Model State Protocols for Critical Infrastructure Protection Cost Recovery

Prepared for the
NARUC Ad Hoc Committee on Critical Infrastructure

by

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The views and opinions expressed herein are not necessarily those of the National Regulatory Research Institute (NRRI), the National Association of Regulatory Utility Commissioners (NARUC), the U.S. Department of Energy (DOE), or any particular state or federal regulatory commission.

FOREWORD

The cost recovery of expenses associated with protecting critical electric, natural gas, telecommunications and water infrastructures is one of the most important issues to be addressed by the NARUC Ad Hoc Committee on Critical Infrastructure. This report synthesizes the work of the Committee to date and identifies cost recovery protocols successfully used by State regulatory commissions to address infrastructure security cost recovery requests. These cost recovery protocols can serve as models for States and will provide an essential means to help ensure that our Nation's critical utility infrastructure is protected. The impressive amount of effort by State commissions shows a bedrock commitment for ensuring that utility infrastructure protection efforts are adequately funded in order that our Nation's consumers can continue to receive an uninterrupted supply of utility services.

Much of the Nation's critical infrastructure is subject to regulation through an administrative hearing process that is carried out through State public utility commissioners. The regulatory processes for recovering investment costs in utility infrastructures in many States are handled through rate of return regulation and other cost recovery mechanisms. This paper examines the manner in which investments to protect critical utility infrastructures can be effectively accommodated within these existing regulatory frameworks. The first part of the report provides an overview summary, and the subsequent parts provide a more detailed discussion.

I gratefully acknowledge the assistance provided by the U.S. Department of Energy's Office of Energy Assurance to support this important effort.

The Honorable Connie O. Hughes, Chair
NARUC Ad Hoc Critical Infrastructure Committee and
Commissioner, New Jersey Board of Public Utilities

EXECUTIVE SUMMARY

State regulators and energy utilities have focused a considerable amount of attention on protecting the critical infrastructure of America's electric and natural gas utilities. One example of this is the cost recovery work done by the NARUC Ad Hoc Committee on Critical Infrastructure. This report draws upon the extensive work of the Committee, most notably its two cost recovery workshops, and several critical infrastructure surveys of state commissions conducted by NRRI. The objective of the report is to provide state regulators with information about the variety of workable cost recovery protocols that exist for energy utilities.

This report to the Ad Hoc Committee on Critical Infrastructure identifies cost recovery protocols used by state commissions. ***In some states, new legislation or regulatory proceedings were developed to deal with cost recovery.*** In most instances, existing regulatory cost recovery mechanisms were used. Many of the cost recovery protocols involve some form of a rate case proceeding. In most states, commissions have not received a security-specific cost recovery request. It may be that incremental security costs did not reach a materiality threshold in some states, or that security costs were not discussed explicitly in rate case filings. Of the states that have directly addressed security costs, all have done so in a rate case context. Generally, either a separate protocol path was followed that was then paired with a rate case, or the whole cost recovery request was entirely made in a specific general rate case proceeding. ***In all instances, the rate case requirement that a recoverable cost be prudent, or just and reasonable, was a central concern.***

The different protocols are specific attempts to smooth out any bumps on the road to the recovery of prudently incurred costs. Some cost recovery examples include:

- **A Kansas Act providing for confidentiality of the amount requested and allowed.** (See 2003 Kansas HB 2374, codified as Kansas Statute Nos. 66-1234, 66-1235, and 66-1236.)

- **The Florida Commission's use of two adjustment clauses.** (See Florida Public Service Commission, Order No. PSC-02-1761-FOF-El and Florida Public Service Commission, Order No. PSC-01-2516-FOF-El.)

- **A Michigan Act allowing use of deferral accounts and a security recovery factor.** (See Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d.)

- **The New Jersey Board's establishing an ongoing dialogue.**

- **The Oklahoma Corporation Commission's use of a Notice of Inquiry process.** (See Oklahoma Corporation Commission, Case No. PUD 200300624.)

OUR SURVEY OF THE STATES FOUND THAT:

- **State regulators are committed to allowing cost recovery of critical infrastructure costs that are prudently incurred.**
- **Regulators generally felt that they did not have to reinvent the wheel; finding that their existing inventory of cost recovery protocols and cost recovery mechanisms is sufficient for energy utilities.**
- **In restructured states, state legislatures have sometimes acted to reaffirm that post 9/11 security costs are eligible for recovery, as long as the costs are reasonable or prudently incurred.**
- **Insurance should be a part of a utility's cost recovery efforts.**

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PART I

INTRODUCTION AND OVERVIEW

INTRODUCTION AND OVERVIEW

An important new concern for utility industries and regulators alike is the need for cost recovery of security-related expenditures. Utilities expect that state commissions will approve recovery of appropriate critical infrastructure protection costs. The NARUC Ad Hoc Committee on Critical Infrastructure has conducted several surveys, undertaken a series of cost recovery workshops and commissioned this study in order to assist state regulators in developing model cost recovery protocols that address this need.

An important issue raised during the NARUC/DOE cost recovery workshops and by many state commissions in general, was the need for a practical examination and documentation regarding the best ways to handle cost recovery for security related expenses.[1] The nation's utilities have clearly made post 9/11 security investments in both restructured and non-restructured states. This report identifies and discusses critical infrastructure protection cost recovery protocols that are appropriate for energy utilities in a variety of regulatory frameworks. It also includes the existing cost recovery mechanisms successfully used by state commissions associated with each protocol.

What is a Cost Recovery Protocol?
What is a Cost Recovery Mechanism?

Cost recovery protocols, like much of regulation, are about process.

- A **cost recovery protocol** is the identifiable process that a commission uses to address a request by a utility in order to determine whether requested monies will be recovered.
- A **cost recovery mechanism** is the specific technique used for cost recovery. The protocol underlies the logic path for cost recovery for a rate regulated utility and the cost recovery mechanism, say, an adjustment clause, is how the commission authorizes the actual cost recovery.

Many Cost Recovery Protocols Exist

Since 9/11, a number of state commissions have responded to utility cost recovery requests.[2] The cost recovery protocols and mechanisms examined in this report are all reasonable approaches and no one protocol or cost recovery mechanism is recommended over another as the circumstances in different states may make one protocol more appropriate than another. As will be seen later, the actual cost recovery mechanisms — such as a deferral account — can be used in more than one protocol.

In some instances, new legislation or regulatory proceedings were developed to deal with critical infrastructure cost recovery. In most cases, existing regulatory cost recovery mechanisms were used. ***Nearly all of the protocols include a path to some form of a rate case proceeding.*** This

level of activity seems to indicate that the Ad Hoc Committee on Critical Infrastructure's efforts to develop critical infrastructure cost recovery protocols are well timed and will be helpful to a number of state regulatory commissions.

State commissions have reacted in a positive and timely way to address the cost recovery requests of their energy utilities. The protocols and cost recovery methods examined in this report provide a benchmark guide for best practices that all regulatory commissions can use.

1. COST RECOVERY ACTIVITIES, PROTOCOLS AND MECHANISMS

Cost recovery protocols mirror the regulatory reforms that states have undertaken in the past decade. In the energy arena a mix of rate base regulated and competitive market regulatory frameworks exist, with cost recovery requests occurring only in the regulated portions of each sector. In addition to energy utilities, water utilities have made a significant number of recovery requests, all of which have been handled under a rate base regulatory process. Some form of price caps is the dominant type of regulation for telecommunications utilities. Accordingly, it is not unexpected that no security cost recovery requests were reported in our survey for telecommunications utilities or providers.

Figure 1 provides a general framework for the discussion of cost recovery protocols and identifies three protocols (administrative, traditional, and restructured) along with a set of cost recovery mechanisms.[3] While any state regulatory commission may have important variations, the protocols can be applied to different regulatory regimes and specific cost recovery situations. Because the cost recovery mechanisms available are the same for all three protocols, the real regulatory differences in Figure 1 are driven by three considerations:

1. ***Do pre-existing critical infrastructure cost recovery mechanisms already exist?*** If the answer is "Yes", then it is appropriate to use the administrative protocol for those pre-existing mechanisms.
2. ***Is the energy market in the state subject to traditional rate-based regulation?*** If the answer is "Yes", then the traditional regulatory protocol is the correct protocol.
3. ***Has the energy market in the state been restructured?*** If the answer is "Yes", then the restructured protocol is the one to use.

The three protocols shown in Figure 1 arise because of the differences in the underlying logic within each. All states have administrative processes that occur on the front end of a cost recovery issue. Depending on the circumstances, this may lead directly to a cost recovery mechanism, or down one of the other protocol paths (traditional or restructured).

In a restructured environment, the protocol logic says cost reimbursement requests are examined differently than in a traditionally regulated market. Regulatory standards such as used and useful, just and reasonable, and prudence tests are similarly applied in each protocol, except that a competitive market perspective is also employed in the restructured regulatory environment. In most states, security investments have been initiated by utilities and not necessarily solely in response to governmental directives (see Figure 2). Interestingly, the utilities in most states have not filed for recovery security costs (see Figure 3).

