

PEYTO Energy Trust

President's Monthly Report

September 2010

From the desk of Darren Gee, President & CEO

It appears that continued drilling in the US is having the same effect as last year of oversupplying the market with natural gas. The US domestic production has climbed over the last few months to record highs, and now there is a backlog of completions that will likely continue to keep it up. Surprisingly, US producers admit that average supply costs (all-in) across the many shale plays exceeds the current gas price, which means they're losing money by continuing to develop at these prices. It doesn't make much sense, but they are driven by land continuation pressures and a few are even funded with international joint venture capital that allows them to act so irresponsibly. That's the supply side.

On the demand side, hot weather this summer has increased demand for electricity in order to run all those air conditioners - electricity that is generated from natural gas. With the future strip showing low gas prices for a few years, there is even more incentive to invest capital in coal-to-gas fuel switching projects. A \$4/MMBTU gas price is actually cheaper than most coal supplies. And the lack of difference between this summer's price and next winter also means there is less incentive to store gas, so as a result demand is stronger and storage injections have been weaker. Storage levels are fast approaching a "just average" range.

Both of these opposing drivers are resulting in a lack of direction for natural gas markets which continue to drift lower. And when you don't know which direction prices are going, it's hard to make a longer term bet on the commodity. So instead, a gas investor has only one thing left to focus on; determining who the low cost producer is.

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

2009/2010 Capital Summary (millions\$ CND)*

	2009	Q1	Apr	May	Jun	Q2	July	Aug	Sept	Q3
Land & Seismic	6	0	0	0	0	0	0			
Drilling	44	31	3	4	11	18	12			
Completions	23	16	6	0	4	10	4			
Tie ins	10	8	1	1	3	4	3			
Facilities	2	2	1	5	1	6	1			
Drilling Credit Used	-6	-3	-1	0	0	-2	0			
Sub Total	78	55	10	9	19	37	20			
Rem. Drilling Credit	-5	-5	0	0	0	0	1			
Total	73	50	10	9	19	37	21			

*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	Apr	May	Jun	Q2 10	Jul	Aug	Sept	Q3 10
Sundance	16.5	18.3	18.9	18.2	18.5	19.2	20.1		
Kakwa	2.8	2.9	2.7	2.6	2.7	2.8	2.6		
Other	1.3	1.1	1.1	1.0	1.1	1.0	1.0		
Total	20.6	22.3	22.7	21.8	22.3	23.0	23.7	-	-

*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.

Long life, low cost

It used to be that energy companies were measured on their ability to generate cash. "Cashflow is king" used to be the motto. And so multiples of cashflow or debt adjusted cashflow were used as proxy for net asset value and underlying stock or unit prices. The large, taxable, integrated producers might even trade on price to earnings (P/E) ratios instead of price to before tax cashflow ratios (P/CF). Nowadays, however, in an effort to better appreciate future potential, there seems to be a move to a "sum of the parts" net asset value determination as a means of ascertaining a company's stock value.

This sum of the parts NAV consists of a base asset value combined with a prediction of future opportunities that will add additional value when developed. Naturally there is significant focus paid to assessing these future opportunities and what they may or may not create in terms of value for the shareholder.

The problem with this approach is often the faith placed in the prediction of the future cashflow streams and the value they represent. Don't get me wrong. A future cashflow stream, brought back to today's dollars, is the only true way to value an asset. But sometimes the assumptions that go into those future predictions can be all wrong.

For those future predictions to be accurate, one must not only be able to predict the reserves that will be recovered and the rate of recovery (production), but also when they will be developed, the price they will sell for when they are and the cost it will take to recover them. Forecasting future price has always been a tough one, but even if you used today's price held constant, then you still have to forecast the costs.

Capital costs up front are, of course, important but one of the costs that get overlooked is operating costs. Sure, today's operating costs determine today's netbacks, but it is almost always assumed that today's costs will escalate by some marginal amount and really won't factor into ultimate reserve recovery or long term value. This couldn't be farther from the truth.

If you look at any of the independent reserve evaluations that determine the NAV of a company's future cashflow streams, they almost always assume a 2% inflation rate for operating costs. This is usually consistent with 2% inflation in commodity prices; so the two offset each other.

In reality, though, many companies have actual operating costs that are increasing at a much greater rate. Those increases over time can have a huge impact by reducing net asset values and ultimate reserve recoveries.

