



California ISO
Shaping a Renewed Future

Cost Allocation Guiding Principles Draft Final Proposal

March 15, 2012

Cost Allocation Guiding Principles
Draft Final Proposal
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1 Introduction

This draft final proposal presents the ISO's proposed guiding principles for allocating ISO market costs among market participants. The ISO has committed to a holistic review of cost allocation of ISO market costs during several stakeholder initiatives over the past 18 months. In many of these individual stakeholder initiatives, the stakeholder community has not agreed as to how to allocate costs.

The ISO plans to first apply these guiding principles to the flexible ramping product currently being developed. Later in 2012, the ISO will commence a subsequent stakeholder initiative to review existing cost allocations to ensure they are consistent with the cost allocation guiding principles developed through this process.

The proposed cost allocation guiding principles have seven elements: (1) Causation, (2) Comparable Treatment, (3) Accurate Price Signals, (4) Incentivize Behavior, (5) Manageable, (6) Synchronized, and (7) Rational.

2 Plan for Stakeholder Engagement

Item	Date
Post Guiding Principles Draft Final Proposal and Flexible Ramping Product Cost Allocation Straw Proposal	March 15, 2012
Stakeholder Meeting	March 19, 2012
Stakeholder Comments Due	March 29, 2012
Post Flexible Ramping Product Cost Allocation Draft Final Proposal	April 2, 2012
Stakeholder Meeting	April 9, 2012
Stakeholder Comments Due	April 16, 2012
Board Meeting	May 16, 2012

3 Changes from Straw Proposal

This draft final proposal reflects the following changes from the straw proposal:

- Changed the title of the “Policy Alignment” principle to “Accurate Price Signals” to better reflect the intent of the principle.
- Added the need to recognize transitional impacts within the “Manageable” principle;
- Minor clarification to other guiding principles based upon stakeholder comments.

4 Development and Application of Guiding Principles

The ISO has committed to a holistic review of cost allocation during several initiatives over the past 18 months. The stakeholder community has been divided on how to address cost allocation in these individual stakeholder initiatives.

Stakeholders have recently commented on cost allocation issues in the following stakeholder initiatives:

- 2012 Grid Management Charge¹
- Flexible Ramping Constraint²
- Renewable Integration: Market and Product Review Phase 1³
- Renewable Integration: Market Vision and Roadmap⁴
- Flexible Ramping Product⁵
- Pay for Performance Regulation⁶

The ISO reviewed stakeholder comments from these initiatives to develop the straw proposal for cost allocation guiding principles. The straw proposal was the starting point from which stakeholders further refined the guiding principles through this stakeholder process.

After receiving stakeholder comments, the ISO has refined and developed a final set of guiding principles. The ISO has applied these guiding principles to develop a straw proposal to allocate the costs of the flexible ramping product currently being developed. Based upon stakeholder comments, the ISO will further refine the flexible ramping product cost allocation mechanism

¹ Additional information is available at <http://www.caiso.com/Documents/2012%20grid%20management%20charge%20process%20-%20papers%20and%20proposals>

² Additional information is available at <http://www.caiso.com/informed/Pages/StakeholderProcesses/CompletedStakeholderProcesses/FlexibleRampingConstraint.aspx>

³ Additional information is available at <http://www.caiso.com/informed/Pages/StakeholderProcesses/RenewableIntegrationMarketProductReviewPhase1.aspx>

⁴ Additional information is available at <http://www.caiso.com/informed/Pages/StakeholderProcesses/RenewableIntegrationMarketProductReviewPhase2.aspx>

⁵ Additional information is available at <http://www.caiso.com/informed/Pages/StakeholderProcesses/FlexibleRampingProduct.aspx>

⁶ Additional information is available at <http://www.caiso.com/informed/Pages/StakeholderProcesses/PayforPerformanceRegulation.aspx>

and will seek approval for both the market design and cost allocation mechanism when the ISO seeks Board approval in May 2012 for the flexible ramping product.

The ISO will commence a second stakeholder initiative to review how other costs are allocated later in 2012. The initiative will review all current cost allocations and assess how well the allocations align with the cost allocation guiding principles. The ISO seeks stakeholder comments regarding the prioritization of applying the cost allocation principles to other product allocations and uplifts to be reviewed in the second stakeholder initiative.

Several stakeholders commented that the ISO can apply the cost allocation guiding principles to all cost allocations and uplift simultaneously rather than first applying to the flexible ramping product. The ISO disagrees. It is beneficial to evaluate the appropriateness of the guiding principles by actually applying them to a specific product. As many of the same stakeholders argued, the guiding principles have limited value until applied to a specific product. More importantly, the ISO believes that cost allocation is a necessary component of the flexible ramping product when the ISO seeks approval from FERC. Since the flexible ramping product is will be brought to the Board for approval in May 2012 and subsequently FERC in mid-summer it is appropriate to prioritize applying the cost allocation guiding principles to the flexible ramping product design.

5 Proposed Guiding Principles

Several stakeholders commented that there may be instances where the guiding principles are in conflict. The ISO agrees that there may be instances where strict adherence to one guiding principle may conflict with another. However, the ISO intends to use the guiding principles to guide cost allocation market designs. The principles should not be viewed as strict design rules. The ISO will seek to maximize adherence to the guiding principles, however, the proposed design may not strictly adhere to a specific guiding principle due to limitations inherent in the cost allocation design or implementation timeframe.

The guiding principles that the ISO proposes for allocating costs are summarized below:

Causation – Costs will be charged to resources and/or market participants that benefit from and/or drive the costs. It is a fundamental tenant of just and reasonable energy markets that costs are allocated in this manner.

