

Peyto Exploration & Development Corp.

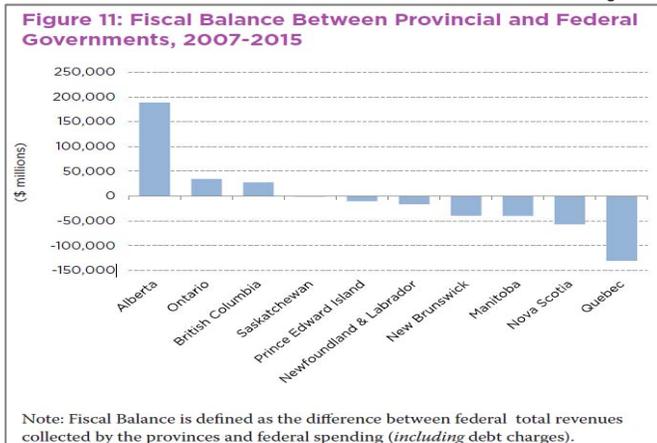
President's Monthly Report

September 2018

From the desk of Darren Gee, President & CEO

I think [Rex Murphy](#) said it best this week with his commentary, "...how many of the slings and arrows of outrageous greenism can or will Alberta take?" Last week's ruling on the TMX pipeline is just another in a long list of reasons why Alberta should be seriously considering whether it should remain part of Canada. If we were Quebec, we'd have had a national referendum long ago. The truth is that anti-oilsands, anti-oil&gas, anti-pipelines, is anti-Alberta. And if the rest of Canada want to support the federal government in this "Paris before Calgary" ideology, then there is no place for Alberta. The oil and gas industry in Alberta, is Alberta. It defines us, and it is our industry. And by the way, we are bloody well proud to be a world leader when it comes to our responsible, and environmentally sustainable resource development. It is a fact that we do it better. The real debate should not be about how we can be *filibustered* into doing less, it should be how we can be empowered to do more. Less oil and gas from Alberta means more from elsewhere, where they could give a damn about human rights or environmental considerations. Besides, [Alberta has contributed more](#) to Canada's economy than any other province and yet receives nothing but obstruction and villainization in return. With this latest nail in our coffin, perhaps it's time for Albertans to start considering their alternatives.

Figure 1



Source: Fraser Institute

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 Summary (millions\$ CND)*

	2016	Q1 17	Q2 17	Q3 17	Q4 17	2017	Q1 18	Apr	May	Jun	Q2 18	Jul
Acq/Disp	34	4	0	0	0	4	-4	0	0	0	0	0
Land & Seismic	9	9	2	1	4	17	1	0	0	0	1	2
Drilling	219	67	48	73	69	256	14	0	0	7	7	9
Completions	105	36	21	34	42	134	17	0	0	1	1	6
Tie ins	42	13	9	15	16	53	4	0	0	0	1	1
Facilities	60	25	17	11	4	57	4	0	2	3	5	2
Total	469	154	98	135	134	521	35	1	2	12	15	20

Production ('000 boe/d)*

	Q1 17	Q2 17	Q3 17	Q4 17	2017	Q1 18	Apr	May	June	Q2 18	Jul	Aug
Sundance	59	56	55	58	57	56	54	49	49	50	49	48
Ansell	21	20	22	21	21	20	19	18	18	18	16	16
Brazeau	18	19	21	25	21	24	21	19	18	19	17	16
Kakwa	2	2	2	2	2	2	2	2	2	2	2	2
Other	1	1	2	3	2	3	2	2	2	2	2	2
Total	101	98	102	110	103	105	97	89	89	92	86	85
Deferral		-	6					4	2	2	1	
Capability	101	98	108	110	103	105	97	93	91	94	87	85
Liquids %						9.5%	10.0%	10.3%	10.0%	10.1%	10.0%	10.6%

*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.

What about Profit?

I read an interesting article in the [New York Times](#) over the weekend, by Bethany McLean co-author of *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*. The editorial discussed how America's energy boom has been fueled by cheap debt and is therefore on shaky ground when it comes to its sustainability as an energy exporter. She goes on to suggest that the industry has a notoriously bad record of spending more capital than it makes in cashflow, without delivering any profit. For the most part, her conclusions are correct, and we have industry players on both sides of the US/Canada border that are guilty of that behavior – using other people's money to drill wells and grow production without ever generating any return.

But unfortunately she still seems to lack a basic, but very important, understanding of oil and gas reservoirs. Oil and gas assets, by their very nature, deplete. That's what they are supposed to do. So by suggesting that because a company or an industry is unable to maintain a certain level of production with its cashflow, therefore renders them unprofitable or unsustainable, is actually incorrect. Her conclusions are unsupported by her annual cash in, cash out math.

Think of it this way (which is the only way you should think of it, IMHO). Say you only had one opportunity to drill one well, which required you to spend \$1 million. And say that well would start producing on day one at 1,000 barrels of oil per day but would never stay at that rate, declining continuously until the reservoir was fully depleted (as it's supposed to). But over the life of the well, it would produce cashflow (revenue minus expenses) of \$2 million, giving you \$1 million of profit. And even if you brought all that future profit back into today's dollars by discounting it at some rate (maybe equivalent to your cost of capital), so that you made back \$1.3 million (in today's dollars) from your \$1 million investment, or a 30% return. Would you choose to do it? It's never sustainable at 1,000 bbls/d. In no year was your "cashflow in" balanced with your "capital out". In fact, it may even have taken you several years to recover your initial capital investment. Isn't the 30% profit the whole point?