Figure 1: Security-Related Cost Recovery Protocols and Mechanisms

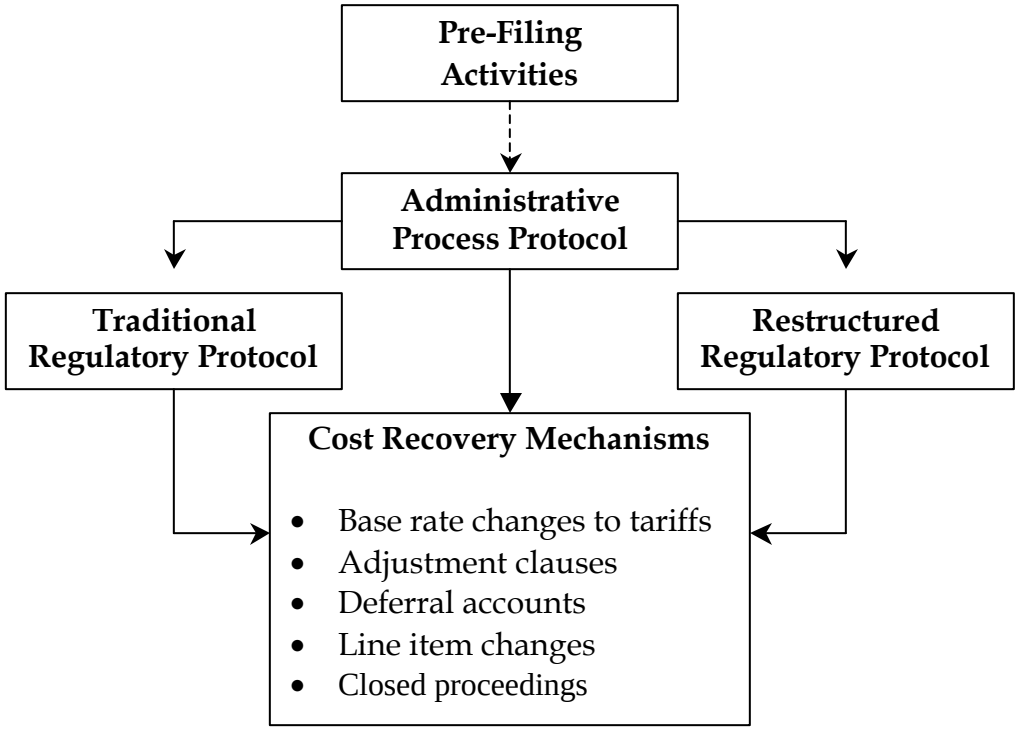
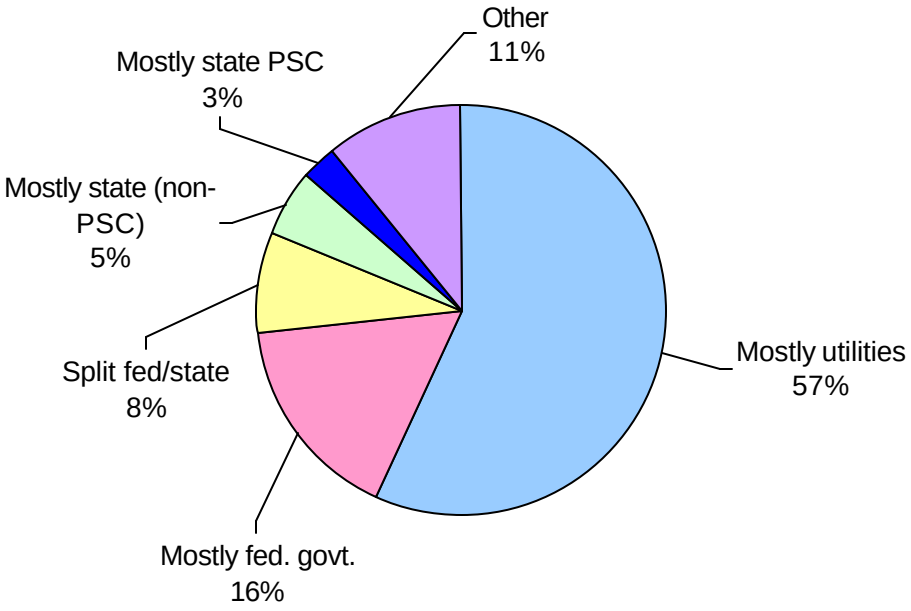


Figure 2: Who is driving security-related investments?



According to state public service commissions (PSCs) - It is mostly the utilities.

Source: Authors' construct from McGarvey and Wilhelm (2003), n=37 (10 other states reported no investments).

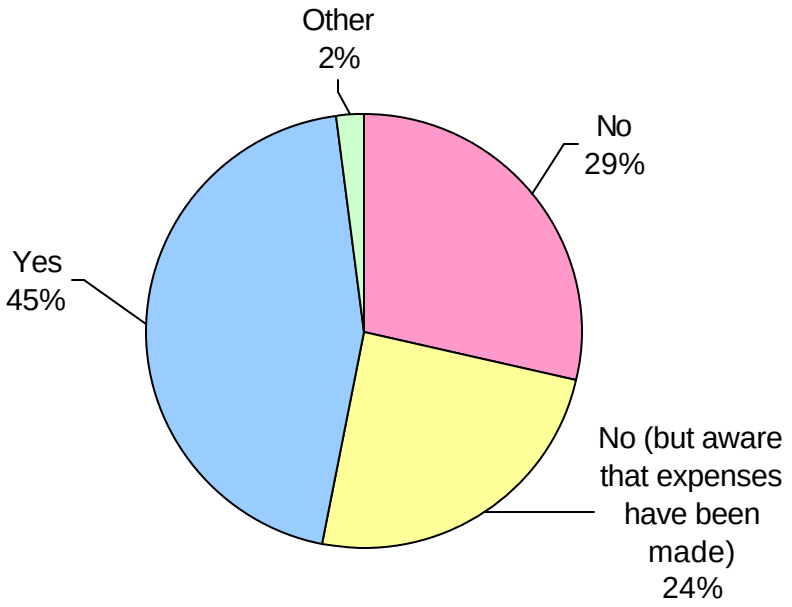
2. PRE-FILING ACTIVITIES AND ADMINISTRATIVE PROCESS PROTOCOL

Prior to the filing of a formal rate case, state rules may permit a utility to discuss issues with the state commission. Two types of preliminary activities identified are pre-filing discussions and ongoing dialogues. While significant differences exist between states,

- Some state rules allow for discussions between utility and regulator prior to filing. This can serve to brief regulators about security cost considerations.
- Another activity is to promote an ongoing dialogue, such as New Jersey has done, that allows regulators and utilities to discuss infrastructure security issues, including cost recovery.[4]

Commissions clearly have a well-formed set of administrative processes for addressing cost recovery issues. These processes serve as filters. The administrative protocol for security-related costs is applicable if and when a legislative act or commission rule specifies a particular cost recovery mechanism, such as Connecticut's Special Infrastructure Cost Recovery Hearing. This allows the commission to have a more focused cost recovery process, and not to have to rely on the traditional regulatory protocol.

Figure 3. Are utilities filing for security-related cost recovery?



Most states still have not had filings even though they are aware that security-related expenses have been made.

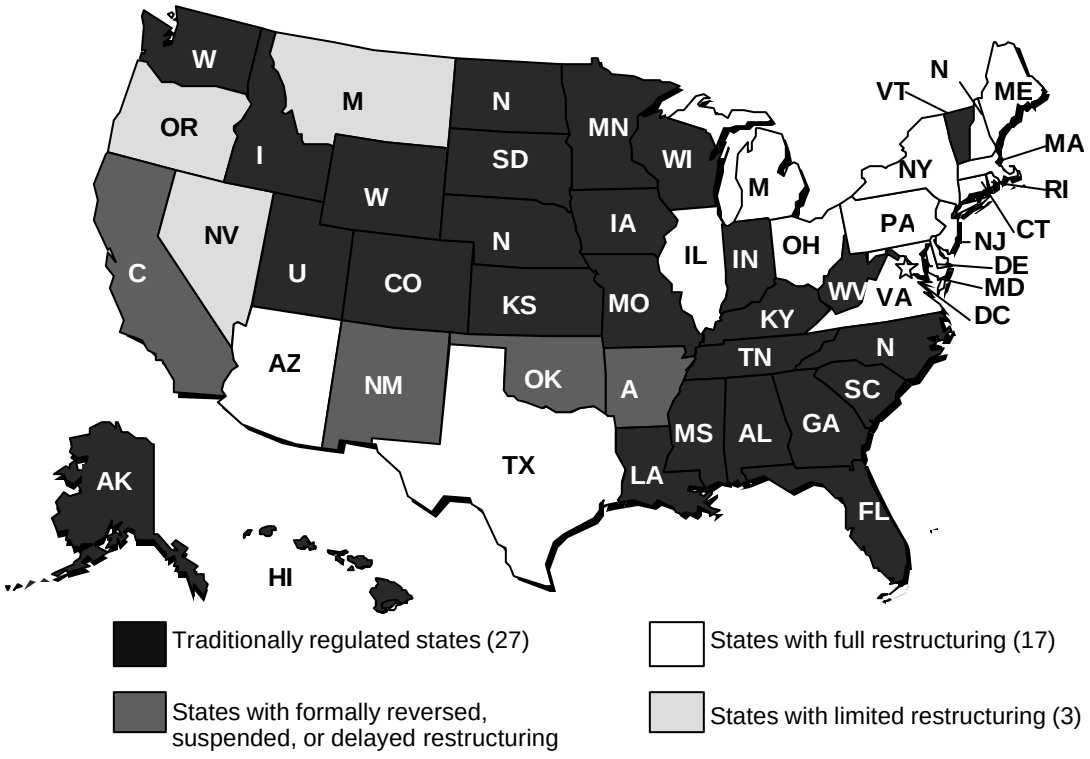
Source: Authors' construct from McGarvey and Wilhelm (2003), n=49.

3. REGULATORY PROTOCOLS

Regulatory protocols guide the processes state commissions use to make cost recovery decisions. In states with vertically integrated, rate base regulated electric and natural gas utilities (see Figure 4), rate cases are the primary way that critical infrastructure costs are addressed. Iowa, for example, examined and allowed specifically identified critical infrastructure costs in several rate cases. In some other states, rate cases were pending but not resolved. Most states surveyed by NRRI indicated that they had not seen a specific critical infrastructure protection cost recovery request.

In states with restructured electricity markets, generally a base case exists that deals with cost recovery. The logic underlying a utility cost recovery request is that the increase in security costs was not known at the time of restructuring and that a filing to recover these costs is appropriate. In Connecticut, as noted above, and in Michigan the legislature acted to allow the regulator to consider cost recovery for electric utilities. In restructured markets, cost recovery is more risky than in traditionally regulated markets.

Figure 4. Map of state electricity markets



Source: Authors' construct from Potter (2003), updated to June 2004.

In each of the cost recovery protocols and cost recovery mechanisms, regulators consider all cost changes before determining what security costs are authorized for recovery, although cost recovery is not guaranteed, just allowed. A utility may present valid and well-documented critical infrastructure protection cost information, but not be allowed the opportunity for cost recovery because an equal offsetting cost savings has occurred. It may be that the cost-of-capital has decreased and these documented savings necessarily reduce some portion of the security costs allowed for recovery. Equally, significant cost offsets may not exist, or may be dealt with in a subsequent proceeding. These cost recovery considerations also apply to regulated water and telecommunications utilities.

4. COST RECOVERY MECHANISMS AND OPTIONS

NRRI's survey of the states identified eight main cost recovery mechanisms (see Table 1) that have been successfully implemented in various states. Utilities have been allowed the opportunity to recover their critical infrastructure protection costs in restructured as well as traditional regulatory environments. All of the mechanisms are described in detail in Section 3, Detailed Discussion of Security Related Cost Recovery, but the outlines of each cost recovery mechanism can be seen in Table 1, and additional cost recovery options are noted in Table 2.

