

Peyto Exploration & Development Corp.

President's Monthly Report

October 2012

From the desk of Darren Gee, President & CEO

The idea of LNG exports off the west coast of Canada has dominated headlines over the past couple of years. Several international firms have partnered up with Canadian players to announce projects from Kitamat to Prince Rupert totaling 6 to even 10 BCF/d of export capacity. An announcement in September by Sasol, however, takes the move to enhance the value of Canadian natural gas resources in a whole new direction. Sasol is planning to build a Gas to Liquids refinery near Edmonton (Fort Saskatchewan), Alberta to convert natural gas to diesel fuel and sell it for more, rather than try to ship it to the other side of the globe. Their proposal would ultimately convert about 1.0 BCF/d into approximately 96,000 bbl/d of diesel. That's \$2-\$3MM in feedstock converted into close to \$20MM worth of diesel fuel every day. The \$8B refinery would take up to 2 years to build but with that kind of value uplift, the incentive is very strong. I wonder if they need a natural gas partner with a lot of feedstock?

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)*

	2010	Q1	Q2	Q3	Q4	2011	Q1	Apr	May	Jun	Q2	Jul	Aug	Sep	Q3
ONR Acq./other acq.															205
Land & Seismic	19	6	1	14	7	28	3	1	1	0	1	0	1		
Drilling	141	51	32	46	49	178	52	6	0	16	23	19	17		
Completions	65	33	18	26	28	104	31	4	0	10	14	9	14		
Tie ins	30	7	5	10	10	32	8	2	1	2	5	3	4		
Facilities	19	8	16	16	0	40	4	1	1	1	3	1	2		
Total	262	104	69	112	95	379	99	14	4	29	46	33	243		

*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	Q1 12	Apr	May	June	Q2 12	Jul	Aug	Sept	Q3 12
Sundance	28.0	30.2	32.3	35.1	35.4	34.6	34.1	34.2	34.3	35.5	35.6	36.1	35.7
Kakwa	2.6	3.2	3.0	3.4	3.8	4.4	4.1	4.0	4.2	3.9	3.6	3.4	3.6
Ansell											2.6	6.1	2.9
Other	1.1	1.1	1.0	1.3	2.0	2.7	2.7	3.0	2.8	3.4	4.1	3.4	3.6
Total	31.7	34.4	36.4	39.8	41.2	41.7	41.0	41.2	41.3	42.8	45.9	49.0	45.9

*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.

Big in Japan

"Big in Japan" (or Malaysia, or China) is more than just a pop song on my kids' ipod these days. It's where Canadian energy companies sit on the radar of Asian interests to secure hydrocarbon resources for their future energy needs. And not just Japan, but China, Malaysia, India, South Korea

and even the US. The most recent two big deals are a case in point. Petronas of Malaysia put up \$6B to buy Progress Energy and CNOOC of China put up \$17B to buy Nexen. Both deals need the blessing of the Canadian government before they can go ahead, but I suspect they are also only the first of many to come.

In many ways, the acquisitions make sense. We have huge hydrocarbon resources in Western Canada and if we want to offer them to the rest of the world for consumption it will take money to develop them and someone to do it. *(In reality, that has always been the case. For instance, we've known of the existence of billions of barrels of oil sands for decades, but it's taken billions of dollars of investment and some very large operators to develop it.)*

So the first thing we need is the capital. Which the Canadian producers don't have or are not prepared to borrow. So instead, we sell the undeveloped resources to someone who does. Progress is a perfect example of that strategy and makes an interesting case study.

In their 2011 annual information form, Progress stated they had 91.6 mmoes of producing reserves and an additional 231.8 mmoes of undeveloped reserves (*very similar total reserves to Peyto actually*). They estimate the undeveloped reserves are going to take \$1.87 Billion to develop. Since Progress only made approximately \$180 million in cashflow over the last 12 months, that implies it would take over 10 years to fund that development at current pricing.

In addition, they had mineral rights to over 1.1 million acres of undeveloped land. Some of the land contains the undeveloped reserves quoted above while some possibly contains even more. And if you can get it drilled and validated before it expires, you can retain the right to produce what you find.

