fixed prices ~ 60,000 boe/d) to a temporary sub-$2/GJ price. So we are doing maintenance and stockpiling production capability for when gas prices are forecast to return to above $3/GJ, in October/early November (see Figure 1). The stockpiles are getting higher, with over 7,000 boe/d behind pipe at last count, and more to come before late October.

Figure 1



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*

*2012/13 Capital Summary (millions $ CND)**

	Q1	Q2	Q3	Q4	2012	Q1	Apr	May	Jun	Q2	Jul	Aug	Sep	Q3
CNRAcq/other acq.			205	-21	184	0				0				
Land & Seismic	3	1	2	6	12	2	3	2	1	6	1	1		
Drilling	52	23	59	78	211	76	9	3	20	32	32	30		
Completions	31	14	35	47	127	41	9	0	1	10	20	19		
Tie ins	8	5	11	22	46	33	2	1	4	7	3	5		
Facilities	4	3	6	25	37	17	6	6	6	18	7	9		
Total	**99**	**46**	**317**	**157**	**618**	**169**	**29**	**13**	**32**	**73**	**62**	**63**		

Production*

*2012/13 Production ('000 boe/d)**

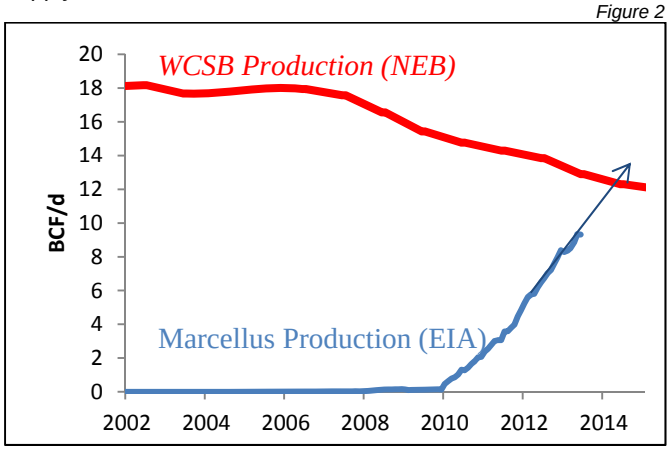
	Q3 12	Q4 12	2012	Q1 13	Apr	May	June	Q2 13	Jul	Aug	Sept	Q3 13
Sundance	35.7	36.0	35.4	39.7	43.2	41.7	40.0	41.6	38.1	42.1	44.5	41.5
Kakwa	3.6	3.1	3.7	3.3	3.2	2.9	2.9	3.0	2.7	2.5	2.7	2.6
Ansell	2.9	6.8	2.4	8.8	10.2	11.3	10.5	10.7	10.3	10.5	9.0	9.9
Other	3.6	3.6	3.0	3.3	3.4	2.8	2.6	2.9	2.4	2.5	2.4	2.4
Total	**45.9**	**49.5**	**44.5**	**55.2**	**60.0**	**58.7**	**56.0**	**58.2**	**53.5**	**57.6**	**58.6**	**56.5**

***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.**

Death of the Canadian gas industry? Or the future of the Canadian gas industry?

I would prefer to ponder the latter question in the title even though some are starting to think it might be the former. I can understand why they are so concerned. The most recent projections of the Marcellus shale gas play in North Eastern US are showing natural gas production there to eclipse that of the entire Western Canadian Sedimentary Basin (WCSB) over the next year (Figure 1). So one has to wonder who are we going to sell our excess gas production to and will there be enough demand in North America to support our industry going forward? There is enough demand in the rest of the world, but we are years away from being in a position to supply that market.

Figure 2



Historically (say, 10 yrs ago), we shipped our Western Canadian excess gas supply east, to consumers in Eastern Canada and NE United States. And we had a lot of excess, some 10 to 11 BCF/d from Alberta alone. Now, it seems, the Marcellus play will be sufficient to fill those markets. And since we have to cover the transportation cost in order to compete with that supply, the price we realize in W. Canada would not be sufficient to cover WC's average supply cost. That in turn causes our basin's production to fall as fewer and fewer wells can be profitably drilled to replace declines. All of this has already been happening for the last few years.

Western Canadian natural gas supply is dominated by Alberta, which represents 80-85% of total production. Looking to the Alberta ERCB (now AER, Alberta Energy Regulator) data (Figure 3), we see the above scenario at work. Total gas production has been steeply declining as US shale gas production pushes WCSB gas out of traditional markets causing depressed Alberta prices and reduced development activity.

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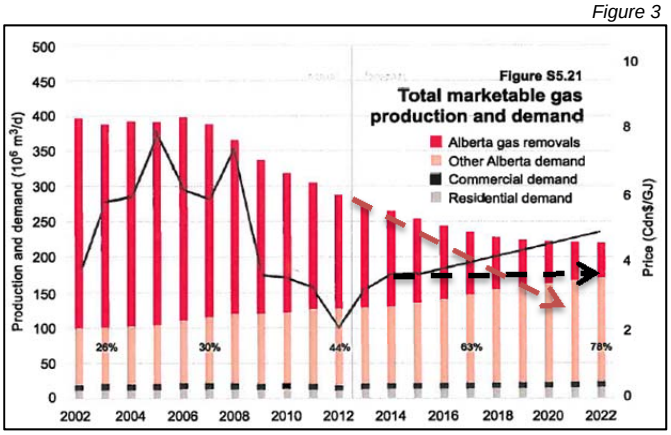
Figure 3

