

# Peyto Exploration & Development Corp.

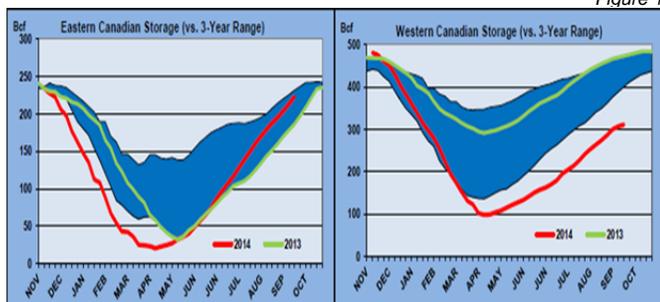
## President's Monthly Report

October 2014

From the desk of Darren Gee, President & CEO

A big snow in Calgary in early September was a rather rude reminder of the need to be prepared for the impending winter (note to self: get winter tires on). Considering the state of the Western Canadian natural gas storage levels, relative to the rest of North America, I'm not sure we're as ready as we should be. Figure 1 shows Eastern Canadian storage on the left and Western Canadian storage on the right. Eastern Canada storage is at 3 yr norms, but clearly Western Canada is quite a bit behind. And with the most recent production outages due to TCPL pipeline maintenance, we're now even further behind. The implication is that the AECO to NYMEX gas price differential could be smaller than is currently forecast as the West needs to keep more gas just to stay warm this winter.

Figure 1



Source: Nexen

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\*

2013/14 Capital Summary (millions\$ CND)\*

	Q1	Q2	Q3	Q4	2013	Q1	Apr	May	Jun	Q2	Jul	Aug
ONR Acq./other acq.	0	0	0	0	0.0	0				0		
Land & Seismic	2	6	3	2	11.9	7	1	0	7	8	0	0
Drilling	76	32	86	60	253.0	80	22	22	24	68	28	30
Completions	41	10	54	47	151.7	36	16	14	18	48	17	14
Tie ins	15	7	14	12	48.2	16	4	3	3	10	3	4
Facilities	36	18	24	34	112.2	40	6	4	7	16	11	16
<b>Total</b>	<b>169</b>	<b>74</b>	<b>181</b>	<b>155</b>	<b>578</b>	<b>179</b>	<b>49</b>	<b>43</b>	<b>60</b>	<b>151</b>	<b>60</b>	<b>63</b>

### Production\*

2013/14 Production ('000 boe/d)\*

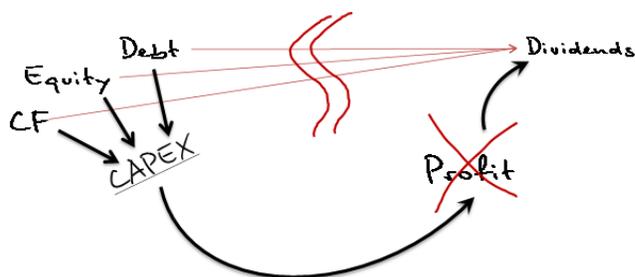
	Q1 13	Q2 13	Q3 13	Q4 13	2013	Q1 14	Q2 14	Jul	Aug	Sept	Q3 13
Sundance	39.7	41.6	41.5	47.4	42.6	49.3	51.6	55.1	58.0	58.3	57.1
Kakva	3.3	3.0	2.6	2.5	2.9	2.4	2.4	2.3	2.4	2.4	2.4
Ansell	8.8	10.7	9.9	13.9	10.8	15.7	14.2	13.2	14.5	15.3	14.3
Other	3.3	2.9	2.4	3.6	3.1	4.8	3.9	3.5	3.7	4.0	3.7
<b>Total</b>	<b>55.2</b>	<b>58.2</b>	<b>56.5</b>	<b>67.3</b>	<b>59.3</b>	<b>72.3</b>	<b>72.1</b>	<b>74.1</b>	<b>78.6</b>	<b>80.0</b>	<b>77.5</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.

### The Sustainability Math

A question was raised recently by an investor about why Peyto has more cash going out the door in terms of capital expenditures and dividend payments than it has coming in the door from funds from operations. It's not the first time I've heard that query raised, especially with the trend of junior E&Ps converting to dividend payers. The concern about sustainability of that math is valid.

I think the primary thing that investors are missing when they are looking at the balance of cashflow, capex and dividends is the profit. Let me use the following diagram to illustrate:



When money flows in the proper direction, all is as it should be. If you have an opportunity to invest capital into a project, you can fund that 3 different ways: Cashflow, Equity or Debt. There are various costs to each of these forms of capital. If the capital project is successful, then it should yield a profit. It is from this profit that dividends to investors are paid (profit sharing). The problem investors are having with today's oil and gas companies is that many dividend payers don't actually generate a profit (despite what they might advertise in their play economics, the "companies" themselves don't generate real profits). So that leaves investors wondering how the dividend is being funded: it must be coming from either Cashflow, Equity or Debt. All monies that are needed to fund the capital program. Clearly, that is not sustainable over the long term and so we end up doing all this sustainability math (dividends plus capex must equal cashflow, etc.).

