



## **Comments on the Straw Proposal for Cost Allocation Guiding Principles Department of Market Monitoring February 29, 2012**

The Department of Market Monitoring (DMM) appreciates the opportunity to provide comments on the Cost Allocation Guiding Principles Straw Proposal posted on February, 14 2012.

### ***Holistic Approach***

DMM supports the ISO's decision to evaluate cost allocation principles uniformly across initiatives. It is more efficient to use a consistent set of guidelines across market initiatives rather than approach each market initiative as a unique process. Allocating costs is often an unwieldy exercise and a holistic approach can help frame individual market initiative market design and cost allocation decisions. We feel the ISO's timeline is reasonable and support the second stakeholder initiative to review how other costs are allocated later in 2012. DMM also supports applying these principles at the earliest opportunity, which appears to be the allocation of costs associated with the flexible ramping product.

In our last two annual reports, DMM has expressed support for efforts to apply principles of cost causation when allocating costs of ancillary services and other new products being developed to facilitated increased reliance on intermittent resources. As noted in our 2009 Annual Report<sup>1</sup>:

The costs of any additional ancillary services needed to integrate different resources should also be allocated in a way that reflects the reliability and operational characteristics of different resources. This will help ensure proper price signals for investment in different types of new resources. As increased reliance is placed on renewable energy and demand response resources, this will also ensure that the ISO maintains the necessary mix of resources to maintain reliability and market efficiency.

DMM reiterated this recommendation in our 2010 Annual Report.<sup>2</sup>

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<sup>1</sup> 2009 Annual Report on Market Issues and Performance, April 2010, p. 23.

<http://www.caiso.com/Documents/2009AnnualReportonMarketIssuesandPerformance.pdf>

<sup>2</sup> 2010 Annual Report on Market Issues and Performance, April 2011, p. 13

<http://www.caiso.com/Documents/2010AnnualReportonMarketIssuesandPerformance.pdf>

## ***Guiding Principles***

Market design initiatives can be broken into three parts: (1) defining the objective of the initiative, (2) the design the ISO proposes to achieve the objective, and (3) the allocation of the costs that occur due to the market design. DMM believes that adhering to principles of cost causation to the degree practicable when allocating costs is ultimately the best way to ensure that the objective of initiatives is achieved as efficiently as possible.

Moreover, DMM believes that if cost causation principles are followed in the assignment of cost allocation, this is most consistent with other key guiding principles outlined in the ISO straw proposal: *incentivizing efficient behavior, comparable treatment, synchronized and rational*. Ultimately, we believe that placing emphasis on allocation cost of costs based on cost causation is also consistent – at least over the long run – with the principles of *manageable* and *policy alignment*.

We also note that in some cases an exact formulation of cost causation may be difficult to derive or may be otherwise intractable. However, DMM believes that the short-run and long-run benefits of allocating costs most closely to the actions that caused them merit adopting this approach even if a close approximation must be adopted.

The merit of closely adhering to cost causation principles has also been acknowledged over time by the FERC, who has asserted that the ISO must allocate costs back to market participants in a just and reasonable manner according to the principles of cost causation.<sup>3</sup>

## **Causation**

Cost causation is the concept that costs should be allocated to the market participants whose activities create the cost. In the short run, this provides a signal and incentive for participants to reduce their cost-causing activity, resulting in more efficient, cost minimizing, market outcomes. Over the longer term, this provides incentives to incorporate these costs when making investment decision between different technologies. For instance, if one type of renewable resources (such as solar) imposes significantly integration costs than another resource (such as wind), then this can be factored into the relatively economics of these two types of resources. This may also provide a way design or retrofit new or existing resources in a way that cost effectively reduces the costs of integrating these resources into the system.

When no cost causation relationship can be reasonably determined, a next-best approach is to allocate cost in proportion to participants who benefit most from the actions taken that create the cost. Many of the current costs as well as costs from envisioned new products can be reasonably linked to market

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<sup>3</sup> *K N Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992) (defining cost causation as “requiring that all approved rates reflect to some degree the costs actually caused by the customer who must pay them.”) Also, as recent as September 30, 2011 in FERC’s Order Accepting 2012 Grid Management Change Tariff Amendment FERC has ordered the ISO to design rates in accordance with cost causation principles. (Docket No. ER11-4000-000)

participant activity. This creates an opportunity for the ISO to improve market efficiency and provide incentives to reduce unwanted participant actions through allocating cost based on cost causation principles.

For these reasons, DMM believes that cost causation should be the primary principle applied to cost allocation. Even in cases where no exact formulation is obvious or tractable, a reasonably close linkage is preferred than defaulting to allocating to those who benefit from the cost causing activity or simply socializing the cost.

### **Incentivize Behavior**

The ISO in the guiding principles separates “cost causation” from “incentivize behavior”, but acknowledges an overlap. Again, DMM believes the primary principle used in cost allocation is cost causation since this generally incentivizes efficient behavior. At the same time, cost allocation should not be adjusted beyond cost causation to provide further incentives. Instead, any need for further incentives for efficient behavior should be directly and explicitly incorporated in the market design.

### **Comparable Treatment**

DMM believes “comparable treatment” (or technology agnostic) is a vital guiding principle for market design and cost allocation that we have continually supported in our comments. Resources have different technological capabilities and operating attributes. Given the comments above regarding allocation based on cost causation, the principle of comparable treatment is best applied in the design of market products and rules. Cost allocation based on cost causation principles will inherently impose comparable treatment and eliminate the need for discussion of fairness or comparable treatment. DMM agrees with the principle of comparable treatment, and recommends enforcing that in the cost allocation process through adhering to cost causation principles

### **Efficient Market Design**

The two proposed cost allocation guiding principles “synchronized” and “rational” are aspects of efficient market design. DMM recognizes that costly and complicated allocation mechanisms for what may be trivial cost allocation are irrational. However, in these cases a simplified approximation that is still in line with cost causation may provide a more rational solution. Again, DMM believes that adhering to cost causation principles is ultimately a key part of efficient market design.

### **Manageable**

DMM agrees with the goal to minimize variability and complexity of the allocation mechanism and maximize transparency. DMM recognizes that even with perfect transparency, there can be a lag to when market participants can adjust their behavior to best avoid certain allocated costs. Market participants may not have the ability to manage their exposure to cost allocation in the short-run. However, there can be strong incentives to invest or alter practices that provide efficiency over the longer run and help to meet the original design objectives. Moreover, it is not clear from the proposal

where costs would be allocated if they were not manageable when allocated in accordance with cost causation principles.

### **Policy Alignment**

Policy alignment is clearly an appropriate factor for the ISO to consider in the market design process. This is particularly true when considering alternative market designs that may be comparable in terms of efficiency or ways to remove any administrative barriers that may exist which may hinder achievement of policy goals.

However, in the case of the state's renewable energy policies, DMM believes that adhering to principles of cost causation when allocating costs is generally most consistent with these policies over the long run. Again, adhering to these cost causation principles ultimately provides incentives for more efficient behavior and investment decisions – which will in turn reduce the overall cost of achieving these policy goals. Seeking to introduce additional policy direction (or subsidies) through cost allocation will generally decrease the efficiency and potential effectiveness of the overall market design.