CENTRA GAS MANITOBA INC.
TRANSPORTATION & STORAGE PORTFOLIO APPLICATION

NATURAL GAS MARKET UPDATE

INDEX

CENTRA GAS MANITOBA INC.
TRANSPORTATION & STORAGE PORTFOLIO APPLICATION

NATURAL GAS MARKET UPDATE

5.0 Natural Gas Market Update

The discussion of the North American natural gas market was provided in advance of the July 8, 2011 Technical Conference as incorporated in the document "Review of Natural Gas Supply Portfolio Options for Centra Gas" prepared by ICF International. This paper has been provided in this Application as found at Attachment 1 of Tab 4. The underlying trends and market fundamentals outlined in the ICF discussion paper remain applicable today.

With respect to the matter of the TransCanada Pipeline Mainline system, Centra provided background information at the July 8, 2011 Technical Conference in its presentation "Canadian Mainline Overview – A Significant Consideration". A copy of this presentation may be found as Attachment 2 of Tab 4 of this Application.

This Tab provides an update to the discussion of the North American natural gas market and the TCPL Mainline tolls situation.

5.1 North American Natural Gas Market Update

5.1.1 Market Prices

Market prices for natural gas continue to decline across North America. Sustained growth in production, combined with lower space heating demand and resulting record high winter storage levels as a result of the warm 2011/2012 winter, has driven

Canadian prices to their lowest levels in more than 13 years. The March 2012 AECO 'C' monthly firm index price settled at $1.97/GJ. The last time the AECO monthly price index settled below $2.00/GJ was in September 1998. Calendar 2011 average prices, at $3.48/GJ, were also the lowest average annual price in over twelve years.

In addition to current pricing levels, futures markets are pricing in the expectation that the current low gas price environment will continue well into the future. As of this writing, the 12-month forward average of AECO futures prices was trading at approximately $2.20/GJ. This is the lowest level ever seen since the trading of discreet futures contracts for the near 12-month period began. Further, the five-year forward average of AECO futures prices was trading at $3.15/GJ.

The effect of the recent price environment on the average residential natural gas customer in Manitoba has been positive and significant. As of February 1, 2012, the total annual natural gas bill of the average Manitoba residence under normal weather conditions had fallen by more 30% relative to the typical annual bill of ten years ago. After adjusting for changes in the Consumer Price Index over that time, these savings become even more significant at nearly 45% in inflation adjusted terms. Measured across Centra's sales customer base, lower gas prices are currently generating savings in excess of $250 million per year for the Manitoba economy relative to a decade ago.

5.1.2 Natural Gas Production and Consumption

While the consumption of natural gas continues to increase each year across North America, growth in natural gas production is outpacing the growth in its use. This is occurring in spite of what is being characterized as unsustainably low market prices.

Producers have continued to invest in growing natural gas production in spite of low market prices.

The employment of innovative new exploration and production technologies such as four-dimensional seismic imaging (height, length, width and time) and multiple directional horizontal drilling, as well as combining these new techniques with existing drilling and production techniques such as hydraulic fracturing (which has been widely used by the oil and gas industry for more than sixty years), has resulted in significant reductions in both exploration risk and production costs. Multiple directional drilling results in significant economies of scale as producers may now drill as many as 150 separate producing wells from a single drill pad site.

The reduction in the cost structure for natural gas producers as a result of the employment of these innovations and new technologies has created an environment whereby producers indicate their ability to earn positive returns on their capital investments even with natural gas market prices at or below $3/GJ. In addition, new production basins that are now being opened up to unconventional gas production are also rich in natural gas liquids such as propane, butane and ethane, as well as unconventional crude oil. Higher market prices for both oil and natural gas liquids have allowed these producers to continue to be profitable despite low natural gas market prices.

5.1.3 Risks to Continued Expansion of Unconventional Resources

The main risk to the continued growth in supplies and current low natural gas prices is of a public policy and regulatory nature. More onerous and multi-layered regulation of

hydraulic fracturing, and unconventional natural gas production in general, has the potential to add significantly to production costs and therefore, market prices. While the ultimate resolution of these policy uncertainties remains unclear at this time, they are likely to become clearer within the next few years.

5.2 TransCanada Mainline Update

The TransCanada Mainline physically transports all natural gas supplies that are consumed in Centra's service territory and is the only pipeline available to serve the Manitoba market at this time and in the foreseeable future. Due to the dependence on the Mainline, Centra's gas supply planning and operations are inevitably influenced and affected by the current and future business environment experienced by the Mainline.

