



EnergyAustralia[®]

EnergyAustralia Retail Negative Pass Through Event Application

January 2011

Negative Pass Through Event Application

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1 Overview

On 27 April 2010 the Australian Government announced its decision to delay the introduction of the Carbon Pollution Reduction Scheme (CPRS) from the scheduled commencement date of 1 July 2011.

The delay in the introduction of the CPRS has meant that EnergyAustralia will now not be exposed to the cost of carbon in 2011/12 and 2012/13 that was anticipated within IPART's 2010 Determination. However, the delay in the introduction of the CPRS has caused other costs to increase. Delay in the introduction of the CPRS now means the obligations under the Greenhouse Gas Abatement Scheme (GGAS) exceed that assumed in the 2010 Determination and therefore the costs of complying with the (GGAS) scheme will be greater. Additionally, the costs of complying with the Renewable Energy Target (RET) are also expected to change as a result of the delay in the introduction of the CPRS.

Despite the increase in costs in 2010/11, the delay in the introduction of the CPRS meets the definition of a Negative Pass Through Event as defined in Clause 2(b) of Schedule 4 of the 2010 Determination as the delay in the introduction of the CPRS results in significant savings over the three years of the Determination. This definition is met as the announcement of the delay falls under the definition of a Regulatory Change Event and the cost reduction resulting from the announcement meet the materiality threshold set in the 2010 Determination.

The savings to be passed through as a result of the delay in the introduction of the CPRS are:

Financial Year	Amount to be pass through (\$ '000)
2011/12	\$(21,633)
2012/13	\$(265,652)
\$2010/11	

These savings are primarily due to the removal from the energy cost allowance of the carbon component included in the 2010 Determination. The savings are partially off-set by increases in the cost of complying with GGAS and RET obligations. As the changes for 2011/12 and 2012/13 will be addressed as part of the Annual Reviews, a recovery of approximately \$23 million¹ in 2011/12 is required. This amount relates to the additional costs incurred in 2010/11 that would not otherwise be recovered.

¹ In \$2010/11

EnergyAustralia is lodging this application in accordance with Clause 4 of Schedule 4 of the 2010 Determination.

This application consists of the following sections.

Section 2 discusses the event that has occurred, namely, the delay in the introduction of the CPRS and demonstrates how this event meets the definition of a Negative Pass Through Event. While Section 3 covers the financial impact of the event and specifies the pass through amounts that EnergyAustralia is seeking to pass on and demonstrates that all reasonable steps have been taken to maximise the cost savings.

Unless stated otherwise all dollar amounts are in \$2010/11.

2 Negative Pass Through Event

The 2010 Determination requires that a Standard Retail Supplier must give notice to IPART of a Negative Pass Through Event within 90 Business Days of that Negative Pass Through Event occurring, or by any other date notified by IPART.

The Standard Retail Supplier's notice to IPART of the Pass Through Event must be in writing and must specify (amongst others):

- (1) the details of the Negative Pass Through Event;
- (2) the date the Negative Pass Through Event occurred;

Relevant for this application are the following definitions:

Negative Pass Through Event, for a Standard Retail Supplier, means a Pass Through Event which results in that Standard Retail Supplier incurring **Materially** lower costs in providing Pass Through Services than it would have incurred but for that event

An event results in a Standard Retail Supplier incurring **Materially** higher or lower costs in providing Pass Through Services than it would have incurred but for that event if, in the case of a Negative Pass Through Event, that event results in the Standard Retail Supplier's average annual costs saved (or likely to be saved) during the Term (after taking all reasonable steps to maximise those cost savings) exceeding 0.25% of its total revenue arising out of Regulated Retail Tariffs (including Network Use Of System Charge components of Regulated Retail Tariffs) for the Year in which the event occurs, consistent with the Annual Pricing Proposal for the relevant Year.

Pass Through Event means a Regulatory Change Event or a Tax Change Event.

Pass Through Services means services of or in relation to Supplying electricity to Small Retail Customers under a Standard Form Customer Supply Contract.

Green Energy Scheme means any mandatory scheme that imposes financial obligations on a Standard Retail Supplier in order to produce a Green Energy Outcome, excluding the Carbon Pollution Reduction Scheme, but including the Commonwealth mandatory renewable energy target scheme under the Renewable Energy (Electricity) Act 2000 (Cth) and the New South Wales Government's energy savings scheme under the ESA.

