October 26, 2018
Vol. 5 Issue 10

Monthly Update

GEAR ENERGY

FROM THE DESK OF INGRAM GILLMORE, PRESIDENT & CEO

We regularly include the following data populated with estimated monthly results:

Capital *									
($k CAD)	Q4 17	**2017**	Q1 18	Q2 18	18-Jul	18-Aug	18-Sep	Q3 18	**2018 YTD**
Drill & Complete	7,737	**33,766**	3,624	3,451	3,817	6,141	4,978	14,936	**22,011**
Facilities	5,247	**14,223**	3,742	2,742	1,532	2,295	-337	3,490	**9,974**
Land & Seismic	583	**2,280**	2,766	282	7	13	19	39	**3,087**
A&D	14	**1,710**	390	10	0	-556	66,027	65,471	**65,871**
Other	-1,260	**-2,505**	-889	-90	-1	-14	300	285	**-694**
TOTAL	**12,321**	**49,474**	**9,633**	**6,395**	**5,355**	**7,879**	**70,987**	**84,220**	**100,248**
Production (boe/d) *									
Sales	**7,091**	**6,511**	**6,522**	**7,025**	**6,753**	**6,510**	**6,987**	**6,747**	**6,766**
Field	7,380	6,648	6,810	6,532	6,590	6,526	7,082	6,729	6,690
	** Estimates based on field data, actuals will vary from estimates due to accruals and adjustments. Such variances may be material.*								

Let's start this month's letter with an unpleasant chart from our friends at AltaCorp Capital.

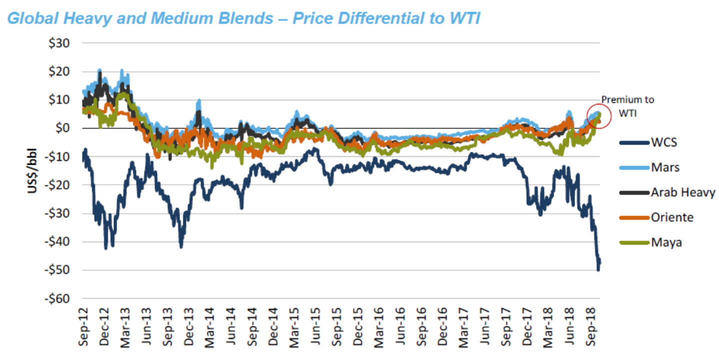

Figure 5. Heavy Oil Grade Price Differentials to WTI
Source: Bloomberg, AltaCorp Capital Inc.

Canadian heavy oil differentials are trading in record wide territory. Meanwhile, the equivalent quality of oil south of the border is trading at a premium to WTI. Yes, you read that right. Heavy oil in the Gulf of Mexico is at times worth US$50 per barrel more than the Canadian WCS barrels. In other words, Canadian heavy oil is being sold for up to 70% off the regular price!

The team at AltaCorp hit the nail on the head when they titled a recent research piece, "Canadian Heavy Oil Is Not a Discounted Product, It's A Stranded Product". Their premise (and a view shared by many of their peers) is that the global demand for heavy oil is exceptionally strong and is very likely to continue increasing for the foreseeable future. The problem in Canada is the difficulty we have getting our product to market, due to a continued and exceptionally frustrating lack of pipelines. Add to the equation an anomalously large US refinery maintenance season coupled with increasing Canadian oilsands production and you're left with material price deterioration.

The frustrating part is that this all could have been avoided if not for the Canadian government's inability to support its own energy industry. Just one new pipeline could have eliminated this problem. My favorite one was Energy East, use Canadian oil to supply Canadian consumers instead of buying foreign oil at full cost while supporting other less scrupulous regimes. However, that pipeline was cancelled due to increasing and uncertain regulatory burdens. Then there was the Northern Gateway, another excellent project that would have enabled Canadian crude to make its way to non-US markets, assisting those markets in getting off fuels like coal and helping them to improve their standard of living. Unfortunately, that project was also cancelled. This time it was because of a ban on oil tankers, coincidentally on the same coast that happens to be North America's largest exporter of coal. Looking forward, the story is also frustrating, with the Trans Mountain pipeline stuck in ongoing regulatory reviews and delays, and Keystone XL now celebrating its eight-year anniversary of trying to start construction. The best current option is the Enbridge line 3 expansion, which is forecast to be operational approximately a year from now.

