Memorandum

To: ISO Board of Governors

From: Keith Casey, Vice President, Market & Infrastructure Development

Date: May 9, 2012

Re: **Briefing on Cost Allocation Guiding Principles**

This memorandum does not require Board action.

EXECUTIVE SUMMARY

As part of several recent stakeholder initiatives to develop new market features, a number of market participants have maintained that traditional methods for allocating ISO market costs, in which many costs are simply allocated to load, are no longer appropriate. This is because the changing nature of the ISO system, particularly changes to the generation fleet, is causing other factors besides load variability and uncertainty to increase the balancing and other measures the ISO must perform to match supply with demand. In addition, recent FERC decisions reinforce the regulatory requirement to allocate costs consistent with cost causation principles.

In response, Management committed to stakeholders to conduct an overall review of the cost allocation of ISO market costs. Stakeholders have had a diverse range of opinions as to how individual costs should be allocated. Consequently, Management commenced a stakeholder initiative to develop a set of cost allocation guiding principles that could be applied to an overall review of how current market costs are allocated and similarly applied to cost allocation rules for new market products. Management reviewed and published on the ISO website stakeholder comments received on a straw proposal for these cost allocation guiding principles and made a number of modifications that are embodied in the draft set of cost allocation guiding principles described below.

The cost allocation guiding principles consist of seven elements:

1. **Causation:** Costs will be charged to resources that benefit from the service being procured or to resources that drive the procurement decision.
2. **Comparable treatment:** Market participants with similarly situated resources should receive similar allocation of costs and not be unduly discriminated against.

3. **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.
4. **Incentivize behavior:** Cost allocation design should provide appropriate incentives for market participants to take action to reduce costs
5. **Manageable:** Market participants should have the ability to manage exposure to the cost allocation.
6. **Synchronized:** Cost allocation is aligned with the timing and quantity of the service procured.
7. **Rational:** Implementation costs and complexity should not exceed the benefits that are intended to be achieved by allocating costs.

Management believes these draft cost allocation guiding principles can be further refined and improved by applying them to an actual market product. Therefore, the ISO has started to apply these guiding principles in developing the cost allocation rules for the new flexible ramping product currently being developed. Based upon recent stakeholder comments, Management is further refining the flexible ramping product cost allocation mechanism and is expecting to seek Board approval of both the design of the flexible ramping product and the method for allocating its costs at the July 2012 Board meeting.

Management plans to finalize the draft principles after completing the flexible ramping product stakeholder process and will consider stakeholder comments and recommendations received through both the flexible ramping product design effort and the separate stakeholder initiative on the cost allocation principles in finalizing these principles. Later in 2012, the ISO will start a stakeholder initiative to conduct an overall review of the allocation of ISO market costs to ensure they are consistent with the cost allocation guiding principles.

Management is not seeking Board approval of these cost allocation guiding principles, as they are likely to evolve over time, but felt this was an opportune time to review the principles with the Board and solicit feedback. Management intends to apply these guiding principles to all future cost allocation issues that are brought to the Board for decision. In doing so, the Board will have an opportunity to see how these principles are being applied in practice and to provide additional input to Management on further refinements to these principles or the method in which they are being applied.

DISCUSSION

The cost allocation guiding principles should not be viewed as strict design rules. For example, some stakeholders have commented that there are instances where the guiding principles are in conflict. Management agrees that a strict adherence to one guiding principle may, in practice, conflict with another cost allocation principle. Despite the potential conflicts that may arise, Management believes the guiding principles will be useful in guiding policy development. They are intended to serve as a common starting point against which tradeoffs can be made when applying them to the practical implementation concerns of specific market products.

The cost allocation guiding principles are summarized below.

Causation

Costs will be charged to resources that drive the procurement decision and resulting costs or benefit from the service the ISO procures. It is a fundamental tenet of just and reasonable energy markets that costs are allocated in this manner.

This principle compliments 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 tenet 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 such as the marginal loss surplus allocation.

Many stakeholders commented that this guiding principle alone is the primary objective in developing cost allocation market designs. While Management agrees that causation is an important aspect of cost allocation market design, it cannot be the sole guiding principle. Stakeholders’ opinions vary widely as to how cost causation principles should ultimately be applied. Management expects the appropriate application of the cost causation principle will result from robust stakeholder initiatives targeted to specific market costs.

Comparable treatment

Market participants with similarly situated resources 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. Once causation is identified for a particular cost, all market participants with similarly situated resources 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.

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, Management believes that this guiding principle nevertheless provides a valuable starting point for determining the allocation of ISO market costs.

Accurate Price Signals

This cost principle specifies that 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 and benefits in bilateral market transactions, and providing additional cost transparency.

Incentivize Behavior

Providing appropriate incentives is key to an economically efficient market. Rational economic decisions 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 “incentivize behavior” and “manageable” guiding principles may be in conflict with each other. Management 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 cost 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 cost allocation is intended to incentivize. 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 them 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. Management believes that this argument illustrates the need to balance diverse stakeholder comments such as those who state that cost causation should be the primary guiding principle.

Management 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 idea, Management acknowledges that allocating costs in accordance with these principles, particularly by cost causation, may result in allocations of costs that were not transparent and reasonably contemplated at the time parties entered into existing contractual arrangements. Management 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

Cost allocation should be aligned with the timing and quantity of the service procured and the driver leading to need to procure the service. 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.

Stakeholder comments are supportive of this principle. The "synchronized" guiding principle is highly relevant in the flexible ramping product cost allocation since the procurement target is set based upon expected variability and uncertainty, not actual deviations.

Rational

Implementation costs and complexity should not exceed the benefits that are intended to be achieved by allocating costs. For example, it would be economically inefficient to mail a check or a bill that is less than the cost of postage. In addition, 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, and internal generation. The timeframe over which deviations are measured 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.

Stakeholder comments are supportive of this principle.

CONCLUSION

Management refined and developed this draft set of guiding principles based upon stakeholder comments. Management is applying these guiding principles to develop a mechanism to allocate the costs of the flexible ramping product currently being developed. In response to stakeholder feedback, Management will further refine the flexible ramping product cost allocation mechanism and will seek approval for both the market design and cost allocation mechanism when Management seeks Board approval in July 2012 for the flexible ramping product.

Later in 2012, the ISO will commence a stakeholder initiative to review existing cost allocations to ensure they are consistent with the cost allocation guiding principles developed through this process.