

# Peyto Exploration & Development Corp.

## President's Monthly Report

May 2011

From the desk of Darren Gee, President & CEO

Spring has apparently sprung, but after this past winter and last year's spring, you can't blame people for their skepticism. It has been such a long, snowy winter out West that we were still able to squeeze in a few late-April completions on semi-solid ground. I expect when it does finally give way, it will not be pretty. What with so much snow pack and deep frost, most are expecting a long, wet breakup. The flooding in lower areas has already begun.

Our plan was to try and drill through break-up (when the frost comes out of the ground, typically shutting down roads) and we seem to be mostly on course to achieve it. We still have steady activity on 4 of the 6 rigs which we should be able to maintain unless it gets really bad. This will give us several wells that will be ready for a quick completion and tie in come late May/early June and a jump on our summer program.

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

2010/11 Capital Summary (millions\$ CND)\*

	Q1 '10	Q2 '10	Q3 '10	Oct	Nov	Dec	Q4	2010	Jan	Feb	Mar	Q1 '11
Land & Seismic	0	0	5	1	0	12	13	18.5	-1	2	5	6
Drilling	31	18	34	19	23	15	57	140.5	15	16	20	51
Completions	16	10	13	4	10	12	26	65.3	12	11	10	33
Tie ins	8	4	10	3	3	3	9	30.3	2	2	3	7
Facilities	2	6	5	2	2	2	6	19	3	3	2	8
Drilling Credit Used	-3	-2	-4	-1	-1	2	0	-7.6	0	0	0	0
Sub Total	55	37	63	28	37	45	111	266	29	34	41	104
Rem. Drilling Credit	-5	0	2	0	0	0	-1	-4.1	0	0	0	0
Total	50	37	64	28	37	45	110	262	29	34	40	104

\*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

2010/11 Production ('000 boe/d)\*

	Q1 10	Q2 10	Q3 10	Q4 10	Jan	Feb	Mar	Q1 11	Apr	May	June	Q2 11
Sundance	16.5	18.5	20.1	24.6	27.1	28.1	28.8	28.0	29.9			
Kakwa	2.8	2.7	2.6	2.6	2.5	2.5	2.9	2.6	3.6			
Other	1.3	1.1	1.0	1.1	1.1	1.1	1.1	1.1	1.1			
Total	20.6	22.3	23.8	28.2	30.7	31.7	32.8	31.7	34.6	-	-	

\*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.

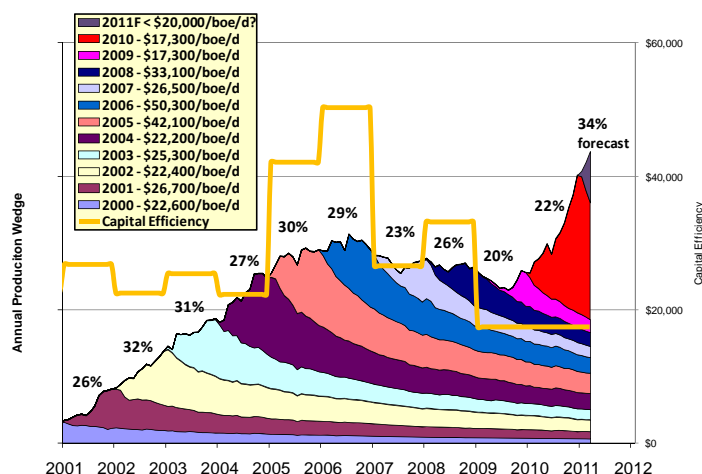
### The Treadmill

One of the recurring questions raised with me, regarding our explosive production growth over the past year, has been the increased corporate decline. There is the perception, perhaps traditionally well justified, that as we continue to grow our production with new producing wells, our corporate decline rate will continue to rise, thus making it harder to continue growing.

I can see where the concern comes from. Traditionally, there have been few companies that have been able to grow consistently through the drill bit. In fact Peyto, as a pure play tight gas company, has been quite unique in that regard. Most E&P companies have had to resort to acquiring production sooner or later to overcome the decline.

Some even point to our history and suggest that it was rising corporate declines that eventually caught up with us and halted our production growth in 2006. This was not at all the case. It was diminishing returns and capital efficiency that caused us to curtail our capital program which resulted in smaller production adds and declining corporate production. In other words, exercising capital discipline was the real reason, not increased declines. Figure 1 illustrates this point showing the layers of production that were built over the last dozen years, along with the corporate aggregate decline rates. I also overlaid the capital efficiency numbers.