Table 1: Key Cost Recovery Mechanisms and State Examples

Cost Recovery Mechanism	Highlights	State Example
Base Rate Changes to Tariffs	• Rate base adjustment for nuclear power plant security • Operations and Maintenance (O&M) security expenses requested	Iowa (page 33)
Adjustment Clauses	• Fuel adjustment and capacity cost recovery clauses used • Focus on incremental post 9/11 security costs	Florida (page 33 and 34)
Closed Proceedings	• Legislative act provides confidential treatment of security costs • Consumer group may review documents	Kansas (page 35)
Deferral (Balancing) Accounts	• Costs must be reasonable and prudent • Costs deferred while rate cap in effect	Michigan (page 36)
Security Recovery Factor Charges	• Enhanced security costs eligible for recovery • Recovery is net of insurance or government funds	Michigan (page 37)

Base Rate Changes to Tariffs

A rate case is the standard way regulated utilities recover costs through a change to the existing, or base tariff, in which prices are authorized to increase to cover allowable and needed increases in capital, O&M, and other costs. While all of the mechanisms listed in Table 1 serve distinct purposes, they all have a common origin in a rate case where utility requests to change tariffs are resolved. In a traditional regulatory environment protocol, other types of cost recovery mechanisms are possible—most notably an adjustment clause—but each mechanism is either authorized in or reconciled to the rates previously approved in a rate case, although a significant time lag may exist. In a restructured environment protocol, commissions are able to consider rate changes for distribution rates, or retail customers, or standard offer customers, but these are generally tied to an initial rate case. NRRI found:

- States with pending utility rate case filings for critical infrastructure cost recovery, but as no action had been taken, no trend lines can be drawn.
- States with rate cases filed, but which do not have specific security costs identified.
- Instances where utilities have indicated that they do not intend to file for cost recovery.
- Iowa's consideration and approval of security costs.

Adjustment Clauses

In many states, adjustment clauses may be used to recover extraordinary costs that occur between rate cases. The Florida Public Service Commission used two different adjustment clauses to allow, in part, three Florida utilities to recover security costs due to compliance with a Nuclear Regulatory Commission order and for security, actions taken that were consistent with Presidential Homeland Security directives and North American Electric Reliability Council actions.[5] Some of the costs authorized for recovery were costs that would normally be classified as capital items.

Closed Proceedings

Except for proprietary information, commission proceedings are generally open. Due to security concerns, the Kansas Legislature acted to provide a confidential proceeding where the amount of recovery requested, the amount allowed, and the method of cost recovery were kept confidential.[6] Its focus was on post-9/11 security costs and provides for a cost recovery period within half of the useable lifetime of the investment. The Act also allowed the Citizen's Utility Ratepayer Board access within a protective order.

Deferral (Balancing) Accounts

Deferral accounts allow a utility to accumulate critical infrastructure protection expenditures that may be recovered in a rate case or other proceeding. This may be the cost recovery mechanism

most commonly used in conjunction with other cost recovery mechanisms. The Michigan legislature specifically authorized such an account so that costs could be accrued and deferred until rate caps are removed.[7]

Security Recovery Charges

In addition to general costs, a commission may allow a specific cost to be recovered through a security factor that can be included in rates. In Michigan, enhanced security costs can be recouped through a security recovery factor. In authorizing recovery, the commission must determine if costs are reasonable and prudent and are jurisdictionally assigned to retail customers.

Table 2. Other Cost Recovery Options and State Examples

Cost Recovery Options	Highlights	State Example
Notice of Inquiry	• Comprehensive regulatory forum to address a wide range of issues, including cost recovery	Oklahoma
Ongoing Dialogue	• Best practices identified	New Jersey
Special Cost Recovery Proceeding	• Ensures that ratemaking includes consideration of reasonable security costs	Connecticut

Notice of Inquiry

Rather than using a rate case, a commission may initiate a special proceeding or notice of inquiry (NOI) to establish a cost recovery framework (see Table 2). Cost recovery, confidentiality of data, and other critical infrastructure protection issues have been approached by Oklahoma through the NOI process.[8] Cost recovery was a central issue covered. Formal commission action is still pending, however.

Ongoing Dialogue

New Jersey, and Ohio told NRRI that they had a dialogue with their utilities. In New Jersey dialogue occurred through the New Jersey Infrastructure Advisory Committee. In Ohio, utilities are informally polled as they file rate cases.

Special Cost Recovery Proceeding

The Connecticut legislature acted to ensure ratemaking consideration of security costs. Connecticut regulators must examine the costs and find them reasonable. Connecticut has accepted some costs, but not others.

Concluding Observations

State regulatory commissions have acted in a number of ways to address the infrastructure cost recovery concerns of utilities, legislatures, consumers, and other stakeholders. ***In the majority of instances, state commissions have not received a specific cost recovery request (see Figure 3).*** It may also be that incremental security costs did not reach a materiality threshold and were not discussed explicitly in rate case filings. Of the states that have directly addressed security costs, all have done so in some form of a rate case context. Often, either a cost recovery mechanism was followed that was then paired with a rate case, or the whole cost recovery request was entirely made in a general rate case proceeding. In all instances, the rate case requirement that a recoverable cost be prudent, or just and reasonable was a central concern.

The cost recovery mechanisms that were paired with the rate cases are interesting and reflect attempts to work out key issues in advance. The Kansas closed rate case focused rate case and appears to be an expedited approach. The adjustment clauses and the focused issue hearings expedite recovery by producing, in effect, a commission-approved cost pre-approval that would be confirmed in a subsequent rate case. A number of rate cases used various forms of stipulation, or agreements between the parties, that also had the effect of looking like a pre-approval of costs, although commissions were not necessarily bound by a stipulation among the parties. The general rate case was without a doubt the most common critical infrastructure protection cost recovery approach.

5. COST RECOVERY CONSIDERATIONS

Subsequent to a determination that there is a need for recovery of costs, how closely a state commission might want to exercise its prudence review should be influenced in part by the type of regulation to which the particular utility is subject. In other words, which protocol path is most appropriate?

If the anticipated expenditures on security are relatively small and the utility is over-earning, then a utility might be reluctant to bring a rate case to recover its additional cost. Some utilities might be uncertain about expending money or investing in security if they are subject to a price cap or a rate freeze. In such a situation, all other things being equal, there might be an incentive for the utility to under-invest in security measures. This can be particularly troublesome as many security-related expenditures have positive externalities and they might have the effect of making the utility network more secure. Equally, state commissioners are also sensitive to not creating an incentive for carte blanche expenditures on security, which in turn end up directly in higher

rates. State and federal commissions have been sensitive to any possible incentive for a utility to cut expenditures to suboptimal levels under price cap or rate freezes, unless other mechanisms for cost recovery are created.

The policy implications are that:

- State commissions regulating utilities subject to either a price cap or rate freeze might mandate security measures (which would be difficult to the extent that asymmetry of information would tend to favor the utility having expertise over the commission).
- The commission might try to isolate prudently incurred security-related expenditures, or investments and provide for a special rate adjustment or rate supplement mechanism to allow these costs to be recovered.

At the federal level, as of June 2004, the FERC had approved at least five cost recovery surcharges.[9] And, as stated in the *FERC's FY 2005 Congressional Performance Budget Request*, the FERC plans to give its highest priority to processing any filing made for the recovery of extraordinary expenditures to safeguard the reliability of our energy transportation systems and energy supply infrastructure. The FERC has set as its performance target of timely processing of such filings: within 30 days for gas and oil rate filings and within 60 days for electric filings.[10]

The FERC, in its Statement of Policy on Extraordinary Expenditures Necessary to Safeguard National Energy Supplies, indicated its awareness that:

> *"…there may be uncertainty about companies' ability to recover the expenses necessary to further safeguard our energy infrastructure, especially if they are operating under frozen or indexed rates. In order to alleviate this uncertainty, the (FERC) assure[d] its jurisdictional companies that it will approve applications to recover prudently incurred costs necessary to further safeguard the reliability and security of our energy supply infrastructure in response to the heightened state of alert. Companies may propose a separate rate recovery mechanism, such as a surcharge to currently existing rates or some other cost recovery method."* (FERC, Docket No. PL 01-6-000, 96 FERC ¶ 61,299 (2001)

6. OTHER IMPLICATIONS

Other implications for states when considering critical infrastructure cost recovery requests include:

- **A need exists for critical infrastructure protection standards or guidelines** that regulators and utilities can use in ensuring that critical infrastructure is protected and that can be used in a cost recovery proceeding, which may be used in a pre-approval or other regulatory proceeding. State commissions can and have made cost recovery decisions without guidelines, but having guidelines is especially helpful for resolving prudence, reasonableness, and used and useful concerns.

- Commissions should **examine existing guidelines** issued by the North American Electric Reliability Council (NERC), the Network Reliability and Interoperability Council (NRIC), and the Department of Transportation's Office of Pipeline Safety (OPS) as a baseline for determining the guidelines or standards that they will use in their proceedings.

- Standards are more prescriptive than guidelines, but **standards may make cost recovery less problematic**. Guidelines, however, may offer greater flexibility that accounts for regional differences.

- **Critical infrastructure investments also need to be thought of as investments that increase shareholder value**. Both commissions and utilities have a common interest in ensuring continuity of service, but utility shareholders have the added interest in ensuring that net future revenue streams are not disrupted by terrorist attacks.

- Providers of utility services may be fully or partially regulated, or not regulated at all. Cost recovery for a vertically integrated regulated utility raises a different set of issues than a partially regulated utility in a price cap setting. **To date, all identified security cost recovery has occurred directly or indirectly in a rate case proceeding.**

- Whether or not standards or guidelines are used, **the state regulatory commission remains the final decision maker** (within constraints set by legislation and court decisions) regarding the timing, amount, and items eligible for cost recovery. A finding of prudence or reasonableness by a commission was a common part of all proceedings.

- **Pre-approval mechanisms exist,** but all identified have been eventually integrated in a larger rate case proceeding.

- **Utilities felt a strong need to have an informal dialogue with regulators** about their critical infrastructure plans. Protocols and rate case proceedings may need to have this flexibility.

- **Insurance** may be difficult to acquire, but regulators may wish to see that insurance was considered as an option.

