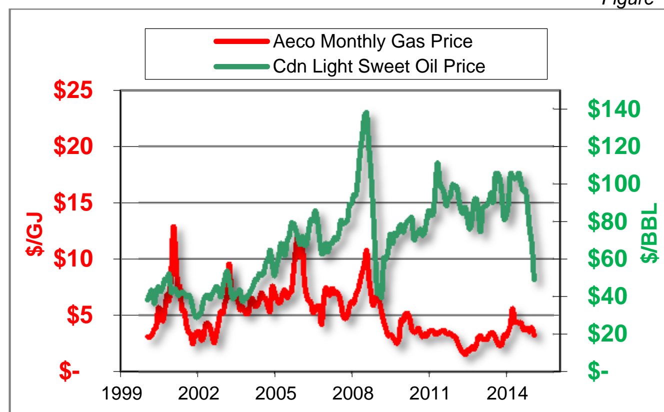
Peyto Exploration & Development Corp.
President's Monthly Report

January 2015 — From the desk of Darren Gee, President & CEO

Books are closed on 2014 and for many of us it was the year of extremes. We started off the year with strong natural gas prices due to cold weather and low storage levels, oil prices were also strong on robust demand and higher cost supply, and, as a result, equity markets were teeming. We ended the year with weaker natural gas prices as storage levels were refilled and production grew, oil prices crashed as OPEC held the taps open and demand decelerated, so equity markets became full of fear and stocks retracted.

At year end, it wasn't the weaker gas prices that were particularly newsworthy - we've been there for a while - it was the new oil price which, if it stays here for very long, creates a whole new world.

Figure 1



Source: Peyto, NRCAN

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*

*2013/14 Capital Summary (millions$ CND)**

	Q3	Q4	2013	Q1	Apr	May	Jun	Q2	Jul	Aug	Sep	Q3	Oct	Nov
Land & Seismic	3	2	11.9	7	1	0	7	8	0	0	0	0	4	1
Drilling	86	60	253.0	80	22	22	24	68	28	30	24	83	28	29
Completions	54	47	151.7	36	16	14	18	48	17	14	15	46	20	16
Tie ins	14	12	48.2	16	4	3	3	10	3	4	4	11	7	5
Facilities	24	34	112.2	40	6	4	7	16	11	16	13	40	14	6
Total	**181**	**155**	**578**	**179**	**49**	**43**	**60**	**151**	**60**	**63**	**57**	**180**	**73**	**56**

Production*

*2013/14 Production ('000 boe/d)**

	Q4 13	2013	Q1 14	Q2 14	Q3 14	Oct	Nov	Dec	Q4 14	2014
Sundance	47.4	**42.6**	49.4	51.7	57.2	59.3	59.6	59.2	59.4	**54.4**
Ansell	13.9	**10.8**	15.7	14.2	14.3	16.1	16.3	17.0	16.5	**15.2**
Brazeau			1.6	1.3	1.2	1.8	3.4	4.4	3.2	**1.8**
Kakwa	2.5	**2.9**	2.4	2.4	2.4	2.4	2.2	2.2	2.3	**2.4**
Other	3.6	**3.1**	3.2	2.5	2.4	2.1	2.0	1.9	2.0	**2.5**
Total	**67.3**	**59.3**	**72.3**	**72.1**	**77.5**	**81.7**	**83.5**	**84.7**	**83.3**	**76.3**

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.

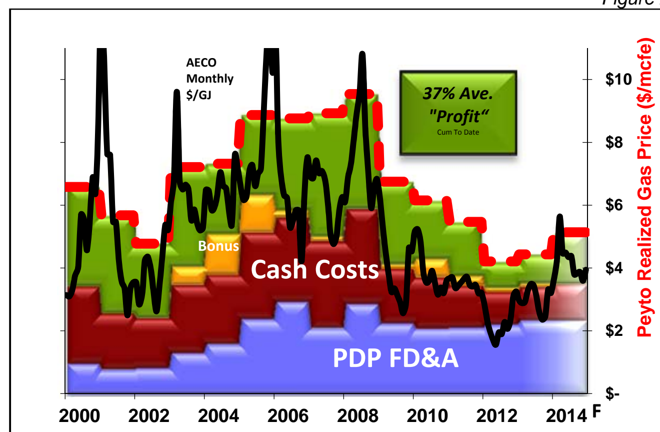
A Whole New World

Not surprisingly, the most pressing question on everyone's mind is what does the world look like at this new oil price? Notwithstanding the blip we experienced post the great recession (2009), we haven't seen this level for over a decade. In 2004 the industry was quite a bit different. That was before shale oil and horizontal multi-stage frac technology. Back then, a reduction in price and a subsequent drop in activity had a much different effect than it does today.

Closer to home, what effect does this new level of oil price have on Peyto? Does it change our strategy going forward?

Despite the fact that lower oil price means lower revenue from condensate and pentanes, the overall effect is actually more positive for Peyto than negative. Remember, we're 90% natural gas and natural gas prices have been low for a while. So we've already "re-tooled" our business to be profitable at these levels (most oil producers can't say that). At the same time, however, we've been fighting underlying inflation in our capital costs, driven by rising oil prices. Figure 2 shows how our FD&A costs have been relatively flat since 2007, despite falling gas prices and improving efficiencies, because oil prices continued to rise.

Figure 2



Source: Peyto

So if our capital costs are driven more by oil and oil related activity than they are gas, a lower oil price should translate into lower FD&A costs and a lower cost to add new production. That ultimately means more profit for Peyto.