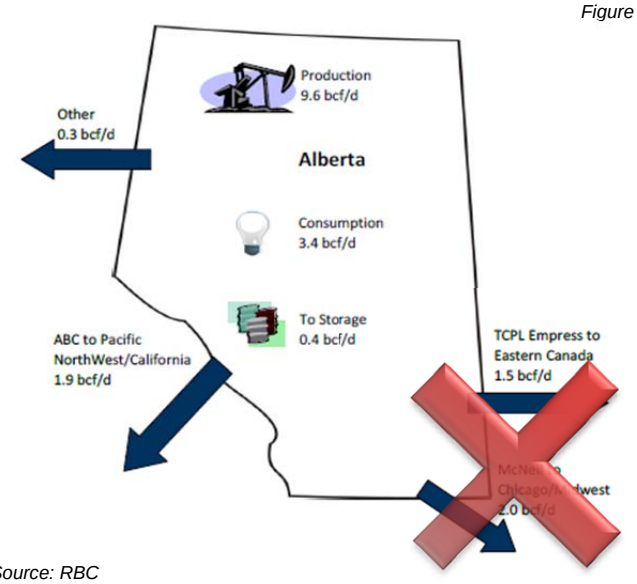


Source: http://www.aer.ca/documents/sts/ST98/ST98-2013.pdf

The AER is forecasting this production decline trend to continue, albeit to a lessening degree as natural gas prices are forecast to improve (black line in Figure 3). At the same time Alberta demand continues to grow. However, should the price realized be lower than forecasted, the decline of Alberta production would likely be steeper (my dashed lines).

I think it would be fair to say that in a $3-$4/GJ AECO gas world, it won't be long (< 5 years) before Alberta production has shrunk to a level that more closely matches Alberta's demands, or at least eliminates the excess volume available for shipments east (currently 3.5 BCF/d, Figure 4). We may still be able to compete for markets to the south as transportation costs are lower and there are fewer local rival supplies.

Figure 4



Source: RBC

If BC follows Alberta's lead, they too won't have much left over to send out. All of this contemplation assumes that any Canadian exports of LNG take closer to a decade to get off the ground. Perhaps that is overly conservative, or maybe that is more realistic than some projections. The Alberta government is obviously expecting sooner as evidenced by their improving gas price forecast.

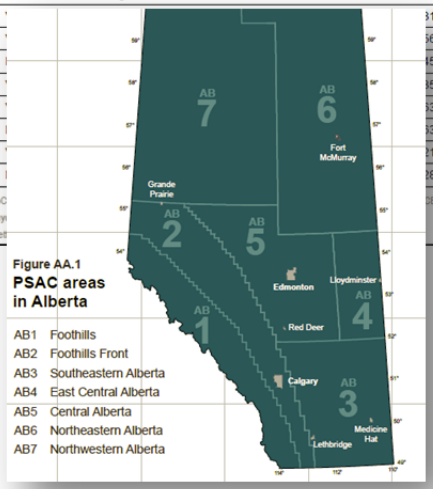
Needless to say, based on the industry's own supply cost studies, there is only one area of the province that has a supply cost less than $3/GJ (PSAC 2 - $1.67/GJ). Thankfully, that is also exactly where Peyto is exclusively positioned.

Figure 5

Table S5.5 Natural gas supply costs for PSAC areas and CBM play areas[a]

Area	Type of well	Type of gas	Total measured depth (m)	Initial productivity (10^3 m^3/d)	Total capital cost $000	Fixed operating cost ($000/year)	Variable operating cost ($/$10^3$ m^3)	Natural gas supply cost ($/GJ)
PSAC 1	Directional	Sour gas	4500	57.6	17970	202	53.2	7.23
PSAC 2	Vertical	Sweet gas	2500	14.6	2734	54	35.5	3.77
PSAC 2	Horizontal	Sweet gas	4200	38.1	4858	45	31.9	1.63
PSAC 3	Vertical	Sweet gas	560	2.0	411	11	49.7	6.98
PSAC 4						31	30.2	14.72
PSAC 5						56	39.0	11.44
PSAC 5						45	31.9	3.36
PSAC 6						95	35.5	7.06
PSAC 7						33	30.2	5.82
PSAC 7						33	33.7	4.88
CBM-HSC[b]						21	40.8	10.19
CBM-MAN[c]						28	31.9	6.97

[a] Data from petroC
[b] Horseshoe Canyo
[c] Mannville Corbett
BM play areas.



Source: http://www.aer.ca/documents/sts/ST98/ST98-2013.pdf

So as the lowest cost producer in the WCSB, we (Peyto) are well positioned to survive. And what *are* the rewards for survival? Well, interestingly enough, if Alberta and Western Canada ever do become either balanced with supply and demand or further, we become a net importer of natural gas, then our local price will not be one after transportation is deducted, it will be one with transportation added. In other words, where we now receive effectively NYMEX minus transportation, we would instead be getting NYMEX plus transportation. And that could be quite the reward when twice the transport costs are almost half of the absolute price (see Table below as illustration).

	NYMEX	Transport	AECO
Canada as net Exporter	$4.00	($0.75)	$3.25
Canada as net Importer	$4.00	$0.75	$4.75

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