PART II

DETAILED DISCUSSION

7. SECURITY RELATED COST RECOVERY – DETAILED DISCUSSION

This section describes in detail the cost recovery protocols and mechanisms identified in our survey of the states. Determining issues related to cost recovery of utility expenditures is a central role of federal and state public utility commissions. One way to look at security costs is through a framework like the one developed by the Battelle Memorial Institute that identifies the key elements of an effective security program. Battelle's framework includes (in no particular order):[11]

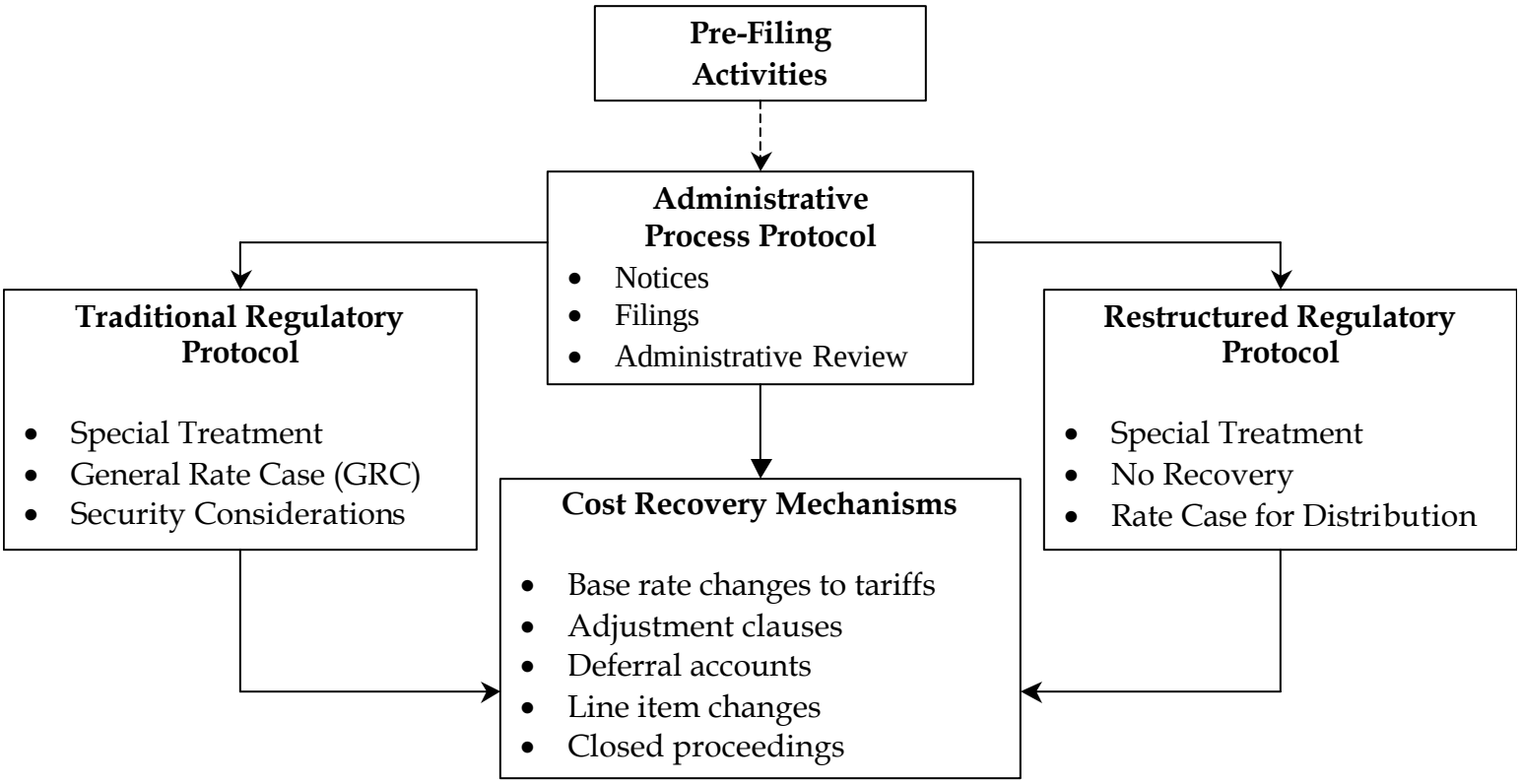
- Vulnerability assessments;
- Information management and intelligence;
- Threat detection;
- Physical security and deterrence;
- Cyber-security;
- Consequence management;
- Event mitigation; and
- Counter-terrorism.

With the exception of counter-terrorism, state and federal public utility commissions may expect a utility to undertake some or all of these functions. The level of effort and the decision on what to focus are a concern that can be somewhat alleviated by the development of standards or guidelines. ***Responding to governmental directives, such as a Nuclear Regulatory Commission directive, is an authoritative and governmentally sanctioned way of determining on which aspects of security a utility should focus.*** Carrying out these functions comes at a cost, whether the cost is a one-time non-capital expenditure (such as a vulnerability assessment), ongoing security expenditures, or capital investments.

This section discusses the protocols, and the underlying rationale, that state commissions can use in their cost recovery decisions. Figure 5 provides a detailed view of the entire security-related cost recovery process – from preliminary activities through various cost recovery protocols, and to the cost recovery mechanisms themselves.

By design, a generic framework that applies to most, if not all, commissions will have many exceptions. Certain steps may be rearranged, or be known by different names in different states. At nearly any point in the process, a state commission can redefine the issues involved and modify the process accordingly. However, even with these caveats, the main outline of the three cost recovery protocols holds for most states. Further, the security-related cost recovery protocol process diagram allows state commissions to visualize and modify their protocols as appropriate.

Figure 5: Detailed Security-Related Cost Recovery Protocols Process Diagram



8. PRE-FILING ACTIVITIES AND INFORMAL DISCUSSIONS

Cost recovery discussions may occur between the utility and the commission prior to an official critical infrastructure cost recovery filing. State laws and administrative rules differ significantly between states regarding the ability to talk to utilities. In some states, utilities are allowed to discuss issues with the commission, but only prior to any formal notice being filed for a proceeding. In these situations, a utility may brief the commission, say, about its security concerns, plans, and costs, but the commission is under no obligation to respond or pre-approve.

In some states, a commission may establish a working group, task force, or committee to look into an issue, such as cost recovery, or protection of confidential information. New Jersey is a good example of a state with an ongoing working group focusing on critical infrastructure. The idea of a dialogue was a central component of the NARUC Cost Recovery Workshop dialogue. While a commission is under no obligation to bind itself in any critical infrastructure dialogue, such a setting could allow the utility to share information and raise issues in a non-adversarial setting. Other groups and stakeholders may need to be included, depending on the state's rules. These dialogues could also take place in public conferences convened by a third-party.

Figure 6: Pre-filing Activities and Administrative Processes

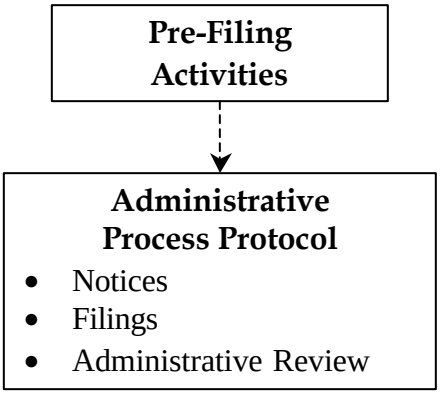
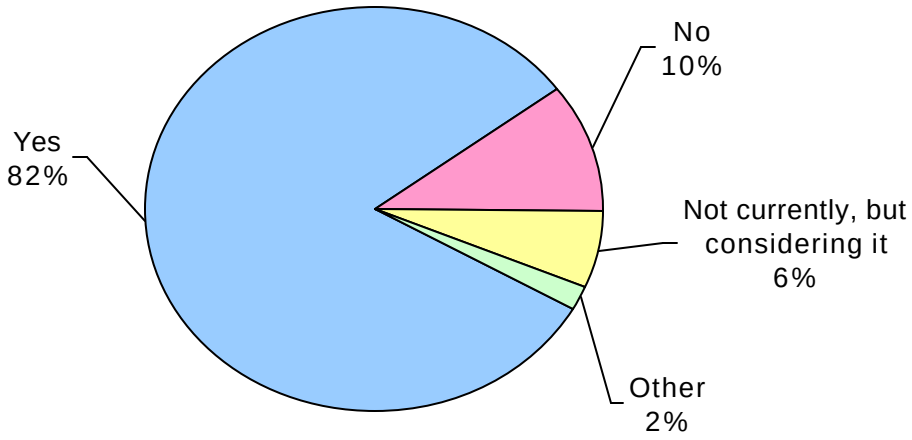


Figure 7: Do states offer utilities protections from disclosure of security-related information?



***Yes - Most do*. And this number has increased significantly since 2002.**

Source: Authors' construct from McGarvey and Wilhelm (2003), n=49.

9. ADMINISTRATIVE PROCESS PROTOCOL

In general, there are three main components to commissions' administrative proceedings for cost recovery. As shown in Figures 6 and 8, these include notices, filings and administrative reviews. A brief discussion of these follows.

Notices and Filings

Oftentimes, the administrative process starts with a pre-filing notice, followed by the formal filing. A commission examines the filing and makes a determination about the issues in the filing and whether the administrative remedy requested is appropriate. This could happen when the commission concludes that the relief being requested is no longer jurisdictional due to changes in regulatory structure. A commission may also examine the filing to see if it is intended as a rate case or for a previously approved proceeding, such as a fuel adjustment or capacity clause.

Administrative Reviews

While done somewhat differently in each state, all filings are initially administratively examined or reviewed to determine their appropriateness. There are several security related issues that may be considered during an administrative review. These include the issue of jurisdiction, whether cost have been pre-approved or not, and the appropriate regulatory framework for cost recovery (traditional, restructured or hybrid) for the utility in question. Figure 8 highlights these issues.

Commission Jurisdiction

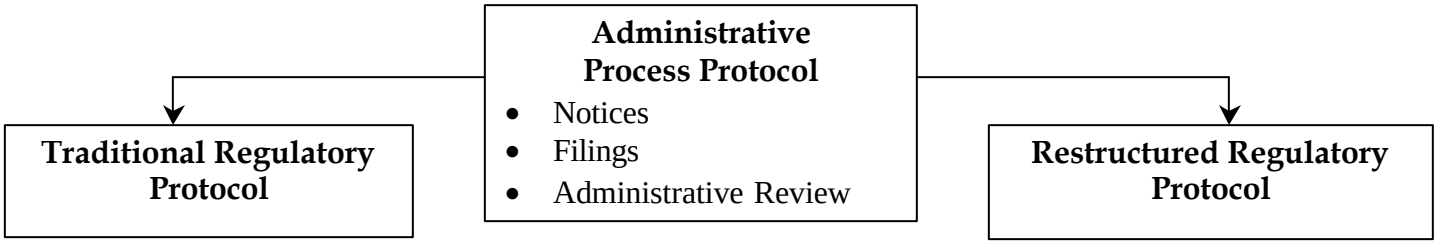
An important step that state commissions need to take when considering a request for recovery of security-related costs is whether or not the costs are jurisdictional or non-jurisdictional, or state or federal. Nearly all telecommunications utilities, most electric utilities, and some gas and water utilities have complex corporate structures that include both jurisdictional and non-jurisdictional entities and activities. ***Only the state commission may consider the security-related costs that are associated with the jurisdictional utility service.*** In order to determine whether security-related expenditures are joint or common costs, the state commission must use established cost allocation methods to divide the security-related costs between the jurisdictional and non-jurisdictional entity or activity. In other words, only those security-related costs related to the regulated activities of a jurisdictional entity should be considered. [12]

In the case of security-related cost recovery for telecommunications network equipment, which is a joint and common cost between state and federal jurisdictions, the telecommunications separations system provides the initial starting point for cost allocation. Currently there is a separation freeze, which means that the allocators used in the separations process are frozen.