Figure 1



As it began to cost us more for new production (2005-\$42k/boe/d, 2006 - \$50k/boe/d) and our returns were being eroded, we reduced the capital program from \$312MM in 2006 to \$122MM in 2007. Our production then began to mature and as it did the decline rate diminished, causing the corporate average decline to drop from 29%/yr in 2006 to 23%/yr in 2007.

Conversely, as we ramped up capital spending in 2010, adding a large wedge of new production, we increased the corporate decline to a forecast 34%/yr.

So the question is: *what happens to the corporate decline if we continue to grow production at this aggressive rate?*

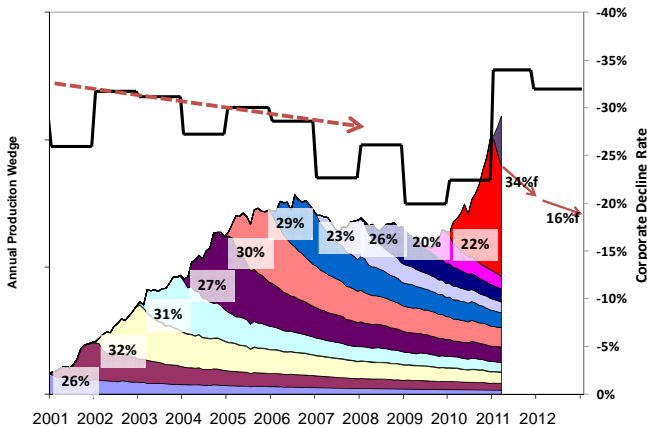
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One clue is exactly what happened in the past. Continuous production growth in the past resulted in corporate decline rates of around 30% that were slowly *falling* over time (see the arrow in Figure 2).

Figure 2



This makes sense because a greater and greater proportion of the base production was slowly declining less and less each year. So it shouldn't come as a surprise that this same phenomenon is predicted to occur again, as we're growing production from the same reservoirs.

The independent engineering firm, that assesses our reserves each year, predicted that for 2011, the base decline will be approximately 34%/yr. This same group of wells is predicted to decline at 16%/yr in 2012. If we add a similar wedge of new production in 2011, say 18,000 boe/d (assume \$312MM at \$17,300/boe/d), which declines in the first year at approximately 50%, then the combined corporate decline rate drops to 32% in 2012. As illustrated in the following table, we would have to deploy a much larger capital program, delivering a much greater wedge of new production, in order to actually increase the corporate decline.

	2011	2012F	2012F	2012F
CapEx	\$261MM	\$312MM	\$400MM	\$500MM
Base @ Jan 1	15,000 boe/d @18%/yr	20,000 boe/d @16%/yr	20,000 boe/d @16%/yr	20,000 boe/d @16%/yr
New @ Jan 1	15,000 boe/d @50%/yr	18,000 boe/d @50%/yr	23,000 boe/d @50%/yr	28,900 boe/d @50%/yr
Ave	34%/yr	32%/yr	34%/yr	36%/yr

"But these are horizontal wells!" you say. "The declines are higher!" Correct, but they are producing from the same reservoirs with the same inherent qualities as the vertical wells. Therefore, their production profile will ultimately be dominated by the same permeability.

If we compare the decline profile of a typical vertical Cardium well with one of our older producing horizontal wells, we see that the declines eventually start to converge and behave the same.

Both theoretically and empirically based then, we could continue to add production at about 25-30%/yr, which would require a growing capital program (25-30%), and the resultant corporate decline would slowly *fall* over time. Not an intuitive conclusion.

This is all hypothetical, of course. We still need to execute a large capital program that delivers the returns we're looking for in order for any of this growth to be realized. If we're not seeing the returns, we'll be exercising that same capital discipline as before.

But it does illustrate the advantages of low permeability or tight gas reservoirs; no water production, predictable long life and ultimately low declines. An entire company of tight gas can, therefore, continue to grow by the drill bit without speeding up the treadmill. As long as they can continue to find places to put that drill bit to work, which at Peyto, we can.

## Activity Levels and Commodity Prices

It's an interesting discussion on growth, but the environment for investment has to stay strong. Right now, with oil prices taking off (Figure 3) and the re-building of Japan pushing up steel, the costs in our business could be on the rise. Unfortunately, our primary commodity, natural gas, is not expected to go up so it would be hard to stomach more costs and less revenue. Makes it tough on the bottom line. For today, the returns are still strong but we remain ever vigilant when it comes to cost.

Figure 3

