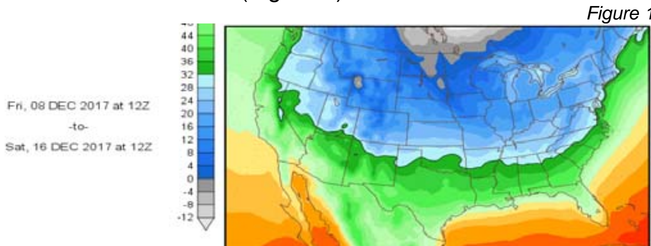
Peyto Exploration & Development Corp.
President's Monthly Report

December 2017 | From the desk of Darren Gee, President & CEO

Winter showed up out West in full force at the start of November and then promptly left again. The latest forecast from NOAA is now suggesting it will be back again for the start of December with colder, more normal temperatures across most of North America (Figure 1).

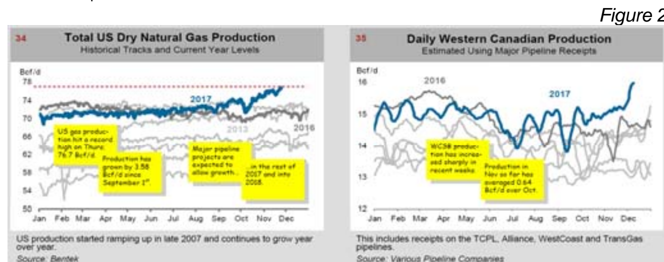
Figure 1



Source: NOAA

The AECO natural gas price could sure use it. A surge of WCSB production at the same time as a surge in US production (Figure 2) has put even more downward pressure on gas prices. Thankfully, we've got about 80% of our winter gas pre-sold at $3/mcf.

Figure 2



Source: ARC Financial

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*

*2016/17 Capital Summary (millions$ CND)**

	Q1 16	Q2 16	Q3 16	Q4 16	2016	Q1 17	Q2 17	Jul	Aug	Sep	Q3 17	Oct
Acq.	28	0	5	1	34	4	0	0	0	0	0	0
Land & Seismic	4	1	1	4	9	9	2	0	1	0	1	0
Drilling	63	30	64	63	219	67	48	25	23	25	73	25
Completions	33	8	27	37	105	36	21	15	11	8	34	17
Tie ins	12	3	13	14	42	13	9	7	4	4	15	6
Facilities	37	9	4	11	60	25	17	4	2	5	11	2
Total	**176**	**50**	**114**	**130**	**469**	**154**	**98**	**51**	**41**	**43**	**135**	**50**

Production*

*2016/17 Production ('000 boe/d)**

	2015	Q1 16	Q2 16	Q3 16	Q4 16	2016	Q1 17	Q2 17	Jul	Aug	Sept	Q3 17	Oct	Nov
Sundance	59	61	54	58	59	58	59	56	54	57	55	55	58	59
Ansell	17	25	20	21	22	22	21	20	20	23	22	22	21	22
Brazeau	7	12	11	14	17	14	18	19	21	22	19	21	23	27
Kakwa	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Other	2	2	1	1	1	1	1	1	1	3	2	2	3	3
Total	**86**	**101**	**88**	**96**	**102**	**97**	**101**	**98**	**99**	**107**	**100**	**102**	**106**	**112**

*This estimate is based on real field data, not a **forecast, and actual numbers will vary from the estimate due to accruals and adjustments. Such variance may be material. Tables may not add due to rounding.***

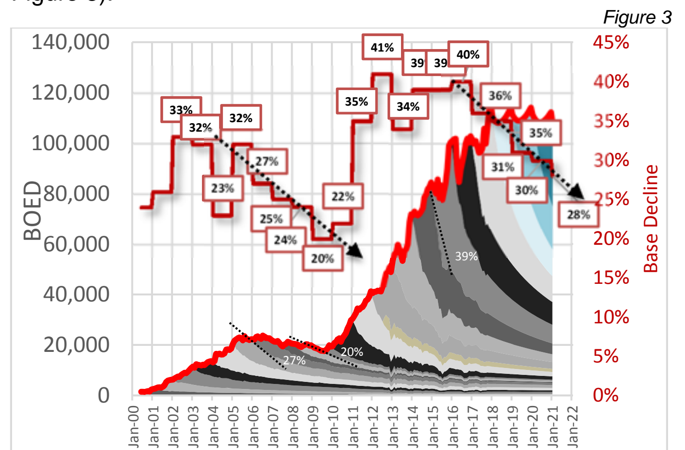
Defensive Bias

At the risk of showing my age and repeating myself, I thought it would be worthwhile hitting on a topic that I've written about before. Because when it comes to weak commodity prices as a result of an abundance of supply, it's always good to review your defensive strategies. Sometimes, the best defence is good offence, something our Calgary Stampeders tried (and failed) to do in this year's Grey Cup, and sometimes the best defence is just good defence. Knowing your strengths and when to deploy either strategy is what determines the long term financial success of any good business.