Unless utility requests an exception, 76 percent of all increased expenditures that are joint and common costs are state jurisdictional, while 24 percent are federal.

If an inappropriate regulatory remedy is requested, the commission may reject the filing. It may or may not suggest the appropriate regulatory remedy. This procedure essentially involves a shortened staff review and commission concurrence and signing.

Figure 8: Security-Related Considerations in an Administrative Review



Pre-approved expenditure determination

In some instances, such as a previously established deferral or holding account, or adjustment clause, the utility is simply filing or registering expenditures that will be recovered later in a manner previously established by the commission. This protocol approach has been used in critical infrastructure cost recovery requests.

Applicable regulatory framework

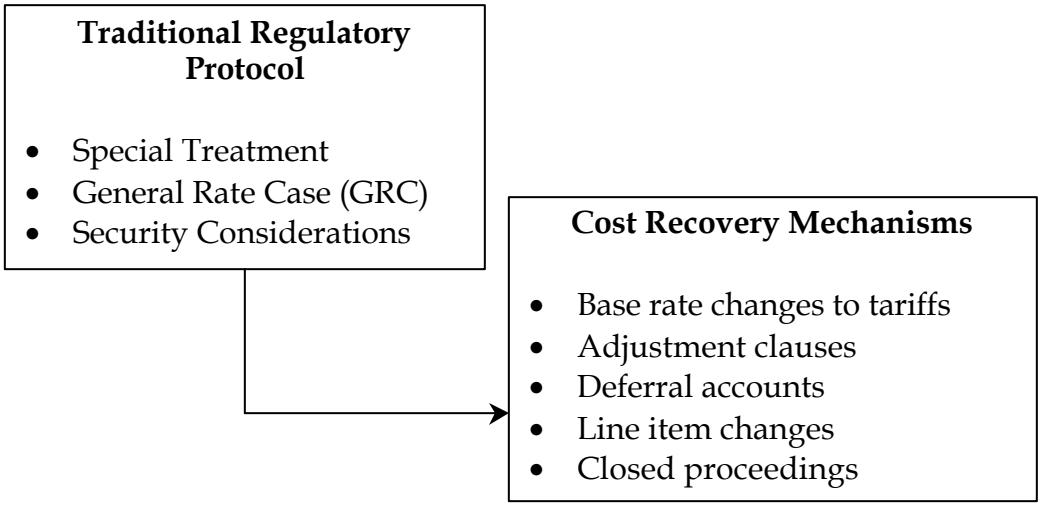
Many decisions are made in rate cases and are discussed in detail in a subsequent section. Commissions decide whether utility customers or utility shareholders are to pay for security costs. Traditionally security costs have not generally received a lot of regulatory attention. In the cost recovery protocols examined in this report, the existing level of security costs were accepted as a given and any regulatory review centered on the incremental post-9/11 security costs. The most visible example of this being utilities filing for cost recovery requests due (in part) to complying with post-9/11 Nuclear Regulatory Commission directives.

The "last mile" is generally still regulated in states that have competitive or restructured utility markets. This "last mile" may provide a common platform for incumbent and competitive providers that is still regulated and subject to commission oversight. The issue of concern to regulators is whether in a mixed regulatory regime — one partially regulated—that costs are properly assigned. ***Captive ratepayers and competitive providers of utility services can be disadvantaged if costs are wrongly assigned.*** For the portion of the utility still under state jurisdiction, most of the same cost recovery protocols already in use by the commission are appropriate.

Prior regulatory hearings or legislative acts may have established an adjustment clause, line item charge, or special proceeding that a state may use in an administrative protocol, even in a traditionally regulated state. This administrative protocol allows a pre-existing cost recovery mechanism to be used for critical infrastructure protection cost recovery requests. The Florida Public Service Commission, as part of its annual proceeding on fuel and purchased power expenses, approved certain security-related costs. These costs, incremental to costs recovered through base rates, were recovered through the fuel cost recovery clause and the capacity cost recovery clause.[13] These costs, once approved, would flow through and be a base rate tariff charge. In a restructured state, such as Connecticut, a legislative act allowed the Connecticut Department of Public Utility Control to examine and authorize critical infrastructure costs to be included in base tariff rates.[14] Within the administrative protocol, then, the commission may examine the costs according to its rules and determines the amount to be recovered.

10. TRADITIONAL REGULATORY PROTOCOL

Figure 9: Traditional Regulatory Protocol and Cost Recovery Mechanism



Well-established cost recovery procedures exist in all states that regulate utility services. Whether the state's utility markets are served by single provider or are open to competition, states have a long history of experience with traditional cost recovery of the jurisdictional wholesale and retail portions of a utility operation. Traditional cost recovery mechanisms for specific items can take many forms, including previously approved rate adjustment clauses, retail bill line-item charges, simple tariff changes, and all the way up to a large general rate case. These cost recovery mechanisms have been variously applied by commissions in their response to critical infrastructure cost recovery reimbursement requests. Figure 9 highlights key components that might be encountered when the administrative review dictates following the traditional regulatory path. Figure 9 also outlines the potential cost recovery mechanisms that might be appropriate.

The first step down the traditional path is to determine whether the applicant's filing falls within a pre-defined set of special treatment protocols such as a pre-existing approval to issue a line-item charge or an adjustment clause that might have been pre-approved in a previous case. If such treatment is warranted the case would proceed to be reviewed for allowance or disallowance using that specific cost recovery mechanism. If such treatment is not appropriate, the recovery request would proceed into the general rate case (GRC) process. Within the GRC process, the commission would undertake the evaluation of the critical infrastructure expenditures. Ultimately, the GRC would conclude with a determination of recovery, allowance or disallowance, within a well defined, traditional ratemaking process.

Traditionally regulated utilities are given an opportunity to recover jurisdictional service costs that are at the same time prudent, used and useful. ***Once costs are determined to be associated with jurisdictional utility service, a state commission must determine whether the security-related costs are used and useful, as well as whether they are prudent.*** It is the utility's responsibility to identify and make the link between an expenditure and its security function for the commission.

Security-related expenditures and investments mandated by either state or federal agency may be considered prudent. To date, most security-related investment or expenditures have necessarily been driven by the utilities themselves and not by state or federal mandates. In the NARUC Cost Recovery Workshops, it was noted by several participants that state commissions should consider a collaborative dialogue to discuss what actions are necessary to meet the security needs of the utility. Such commission-utility discussions would, it was felt, be general in nature and details would need to be kept confidential. Traditionally, cost recovery and reasonable access to information associated with utility expenditures have gone hand-in-hand. Developing appropriate policies, practices and procedures for the disclosure and handling of security sensitive information is a fundamental necessity for cost recovery.

If it is determined that security-related costs are used, useful and prudent, there are a variety of cost recovery protocols that might be appropriate. In choosing a cost recovery mechanism state commissions may also consider the relative size of the security-related expenditures.

A cost recovery mechanism can be used in a traditional rate case, or other regulatory proceeding, such as an adjustment clause. It can also be used, to a much lesser extent, for restructured utilities, and mainly for the distribution utility. A cost recovery mechanism is the final administrative tool that the commission uses to allow cost recovery.

Special Considerations and Treatment

When a utility seeks recovery for critical infrastructure investments, the filing may provide the commission with cause to apply special considerations or treatment outside of the larger parameters of a traditional review. An example of special consideration might be an expedited review process. It might be that the recovery sought was for expenditures on critical

infrastructure that fell into a certain previously approved, reviewed, or generally accepted category of expenditures. Depending upon the regulations, statutes, and practices of the state, a commission may need to consider special confidentiality treatment for the sensitive security information portion of the pleading and proceeding. The NARUC/NRRI 2003 Survey on Critical Infrastructure found that 84% of the states have exemptions to Freedom of Information Acts or other protection mechanisms in place to guard against the disclosure of sensitive security information that applicants share with the state commission.[15] In part due to the commission experience with Y2K, and in dealing with confidential information with competitive implications, and because of the clear consensus to prevent information from being revealed to terrorists, state commissions overwhelmingly acted to modify their disclosure rules and sought legislative authority when needed.

If the nature of the pleading was so overwhelmingly sensitive that attempting to protect the sensitive information, as part of a general rate case would prove too difficult, a commission might conduct a special entirely closed proceeding. Generally, parties to rate case proceedings have recognized the need to protect data and developed reasonable ways to handle confidential data. When confidentiality issues have been important issues in regulatory proceedings, the issue appeared to center on financial data. Commissions generally resolved this through the use of stipulations and by approving rates that did not specifically identify the security cost component.

General Rate Case (GRC) Considerations

Absent a previously established specific cost recovery mechanism, a showing for special consideration in terms of expedited recovery, or other special treatment, the merits of a critical infrastructure cost recovery pleading have been resolved in the course of a traditional general rate case proceeding. However, even a GRC from the start may have to consider and implement mechanisms for the protection of confidential security-related information.

A "prudence review" is a common activity that occurs during a GRC. Various aspects of security-related costs can be evaluated through this process. Within the prudence review is the *prudence test* and the *used and useful test*. The consideration of insurance may also be necessary. The existence (or lack of) of security guidelines will drive the scope and scale of the prudence review tests. The review will culminate in a determination of the allowance of the claimed expenditures. If recovery is allowed, the process will proceed to the appropriate cost recovery mechanism.

Prudence and used and useful reviews

Under traditional regulation, utilities may recover costs that are both "prudent" and "used and useful."[16] ***It is the role of a commission to review costs and ensure that recovery is based on prudently incurred costs that are both used and useful.*** How that review occurs is a product of state statute, administrative rules, and traditions of practice. There are some general guidelines

that a typical state prudence review would follow to determine whether a critical infrastructure expenditure was prudent and used and useful.

Critical infrastructure protection may have special characteristics that do not neatly fit into the established prudence and reasonable standards used by commissions. In the NARUC Cost Recovery Workshops, participants expressed several concerns. The first was that the utilities felt that they were going to incur significant costs when the U.S. Department of Homeland Security (DHS) changed its color alert levels in response to a threat. If no attack occurs, the issue was whether an after-the-fact review in a rate proceeding would disallow some or all of these expenditures as not being "used and useful", however prudence guidelines prevent hindsight. A second concern, that follows the same line of reasoning, is whether capital investments and other expenses may be ruled to be non-recoverable after the fact. Some also felt that normal requirements to have construction projects competitively bid might result in some costs being disallowed if the utility felt it had to respond quickly.