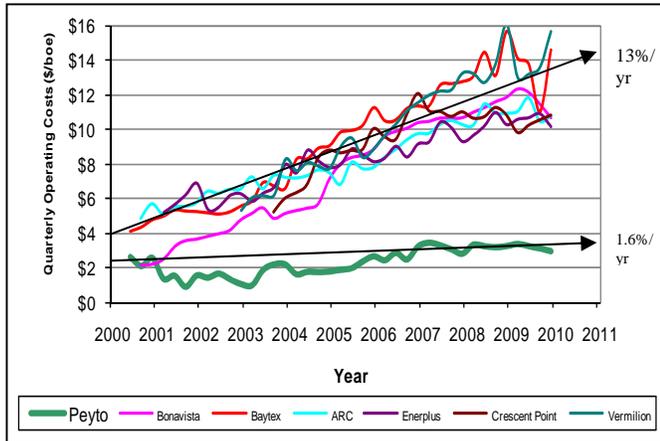
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Figure 1 below, shows a collection of Peyto's peers which have total operating costs (including transportation) that have been escalating at a rate of over 10% per year. While Peyto's costs have been escalating at less than 2% per year. But do you think their engineering evaluations assume a 10%/year increase in operating costs? Unlikely. I would bet most assume 2%/yr because that is the standard.



But the effect of that difference can be significant. Take one of our new Cardium horizontal wells for instance. Here the economics, with \$4/GJ gas and \$70/bbl oil, drive an Internal Rate of Return (IRR) of close to 50%, with op cost of \$2.70/boe. This assumes both prices and costs escalate at 2%/yr. However, if costs are \$12/boe (industry average) then the IRR drops to 23%. If those costs further escalate at 10%/yr rather than 2%/yr, then the IRR drops to 17%.

Reserves also become affected. In the above case, the Estimated Ultimate Recovery (EUR) for the Cardium horizontal at \$2.70/boe op cost is 3.2 BCFe. If we up the op costs to \$12/boe, the EUR drops to 3.0 BCFe. This is because at some point in the future now, the costs start to exceed the revenue, so the well is prematurely shut in. If we increase the escalation rate on the operating costs to 10%/yr, the EUR drops to 2.2 BCFe.

Cardium Hz Gas Well Economics (\$4/GJ & \$70/bbl)

\$12 Op Costs	EUR	IRR	\$2.70 Op Costs	EUR	IRR
esc %/yr	bctfe	%	esc %/yr	bctfe	%
2%	3.019	23%	2%	3.219	48%
5%	2.557	21%	5%	3.174	48%
10%	2.195	17%	10%	2.772	47%
15%	1.995	12%	15%	2.557	47%

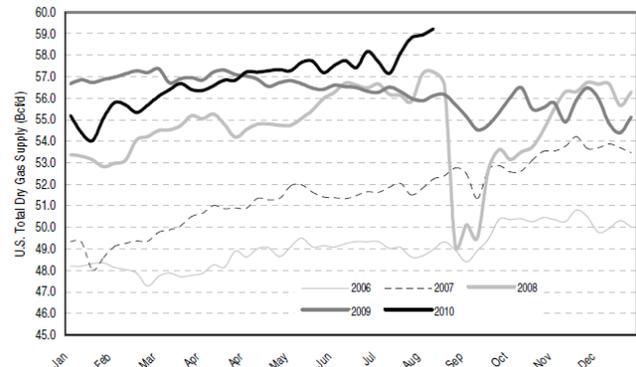
It is interesting to note that the IRRs at low cost are less sensitive to escalation rates. That's because the IRRs are high enough that those future years where the escalation

rates really start to affect netbacks are so far out, they don't have much impact on the returns. The same can't be said when you start with much higher op costs like \$12/boe.

Net Asset Value (NAV) is definitely the most accurate way to assess what a company is worth and should ultimately dictate what it should sell for in the market. But it has to be done correctly and any future predictions of cashflow need to reflect the reality of changing costs and revenues that have occurred in the past. Long life and low cost assets are definitely worth more, so long as they stay that way. Rapidly escalating costs can change that value significantly if you're not careful. This is why careful investors pay close attention to them.

Activity Levels and Commodity Prices

U.S. Dry Natural Gas Production



As I mentioned earlier, it is record US domestic production (see above from CIBC) that has commanded the attention of the natural gas market. Apparently it's at the highest level since 1974. That fact plus a high gas directed rig count is overshadowing "average" storage levels and higher than average industrial/electrical power demand. The gas bears are out in full force claiming we'll be oversupplied for years, keeping prices low. We'll see. When everyone is in agreement on commodity prices is usually when everyone is surprised to be proven wrong.

On the bright side, spot natural gas prices in the US have finally started to come back down to the Canadian levels (Aug. 30/10 - HH Spot \$US3.77/MMBTU vs AECO Spot \$C3.25/mcf). At least we can compete on a more level playing field as opposed to a severely discounted price here vs in the US. Rationally, US gas drilling should slow down at these prices and production should fall off. But then who said this industry was acting rationally?

Since we can't control or predict the price, we'll have to focus on what we can control; costs and quality of investment. The same as always.