

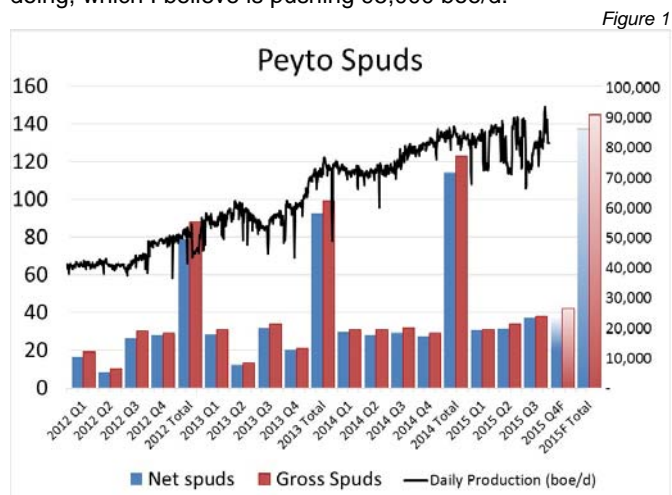
Peyto Exploration & Development Corp.

President's Monthly Report

October 2015

From the desk of Darren Gee, President & CEO

As we start the fourth quarter of 2015, there finally seems to be some light at the end of the pipe with respect to transportation restrictions. During all these production restrictions, our capital program hasn't slowed one bit, with 2015 looking to be a record year of drilling (Figure 1). Now, hopefully, we will finally get to see the true productive capability of all this drilling we've been doing, which I believe is pushing 95,000 boe/d.



Source: Peyto

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*

2014/15 Capital Summary (millions\$ CND)*

	Q1	Q2	Q3	Q4	2014	Q1	Apr	May	Jun	Q2	Jul	Aug
Acq.	0	0	0	0	0.3	3	0	0	0	0	0	-5
Land & Seismic	7	8	0	6	21.3	4	1	0	1	1	0	3
Drilling	80	68	83	81	310.8	70	19	16	25	59	31	29
Completions	36	48	46	54	183.1	43	11	8	14	33	15	15
Tie ins	16	10	11	14	51.3	7	3	3	5	11	4	5
Facilities	40	16	40	26	122.2	12	2	2	9	12	7	13
Total	179	151	180	180	690	138	35	28	54	117	57	61

Production*

2014/15 Production ('000 boe/d)*

	Q2 14	Q3 14	Q4 14	2014	Q1 15	Apr	May	June	Q2 15	Jul	Aug	Sept	Q3 15
Sundance	51.7	57.2	59.4	54.4	56.5	57.9	54.5	58.9	57.1	56.7	57.4	60.7	58.2
Ansell	14.2	14.3	16.5	15.2	16.8	17.1	14.6	14.5	15.4	12.3	12.8	12.7	12.6
Brazeau	1.3	1.2	3.2	1.8	4.3	6.9	6.3	6.1	6.4	5.4	7.0	8.1	6.8
Kakwa	2.4	2.4	2.3	2.4	2.2	2.2	2.2	2.0	2.1	2.1	2.1	1.5	1.9
Other	2.5	2.4	2.0	2.5	1.7	1.8	1.0	2.0	1.6	1.5	1.8	1.3	1.5
Total	72.1	77.5	83.3	76.3	81.6	85.9	78.6	83.5	82.6	78.0	81.1	84.3	81.1

* 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.

Encouraging the right behavior

A new study by the C.D. Howe Institute ([Report](#)) was recently released suggesting that Alberta, in its upcoming royalty review process, should consider replacing its system of Gross Revenue Royalties with one of Cash Flow Taxes. The study suggests that "cash flow taxes are a better way of reflecting the cumulative costs that resource companies face to extract energy than are gross revenue royalties". They go on to suggest that "the provinces can collect more while not harming investment in mining and oil and natural gas extraction if they change their distortive gross-revenue royalties into better designed cash-flow taxes."

A cash flow tax system, which C.D. Howe suggests is an internationally used "best practice" in resource taxation, would be one in which "barely profitable projects would face little or no tax, while highly profitable projects would pay a heavier tax." Huh?

The immediate question that jumps into my mind is why would we want to deliberately reward high cost, inefficient extraction of resources that generates no profit, with a system of low taxes, while at the same time penalizing low cost, efficient extraction, with higher taxes? This proposal seems totally illogical to me and smacks of the same political rhetoric we are hearing from our socialist bent government. As Karl Marx put it "from each according to his ability, to each according to his need."

Our current gross revenue royalty system is a form of resource taxation that occurs before costs and before risk. Meaning that the owners of the resource, in this case the provincial residents, can dissociate their resource benefits from the abilities of the resource companies that are attempting to extract said resource. The competitive motivation for the resource companies, for the benefit of their owners and shareholders, is to extract the resource in the lowest risk, most efficient and cost effective manner possible so as to maximize the return on the required capital investment (ie. generate a profit).

This existing system rewards and encourages the lowest cost, most efficient resource extractors while ensuring the provincial residents always get their share.