Examining prudence first, expenditures must be prudent to be subject to cost recovery. There are **four widely accepted guidelines** that can be used to determine whether an investment or expenditure is prudent.

1. The first guideline is the presumption that the investment and expenditure decisions of a utility are prudent. Unless the presumption of prudence is overcome, there is no need for further examination of the investment or expenditure. The existence of standards or guidelines, or governmental security protection requirements would be important in reinforcing a presumption of prudence. However, an allegation of imprudence that is backed by substantive evidence creating a serious doubt about the prudence of the investment or expenditure decision would require a commission to apply the prudence test to determine whether or not the expenditure or investment qualifies for full or partial cost recovery or no cost recovery at all. ***There is no presumption of prudence for affiliate transactions, whether they are for expenditures or investments.***
2. The second guideline is that, to be prudent, a utility decision resulting in expenditures or investments must have been reasonable under the circumstances that were known or knowable at the time the decision was made.
3. A corollary to this is the third guideline: the proscription against hindsight. The proscription against hindsight means that one cannot supplement reasonableness under the circumstances at the time of the investment decision with other standards that first look at the final outcome of the decision. How this proscription against hindsight is applied will greatly resolve the dilemmas posed at the Cost Recovery Workshops. Nevertheless, consideration of the outcome may legitimately be used to overcome the presumption of prudence.
4. The fourth guideline is that prudence is determined in a retrospective, factual inquiry, which should exemplify the proscription against hindsight.[17]

In addition to being prudent, expenditures must be used and useful. State commissions may consider security-related expenses to be used and useful so long as they are directly related to jurisdictional critical infrastructure or linked to the critical infrastructure through processes that support the critical infrastructure. For example, if electricity or telecommunications distribution systems are considered to be critical infrastructure, then the distribution service restoration processes may be found to be critical to supporting that infrastructure. Consequently, assets and expenditures that support the service restoration process might, therefore, be considered to be security-related costs. As noted above, security-related costs can be classified as serving one or more of the following functions: vulnerability assessment; information management and intelligence; threat detection; physical security and deterrence; cyber-security; consequence management; and event mitigation.

Michigan has defined security costs for recovery purposes as those costs that are reasonable and prudent costs of new and enhanced security measures mandated by government or found necessary by the commission. [18] The statute goes on to include applicable insurance and service restoration costs.

In the NARUC Cost Recovery Workshops *it was noted that security expenditures can be:*

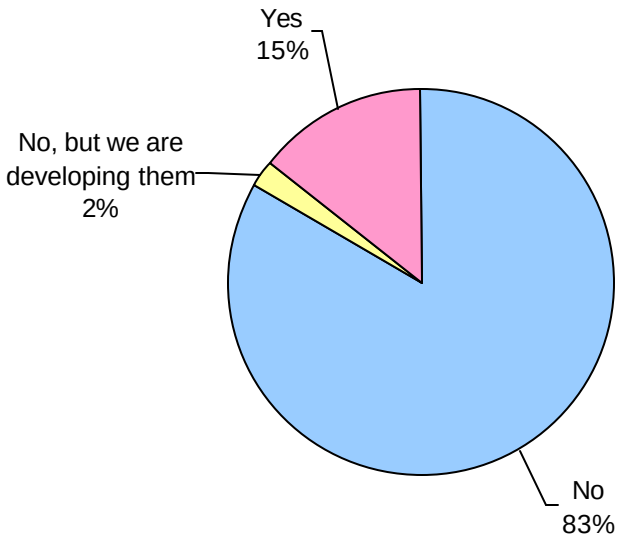
- ***One-time, non-capital expenditures;***
- ***Ongoing security expenditures; and***
- ***Capital expenditures.***

They can be the same as or different than pre-9/11 costs. In some cases, there will be a one-time expenditure that might properly be amortized over several years. There might be new facilities and equipment (including additions to spare equipment in inventory), or additional ongoing expenditures, such as the hiring of personnel or the purchase and ongoing training of security dogs. There are wide arrays of additional expenditures that may be considered security-related, and as long as they serve one of the above security functions for critical infrastructure or its support, the expenditure should be considered used and useful. It is the utility's responsibility to identify and make the link between an expenditure and its security function for the commission to be satisfied that the expenditure is used and useful.

As part of a prudence review, a commission may need to consider the role that contracted insurance plays in the applicant's critical infrastructure plans and expenditures. ***Insurance can provide both an incentive and a risk management tool for utilities.*** Insurance companies can require that certain actions be undertaken by utilities if they wish to purchase insurance. Second, utilities can minimize their risk by purchasing insurance. Michigan explicitly requires that the reimbursement of security recovery costs must be net of any insurance proceeds.[19]

Independently of the shared concerns of both regulators and utilities about service availability, utility shareholders have an unmistakable interest in preserving net future revenue streams. Losing customers through an inability to provide needed services due to terrorist attacks affects the utilities' revenues and bottom line profitability. Utilities have a clear interest in insurance coverage, as well as preventative and service restoration planning and investment.
The existence of security investment guidelines (or standards or rules)[20] will have significant impact on the review process of critical infrastructure expenditure recovery sought in the context of a GRC. If a state commission has security investment guidelines the application of the prudence review and used and useful tests will be faster and less arguable. If the guidelines are specific enough, it may be that prudence review steps can be by-passed for items that fall within the security guidelines. A commission's guidelines may go so far as to establish a list of critical infrastructure expenditures that will receive approval *prima facie.* If a state has security

Figure 10. Are there separate prudence guidelines for security costs?



***No* – most states plan to use their existing prudence review process for handling security-related expenses. However, a few state commissions are developing them or have some modifications in place.**

Source: Authors' construct from McGarvey and Wilhelm (2003), n=48.

guidelines and an applicant's request for recovery is not within the parameters of those guidelines, the commission could review the request through a detailed prudence review as described above. The presumption of prudence seems to have been the prevailing regulatory perspective in the cost recovery protocols identified in our survey. If the security guidelines are written such that any security expenditure outside the guidelines is by definition non-recoverable, the commission would simply deny the recovery in its order for the GRC.

In contrast to other expenditures where standards have been developed and refined over many years, state commissions do not have well-established, security-specific, standards by which to evaluate the appropriateness of utilities' efforts to protect their critical infrastructure. Without standards, commissions would have to rely on witnesses in a proceeding in order to make a determination on cost recovery. Both the gas and electric industries now operate under some level of security guidelines. In the electric industry, the North American Electric Reliability Council (NERC), an intra-industry organization, has compiled the most extensive set of guidelines for both physical and cyber security.[21] Originally developed in June 2002, the physical guidelines are arranged by security topic and are periodically updated with the understanding that the guidelines are intended to evolve along with the threats to the electric industry. The existence of the NERC physical security standards is beneficial, but they leave room for differences in protection.

The gas industry largely relies upon the Security Practices Guidelines developed by the Department of Transportation's Office of Pipeline Safety (OPS) and issued in September 2002.[22] These guidelines were developed with the assistance of state pipeline agencies and pipeline industry representatives. The guidelines are not publicly available, but a review by the Oklahoma Corporation Commission (OCC) found the guidelines to be methodical and comprehensive. In addition to on-site follow-up by OPS, compliance with the guidelines is subject to review by state pipeline agencies.[23]

In its review of the status of state and federal security standards and guidelines, the OCC noted full agreement among the commission and industry participants that any measures passed by the state commission should be consistent with the requirements of other states and the federal government since companies should be held to conflicting requirements. The OCC found the NERC and the OPS guidelines to be the most authoritative and extensive guidelines available for their respective industries.

Within the telecommunications sector, the Network Reliability & Interoperability Council (NRIC) is an intra-industry organization that has developed an extensive list of best practices for the telecommunication industry.[24] Although the telecommunication industry participants in the OCC's review supported the commission's use of the NRIC guidelines, NRIC states that the guidelines are not intended to be imposed as government regulations. More to the point, the nearly 800 highly technical items in the list would be impractical to adopt as regulations; in order to make use of the NRIC guidelines, it would be necessary for a commission to identify those best practices that were relevant for the companies under the commission's jurisdiction.

The Environmental Protection Agency (EPA) is the lead federal agency for the security of drinking water and wastewater. In February 2004, the EPA's National Drinking Water Advisory Council formed the Water Security Working Group in order to establish and disseminate best practices for drinking water and wastewater utilities by 2005.[25] Under the Public Health Security and Bioterrorism Preparedness and Response Act, the EPA requires water operators serving populations larger than 3,300 people to certify to EPA that they have conducted a vulnerability assessment, and revise their emergency response plan correspondingly.[26] EPA provides grants of up to $115,000 to defray the costs of assessments. Smaller water companies (i.e., those serving fewer than 3,300 people) are not required to conduct assessments partly out of concern that they could not recoup the relatively high costs, although grants and other assistance for voluntary assessments and low-cost security strategies may be offered by state agencies. In addition, intra-industry organizations such as the American Water Works Association (AWWA) and the National Association of Water Companies (NAWC) support members with vulnerability assessments.

Commissions must decide whether to employ mandatory security standards or a set of official voluntary security guidelines. In the NARUC Cost Recovery Workshops the distinction between standards and guidelines was drawn. Mandatory standards make questions of cost recovery easier to resolve since the mandate would usually imply the prudence of the corresponding expenditure. Mandatory standards also offer greater assurance against certain companies under-investing in security. However, voluntary guidelines (possibly including a method of self-certification) would allow a commission greater flexibility in dealing with the cost burden on companies of different sizes and criticality and would allow companies more flexibility to develop security plans specific to their needs. Commissions must also resolve whether imposing equal standards on all companies would require openly publishing what those specific standards are, thereby serving notice to potential attackers.

The four prudence guidelines discussed earlier can raise a more fundamental question: how does one determine what is reasonable under the circumstances for the purpose of determining the prudence of security-related expenditures or investments? The NARUC/NRRI 2003 Survey on Critical Infrastructure Security found that a large majority (83 percent) of commissions do not have different guidelines for determining the prudence of security investments and only a few are developing them at present.[27] So, what can be said about a prudence standard for security-related expenditures or investments? Certainly, security-related expenditures and investments that are mandated by either a state or federal agency are considered prudent (so long as no gold-plating takes place). However, the NRRI survey shows that most security-related investment or expenditure has been driven by the utilities themselves and not by state or federal mandates. In such cases, it might behoove state commissions to begin a collaborative dialogue, similar to that undertaken for Y2K expenditures, to discuss generally, what actions are necessary to meet the security needs of the utility.