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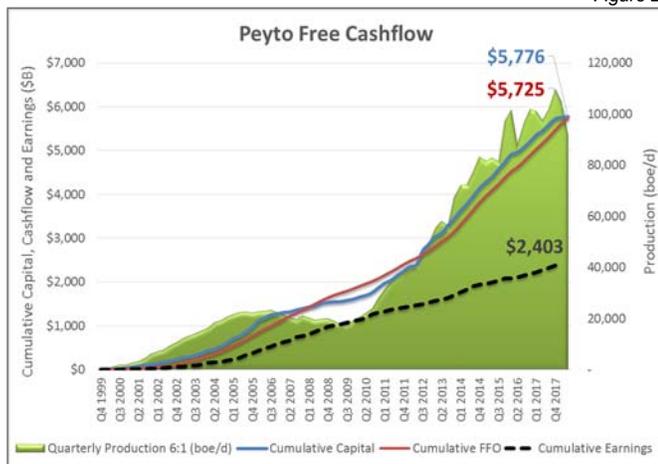
That is the way oil and gas works. Or at least, it's supposed to work. You invest capital, sometimes lots of capital, to create an asset that over time delivers more than your initial capital back. And yes, it usually takes a long time to get your capital back and all the profits. Cash in and cash out. The stuff in the middle is really almost irrelevant. What a company's or an industry's level of production or cashflow is, *at any point in time*, doesn't really matter. All that really matters is how much profit is ultimately recovered from that capital investment when it's all said and done.

I'd suggest that the fundamental problem that creates all the misunderstanding and confusion is that the focus never seems to be on the profit or the returns that are generated. Why do we not look at oil and gas like every other industry and compare the earnings? Why do we focus on the instantaneous cashflow or the production or the capital required to sustain that production?

Maybe we don't look at profit because for most of the world, oil and gas is viewed as "not for profit". Oil and gas is energy. And energy is critical for human survival. It's critical for security. Even world wars have been won and lost by those who had the most energy and the securest access to it. In many countries, oil and gas is owned, developed and produced by the state, for the benefit of its people, not for the profit of private companies.

From Peyto's perspective, we have a 20 year history of investing capital to generate profit. That is our solitary goal. Interestingly, our production has never really been stable. At times it has grown, at other times shrunk. Is that relevant, considering our goal to invest capital for profit? Not really. Cashflow is somewhat relevant. Particularly as it pertains to the timely recovery of capital and the generation of profit. Is the balance of cashflow in and capital expenditures out important? Again, not really.

Figure 2



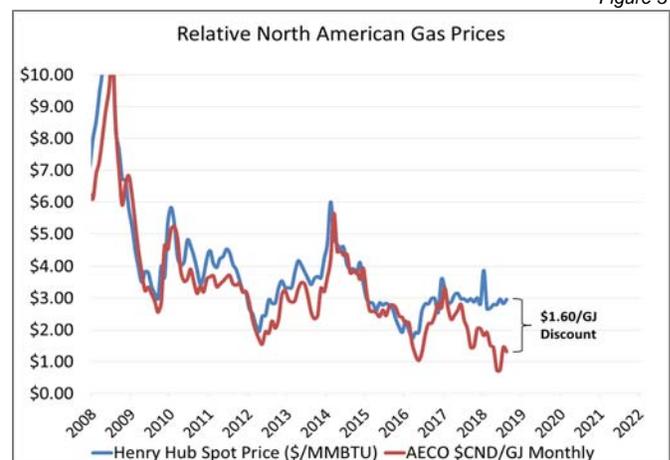
Source: Peyto

In the past 20 years, we've invested \$5.7 Billion of cumulative capital, which to date has generated \$5.7 Billion in Funds from Operations (so effectively we've recovered all our capital), and \$2.4 Billion of earnings (profits we expect to be getting). And if we do no more, the producing assets will deplete to zero. But it's just pure coincidence that our cash out currently equals our cash in. The most important consideration is that we have indeed earned a profit.

Activity Levels and Commodity Prices

One could make the argument that the current discount to Canadian gas is having almost as much of an impact to overall Canadian oil and gas revenues as is the WCS discount to WTI. Oil may get all the press, but gas is really no better. Just looking at 2018, if we were getting our historical discount, we'd be receiving something closer to \$3CND/GJ right now (\$1.60/GJ more on average for 2018), and the 16 BCF/d would be garnering \$9-\$10 billion more annually. That's on top of the \$15 billion were supposedly losing as a result of the oil discount.

Figure 3



Source: EIA, TD, Peyto

Combined, the \$25 billion could easily erase the Federal government's projected \$18 Billion deficit this year. Ironically, the Canadian government is spending like they have it but seem hell bent on ensuring they won't.

I can't imagine that anything they are debating in Washington right now, with respect to North American free trade, will have as big of an impact on the Canadian economy as diversifying our markets for hydrocarbons. It seems like the only products that have a chance at a decent price these days are Condensate and Propane. Good thing our Cardium play is rich in both and we have existing and planned infrastructure that can maximize recoveries of both products.

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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 (mcf) 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.