California ISO
Shaping a Renewed Future

Cost Allocation Guiding Principles
Straw Proposal

February 14, 2012

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1 Introduction

This straw 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 intends, through this stakeholder initiative, to establish a set of cost allocation guiding principles that can be applied throughout the market.

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 ISO has reviewed stakeholder comments regarding cost allocation from individual stakeholder initiatives and used those comments to develop this straw proposal. The proposed cost allocation guiding principles have seven elements: (1) Causation, (2) Comparable Treatment, (3) Policy Alignment, (4) Incentivize Behavior, (5) Manageable, (6) Synchronized, and (7) Rational.

2 Plan for Stakeholder Engagement

Item	Date
Post Guiding Principles Straw Proposal	February 14, 2012
Stakeholder Conference Call	February 21, 2012
Stakeholder Comments Due	February 28, 2012
Post Guiding Principles Draft Final Proposal and Flexible Ramping Product Cost Allocation Straw Proposal	March 12, 2012
Stakeholder Meeting	March 19, 2012
Stakeholder Comments Due	March 26, 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 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 Charge[1]
- Flexible Ramping Constraint[2]
- Renewable Integration: Market and Product Review Phase 1[3]
- Renewable Integration: Market Vision and Roadmap[4]
- Flexible Ramping Product[5]
- Pay for Performance Regulation[6]

The ISO reviewed stakeholder comments from these initiatives to develop the straw proposal for cost allocation guiding principles. The straw proposal is the starting point from which stakeholders will be able to further refine the guiding principles through this stakeholder process.

After receiving stakeholder comments, the ISO will incorporate requested changes and refinements and propose a final set of guiding principles. The ISO will then apply these guiding principles to develop a straw proposal to allocate market 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 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 then 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.

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[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

4 Proposed Guiding Principles

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).

Comparable Treatment – Similarly situated resources and/or market participants should receive similar allocation of costs. 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.

Policy Alignment – The cost allocation design supports the economically efficient achievement of state and federal policy goals. Economic efficiency is achieved through the design and allocation of costs in the ISO market, incorporating costs/benefits in the bilateral capacity market, and providing additional cost transparency in the ISO market for other policy decisions.

An implementation question in allocating costs in accordance with policy alignment is the mechanism for allocating costs according to causation. For example, 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.

Incentivize Behavior – Providing appropriate incentives is key to an economically efficient market. Profit maximization by market participants that are allocated the costs should lead to lower costs incurred by the ISO market over a reasonable timeframe. The 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).

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. Allocating unmanageable costs does not provide market participants with the opportunity to minimize the cost drivers the cost allocation is intended to incent.

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. The procurement requirement was not set and the cost was not incurred because of the actual outcome, but because of the expected outcomes.

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.

5 Next Steps

The ISO plans to discuss this straw proposal with stakeholders during a conference call on February 21. The ISO requests comments from stakeholders on the proposed guiding principles. Stakeholders should submit written comments by February 28 to CostAllocation@caiso.com.