

Commodity Rate and Buying Natural Gas

The following is a discussion of how SaskEnergy sets its commodity rate and how the Corporation purchases its natural gas supply. The cost of natural gas purchased for customer consumption is recovered through the commodity rate.

A. Commodity Rates

In setting the commodity rate, SaskEnergy follows the standard Canadian natural gas utility regulatory practice which is to pass through the cost of natural gas sold to customers without applying any margin or additional costs. No profit or loss should be incurred by the utility on the sale of natural gas.

The cost of gas sold includes all costs of obtaining gas at TEP (TransGas Energy Pool). Gas can be purchased directly at TEP from gas producers or marketing agents or outside the Province, mainly Alberta. In addition to the “raw” cost of the commodity, the cost of gas includes the effect of natural gas price risk management transactions, administrative costs of acquiring the gas, transporting gas to TEP and financing of gas inventory in storage.

The difference between SaskEnergy’s cost of gas and the revenue generated from commodity rates is tracked in the Gas Cost Variance Account (GCVA). The outstanding balance in the GCVA is refunded to or collected from customers in the next commodity rate application. This process supports the principle that no profit or loss is made by SaskEnergy on the sale of natural gas. The Corporation’s independent auditors, on behalf of the Provincial Auditor, as well as the Saskatchewan Rate Review Panel, monitor the GCVA to ensure this principle is followed.

Natural gas utilities across Canada have different rate setting processes. SaskEnergy’s process is to recommend a rate based on the forward natural gas market and reduction of the GCVA balance to zero over that same time period. The rate is established for November 01 of each year. It is reviewed for April 01 and adjusted if the GCVA continues to be too large or if market conditions change materially. Rate applications are reviewed by the Saskatchewan Rate Review Panel, which makes a recommendation to Cabinet for their approval.

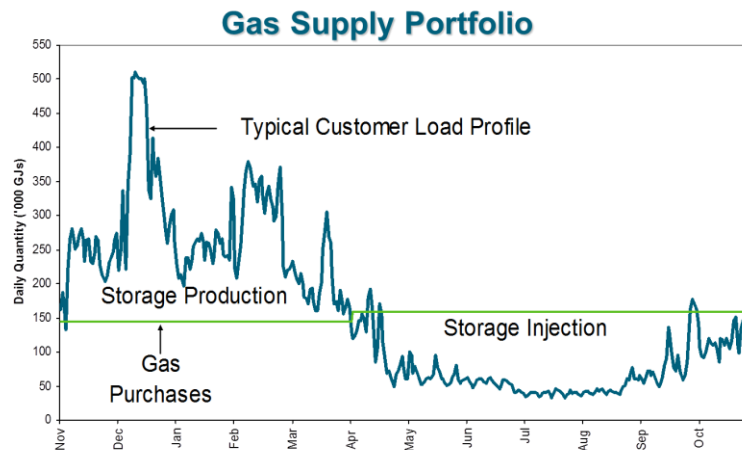
SaskEnergy rates contain a component of price protection, which protects customers against rising or volatile prices. SaskEnergy has utilized a price management strategy since the mid 1990’s which has allowed customers to have stable rates in what is usually a volatile market. The notion of “rate stability” still appears to resonate with SaskEnergy customers. Few other jurisdictions currently have price protection. When natural gas prices are declining, utilities that do not hedge tend to have lower commodity rates. However, the opposite is true when natural gas prices begin to rise as the hedging provides price protection, allowing utilities that hedge to have lower rates.

B. SaskEnergy Gas Supply

i) Buying Natural Gas

Historically, SaskEnergy has purchased the majority of its natural gas in Saskatchewan. In 2011, Saskatchewan became a net importer of natural gas as conventional natural gas production in the province declined, while demand increased. SaskEnergy now purchases approximately 60% of its natural gas in Alberta.

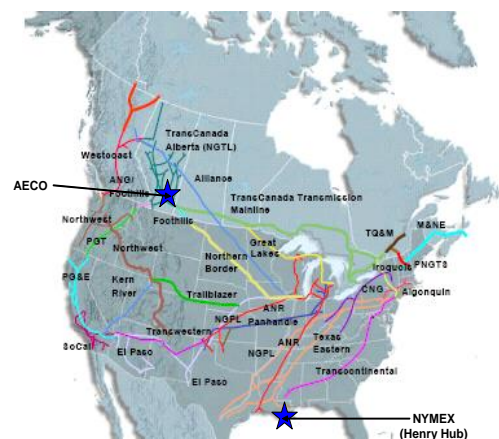
Typically about the same amount of natural gas is purchased every day of the year. In the summer, when natural gas demand is low, the natural gas not used that day is injected into storage. During the cold winter months natural gas is produced from storage to supplement the daily purchases in order to meet the higher heating loads. In a normal year, approximately 45% of winter requirements come from storage. This supply strategy is very effective given the operational challenges of serving Saskatchewan customers in such a large geographical area with extreme weather conditions.



ii) Natural Gas Prices

SaskEnergy purchases its customers' natural gas on the open market. The price is determined by the forces of supply and demand.