One of our best defenses at Peyto, as I've discussed ad nauseam, is our low cost structure. When you have high margins and low costs, you can sit back and be a price taker which becomes your best defence against volatile commodity prices that are out of your control. Another, less discussed defence, is the very nature of our asset base. The sweet, deep basin, tight gas reservoirs that we develop and produce from have no mobile water and ultimately exhibit very stable shallow decline production. What this means is that as our production base ages and becomes more mature, it requires less and less maintenance capital to hold it at a certain level.

This is a concept that is rather foreign to investors and hard for them to wrap their head around. "Don't oil and gas reserves deplete? Don't you have to spend money to replace this depletion every year? Isn't this a constant challenge?" Well, yes and no. It somewhat depends on the amount of decline and shape of the decline curve. For our tight gas reservoirs, the production curve declines steeply in the early time but also shallows very quickly from steep to flat. And when you have an entire production base of this type of curve, it means the amount of production you have to build every year gets less and less just to hold at a certain level. This was a concept we demonstrated from the start of 2007 to the end of 2009 (see Figure 3).

Figure 3



Suite 300, 600 – 3rd Avenue SW
Calgary, AB T2P 0G5
Fax: 403 451 4100

TSX Symbol: PEY
E-mail: info@peyto.com

During that time period, the base decline that Peyto was offsetting fell from 27% in late-2006 to just 20% by 2009. That meant Peyto spent less and less capital each year to hold production relatively flat (-5% CAGR, '07-'09). Capital spending relative to funds from operations decreased each year as illustrated in Figure 4.

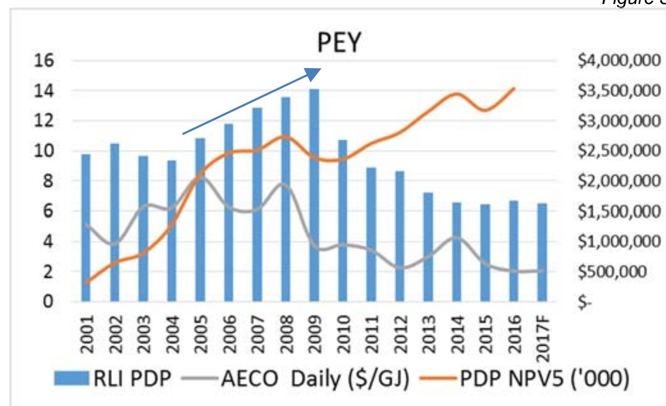
Figure 4

	Production	Base Decline	Funds from Operations	Capital Expenditures	Capex/FFO	Free CF
2006	22,873	27%	$ 306	$ 312	102%	$ (6)
2007	20,669	25%	$ 280	$ 122	44%	$ 158
2008	19,996	24%	$ 287	$ 139	48%	$ 148
2009	18,481	20%	$ 203	$ 73	36%	$ 130

In aggregate over that period from 2006 to 2009 inclusive, Peyto spent less than 60% of its available FFO. That meant there were significant funds available to pay out distributions (we were a Trust then) or pay down debt. We chose the distribution route as our balance sheet was in fine shape. A third option to buy back stock wasn't available back then, like it is today, due to our smaller size.

At the same time as we were holding production basically flat, our producing reserve life and NPV was increasing *(I've written about this phenomenon too back in Dec 2006 and Jan 2007)*.

Figure 5



The same potential is true today. While our current base decline is relatively high due to the last 5 years of rapid production growth, forecasting future base declines with a total production profile that stays relatively flat, indicates a shallowing of corporate decline from 36% currently down to 28% in a few years (Figure 3). Assuming a constant cost to add new production (85% of the current full cycle $10,000/boe/d to account for no facility investments), the amount of capital required to offset the decline becomes a smaller and smaller portion of the total funds available. As before, this then leaves more and more cash available for dividends, debt repayment or share repurchases.

As illustrated in Figure 6, this theoretically results in less than 60% of funds from operations required for capital investments.