This principle has some overlap with the “Incentivize Behavior” principle below, as properly allocating costs in accordance with their causation provides an incentive to minimize the cause of the costs. For example, this is a key tenant behind locational marginal pricing market design, in which energy prices reflect a generating unit’s contribution to exacerbating or relieving transmission congestion.

For each type of charge in the ISO market, the ISO market settlement generally collects payments from one set of market participants that use a product and then allocates these payments to market participants that provide the product. Appropriate consideration of causation addresses both sides of the settlement process, considering how costs are allocated as well as how the collected proceeds are distributed back out to the market. This is also an important consideration for costs that the market design must over collect and then allocate the surplus (e.g. marginal loss surplus allocation).

The ISO is not proposing to change this guiding principle. Many stakeholders commented that this guiding principle alone is the primary objective in developing cost allocation market designs. While the ISO agrees that cost causation is an important aspect of cost allocation market design, it cannot be the sole guiding principle.

Comparable Treatment – Similarly situated resources and/or market participants should receive similar allocation of costs and not be unduly discriminated against. This principle is similar to “Causation” above, but is intended to emphasize non-discrimination as well as avoiding special treatment of different types of technologies and/or market participants. Once causation is identified for a particular cost, all similarly situated resources and/or market participants fitting the causation criteria should be allocated the costs. This principle is important in encouraging development of new technologies as well as ensuring fair treatment of existing ones.

The ISO is not proposing to change this guiding principle. Many stakeholders commented that this guiding principle is simple to state, but difficult to achieve in reality. While there may be instances where this is true, the ISO does not believe the difficulty in adhering to the guiding principle is justification for removing the principle.

Accurate Price Signals – The cost allocation design supports the economically efficient achievement of state and federal policy goals by providing accurate price signals from the ISO market. Economic efficiency is achieved through appropriate and accurate allocation of costs in the ISO market, incorporating costs/benefits in bilateral market transactions, and providing additional cost transparency.

Many stakeholders stated that the ISO should not consider state and federal policy goals in determining how to allocate ISO market costs. An interpretation of the prior “Policy Alignment” guiding principle was that the ISO would consider not allocating costs to a specific class of market participants because state and/or federal policy has prioritized development of specific technologies and/or has provided benefits to a certain class of market participants. This was not the ISO’s intent. The ISO believes that accurate price signals from the ISO markets are vital to achieving efficient implementation of state and federal policies and informing and influencing development of state and federal policy that are independent of the ISO markets.

Incentivize Behavior – Providing appropriate incentives is key to an economically efficient market. Profit maximization by market participants that are allocated costs should lead to lower costs incurred by the ISO market over a reasonable timeframe. Market design and cost allocation should also recognize when other market mechanisms incentivize the same behavior (for example, exposure to real-time prices for deviations from day-ahead schedules provides an incentive to reduce deviations).

Many stakeholders commented that the “Incentive Behavior” and “Manageable” guiding principles may be in conflict with each other. The ISO recognizes that there may be costs that cannot be avoided by a market participant given how the market participant currently manages its generation resource or load. Nevertheless, this is not sufficient justification that a resource or load should not be allocated costs consistent with cost causation. Incentivizing behavior should work in parallel with accurate price signals over a reasonable timeframe to provide market participants incentives to reduce the drivers that are incurring the costs.

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 results in a more predictable cost allocation. This principle is important for ensuring that cost allocations have the desired effect. Allocating unmanageable costs does not provide market participants with the opportunity to minimize the cost drivers the cost allocation is intended to incent. In addition, changes to cost allocation mechanisms should recognize that transitional measures may need to be assessed to allow sufficient time for market participants to implement within contractual arrangements.

Several stakeholders commented that if a resource cannot manage its cost allocation due to the nature of the resource type, then that is sufficient justification for not allocating costs to that resource. For example, resources that are inherently variable may not be able to manage costs based on variability. The ISO believes that this is the mirror image of other stakeholder comments that cost causation should be the primary guiding principle.

The ISO believes that costs allocated to resources because of their inherent characteristics should not be considered to be unmanageable as long as these costs are transparent. Consistent with this, the ISO acknowledges that allocating costs in accordance with these principles, particularly by cost causation, may result in allocations of costs that were not transparent and contemplated at the time parties entered into existing contractual arrangements. The ISO believes that this “Manageable” principle will call for appropriate transition periods and/or mechanisms for parties to assign costs in a manner that is consistent with their contractual agreements.

Synchronized – The cost drivers of the allocation should align as closely as possible to the selected billing determinant. For example, if a procurement target is set based upon expected outcomes, the actual outcome in a single settlement interval may not be indicative of the cost driver. Over an appropriate timeframe, the sum of actual deviations will be more aligned with the expected deviations used to set the procurement target.

The ISO proposes no changes to the synchronized guiding principle.

Rational - Implementation costs/complexity should not exceed the benefits that are intended to be achieved by allocating costs (e.g. it would be economically inefficient to mail a check/bill that is less than the cost of postage). Other market design changes must be identified and considered that can also achieve the desired outcomes. For example, allocation based upon deviations should consider the scheduling and metering granularity of different types of resources: import, export, load, internal generation. They are very different for these various resources and the implementation challenges should be considered in allocating costs. As with any market design component, the practicality of the proposed approach is an important consideration.

The ISO proposes no changes to the rational guiding principle.

6 Next Steps

The ISO plans to discuss this draft final proposal with stakeholders at a meeting on March 19. The ISO requests comments from stakeholders on the proposed guiding principles. Stakeholders should submit written comments by March 29 to CostAllocation@caiso.com.