Regulatory Change Event means:

- (a) a decision made by any Authority;
- (b) the coming into operation of an Applicable Law; or
- (c) the coming into operation of an amendment to or revocation of an Applicable Law, on or after 18 March 2010 that has the effect of substantially varying:

(d) the nature, scope, standard or risk of the Pass Through Services; or

(e) the manner in which a Standard Retail Supplier is required to undertake any activity in order to provide the Pass Through Services, including obligations:

- (1) under any Customer Hardship Program (subject to paragraph (j));
- (2) arising as a consequence of any Last Resort Supply Event; or
- (3) under any Green Energy Scheme,

but does not include:

- (f) the making of the Determination;
- (g) a Tax Change Event;
- (h) any decision, determination or ruling in relation to Energy Loss Factors;
- (i) the phasing out of the Electricity Tariff Equalisation Fund (as defined in the ESA); or
- (j) the coming into operation or amendment of any Customer Hardship Program to the extent the Standard Retail Supplier's costs of compliance with obligations imposed under that program are funded by a government or third party.

2.1 Delay in the Introduction of the CPRS²

On 27 April 2010 the Commonwealth Government announced that it had decided to delay the introduction of the CPRS legislation. This means that the scheme will not be introduced on 1 July 2011, the start of the second year of the Determination Period, as originally anticipated.

In reliance of the CPRS being implemented on 1 July 2011, the Terms of Reference from the NSW Government for the 2010 – 2013 Electricity Review instructed IPART to factor into the Determination an assumption that the CPRS would commence from the scheduled date. The Terms of Reference stated:

“The Energy Purchase Cost Allowance should be set, using transparent and predictable methodology, at a level that would allow a Standard Retail Supplier to recover the efficient costs of managing the risks associated with purchasing electricity from the NEM (including the Carbon Pollution Reduction Scheme)”³.

The decision to delay the introduction of the CPRS has had a consequent effect on the costs of meeting two other schemes, namely, the Greenhouse Gas Reduction Scheme (GGAS) and the Renewable Energy Target (RET).

Section 97KB of the *Electricity Supply Act 2005* provides that the GGAS is required to be terminated at the time that a price for carbon is introduced. On this basis, all obligations under the GGAS scheme were scheduled to end on 1 July 2011. The decision to delay the introduction of the

² Required under Clause 4.1(c)(1) of Schedule 4 of the 2010 Determination.

³ IPART, Review of regulated retail tariffs and charges for electricity 2010 – 2013, Electricity – Final Report, March 2010, p201.

CPRS means that the GGAS will now continue for longer than anticipated within IPART's 2010 Determination.

The decision to delay implementation of the CPRS also affects the price of Renewable Energy Certificates under the Renewable Energy Target (RET) due to the relationship between wholesale energy prices and REC prices.

The biggest impact of the decision to delay the introduction of the CPRS is on the energy purchase cost where the allowance in the 2010 Determination included a carbon component which will now be removed (assuming that the CPRS is not introduced during the Determination period).

2.1.1 How does the event qualify as a Negative Pass Through Event?

A negative pass through event is defined as a Tax or Regulatory Change Event that passes the materiality threshold. The decision to delay the introduction of the CPRS is a Regulatory Change Event.

EnergyAustralia considers that the delay in the introduction of the CPRS meets IPART's definition of a Regulatory Change Event. The remainder of this section details the reasons for this.

The Commonwealth Government, meeting the definition of an Authority, made a decision, namely the decision to delay the introduction of the CPRS.

This decision has the effect of varying the scope, nature, manner or risk of how EnergyAustralia provides the Pass Through Service in the following ways:

- The attributes of energy costs have changed. Energy costs will no longer have an uplift related to the forecast price of carbon in the economy as had been provided in the 2010 Determination with respect to the provision of the Pass Through Service; and
- The obligations to procure NSW Greenhouse Abatement Certificates (NGACs) was assumed to have been terminated due to the introduction of the CPRS. However, the delay in the introduction of the CPRS means that retailers now need to continue to procure NGACs beyond the period assumed in the 2010 Determination in order to provide the Pass Through Services.