5.2.1 Mainline Business Challenges

Over the past decade, the Mainline has experienced dramatic business challenges. A persistent trend of decontracting away from the Mainline has resulted in the current situation where only approximately 2.7 bcf/day flows on a pipeline that has the nominal capacity to transport in excess of 7.3 bcf/day. The decontracting trend that became evident early in the last decade was attributed to competitive pressures from the development of new long haul pipeline infrastructure out of the WCSB, exemplified by the advent of the Alliance Pipeline. However, in the later years of the last decade, this situation has been exacerbated by the emergence of unconventional shale gas resources in basins with closer proximity to the large continental markets, and by the weakness in the U.S. economy due to the financial crisis and resulting economic slowdown. While the U.S. economy may begin to experience signs of recovery, the fundamental change to the North American natural gas supply profile continues, driven

by steady expansion of the development of shale-based resources.

The historic regulatory compact that has been established largely insulates the Mainline from the financial consequences of deteriorating shipper participation. Under these circumstances, the shippers that remain contracted on the Mainline will ultimately bear the revenue requirements for the entire Mainline system in their future tolls. Given the largely fixed cost structure inherent with pipelines, under this regulatory construct and absent a resurgence in shipper commitment to the subscription of available capacity, the revenue requirement in future test years will be recovered over fewer billing determinants and the resulting tolls for remaining shippers will inevitably rise.

Since 2006, the level of contracting for Firm Transportation has declined on the Mainline by approximately 70%. The level of the benchmark final Eastern EZT in 2006 was $0.94/GJ. By comparison, the NEB approved interim 2011 tolls effective March 1, 2011 that provided for the benchmark EZT to be set at $2.24/GJ. TransCanada subsequently sought approval of final tolls for 2011 to be set in accordance with the 2007-2011 Mainline Settlement, which would provide an equivalent benchmark EZT of $2.45/GJ.

5.2.2 Mainline 2012-2013 Tolls Application

TransCanada filed its Business and Services Restructuring and Mainline 2012-2013 Tolls Application with the NEB on September 1, 2011. In an attempt to mitigate toll increases for 2012 and 2013, TransCanada's Application includes the following proposals:

1. A segmentation of depreciation between the Prairie Line, Northern Ontario Line and Eastern Triangle with a subsequent re-allocation of accumulated

depreciation from the Prairie Line and Eastern Triangle to the Northern Line, which is intended to result in an overall reduction in the Mainline depreciation rate of approximately 1%.

2. A shift of costs from the Mainline to TransCanada's Alberta System shippers through the formation of an Alberta System Extension, which requires the Alberta System to contract for export capacity on the Mainline and on TransCanada's Foothills System, synthetically expanding the boundaries of the Alberta System to the Saskatchewan/Manitoba border to the east, and to the Saskatchewan/North Dakota border and British Columbia/Montana border to the south.
3. A shift of costs from current shippers to future shippers via a proposed deferral of a portion of the current revenue requirement into future periods through the inclusion of mechanisms including the Long Term Adjustment Account. TransCanada has proposed to defer the collection of $100 million in costs from 2012 by use of the Long Term Adjustment Account, to be included in rate base and amortized in future periods at rates equivalent to the Mainline composite depreciation rate.
4. A modification to services and tolling, which includes raising the bid floors for Interruptible Transportation and Short Term Firm Transportation Services and eliminating the Risk Alleviation Mechanism from FT contract services.

The regulatory schedule for TransCanada's Application contemplates the commencement of an oral hearing in early June 2012, which is expected to sit at least over the summer months. Centra is an intervenor in TransCanada's Application and expects to participate in the hearing.

5.2.3 Observations on the Mainline Business Environment

Given the magnitude of the issues that exist and the nature of the proposals made by TransCanada in its Application, it is reasonable to assume that these significant business challenges will not be quickly resolved. It is likely that the toll uncertainty that exists in such an environment will persist beyond the 2012 – 2013 timeframe considered in the current TransCanada Application.

Furthermore, the situation is particularly difficult in light of the competition that WCSB supply faces in Eastern markets, predominantly from shale gas produced from U.S. basins such as the Marcellus. Under these competitive constraints, TransCanada is faced with the challenge of keeping tolls as low as practicable in order to have WCSB supplies retain Eastern market share and be transported on the Mainline, while recovering the Mainline's full revenue requirement. It is currently unclear how these apparently mutually exclusive objectives can be reconciled.

5.3 Conclusion

Centra will continue to adapt to changes in the natural gas marketplace and the overall business environment within which it is operating, recognizing that it has certain limitations given the extent to which it is reliant on the Mainline. Although the NEB proceeding on the matter of TransCanada's restructuring proposal is expected to confirm tolls for 2012 and 2013, in all likelihood considerable toll uncertainty will still exist post-2013.