These discussions could focus on both short-run actions that the utility can take to protect its existing system as well as long-term planning solutions that might provide for event mitigation or produce a self-healing or redundant utility system, which inherently mitigates the damage of any attack. Such discussions could deal with issues of resource allocation and the level of costs for security-related expenditures, and could allow both the commission and the utility to wrestle together with issues of whether the benefits of increased security are worth the costs as well as potentially prioritizing alternative or complementary projects by cost-benefit ratios. This would lead to the lowest cost expenditures being made on the most vulnerable part of the utility system first, something noted in the NARUC Cost Recovery Workshops. Another alternative might be to provide for outage risk insurance for ratepayers and/or shareholders. Such commission - utility discussions would necessarily be general in nature and details would need to be kept confidential.

Such collaborative dialogue might strongly appeal to state commissions and be worthwhile, particularly given the "obligation to serve" standard that state commissions still have and enforce regardless of whether their network utilities have restructured. Nevertheless, the utility needs to fulfill its obligation to provide safe, reliable, and adequate service. Further, it is the utility itself that has the expertise and knowledge of its own system, which is necessary to do a proper cost-benefit analysis. While commissions can review utility decisions, care must be taken not to substitute the commission and commissioners in place of utility management and their responsibilities. Indeed, if the commission's level of involvement becomes too great, the commission will have essentially pre-approved the decision of the utility to make its security-related expenditures. The commission would be left only to decide how well the utility had executed its security plans.

Security Considerations – Information Handling

Traditionally, cost recovery and reasonable access to information associated with utility expenditures have gone hand-in-hand. ***Prior to Sept. 11, 2001, the trend in regulation, as in most segments of our society, was to move more and more information into the public domain.*** The Freedom of Information Act (FOIA), public records laws, open meetings, sunshine requirements, and *ex parte* communication rules all served to increase both the types and amount of information that was available to a broad-based set of stakeholders affected by utilities and their operations.

In light of the new developments concerning critical infrastructure security, the "right-to-know" proposition is being challenged or at least tempered by the more limiting proposition of "need-to-know." Developing appropriate policies, practices, and procedures for the disclosure and handling of security sensitive information is a fundamental necessity for cost recovery.

The recent NARUC/ NRRI 2003 Survey on Critical Infrastructure Security found that 82 percent of commissions offer FOIA protection for sensitive utility security information.[28] This is a substantial increase from the 2002 survey, which found that only 42 percent of states offered

protection of sensitive information (shown in Figure 7). Nonetheless, the 2003 survey also found that most commissions (54 percent) still believe that utilities are either somewhat or very reluctant to share their security information with the commission. However, this level represents a decrease from the previous year, when 74 percent of respondents reported that utilities were reluctant to share information.

Although considerations regarding the sensitivity of security-related data clearly go beyond the cost recovery issue, a commission's access to pertinent information is at the heart of traditional cost recovery determinations. It is, perhaps, reasonable to begin with the assumption that, at a minimum, summarized expenditure data on security can be shared with regulators.

The NARUC Resolution on Guidelines for State Commission Procedures Involving the Handling of Security Sensitive Documents and the Recovery of Prudently Incurred Security-Related Costs encourages commissions to:

- ***Review appropriate treatments of security sensitive information*** *that are available to the public.*
- ***Work with utilities*** *and other appropriate government agencies to establish procedures for cost recovery.*
- ***Share information handling procedures*** *among themselves as this issue evolves over time.*

(Resolution available at http://www.naruc.org/associations/1773/files/security.pdf.)

It may be appropriate for regulated utilities to share only generalized cost increase information with regulators. To the extent that any details in the information are sensitive due to national security concerns, state commissions should make that information confidential and not subject to state sunshine acts or FOIA disclosure. Indeed, some states have already specifically excluded information about critical infrastructure from their FOIA procedures. Other state commissions might wish to consider promulgating or proposing similar measures to their legislatures.

As noted in Appendix B, the FERC has issued Final Order No. 630 and Order No. 630-A, both of which deal with the protection of critical energy infrastructure information. Order No. 630 covers only information submitted to or prepared by the FERC. *"Critical energy infrastructure information*" is information about proposed or existing critical infrastructure that relates to the production, generation, transmission, or distribution of energy that could be useful to a person in planning an attack on critical infrastructure; is exempt from mandatory disclosure under FOIA;

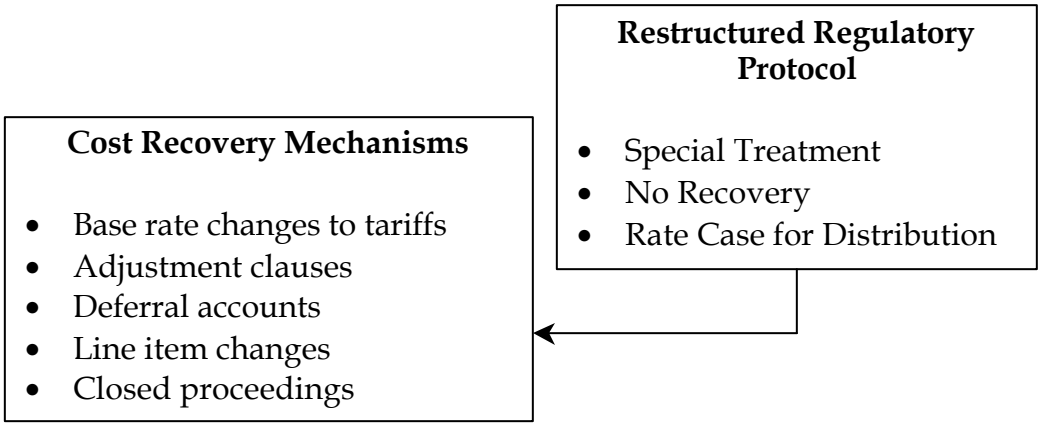
and does not simply give the location of the critical infrastructure. The applicability of FOIA requests is still to be processed on an individual case-by-case basis. Critical energy infrastructure information may or may not include information that would be useful in determining cost recovery for FERC jurisdictional costs. Nothing in Order No. 630 or 630-A prevents state commissions from independently seeking information that they might need to make a cost recovery determination; however, these orders highlight the need for state commissions to consider confidentiality concerns and to have protective order guidelines when handling cost recovery information that may have security implications.

11. RESTRUCTURED REGULATORY PROTOCOL

The filing of an application for critical infrastructure expenditure cost recovery in a state with open utility markets and/or competition may require a state commission to engage in special or additional considerations beyond that of a general rate case. An important part of the administrative review (Figure 8) is to determine if a path other than a traditional cost recovery path is required. For simplicity, this other path is referred to as the restructured regulatory protocol. Important elements of this protocol are highlighted in Figure 11.

The restructured path would necessarily be a consideration for electricity and gas utility services in open-market states, but it might also be a consideration in competitive telecommunications environments. If the restructured path is chosen, ***the first step is to determine if any cost recovery treatment is allowed under the new regulatory regime***. If not, the protocol process ends at that point. The principle in effect here applies to all recovery cost requests in restructured states. If a further review for cost recovery treatment is appropriate, the next step is to determine if the review should happen in the context of a pre-existing cost recovery mechanism, or through a more general rate case type of proceeding.

Figure 11: Restructured Regulatory Protocol and Cost Recovery Mechanisms



Special Considerations and Treatment

The existence of a restructured market in and of itself does not necessarily change the principle issues and considerations of critical infrastructure expenditure cost recovery. There are a variety of cost recovery protocols that might be appropriate for the recovery of security-related costs. In making an initial choice among cost-recovery protocols, regulators should consider whether the entity is subject in any service or organizational structure to rate base, cost-of-service regulation. The answer might be "no" for a variety of reasons. Most, if not all, of a utility's services might be considered to be competitive in nature. In the telecommunications sector many of these competitive services are subject to price cap or other alternative forms of regulation. In other cases, particularly in states that have undergone retail electric industry restructuring, the rates might be subject to a price cap or a rate freeze. Allowable expenditures will still need to meet some pre-authorized qualifications, or pass tests of prudence and used and usefulness.

However, in a restructured environment, a commission may need to take into account special conditions and consider additional factors in its cost recovery review. Among those special condition and factors might be:

- Existing rate freezes or caps.
- The existence of provider-of-last-resort requirements.
- Applicant specific restructuring plan requirements.
- Existing laws, rules, or guidelines that address recovery of excess costs in the restructured environment.
- Effect of recovery mechanisms on market development or competitive neutrality.
- Policy considerations of guaranteed cost recovery in an open market.

No Recovery Allowed

In a fully competitive market, where the requirements for retail service tariffs have been removed, or where rates are now market-based, it may be as simple as saying that ***security-related critical infrastructure expenditures are (like other expenditures) business decisions subject to recovery only as the market will bear*** and not subject to guaranteed recovery through a commission order. For example, if local telecommunications services were deemed to be fully competitive by a state commission, and all providers were subject to the same service standards, even if some basic local rates are still fully regulated, a commission might deny allowance of a guaranteed specific recovery for critical infrastructure investments since all providers would be equally burdened in the competitive market.

Other considerations as discussed below notwithstanding, a similar conclusion might also be reached in a restructured energy market. Generally speaking, in a restructured energy market traditional retail rate controls are replaced with market-based rates. As detailed in a recent report on electric restructuring transition periods, exactly when the market-based rates did or will take

over varies from state-to-state.[29] However, if market-based rates have replaced the traditional non-market rates, a commission might deny recovery allowance of a claimed critical infrastructure expenditures made without a specific government mandate, based on the finding that the expenditure was a competitive marketplace business decision.

Rate Case for Distribution

The utility markets in most states may not be at a level of competition that would give state commissions enough comfort to simply deny cost recovery based on the above arguments – that the investments are equal burdens for all providers or competitive business decisions not eligible for guaranteed cost recovery. A possible scenario in a restructured environment may be the need for state commissions to consider security cost recovery from still regulated services with a mix of rate types (e.g., market-based, capped, frozen, and standard cost-based) and a mix of regulatory scenarios (e.g., negotiated rate settlements, statutorily restricted rates, and alternative or incentive plans).

Assuming a state commission has not issued a *prime facie* dismissal of an applicant's request for cost recovery, the commission will proceed to review that request. If the filing is by an electric utility service provider in a state with electric retail competition, the commission must consider the conditions of that restructuring in its review of the request. We can assume that since most restructuring was in place (or well on its way to being so) prior to September 11, 2001, that recovery of critical infrastructure expenditures was not specifically addressed in most restructuring rules and regulations. While some states have subsequently specifically addressed the recovery of critical infrastructure related costs, according to the NARUC/NRRI survey, 83% of the states do not have specific rules or guidelines.[30] Consequently, a state may likely have to develop guidelines, practices, and precedents as they examine the filings and consider the restructuring conditions.