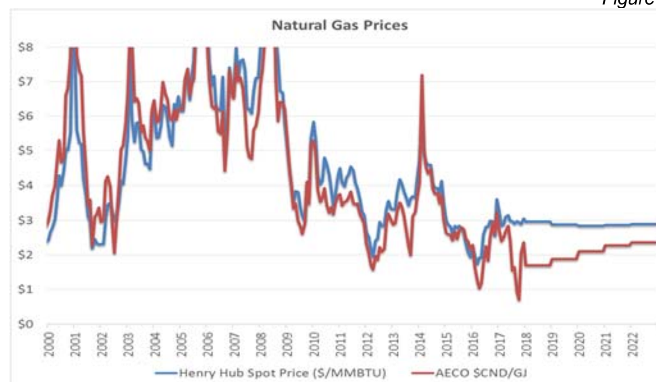
Figure 6

@$12.50/boe unhedged netback from $2/GJ AECO, $70 CND WTI, $0.78/mcfe cash costs							
	Production	Base Decline	Cash Netback	Funds from Operations	Capital Expenditures	Capex/FFO	Free CF
2017	103,000	36%	$ 15.15	$ 570	$ 530	93%	$ 40
2018	115,000	35%	$ 14.00	$ 588	$ 342	58%	$ 246
2019	115,000	31%	$ 12.50	$ 525	$ 303	58%	$ 222
2020	115,000	30%	$ 12.50	$ 525	$ 293	56%	$ 231
2021	115,000	28%	$ 12.50	$ 525	$ 274	52%	$ 251
				$ 2,731	$ 1,742		$ 989

I'm not saying this is necessarily what we'll do. But we easily could. We've done it before. At Peyto, we've always been extremely nimble with our capital programs and very responsive to the changing commodity landscape. Our ultimate goal has always been to deploy capital in the most efficient and profitable way possible. That is something that we will continue to do. To conclude with a different sports analogy, while perhaps it's more fun to play offence than defence, a complete player is one who can score goals but also backcheck and play defence. That's how you win Stanley Cups.

Activity Levels and Commodity Prices

Figure 7



Source: Peyto, TD

As I mentioned last month, we continue to have a broken natural gas market in Canada in the near term, reflective of a disconnection between the relative value of the commodity and the cost to get it to market (see Figure 7 and the difference between CND and US gas prices). If there can't be more competition in the gas shipping business, perhaps a more timely review of pipeline tariffs by the NEB would help the situation. Barring that we'll have to rely on local demand increases to put the excess supply to use. Petrochemical, fertilizer and power generation industries in Alberta are all looking at ways to take advantage of this short term disconnection.

Forward Looking Statements

Certain information set forth in this monthly report, including management's expectation of future natural gas prices and the reasons therefore and management's estimate of monthly capital spending, field estimate of production, production decline rates and forecast 2018 netback, contains forward-looking statements. By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond Peyto's control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other industry participants, the lack of availability of qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. Readers are cautioned that the assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Peyto's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what benefits that Peyto will derive there from. The forward-looking statements contained in this monthly report are made as of the date of this monthly report. Except as required by applicable securities law, we assume no obligation to update publicly or otherwise revise any forward-looking statements or the foregoing risks and assumptions affecting such forward-looking statements, whether as a result of new information, future events or otherwise.

All references are to Canadian dollars unless otherwise indicated. Natural gas liquids and oil volumes are recorded in barrels of oil (bbl) and are converted to a thousand cubic feet equivalent (mcfe) using a ratio of six (6) thousand cubic feet to one (1) barrel of oil (bbl). Natural gas volumes recorded in thousand cubic feet (mcf) are converted to barrels of oil equivalent (boe) using the ratio of six (6) thousand cubic feet to one (1) barrel of oil (bbl). Boe may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf:1 bbl is based in an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. In addition, given that the value ratio based on the current price of oil as compared with natural gas is significantly different from the energy equivalent of six to one, utilizing a boe conversion ratio of 6 mcf:1 bbl may be misleading as an indication of value.

Certain measures in this monthly report do not have any standardized meaning as prescribed by International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. These measures may not be comparable to similar measures presented by other issuers. Non-IFRS measures are commonly used in the oil and gas industry and by Peyto to provide potential investors with additional information regarding Peyto's liquidity and its ability to generate funds to conduct its business. Non-IFRS measures used herein include netback and funds from operations.

Netbacks are a non-IFRS measure that represents the profit margin associated with the production and sale of petroleum and natural gas. Netbacks are per unit of production measures used to assess Peyto's performance and efficiency. The primary factors that produce Peyto's strong netbacks and high margins are a low cost structure and the high heat content of its natural gas that results in higher commodity prices. Funds from operations is a non-IFRS measure which represents cash flows from operating activities before changes in non-cash operating working capital and provision for future performance based compensation. Management considers funds from operations and per share calculations of funds from operations to be key measures as they demonstrate Peyto's ability to generate the cash necessary to pay dividends, repay debt and make capital investments. Management believes that by excluding the temporary impact of changes in non-cash operating working capital, funds from operations provides a useful measure of Peyto's ability to generate cash that is not subject to short-term movements in operating working capital. The most directly comparable IFRS measure is cash flows from operating activities.