However, if there is a profit from the capital investments, then paying some of that profit out to shareholders in the form of dividends is fine. That's how it's supposed to work.

Now, we can still have the discussion of how to fund the capital project(s) and should excess funding be used to accelerate those projects. As I've said in the past, Peyto tends to take a counter cyclical view as to the timing of funding capital projects in order to generate the maximum possible return. Sometimes that means we are funding beyond our cashflow, using debt and equity to be aggressive, sometimes that means we are paying down debt and

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returning capital to shareholders to preserve value when it's the wrong time to invest capital. For the last several years, we've been in a mode of aggressive capital investing, because we feel now is the time we can generate maximum return. That won't always be the case. And hasn't always been the case (see our period Q2 2006 - Q3 2009).

If you look at Peyto over the long term, we've invested some \$3.8 Billion into capital projects. Out of those investments we've generated about \$1.8 Billion in profit (earnings). And out of those profits paid \$1.6 Billion in dividends and distributions to shareholders (\$1.3B of that was return on capital, while \$0.3B was return of capital). We funded that \$3.8 Billion of capital with \$1.3 Billion of equity, \$0.9 Billion of debt and \$1.6 Billion of cashflow. We could have chosen to re-invest all those profits and they would have funded almost all of the shortfall over the years, suggesting we could have grown the business from start to today, almost entirely on its cashflow. That tells me that the growth has been highly profitable and highly accretive (a 45% production/share CAGR over almost 15 yrs).

However, had we done that, there would have been times when we would have been very fat with cash on the sidelines (which is not very tax efficient and usually makes you vulnerable - especially bad for a public company), and other times when we would have had loads of debt (also makes a public company vulnerable).

It also means that shareholders would have had to sell shares to realize any profit. Instead, by paying a dividend, we can all share in the profits along the way, and by using debt and equity to balance the over/under capital funding, we can maintain a more even keel. This works fine, so long as the cost of that capital is low, which ours has been (less than 5% over our history).

As I started out this discussion, it all hinges on a profit being generated from the capital investment. Something that we at Peyto have been very good at, but sadly our industry is woefully not.

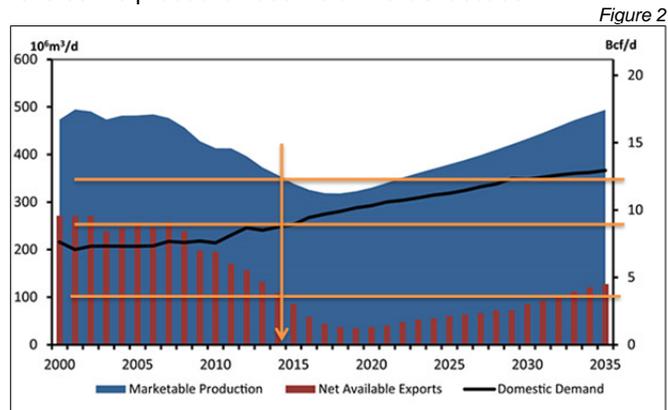
To answer the short term question: Yes, we expect this year our capital program plus our dividend will exceed our funds from operations - just like it has for the last several. We expect that about 80% of the capex will be funded with FFO, the rest with debt and equity. Out of that capex we will generate a healthy return or profit, and from that profit we'll pay a dividend to investors. The cost of that extra 20% is cheap (see our most recent debt deal at 3.79% CND), so it makes sense to use some extra if it's the right time to generate great returns. As I previously mentioned, it isn't always the right time.

Now some might say, why use so much equity? Why not just use more debt if it's so cheap? Actually, we did. The reason we have more cumulative equity than cumulative debt, after 15 years, is that some of the debt we drew was paid back over that time, whereas we have yet to buy back any stock (reducing equity).

At the end of the day, the real issue is profit, profit, profit. "A dividend is a distribution of a portion of a company's earnings or profits." And it is the lack of real profits that is the reason why some companies are unsustainable businesses. That's the real math.

### Activity Levels and Commodity Prices

AECO gas prices have been rather volatile of late. Sentiment about the long term fate of Western Canadian natural gas still seems to focus on the risk that the Marcellus shale gas in NE US "backs out" Western Canadian supplies. I just don't buy it. Looking at the NEB projections for supply, demand and exports of Canadian natural gas (Figure 2) it still looks to me like we will barely have enough for our own needs in a couple years. And that is counting on our ability as an industry to reverse the production decline of the last decade.



Reversing that decline seems like a Herculean effort to me, considering that the current capability of our service sector is well matched to the current activity levels, which are resulting in this decline. To reverse it will require significantly more activity than we have today, necessitating a dramatic increase to our service sector. A material price improvement will have to occur for that to happen.

I think it's just as plausible that we can't arrest the decline and we end up, at least for a short time, with less production than we need - all happening at the same time as we are bringing on additional export capacity. And we think gas prices today are volatile!