The delay in the introduction of the CPRS then meets the definition of a Negative Pass Through Event as not only does it meet the definition of Regulatory Change Event it also passes the Materiality threshold of 0.25% as defined in the 2010 Determination.

The total average annual savings to EnergyAustralia from all cost changes over the period 2010 – 2013 as a result of the delay in the introduction of CPRS is estimated to be \$████ million per year

which is over 6% of total revenue arising out of Regulated Retail Tariffs for 2009/10 consistent with the Annual Pricing Proposal for 2009/10.

2.2 Date of the Negative Pass Through Event⁴

The date of the Negative Pass Through Event was 27 April 2010, being the date the Commonwealth Government announced the decision to delay the introduction of the CPRS.

EnergyAustralia is submitting its application for a Negative Pass Through Event due to the delay in the introduction of the CPRS in accordance with the notification date set out by IPART in the letter dated 22 December 2010.

⁴ Required under Clause 4.1(c)(2) of Schedule 4 of the 2010 Determination.

3 Amounts to be passed through

The Determination requires EnergyAustralia to specify the following amounts in its written application:

- (1) the costs in the provision of Pass Through Services that the Standard Retail Supplier has saved since 1 July 2010 and is likely to save during the Term as a result of the Negative Pass Through Event, including supporting documentation demonstrating that all reasonable steps have been taken to maximise the cost savings;
- (2) the total amount that the Standard Retail Supplier proposes to pass through to Customers as a result of the Negative Pass Through Event;
- (3) the amount that the Standard Retail Supplier proposes to pass through to Customers in each Year as a result of the Negative Pass Through Event.

Clause 4.1(c)(3) of IPART's Final Determination requires EnergyAustralia to notify IPART of the costs in the provision of Pass Through Services that the Standard Retail Supplier has saved since 1 July 2010 and is likely to save during the term as a result of the Negative Pass Through Event.

EnergyAustralia observes that the pass through clauses in the Determination appear to assume that the retail price controls include an allowance for the efficient cost the standard retailers bear when providing the Pass Through Services, and as a consequence draw attention to the incremental cost that the standard retailers would be expected to bear as a result of the Pass Through Event. Consistent with this, EnergyAustralia has presented the incremental costs as being the difference between actual costs incurred or estimated to be likely to be incurred relative to the 2010 Determination allowances.

The allowances included in the 2010 Determination for the RET and GGAS costs were based on the long run marginal cost (LRMC) of meeting this obligation. EnergyAustralia is of the view that as a general guiding principle the higher of the LRMC and market rates should be used, however, recognises that the approach has been fixed for the 2010 Determination. EnergyAustralia's interpretation of the requirements of the pass through clauses of the 2010 Determination means the methodology used by EnergyAustralia to determine the costs for the purposes of this application are based on a combination of historical and future market costs only.

As the cost allowance for the GGAS and RET were based upon Frontier Economics' estimates of the long run marginal cost (LRMC) of meeting these obligations, which Frontier also described as equivalent to the cost to society (rather than the individual Retailers) of this obligation and IPART has indicated that it intends to apply the same method to derive the pass through amounts, EnergyAustralia has included a theoretical discussion of the likely impact of the delay in the introduction of the CPRS on the LRMC.

It should also be noted that there remains considerable uncertainty about the expected introduction of a price on carbon. This uncertainty relates to the implementation date, mechanism employed and impact on wholesale electricity costs. On that basis EnergyAustralia considers that it would be inappropriate to assume that the CPRS, in its current or any other form, will be introduced. To do so raises again the risk that the costs allowed for EnergyAustralia do not allow it to recover the efficient costs of providing the Pass Through Service.

3.1 Impact on incremental costs⁵

While the delay in the introduction of the CPRS results in savings in the Energy Purchase Cost due to the exclusion of the carbon component, it also results in cost increases due to an increase in GGAS and RET compliance costs. The net effects of these changes is an increase in costs in 2010/2011 and a decrease in costs in 2011/12 and 2012/13.

3.1.1 Carbon Costs

The cost savings that EnergyAustralia expects as a result of the delay in the introduction of the CPRS scheme come from the removal of the carbon component from the Energy Purchase Cost and are set out in the table below:

TABLE CONTAINING CONFIDENTIAL LOAD AND COST INFORMATION
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As there was no carbon component in the 2010/11 Energy Purchase Cost there are no savings in that year as a result of the delay in the introduction of CPRS. The forecast savings for 2011/12 and 2012/13 are calculated using IPART's forecast impact of CPRS⁶ and EnergyAustralia's forecast Regulated load. The savings due to the carbon component includes the removal of the allowance for losses included in the 2010 Determination. This was calculated based on the loss factor of 7.06% included in the 2010 Determination.