The primary pricing point of natural gas in North America is Henry Hub in Louisiana. Because of its pipeline connections to high consuming regions in the United States, a futures contract based on Henry Hub trades on the New York Mercantile Exchange (NYMEX). This provides a high degree of transparency to natural gas prices. The U.S. NYMEX natural gas price is the most commonly quoted natural gas price in the media.

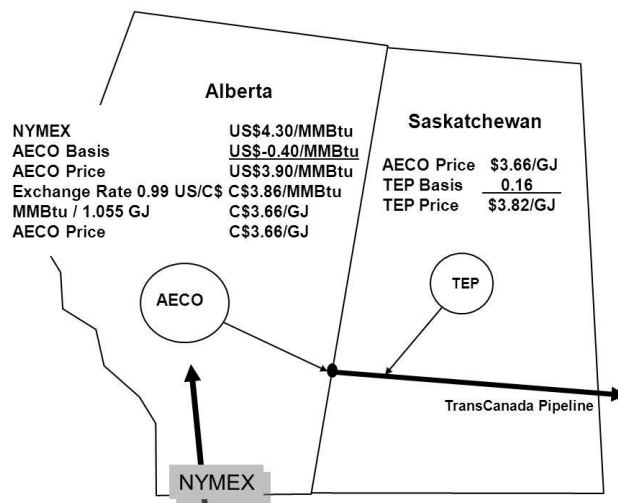


AECO is the largest natural gas hub in Canada and is located in Alberta. AECO is priced as a basis (differential) to NYMEX. The basis typically represents regional differences in supply and demand and usually considers the cost to transport gas from western Canada to the high consuming regions in the east. When a large volume of transactions occur at a hub, such as AECO, it

becomes a pricing reference point for smaller hubs such as in Saskatchewan. SaskEnergy purchases 40% of its natural gas supply from producers in Saskatchewan. This gas is exchanged at the TEP and the price is quoted as a basis (differential) to AECO prices in Alberta. Factors affecting the price of natural gas in North America, reflected in the NYMEX natural gas price, affect the price of gas in Saskatchewan.

NYMEX natural gas is quoted in U.S. dollars and is bought and sold in millions of British Thermal Units (MMBtu). Gas purchases in Canada must be converted to Canadian dollars and to gigajoules, the standard energy unit used in Canada. Changes in the Canada-U.S. exchange rate affect the price of natural gas in Canada. An appreciating Canadian dollar results in lower Canadian natural gas prices and a depreciating Canadian dollar results in higher natural gas prices, all things being equal. The adjacent chart is an example of NYMEX natural gas prices converted to the price of gas in Saskatchewan.

Example of Pricing Relationship



iii) SaskEnergy’s Natural Gas Price Risk Management Program

SaskEnergy has a natural gas price risk management program. It uses financial instruments and fixed price gas purchases to manage the price of the natural gas it buys on behalf of its customers. The goal of the price management program is to reduce the volatility of natural gas prices and to have rates that are competitive to other utilities. Historically, natural gas prices have demonstrated considerable volatility (+/- \$4.00/GJ annually) making stability highly valued by our customers.

In order to reduce volatility, SaskEnergy may use fixed price swaps or futures (forward) contracts to lock in the price of gas for a period in the future. If natural gas prices have changed by the time the gas is delivered, SaskEnergy’s contracted price remains the same. At times, SaskEnergy’s contracted price will be lower than the market price when the gas is delivered and sometimes it will be higher. The benefit of this type of strategy is that the price for natural gas that SaskEnergy will be paying is known in advance – regardless of the variability of the market price of natural gas.

To contribute to its goal of having rates that are comparable to other utilities, SaskEnergy will sometimes accept the market price of natural gas and/or use options strategies to keep the price it pays for natural gas within certain ranges. The benefit of these strategies is that if market prices fall, SaskEnergy’s commodity costs will also fall. On the other hand, if prices rise, SaskEnergy’s cost of gas may also rise.

The two objectives naturally oppose each other and the balance between the two may change depending on existing market conditions. SaskEnergy's price management strategy has proven to be effective and has historically provided our customers competitive rates, but more importantly, the stability they have indicated they prefer.

C. Natural Gas Markets

Natural gas prices are set in an open market and are influenced by a number of variables including production, demand, natural gas storage levels and economic conditions. Because of the high demand for natural gas to heat homes and businesses during the cold winter months and the demand for natural gas to generate incremental electricity for air conditioning in the summer, weather has the greatest impact on natural gas prices in the near term. Natural gas prices can be very volatile due to the high degree of uncertainty associated with weather.

For more information with regards to the natural gas market place, refer to the following links for the National Energy Board (NEB) and the United States Energy Information Administration (EIA).

NEB: <http://www.neb-one.gc.ca/clf-nsi/rnrgynfmtn/prcng/prcng-eng.html>

EIA: <http://www.eia.gov/naturalgas/>