Of course, it won't happen overnight. For one thing, everybody isn't going to go to work tomorrow for 30% less pay just because the oil price dropped 30%. We will have to spend some time at this level and activity will have to slow down significantly. There is a whole generation of today's oilpatch that have never heard the term "layoff" before. This

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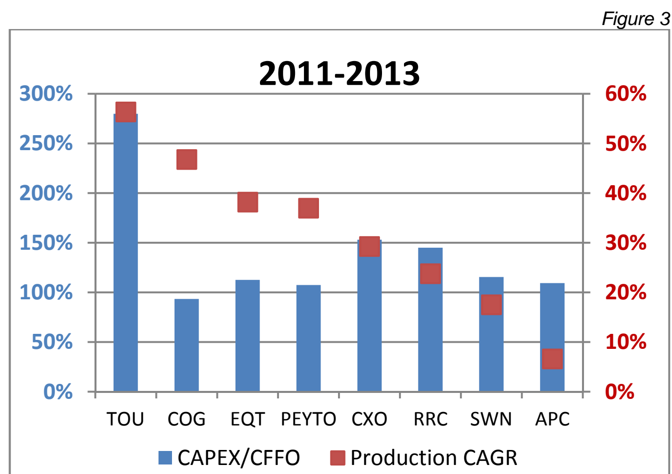
will be a chance to weed out the lower end performers and possibly trade some high end salary burden for lower cost up-and-comers.

The other thing low oil price does is reduce the capital available for both oil and gas volumes to grow. Even on the gas side, many producers and plays have been reliant on the liquids revenue to make the economics work. And the reduction in capital is not just the capital coming from revenue. The larger capital pool that was coming from debt and equity dries up too. Because let's not kid ourselves, it was less the wildly profitable plays that were driving the supply growth of oil and natural gas in North America, and more the abundant access to and cheap cost of external capital. If low oil prices causes this capital to dry up or significantly increases the cost of it (for example, high yield spreads blow out), that will dramatically influence any future supply growth.

Just have a look at Figure 3 and the amount of "extra" capital that the top gas companies were using to grow production.

Figure 3



Source: BMO Global Cost Study

On average, these "re-tooled" gas guys, in terms of efficiency and growth, still required close to 140% of cashflow over the last 3 years to grow their businesses at a 32% rate.

So the real question for me is what happens if this "extra" capital is no longer available? If equity markets have come off, then companies will be reluctant to issue new equity to fund the extra and if debt markets are closed or become too expensive then that extra is gone. Low oil price means less cashflow too. All of this has to translate into less (if any) funding for growth in supply. And if supply stops growing, but demand continues, then the price will ultimately rise.

In a Dec 19/2014 Bloomberg article I noticed this comment:

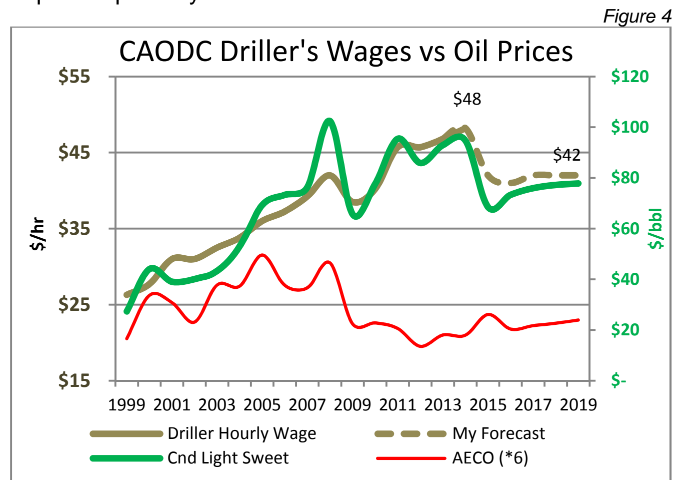
> *"Financing costs are now rising as prices sink. The average borrowing cost for energy companies in the U.S. high-yield debt market has almost doubled to 10.43 percent from an all-time low of 5.68 percent in June, Bank of America Merrill Lynch data show."*

So that's my conclusion. Low oil price translates into reduced cost (better profits for Peyto) but also translates into reduced growth for the industry which should cause natural gas prices to rise, further improving returns. Like I said, for a re-tooled gas producer like us, it's more good news than bad.

Activity Levels and Commodity Prices

The current strip for Cnd Light oil price is a far cry from the current spot price. But even if the strip is right, and oil settles in for a few years at the $70 level, it will probably be a while before service costs truly reflect the new world order. Looking at a correlation of a driller's hourly rate vs oil price I would suspect that a 30% drop in oil price might only translate into a 15% reduction in labor rates. If that's all it ends up being, I'll still take it. A 15% reduction in our F&D costs, by extrapolation, translates into around $0.35/mcfe, which in turn improves profit by close to 20%. I like that.

Figure 4



Source: CAODC, NRCAN, Peyto

It is kinda funny how, as a gas producer, we look at oil price so much. But when you see how the service costs are much more correlated to oil price than gas, how can you blame us. This phenomenon still confuses me, however, because the WCSB is primarily gas not oil. One would think a reduction in natural gas price would have had a more pronounced effect on service costs but that doesn't seem to have been the case, especially back in 2008 when the recession hit. That was when gas prices changed from $6-$8 to $3-$4. Labor rates though, as shown by Driller Hourly Wage, continued to climb with oil price (Figure 4).