⁵ Required under Clause 4.1(c)(3) of Schedule 4 of the 2010 Determination.

⁶ Source: Table 6.9 from Review of regulated retail tariffs and charges for electricity 2010 – 2013, March 2010 p 100.

DISCUSSION OF CONFIDENTIAL LOAD FORECAST REMOVED

The total savings from carbon costs includes savings due to the removal of the carbon component from the allowance for loss factors in the 2010 Determination.

3.1.2 GGAS

The delay in the introduction of the CPRS extends EnergyAustralia's obligations with respect to the GGAS scheme beyond that assumed when the 2010 Determination was made. GGAS aims to reduce greenhouse gas emissions associated with the production and use of electricity. Introduced in 2003, the GGAS establishes annual statewide greenhouse gas reduction targets, and then requires individual electricity retailers and certain other parties who buy or sell electricity in NSW to meet mandatory benchmarks based on the size of their share of the electricity market. GGAS requires EnergyAustralia to obtain and surrender NGACs to meet its annual liability based on EnergyAustralia electricity purchases.

IPART is both the scheme administrator and the scheme regulator. As Scheme Administrator it oversees the accreditation of abatement certificate providers, the creation and transfer of greenhouse gas abatement certificates, monitors the performance and compliance of accredited parties, and maintains the GGAS registry. As Compliance Regulator it oversees the annual compliance of mandatory benchmark participants with their greenhouse gas benchmarks, and the election of large customers and persons carrying out state significant developments to become elective benchmark participants

The following table provides the estimate of the efficient NGAC costs for EnergyAustralia for the Determination Period.

TABLE CONTAINING CONFIDENTIAL LOAD AND COST INFORMATION

EnergyAustralia has forecast the expected actual cost of GGAS as a result of the delay in the introduction of the CPRS. The forecast is based on EnergyAustralia's expected total NGAC obligation for its entire portfolio over the relevant period to create an average \$/MWh cost for NGACs. EnergyAustralia's estimated cost of NGACs is based on its current NGAC inventories, forward NGAC contracts and a quantity of NGACs to be sourced from the market based on current forward price estimates.

The GGAS was expected to terminate on 1 July 2011 due to the introduction of the CPRS. IPART reflected this expectation by having a zero allowance for NGAC costs in the 2010 Determination due to the combination of the assumed termination of the scheme (due to the introduction of the CPRS) and a surplus of NGACs. Therefore the incremental NGAC costs resulting from the delay in the introduction of the CPRS are:

TABLE CONTAINING CONFIDENTIAL LOAD AND COST INFORMATION

The incremental NGAC costs includes an allowance for losses calculated based on the loss factor of 7.06% included in the 2010 Determination. This is required as NGAC obligations are based on purchases not sales.

As the delay in the introduction of the CPRS alters the key assumptions that resulted in a zero allowance, EnergyAustralia considers that the estimated costs of complying with GGAS over the Determination period reflect the incremental costs of the delay in the introduction of the CPRS. For the purposes of this Negative Pass Through Application, EnergyAustralia has ignored the changes in the NGAC target resulting from the changes to the RET scheme as the changes to the RET scheme have been covered under a separate pass through application.

The original surplus of NGACs existed due to the assumption that the GGAS scheme was to cease on 1 July 2011. Since this assumption no longer applies the surplus of NGACs no longer exists. Additional NGACs need to be produced in order for the New South Wales retailers to meet their obligations under the GGAS. Accordingly the scheme now imposes a real resource cost on society. The resource cost of meeting the GGAS obligation for retailers is the cost of eligible technology to meet the target.

The previous LRMC of GGAS was assumed in the Final Determination as zero on the basis that an excess of NGACs already existed. As GGAS will continue beyond 1 July 2011, this assumption no longer holds.

