CALIFORNIA ISO
COST ALLOCATION GUIDING PRINCIPLES

COMMENTS OF THE STAFF OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION ON THE FEBRUARY 14, 2012 STRAW PROPOSAL

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March 1, 2012

The Staff of the California Public Utilities Commission ("CPUC Staff") appreciates this opportunity to comment on the California Independent System Operator's ("CAISO"), *Cost Allocation Guiding Principles Straw Proposal* ("Straw Proposal").

1. The CAISO Should Keep this Initiative at the Level of Guiding Principles and not Address Allocation of any Specific Costs.

The CPUC Staff supports the CAISO's decision to draft the Straw Proposal in a manner that addresses, and stays at the level of general principles rather than the allocation of specific costs or the identification of specific market participants or technologies to whom costs should be allocated. The CPUC Staff believes that the establishment of cost allocation principles that are understood and supported by stakeholders may expedite the challenging processes of developing cost allocation methods for specific services and products in future stakeholder initiatives. But this initiative and future cost-allocation efforts will be most constructive if the guiding principles established here are just that – principles that can be applied broadly – and do not delve into particular costs, products, services, or effects on particular market participants. The allocation of specific costs (in later initiatives) should be informed by the principles developed here but based on the specific circumstances at hand and consider tradeoffs and balancing of conflicting principles.

Accordingly, the CPUC Staff recommends that the Guiding Principles avoid discussions of the specific mechanics of cost allocation, including the way that costs are tracked and billed (e.g., market data and billing determinants). Such empirical specificity should not be a part of guiding principles development. Rather, the value of this initiative lies in establishing boundaries, priorities, and values that should be considered when determining how to allocate any specific costs. Although these boundaries and priorities might be refined and adjusted over time, they should be established here to provide a starting platform for cost allocation discussions in future initiatives and avoid rehashing the basic principles over and over again.

2. *Cost Causation and Comparable Treatment Principles Must be balanced with California's Policy Goals and Priorities.*

The Straw Proposal's identifies three principles – Causation[1], Comparable Treatment and Policy Alignment – that are all valid and important but that will require making tradeoffs when applied to determine how to allocate specific costs under specific circumstances. The CAISO should explicitly recognize the need for these tradeoffs when defining the Policy Alignment principle and should ensure that the Cost Causation and Comparable Treatment principles do not thwart or impede the achievement of California's policy goals and objectives. Rather, the application of these two principles may have to be tempered in specific instances in order to align with California's energy policies.

California's policy objectives themselves should not distort or preclude objective assessment of cost causation and comparable treatment. Indeed, economic efficiency and cost allocation assessments can and should inform implementation strategies for policy objectives. Further, California's ongoing selection and prioritization of energy and environmental policy objectives should be informed by objective considerations of cost causation and comparable treatment. But the CAISO's guiding principles should also

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[1] The CPUC Staff suggests renaming the fist principle, "Causation" to "Cost Causation."

recognize that state energy policies are not determined exclusively (or in some instances even largely) based on considerations of operational market efficiency through the cost causation and comparable treatment principles. Thus, in some instances the Policy Alignment principle may need to be balanced against the short-term economic efficiency principles inherent in the Cost Causation and Comparable Treatment principles.

Accordingly, the CPUC Staff suggests revising the "Policy Alignment" principle to recognize this issue as shown by the underlined (added) and strikethrough (deleted) text below:

> *Policy Alignment – The cost allocation design supports the economically efficient achievement of state and federal policy goals* *<u>and does not obstruct or impede the achievement of California's state energy policies and policy goals</u>. Economic efficiency is achieved through the design and allocation of costs in the ISO market <u>in a manner that provides</u>~~, incorporating costs/benefits in the bilateral capacity market, and providing additional~~ cost transparency ~~in the ISO market for other policy decisions~~.*
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> *~~An implementation question in a~~Allocating costs in accordance with policy alignment <u>may help determine how to apply "Cost Causation" in specific instances</u>~~is the mechanism for allocating costs according to causation~~. For example<u>, if operation of certain resources drives certain costs then those costs may be said to be "caused" by the resources themselves, by those who schedule the resources, or by those who purchase the output, so that Policy Alignment (or other) principles may determine how the Cost Causation principle is best applied in a particular instance</u>~~. is alignment with achieving some policy goals more optimally achieved by allocating costs to load-serving entities that bilaterally procure resources that drive certain costs? In other cases, it may better align with policy goals, as well with other of these principles, to allocate costs directly to the resources that drive the costs.~~ <u>On the other hand there may be multiple cost allocation methods available that support state</u>*

and federal policy goals, and in such instances, application of the Cost Causation and Comparable Treatment principles may aid in finding the most economically efficient method.

