

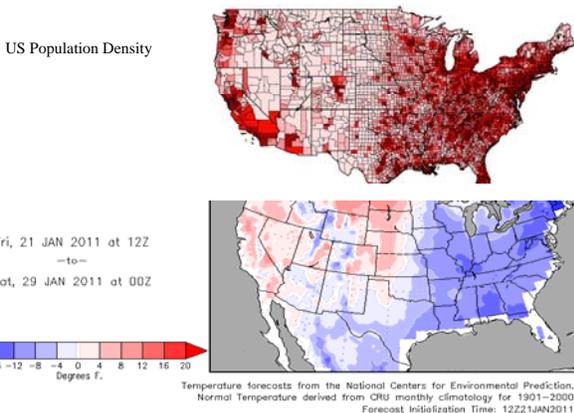
# Peyto Exploration & Development Corp.

## President's Monthly Report

February 2011

From the desk of Darren Gee, President & CEO

It appears to have been cold in all the right places for those wanting greater natural gas consumption and higher prices. Looking at a map of US population density and end of January temperatures, only southern California was getting any break last week (Figure 1). Just when everybody thought they had gas prices all figured out, Mother Nature tosses out a snowball. Peyto investors in New York have lamented about their "Alberta-like winter" with 87 more heating degree days this December than the year before.



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

2010 Capital Summary (millions\$ CND)\*

	Q1 '10	Q2 '10	July	Aug	Sept	Q3 '10	Oct	Nov	Dec	Q4	2010
Land & Seismic	0	0	0	4	1	5	1	0	12	13	18
Drilling	31	18	12	12	11	34	19	23	15	57	140
Completions	16	10	4	5	4	13	4	10	12	26	65
Tie ins	8	4	3	5	2	10	3	3	3	9	30
Facilities	2	6	1	1	3	5	2	2	1	6	18
Drilling Credit Used	-3	-2	0	0	-3	-4	-1	-1	2	0	-8
<b>Sub Total</b>	<b>55</b>	<b>37</b>	<b>20</b>	<b>26</b>	<b>17</b>	<b>63</b>	<b>28</b>	<b>37</b>	<b>44</b>	<b>110</b>	<b>265</b>
Rem. Drilling Credit	-4.90	0	1	1	0	1.5	0	0	0	-1	-4
<b>Total</b>	<b>50</b>	<b>37</b>	<b>21</b>	<b>26</b>	<b>17</b>	<b>64</b>	<b>28</b>	<b>37</b>	<b>44</b>	<b>109</b>	<b>261</b>

\* 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

2010 Production ('000 boe/d)\*

	Q1 '10	Q2 '10	Q3 '10	Oct	Nov	Dec	Q4 '10	Jan	Feb	Mar	Q1 '11
Sundance	16.5	18.5	20.1	22.9	24.4	26.4	24.6	27.1			
Kakwa	2.8	2.7	2.6	2.5	2.6	2.6	2.6	2.5			
Other	1.3	1.1	1.0	1.0	1.0	1.2	1.1	1.1			
<b>Total</b>	<b>20.6</b>	<b>22.3</b>	<b>23.8</b>	<b>26.4</b>	<b>28.0</b>	<b>30.2</b>	<b>28.2</b>	<b>30.7</b>			

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### Upside to NAV (Net Asset Value)

It amazes me sometimes where you find clarity in life. It can be in the simplest of things. As an investor in oil and gas, sometimes finding clarity is a rarity (pardon the poetry). I was

recently sent a video (author unknown); one of those fill in the dialog, homemade jobs with the little animated characters speaking in computer generated voices. In the old days, it would have made a great skit for "the Long Johns" or some other witty, cynical comedy act. Today, it comes in the form of an animated YouTube video.

The dialog is between these two investors (transcribed below), and is in many ways a perfect answer to the question of why we have an over abundance of natural gas in North America from shale gas wells that the developing companies admit are not profitable at today's prices.

"I would like to get some oil and gas exposure in my portfolio."  
"Why don't you buy an E&P company?"  
"Ok, that sounds like a good idea. What E&P company makes the most money drilling for oil and gas?"  
"Well, E&P companies don't actually make money."  
"Well, why would I want to buy one?"  
"Because they provide rapid production growth."  
"How much does it cost them to grow their production?"  
"It costs them more money than they bring in."  
"Why would I want to buy them if they spend more money than they make?"  
"Because of N.A.V. upside."  
"What is N.A.V. upside?"  
"When a company wants to grow production, they lease acreage so they can drill their wells, and that creates the upside to N.A.V."  
"How much does it cost to lease acreage?"  
"Sometimes it costs twenty five dollars per acre, and sometimes it costs twenty five thousand dollars per acre."  
"Can you make money drilling wells when it costs twenty five thousand dollars per acre?"  
"You cannot make money, but you can still generate very high rates of return."  
"I am confused."  
"The cost of acreage is a sunk cost, so it does not really matter."  
"Why does it not matter?"  
"Because investors will pay for the acreage and all the company has to do is drill the highly profitable wells."  
"Do they make positive returns when they drill the wells?"  
"They do not, but they can grow production."  
"How long can they keep growing production?"  
"As long as investors keep buying debt and equity offerings."  
"So, as long as investors keep funding companies with equity and debt, they can continue to drill high return wells that do not make money but create upside to NAV?"  
"Now you understand perfectly."