A number of amendments were also made to the GGAS on the basis that it would cease operation on 1 July 2011, the date the CPRS was expected to commence. These changes were:

- The energy efficiency component of GGAS ceased on 30 June 2009. This means that only on-site generation activities are able to create NGACs for activities taking place under the Demand Side Abatement (DSA) rule. On-site generation accounts for only around seven per cent of certificates created under the DSA rule. Therefore, the impact of this amendment is likely to have a significant on the cost of creating new NGACs.
- Category A generators have been prevented from creating certificates for abatement activity after 30 June 2010.
- New accreditations were prohibited and the transfer of accreditation suspended.

In addition to these amendments, the volume of NGACs voluntarily surrendered also increased. This is likely to have been in anticipation of the scheme ending.

The reduced scope of the scheme, in addition to an increased voluntary surrender of NGACs, is expected to drive up the LRMC of meeting the scheme. This is because there is a reduced supply of eligible providers of certificates and a reduced amount of excess certificates. Therefore, it can reasonably be expected that more expensive technologies or activities are required to meet the target than would otherwise have been the case.

As previously noted, given the considerable uncertainty associated with the potential introduction of a price on carbon, EnergyAustralia considers that it would be inappropriate to assume that a CPRS will be introduced during the 2010 – 13 determination period.

3.1.3 RET

The price of RECs is affected by expectations about the wholesale energy price. That is, the amount of subsidy required through RECs depends on the wholesale energy price. Given a certain price threshold is required to support a renewable energy project, a lower wholesale energy price means the price of RECs will need to increase to encourage renewable generators to participate in the market and visa versa. Following the delay in the introduction of the CPRS the wholesale energy price for 2011/12 onwards will be lower than that previously assumed as the energy price will no longer include a cost of carbon and therefore the REC price is expected to increase.

It is EnergyAustralia's strong view that as a guiding principle for LRET, LRMC is the appropriate benchmark to be applied for cost recovery. This reflects that Standard Retailers will be required to underwrite projects in order to meet their obligations.

The following table provides the estimate of the actual impact on efficient costs for EnergyAustralia relative to the amounts allowed for in the 2010 Determination.

TABLE CONTAINING CONFIDENTIAL LOAD AND COST INFORMATION

As with the NGAC costs the incremental RET cost includes an allowance for losses, calculated based on the loss factor of 7.06% included in the 2010 Determination.

For the purposes of this Negative Pass Through Event Application, EnergyAustralia has ignored the changes in RPP resulting from the changes to the RET scheme resulting from the *Renewable Energy (Electricity) Amendment Act 2010*.

EnergyAustralia has forecast the expected actual costs of the RET given the delay in the introduction of the CPRS. EnergyAustralia's estimated cost of RECs following the delay in the introduction of the CPRS was estimated based on its current REC inventories, firm forward contracts and a quantity of RECs to be sourced from the market based on the current forward curve price estimates. EnergyAustralia considers that the REC price required to support a new renewable project is well in excess of these levels, approaching the penalty rate of \$65/MWh.

For the purposes of this pass through application Energy Australia is utilising internally generating costs that are reflective of actual costs incurred and likely to incur. It is important to note that the numbers in the table above for 2010/11 are below current market prices and the LRMC of RECs. However, EnergyAustralia considers this to be an efficient and justifiable forecasts of costs incurred and expected to be incurred during 2010/11. As the 2011/12 and 2012/13 prices included in the table above are subject to future changes in the forward curve, Energy Australia would expect these costs to revert to a more sustainable price level consistent with the expected LRMC of meeting the scheme.

EnergyAustralia recognises that the REC costs presented in this table represent the combined impacts of the delay in the introduction of CPRS and the changes to the RET legislation (the subject of a separate pass through application). While IPART has indicated that it intends to deal with the two events separately, it is only possible to separate out the cost impacts in a theoretical sense.

In examining the relationship between wholesale energy price and REC costs the LRMC of meeting the RET is such that the marginal plant coming into the market earns enough from the electricity market (which is assumed to equate to the LRMC of black generation) and certificate transactions to recover the LRMC of renewable generation.

This is because eligible renewable generators receive revenue in two ways:

- Through the wholesale energy price; and
- By selling RECs.

If the wholesale price is lower, due to the absence of a carbon price, then, by implication, this will increase the marginal cost of a REC. This is because the size of the subsidy for renewable generators will need to increase in order for the marginal renewable generator to recover total costs.