3. *The Definitions of the "Incentivize Behavior" and "Manageable" Principles should Reflect Their Interdependence in Producing Desired Market Behavior.*

The "Incentivize Behavior" and "Manageable" principles are closely interrelated and must be defined to work together effectively in application. "Incentivize Behavior" should focus on identifying the market actors at issue, the *kinds* of efficient behavior that should be incentivized, and what cost allocation *signals* would elicit the desired responses. "Manageable" should focus on ensuring that the costs are allocated in a manner, and targeted at particular entities, so that the entities to whom costs are allocated can realistically (financially, physically, or otherwise) manage their cost exposure and exercise the behavior required to avoid the costs. If this is not the case, the cost allocation is ineffective. In other words, an economic signal is not going to be effective at incentivizing desired behavior unless it is sent to the right market participants in a manner designed to elicit the right behavior, and the market participants actually have the ability to exercise such behavior. Fundamentally this recognizes a need to balance other principles, especially Cost Causation and Comparable Treatment, against realistic ability to respond.

The CPUC Staff suggests the following revisions to the Incentivize Behavior and Manageable principles to recognize this balance, shown in the underlined (added) and strikethrough (deleted) text below:

> *Incentivize Behavior – Providing appropriate incentives is key to an economically efficient market. Profit maximization or other self-interest behaviors by market participants that are appropriately allocated the market costs should lead to lower costs incurred by the ISO market over a reasonable timeframe. This requires identifying the desired behaviors and the market entities to allocate the costs to produce those behaviors. The market design and cost allocation should also recognize when multiple ~~other~~ market mechanisms incentivize the same behavior (for example,*

having to pay for additional kinds of ancillary services and exposure to real-time prices for deviations from day-ahead schedules both provide~~s an~~ incentives to reduce deviations).

Manageable - Market participants should have the ability to manage exposure to the allocation. The market design should seek to minimize variability and complexity of the allocation and maximize the transparency of cost drivers. This principle is important for ensuring that cost allocations have the desired effect. Costs allocated to targeted market participants can only elicit desired, efficient, behavior if market participants are able to effectively manage exposure to the costs by behaving in a manner that avoids the costs or by otherwise managing or hedging cost exposure. Allocating unmanageable costs does not provide market participants with the opportunity to minimize the cost drivers the cost allocation is intended to incent. If a market participant is given sufficient opportunity to manage costs in an economic manner and is unable to do so, then that participant's exit from the market is not necessarily inconsistent with this principle.

4. The CAISO Should Add a Principle of "Transparency and Disclosure" to Promote its own Efficient Implementation of Market Processes that Impose Costs.

The CAISO should include a principle of "Transparency and Disclosure" to the Cost Allocation Principles adopted through this initiative. This principle would address a need to provide transparency of what actual costs are allocated for specific services and initiatives by timely and regularly disclosing the procurement, deployment, costs, and information on how costs have actually been allocated among types of market participants for CAISO market services subject to the cost allocation principles.

None of the proposed principals recognizes that the CAISO is often itself a market participant who, in the first instance, bears the costs that it subsequently allocates. The CAISO procures services and thus generates costs based on its own estimates of needs, and it allocates these costs based on its own determination of causation and other factors for the particular services in question. Transparency and disclosure will provide incentives for the CAISO itself to manage costs efficiently and will allow other stakeholders an ongoing opportunity to assess how well the CAISO is pursuing efficient behavior, since efficient behavior by the CAISO itself is essential for successful application of *all* of the principles. The CAISO should thus include a principle of "Transparency and Disclosure", and should explicitly recognize that its own transparent, disclosed and efficient behavior is a necessary component of all of the other principles.

Limits on transparency and disclosure are also part of this principle and need to be recognized in its application. It is important to protect market participants' sensitive or confidential information, or information that if released could actually harm market efficiency or ratepayers. Nevertheless, it is also critical to ensure that a principle exists that ensures market participants will have a sufficient ongoing ability to assess costs and cost allocation, and thus ultimately help the CAISO apply the most effective market mechanisms.

Further, the "Rational" principle (in essence, stating that benefits should outweigh implementation costs and complexity) cannot be effectively pursued unless the CAISO adopts the additional principle of "Transparency and Disclosure".

5. *A "Harmonization" (In Place of "Synchronization") Principle Should Ensure that the Actual Mechanisms of Cost Allocation are Not Opaque and are as Transparent and Accessible as Possible.*

Finally, the CPUC Staff recommends using the term "Harmonization" instead of "Synchronization" for the second to last principle. Consistent with the added principle of "Transparency and Disclosure," this "Harmonization" principle should expressly refer to allocating costs based on information and processes that are readily developed (or already available) such as billing determinants and market information, and that are transparent and accessible to stakeholders.

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