In Alberta, our conventional oil and gas gross revenue royalties have been refined over time to adjust for changing commodity prices and changing production rates that occur over the life of a project or well. And at times, this system had to be overhauled for advances in technology that have allowed for deeper or more expensive deposits to be developed and in recognition of the changing costs and risks associated with new exploration and development. At the end of the day,

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however, there is an underlying recognition that the capital required for development of the resource can go anywhere in the world and we need to attract it to Alberta with the promise of a fair, risked return.

Why then, would we want to adopt a system of tax that would scare that capital away by suggesting that the greater the returns that are generated through competition, the greater the tax burden? Where's the incentive to succeed? Instead, I believe we should be incentivizing the most efficient, cost effective extraction by **rewarding** those companies and that capital with lower "take", not higher. I believe this because I also know that lower extraction cost implicitly means lower environmental impact.

If a resource company is expending less costs to extract and sell the resource it is also expending less energy, both human and otherwise. In this business, there is a direct correlation between higher cost and greater energy intensity/inefficiency. Shouldn't we be encouraging companies to be more efficient, and therefore more environmentally friendly, by rewarding them for their efficiency and furthermore penalizing those less efficient businesses with a higher tax? Wouldn't that encourage the right kind of behaviour and then maybe we wouldn't have to consider carbon taxes on the inefficient emitters as a penalty for their inefficiency? Peyto for example, is extremely low cost and efficient and not surprisingly has a CO2 emissions intensity that is basically half that of other natural gas production.

C.D. Howe goes on to suggest that a system of cash flow taxes, that incorporates "loss offsetting" encourages exploration and risk taking, and that those costs should be incorporated when determining which costs can be deducted from revenues to get to taxable cash flows. But this again encourages the wrong type of behaviour.

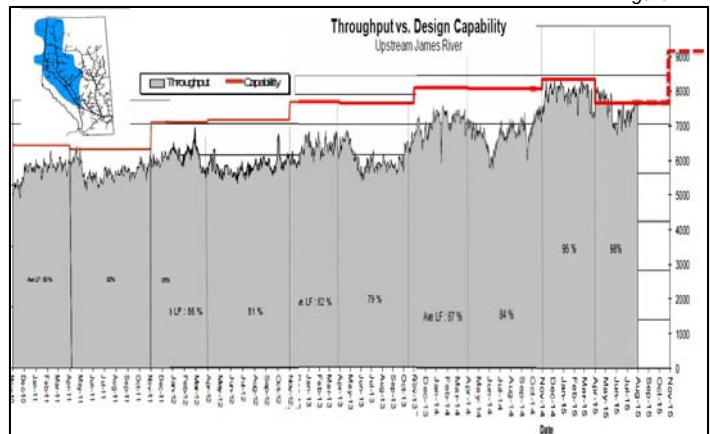
For decades, one of the reasons that resource companies generated such poor overall returns was that in order to deliberately avoid paying high federal taxes, they drilled highly speculative, risky exploratory wells because those expenditures could be immediately written off against their income.

As Albertans, we've already decided we don't want to be direct participants in the development of our resources. We leave that to private resource companies (like Peyto). But, as C.D. Howe states, we would like "to capture the maximum share of natural resource rents as efficiently as possible." In order to do that we need to first encourage capital investment to take a risk with the enticement of a potential return, then we need to encourage competition between the lowest cost resource companies to extract the resources in the most efficient and therefore environmentally friendly way possible. Only then can we collectively maximize both the rents and the returns.

Over its 16 year history (YE 2014), Peyto has invested some \$4.1 billion into development of Alberta's resources. In total, shareholders have earned a cumulative \$0.8 billion in debt adjusted net profit (cumulative earnings minus total net debt), while provincial residents have collected \$0.74 billion in royalty payments. Basically a 50/50 split. Seems fair to me. In addition Peyto has led the industry with respect to the efficiency by which that resource was extracted with its extremely low cost. I would say our resource taxation system is working just fine.

Activity Levels and Commodity Prices

Figure 2



Source: TransCanada

The portion of TransCanada's inter-Alberta natural gas pipeline system (the Nova Gas Transmission system – NGTL) that has been most restricted has been that portion in NW Alberta called "Upstream of James River." As you can see from Figure 2, lately it's not record gas volumes in the pipe that is the problem but rather reduced system capacity. The capacity is lower because of 1) both scheduled and unscheduled maintenance, 2) reduced pressure ratings imposed by the NEB on some laterals and 3) some expansion work that has been ongoing since earlier this year. TCPL is forecasting that the capability of their system should not only return to previous levels, but increase to over 9 BCF/d by November 2015 when all of these issues have been resolved and work completed.

With only a few producers drilling and adding new production in this part of the province (PEY, TOU, Progress, etc.) it is unlikely that total throughput (producer capability) will be back to where it was last winter at just over 8 BCF/d. This means there should be ample room for all volumes plus some additional growth, assuming there isn't a large amount of contracted but unused capacity, which I supposed could be the case but it seems insane that producers would incur the firm transportation costs even when they aren't using it. Considering natural gas is only \$3/mcf, \$0.20-\$0.30/mcf of unused transportation cost is now significant.