To put this into perspective you just need to look at the forward curve for November where the WCS discount settled at US$45/bbl. Subtract an estimate of $15/bbl for shipping to the Gulf of Mexico and exchange adjust it to see that Canada is losing $40/bbl due to this lack of pipelines. Apply that discount to approximately three million barrels per day of heavy oil production and you get well over $100 million of lost revenue per day. That is a massive amount of lost revenue that won't attract royalties, won't be invested back into the country and won't provide much needed funds to support the high standard of living that all Canadians have come to expect.

Remember a few short weeks ago, when our Government was pledging to help the Canadian dairy industry overcome the 3.6% impact of the new USMCA agreement? From what I can tell, the Canadian dairy industry accounts for approximately $20 billion of annual GDP, so the 3.6% that is at risk represents approximately $720 million a year. That sounds like a big number until you realize that the heavy oil industry will lose that same amount of revenue during the first week of November!

Fortunately, despite being a year away from any new pipeline capacity, the forward curve predicts this situation to improve somewhat as the result of a combination of three other factors:

- Refining demand to return to normal levels.
- A continued increase in Crude-By-Rail shipping from Canada.
- A potential supply side response from producers who are unwilling to give away their hard-earned barrels at a loss.

The real question is how long will this situation last? If history can tell us anything, it is that these extreme price shocks tend to be relatively short lived. The team at Gear are busy evaluating various options that can be implemented to try and minimize the impacts of the current situation and maximize the realized revenue and returns on invested capital. Similar to the actions that Gear has taken in the past the following strategies are likely to be considered:

- Temporarily storing oil at surface.
- Slowing down or even shutting in existing production.
- Reallocating investment to light oil projects, particularly those in southeast Saskatchewan where the differential has not been impacted as significantly.

The good news is that these temporary challenges are not expected to have any long-term negative impacts on the future potential of the company. Gear has worked diligently for the last eight and a half years building an excellent suite of diversified assets, driving down costs and cementing a strong balance sheet. As always, the Gear team will remain nimble and opportunistic and will do everything in our power to preserve and create current and future shareholder value.

Certain information in this monthly update is forward-looking within the meaning of certain securities laws, and is subject to important risks, uncertainties and assumptions. This forward-looking information may include, among other things, estimated production, expected cash flow and profit from certain assets of Gear, expectations of commodity prices and price differentials, demand for oil, capital expenditure budgets and estimates, royalty rates, operating costs, credit/debt requirements, and drilling inventory and locations. Readers should not rely on such forward-looking information to make investment decisions as the results or events anticipated or predicted in such forward-looking information may differ materially from actual results or events as a result of a number of factors including based on the risk factors as set forth in Gear's most recent annual information form (the "**AIF**"), which is available on this website and at www.sedar.com. Gear has based the forward-looking information on a number of assumptions including the assumptions identified in such monthly updates, which may not be realized. It has also assumed that the risk factors discussed in the AIF will not cause such forward-looking information to differ materially from actual results or events. The forward-looking information in this monthly update describes the expectations of management of Gear as of the respective dates of this monthly update and Gear does not assume any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws. Readers should not rely on the views of management of Gear as set out in this monthly update to make investment decisions with respect to Gear or other companies in the oil and gas industry and should instead consult with their own investment advisors.

This monthly update may include certain key performance indicators to analyze financial and operating performance such as cash flow from operations, cash flow from operations per debt adjusted share, production per day per thousand debt adjusted shares, operating netbacks, corporate netbacks and net debt, which do not have any standardized meaning prescribed by Canadian generally accepted accounting principles ("**GAAP**") and therefore may not be comparable with the calculation of similar measures for other entities. For additional information on these non-GAAP measures, see Gear's most recent management's discussion and analysis which is available on Gear's website at www.gearenergy.com and at www.sedar.com.

Barrel of oil equivalent ("boe") used in the monthly updates have been based on a conversion ratio of 1 barrel of oil to 6 thousand cubic feet of natural gas. A boe may be misleading, particularly if used in isolation, as such conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.