**DISCUSSION OF LPMC CONTAINING CONFIDENTIAL INFORMATION
REMOVED**

3.1.4 Total Impact on Costs

The total change in costs due to the delay in the CPRS is the combined impact of

- the savings due to the removal of carbon costs from the energy purchase cost;
- the increased cost of NGACs due to the continuation of the GGAS beyond the assumed 30 June 2011 expiry; and
- the incremental cost RET costs.

The table below summarises the cost impact that EnergyAustralia anticipates as a result of the delay in the introduction of the CPRS (the Negative Pass Through Event)⁷:

TABLE CONTAINING CONFIDENTIAL COST INFORMATION

The final column shows the total amount to be passed through to customers as a result of the Negative Pass Through Event. This includes a margin component of 5.4% on the anticipated costs and savings as allowed for in the 2010 Determination but excludes any allowance for the time value of money.

EnergyAustralia proposes to pass the savings through to customers in the following manner⁸:

⁷ Required under Clauses 4.1(c)(3) and 4.1(c)(4) of Schedule 4 of the 2010 Determination.

⁸ Required under Section 3.1(b)(5) of Schedule 4 of the Determination.

Financial Year	Amount to be pass through (\$ '000)
2011/12	\$(21,633)
2012/13	\$(265,652)
\$2010/11	

The amount to be passed through in 2011/12 is the sum of the increases/savings for 2010/11 and 2011/12, with the addition of a further \$█ million to account for the delay in recovering the costs. This amount has been calculated using a WACC of 9.1%⁹ based on a 12 month delay in the revenue being recovered. The amount to be passed through in 2012/13 relates to the savings that occur in 2012/13.

These amounts have been calculated relative to the carbon inclusive costs included as part of the 2010 Determination published in March 2010. The annual review to be conducted in accordance with Clause 3 of Schedule 2 of the Determination will review the Total Energy Cost Allowance and thus the energy purchase cost allowance and the green allowance. This should result in the 2011/12 and 2012 /13 allowances reflecting the delay in the CPRS scheme.

As a result of the presence of the Annual Review, the outcome of this cost pass through application should be a recovery of \$23 million¹⁰ in 2011/12, this amount being the incremental increase in costs for 2010/11 resulting from the delay in the introduction of the CPRS.

⁹ 9.1% being the real pre-tax Retail WACC in the 2010 Determination.

¹⁰ In \$2010/11

4 Conclusion

EnergyAustralia is applying for a Negative Pass Through Event resulting from the delay in the introduction of the CPRS which was announced by the Commonwealth Government on 27 April 2010. The announcement of the delay in the introduction of the CPRS meets the definition of a Regulatory Change Event and the cost impact of the announcement meets the Materiality threshold set in the 2010 Determination. As both the definition of a Regulatory Change Event and the Materiality threshold is met, the event meets the definition of a Negative Pass Through Event.

As a result of the announcement of the delay in the introduction of the CPRS, EnergyAustralia is likely to incur savings of approximately \$[REDACTED] million over the period of the Determination when compared with the allowances included in the 2010 Determination. However, while there are savings over the three years of the Determination there has been an increase in costs for the 2010/11 financial year. This assumes that a CPRS will not be introduced during the Determination Period.

The savings that EnergyAustralia will incur are from the removal of the carbon component from the Energy Purchase Cost in 2011/12 and 2012/13. EnergyAustralia has forecast these savings using consistent with the carbon impact estimated by IPART in the 2010 Determination.

The delay in the introduction of the CPRS results in increased NGAC costs over those allowed for the 2010 Determination. The 2010 Determination assumed the GGAS would cease on 1 July 2011 due to the introduction of CPRS and the current surplus of certificates. This assumption is no longer correct.

As the price of REC is affected by expectations of about the wholesale energy price it follows that the removal of the carbon component from the energy purchase cost results in an increase in the price of RECs. The lower energy purchase costs (following the removal of the carbon component) results in a higher REC price.

While the total savings due to the delay in the introduction of the CPRS are forecast at \$[REDACTED] million, the Annual Review to be undertaken by IPART for 2011/12 and 2012/13 will achieve these savings. Therefore, a recovery of \$23 million¹¹ in 2011/12 being the increased costs incurred by EnergyAustralia in 2010/11 as a result of the delay in the introduction of the CPRS is required.

¹¹ In \$2010/11