Continuation of the land is the tricky part though because here again is a requirement for an extremely large capital expenditure in a short time frame.

Typically in Alberta you have to drill and prove productive every spacing unit (usually 1 section or 640 acres) before the end of the primary term (typically 4-5 years) in order to continue the lands. In some cases one well can validate the term of a group of sections for a secondary term that lasts 5 years, but at the end of that time you still need a producing well in each section. British Columbia is a little more lenient in their land tenure rules. There you might have 5 to 10 years of primary term and can enter an annual extension with continuous drilling activity or penalty payments, but ultimately lands must be drilled to be continued.

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So Progress' 1.1 million acres will theoretically require up to 1,700 wells in the next decade or so. At approx. \$6.5 million per well, that's \$11 billion of capital just to continue the land base!! Obviously a bit more than Progress could muster. Thus, the sale to somebody who could.

But just because someone might have the capital, doesn't mean that the resources get developed. There is the knowhow that needs to be considered. And this is where the Canadian producers can really fit in. Active Canadian producers with a track record of execution create the perfect platform for International Interests to hit the ground running. And the smaller the team they need to "lock up", the better.

Someone who has demonstrated the proficiency of execution with the latest and greatest technology and could transfer those learnings would be of significant value. If you were able to do it profitably at \$3/GJ Canadian gas prices, think how much better that will be when compared to the prices offered in the rest of the world (like \$17/mmbtu in Japan!)

So in some ways its easy to see why these acquisitions are happening - need to be happening.

So the next question, and perhaps the more relevant one for Peyto shareholders, is how are they valuing Canadian assets and Canadian companies?

With large pools of capital to invest, their cost of capital is much smaller than Canadian companies or even the large International Oil Companies (IOCs) so one would expect they are discounting future dollars at a very low rate (long life assets become more valueable at low discount rates).

I would suspect they are also modelling a development scenario that has a much more aggressive timeline, bringing forward future reserves and production into the near term. And they are likely using a commodity price much higher than our domestic over supplied market is currently paying, because they know what they're already paying back home and what it will take to get it there (via LNG export solutions).

In some ways it's ironic. Build it here (the production) cheaper and ship it there to sell for more. Isn't that the reverse of what we're doing with consumer goods right now?

So they (Japan, China, India, etc.) are using higher commodity prices, lower discount rates and more aggressive development timelines. All of which results in much higher implied values in the asset bases of many Canadian producers than the market is reflecting. Add in the technology transfer and knowhow, and that's likely why we are the STARS on the world stage right now.

Activity Update and Commodity Prices

Natural gas prices continue to recover from their lows this summer. I may get to shave off my \$3/GJ rally beard yet! I made the mistake of tying it to AECO rather than to NYMEX. Winter weather is still going to be the big wild card though. If we get another warm winter, just like last year, even the 400 gas rigs currently running in the US will likely be enough to stave off production declines and keep storage levels high. At least now we have the confidence that power generation could consume an extra TCF of storage if prices get down in the \$2 range, so hopefully the outrageous fear of natural gas prices going to zero won't reappear!

On the flip side, 400 rigs may not be enough to keep up with growing demand and especially not enough to meet with a demand spike if we have any kind of cold winter. That would likely result in storage levels being drawn down and fear that we don't have enough, which leads to higher prices. So for right now, anyway, we sit in limbo with \$3/GJ AECO and \$3.75/MMBTU NYMEX for 2013, all waiting on winter. As I've stated before though, \$3/GJ is right in Peyto's "wheelhouse." At that price we can fund aggressive capex programs and our dividend. And combined with our cost advantage, keep our balance sheet in good shape and deliver a 30% profit margin. Plus, we already know that if we're growing production, reserves and cashflows, bank lines also grow.

Looking at a comparison of long dated and short term historical natural gas prices is interesting. For much of the last four years, long dated prices were headed downwards as supply costs were going down due to shale plays and new technology. Lately though, they have stabilized as demand has picked up its pace in response to the over supply.