Pretty good, huh? But I can hear you already. "That's rich," you say, "coming from an E&P company whose production has grown 38% per share over the last year." And you're right, focusing on production and production growth alone does not ensure a return was made. Absolute production rates are a temporary thing, even when adjusted for equity and debt changes. The fact of the matter is, we have a depleting asset base and production will decline. That's just the nature of oil and gas. So you have to be focused on the

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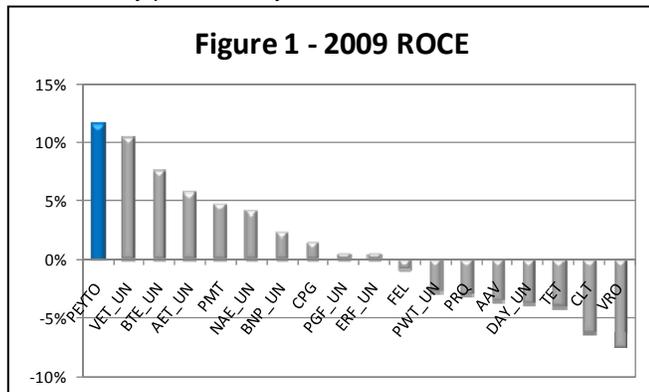
From the desk of Darren Gee, President & CEO

returns that you make on the capital you invest. That's the true *business* part of oil and gas.

True returns can only be measured when you consider all the capital you have to put in, against all the net cash you get out. As the above illustrates, you can't just ignore some of the capital.

But that is exactly what many companies want you to do. Ignore the fact that they invested millions in a competitive land grab, in order to be in a position to drill wells that *might* make money going forward. Or, alternatively, they spent billions on acquisitions that will never pay out the acquisition cost, in order to secure the upside locations that might make a decent return. But, do they ever report the full cycle return on those investments? As an investor, where do you look, how do you know if they are really generating a profit or just creating "upside to NAV?"

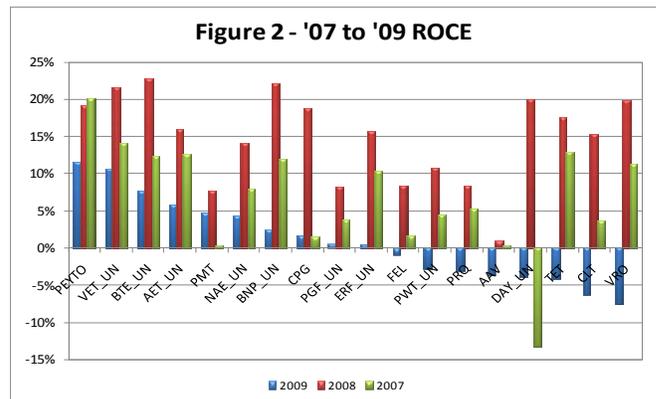
One of the first places we look is at the bottom of the income statement. Are there any earnings? And I know that has become harder to see these days with all of the non-cash, unrealized gains and losses that now flow through the income statement. But over time, those things will work their way through. If there are never any earnings, there can never be any profit, or any real returns.



Once you have earnings to work with, we can look at the Balance Sheet for accumulated asset values and current liabilities that allow us to calculate Return on Capital Employed (ROCE). ROCE being defined as the earnings before interest and tax divided by capital employed (total assets less current liabilities), and will give us a "full cycle" indication of the efficiency and profitability of a company's capital investments over time. An industry cross section of ROCE would look like Figure 1.

This is only one year, however, and may not be entirely representative. For instance, if a company had a lot of future

hedges that were out of the money and those flowed through the income statement, wiping out all their earnings, then they wouldn't generate much of a ROCE that year, or vice versa. Fortunately for investors, Peyto does hedge accounting, which means we don't flow unrealized gains and losses on our marketing activity through our income statement, thus clouding our ROCE calculation (although we do have to flow-through future performance based compensation).



How about over 3 years? Figure 2 shows that same cross section calculated each year for the last three. For some, you can really see how changing commodity prices and future hedges cause huge swings in their earnings, and thus their ROCE calculation. Generally though, I think you can start to get a sense of who is making money on their capital investments and who may not be, but it's not perfect. We've also pointed our investors to Return on Equity (ROE) (Figure 3), or the profit a company makes on the money shareholders have invested. If you can't tell if the company is making money on the capital *they* invested, hopefully you can tell if they're making money on the capital *you* invested. Both require some earnings though, so keep an eye out.