The easiest review of a security-related cost recovery request will likely be for those expenditures that were to comply with a government mandate to enhance critical infrastructure or security. A state or federally mandated security investment would only require the commission to determine that the investment was made according to the mandate to approve the recovery. How that recovery was implemented could depend on the amount of the recovery and the restructuring conditions. It may be possible for a state to treat the recovery of the expenditure through the traditional process of regulating and setting regulated service rates. ***However, restructuring conditions may have placed caps or freezes on the retail rates.[31] In which case, a commission may need to consider other treatment and recovery protocols such as special line item charges and/or deferred recovery after a rate freeze.*** For example, Michigan statute has placed a cap (for large electric utilities) on retail rates that could extend until the end of 2013, depending upon a market test. The statute mandates that excess or new expenses shall be accrued and deferred. Such deferrals will be subject to commission determination of the amount of reasonable and prudent costs, if any, to be recovered after the rate cap is removed.[32]

In addition to recovery of the approved costs from an applicant's retail customers, a commission may need to consider the market neutrality of cost recovery in a competitive market. In some states, recovery rules for restructured markets may clearly define from whom a covered utility service provider can recover security-related costs. In Michigan allowable security-related expenses can only be recovered from the retail customers of the "covered utility."[33] However, if existing regulations or laws do not specify from whom these costs can be recovered, the question must be considered. If a local distribution company incurs an allowable critical infrastructure expense, it may be appropriate for the commission to implement recovery of that expense from not only the retail customers of that distribution company, but also from any competitive providers that sell service to customers over the applicant's distribution system.

Finally, the existence of ***provider-of-last-resort (POLR) requirements may also be a factor in a commission's review of a security related investment***. An applicant that has the burden of an explicit POLR requirement may be able to justify more robust critical infrastructure investments, if such investments are prudently incurred to assure that it can provide service to all customers in a market – including, if necessary, those that are now served by other competitive providers.

12. COST RECOVERY MECHANISMS AND CASE STUDIES

The three cost recovery protocols use different logic to implement cost recovery mechanisms. The protocols establish the process and regulatory framework needed to use the cost recovery mechanisms examined below. A cost recovery mechanism is the actual technique state regulators use to authorize a utility to recover some, all, or none of the monies they have requested. A variety of cost recovery methods exist, ranging from ones that make this determination through automatic adjustment clauses to more elaborate mechanisms, such as a rate case. Since 9/11, a number of state commissions have responded to utility cost recovery requests. The cost recovery mechanisms examined below are all reasonable approaches these states have used and no one is recommended over another as the circumstances in different states may make one method more appropriate. Figure 12 highlights the five main cost recovery mechanisms identified by commissions as being useful with respect to security related expenses.

Figure 12: Cost Recovery Mechanisms

Cost Recovery Mechanisms

- Base rate changes to tariffs
- Adjustment clauses
- Deferral accounts
- Line item changes
- Closed proceedings

Base Rate Changes to Tariffs

The clear majority of the critical infrastructure cost recovery activities identified in our survey of the states was either immediately or ultimately part of a rate case proceeding that resulted in base rate tariff changes. Even the adjustment clauses described below are actually part of a base rate tariff settlement process.

A number of states surveyed indicated that they had rate cases in process, ones where utilities had security costs identified, but that since the commission had not made a final decision or issued an order, nothing definitive could be said.[34] Other states said that they had rate filings from utilities, but that their initial review of the filing did not reveal any distinctly identified critical infrastructure protection costs. Incremental security costs may or may not be subsequently revealed in the course of these rate cases.

Some states surveyed have reportedly learned from their jurisdictional electric and natural gas utilities that the utilities do not intend to file for critical infrastructure cost recovery for a variety of reasons. These reasons include:

- A concern about the confidentiality of the data.
- The desire to avoid having to develop and share detailed cost data on a facility-by-facility basis.

States have addressed these issues in several ways.[35] In New York, a restructured state with a future test year, existing rate processes are used to deal with security cost recovery issues. The New York Public Service Commission has used a variety of cost recovery mechanisms that include:

- Consideration of settlements;
- Forecast reconciliations; and
- Deferral of carrying charges.

Furthermore, utilities that are under-earning can file for deferral under Commission rules. Respondents in some states noted that some utilities said that the security costs were not sufficient to warrant initiating a regulatory proceeding. In California, Pennsylvania, and perhaps in other states, it was felt that the lessons learned and institutionalized from Y2K, earthquakes, fire, and other natural disasters made critical infrastructure protection more of an incremental cost. In other words, ***many utilities already have considerable experience planning and responding to significant service protection and service restoration scenarios***. Incremental security costs could occur, but it was thought these costs would be much lower than if utilities were starting from scratch in their disaster planning.

Other states have reported that they have not established separate or special efforts to recover security-related expenses. Generally, states in this situation report no current security cost recovery requests before them. While their treatment is speculative, these states tend to say that security expenses would be treated and evaluated like any other operating expense in order to verify costs, assess reasonableness, and to determine whether all or part of the costs would be recovered. Maine noted that it would refer to NARUC's preliminary cost recovery guidelines. Other states in a similar situation include Arkansas and Iowa. Iowa has had regulated utilities seek Iowa Board approval for at least $1.6 million in rate base and $982,000 in operations and maintenance for post 9/11 security-related expenses. In a MidAmerican Energy gas rate case, the company requested and was granted an increase in rate base of $780,375.[36] In an Interstate Power & Light electric rate case, the company requested and was granted an additional $938,000 in rate base adjustment for increased security at its nuclear power plant.[37]

The rate case implications for other states include the following considerations:

- No critical infrastructure-only or security-only tariffs, or riders, or surcharges were identified in these cases.
- Approved security costs were included in adjustments to the general tariff.
- Utilities often do not make identifiable infrastructure protection cost recovery requests.
- Security costs specifically under consideration and approved are incremental costs attributed to responses to the post 9/11 threat environment. Base or existing security costs do not appear to have been examined.
- A number of states had cases pending that addressed cost recovery in the context of a general rate case and no conclusions can be drawn about these cases until the commissions act.
- Water utilities have made a number of filings.
- Commissions appear to tend to grant the requested rate base increases attributed to increased security costs.
- While there is not a lot of information, what data that does exist suggests that the incremental post 9/11 critical infrastructure security costs have a modest rate impact.

Adjustment Clauses

The Florida Public Service Commission (FPSC) initially used its fuel adjustment clause and now uses its capacity cost recovery clause to allow recovery of incremental security costs incurred in response to 9/11.[38] In its first order the FPSC responded to the following stipulation:

> The commission should continue to monitor the nature and longevity of incremental security costs being recovered through a cost recovery clause to determine whether and to what extent such costs should be recovered through base rates. Security costs have traditionally been recovered through base rates, although in Order No. PSC-01-2516-FOF-El, issued Dec. 26, 2001, the commission authorized Florida Power & Light Company to recover incremental

> security costs due to recent national security concerns through the fuel adjustment clause.[39]

The FPSC approved the stipulation and said that the Florida Power & Light Company and the Florida Power Corporation's incremental security costs shall be reassessed at the conclusion of settlements in their most recent base rate proceedings.[40] The FPSC then acted to address company-specific cost recovery issues.

For incremental 2002 and 2003 security costs, Florida Power & Light Company (FP&L) requested $12.7 million for costs incurred to comply with directives in Nuclear Regulatory Commission Order No. EA-02-26. Two parties opposed the request based on an earlier settlement and order that said, "FP&L will not use the various cost recovery clauses to recover new capital items which traditionally and historically would be recoverable through base rates."[41] Approximately $1.3 million of the cost recovery request included items that would normally be classified as capital items.

FP&L's 2001 security costs had been approved for recovery using the fuel adjustment clause because of the "…nexus between the protection of nuclear generation facilities and the fuel cost savings that result from the continued operation of those facilities." Further, recognizing that the costs were not clearly defined, the FPSC stated it retained the ability to consider an alternative cost recovery mechanism at a later time.[42] For FP&L's 2002 and 2003 security costs the FPSC found that these costs do not clearly fall within the classification of "items which traditionally and historically would be recoverable through base rates" and approved recovery through a cost recovery clause. Because these costs were seen as extraordinary, recovery (without distinction between capital and expensed items) these costs are treated as current year expenses, and accounted for separately.

The FPSC concluded by stating: "We find that these costs shall be reassessed at the conclusion of the term of the Settlement and Stipulation approved in Order No. PSC-02-0501-AS-EI to determine whether these costs should continue to be recovered through a cost recovery clause or would more appropriately be recovered through base rates."[43] The $12.7 million was authorized for cost recovery. Additional information about Florida's use of the adjustment clause approach is found in Appendix B.

Several implications from the Florida adjustment clause example for other state commissions are readily apparent:

- Only incremental security costs were addressed.
- The company-specific proceedings were initially guided by a stipulation in an earlier proceeding.
- The FPSC accepted one cost recovery mechanism at one point in time, but felt another mechanism (the cost recovery clause) to be more appropriate later.
- While capital costs were identified, all security costs were recovered in the current year.
- Cost recovery requests were documented by reference to federal directives and orders.

- The commission required that incremental security costs be accounted for separately, allowing for auditing.
- The specific utility filings had to consider other relevant regulatory proceedings and orders.

Closed Proceedings

With the exception of Kansas, no closed cost recovery proceedings *per se* were identified. State commissions occasionally used a stipulation process to address security issues. Sometimes commissions approved final rates without specifying what portion of the increase was attributable to existing or post 9/11 security costs. Most states have addressed the issue of confidentiality, as noted elsewhere in this report.

In 2002, Kansas passed a statute requiring the commission to allow utilities to recover expenses that the commission deemed appropriate to secure electric generation or transmission assets or natural gas production and transportation assets.[44] The costs are to be passed through to utility customers' bills. ***The statute directed that the applications for security cost recovery be reviewed in an expedited and confidential manner.***

The Kansas Corporation Commission (KCC) subsequently investigated how to handle requests for security cost recovery and issued an order adopting rules on January 31, 2003.[45] The commission set a target of a 60-day review period on applications, and specified how applications should be identified so as to receive immediate confidential treatment. The commission said it will allow for recovery through its usual manner of depreciation and approved rate of return.

In 2003, Kansas passed the Energy Security Act.[46] The act is specifically intended to address the recovery of enhanced security expenses incurred after the attacks of Sept. 11, 2001. It stated further that:

- The recovery period must be within half of the usable lifetime of the investment.
- Confidentiality exists as to the amount of recovery requested and allowed, as well as the method of recovery requested and allowed.
- The commission must provide protective orders on all filings so that a public watchdog group, the Citizens' Utility Ratepayer Board, may review documents if the board intervenes.
- The security cost recovery charge applies to both retail and wholesale rates, and shall not be identifiable on customers' bills.

With reference to the finding that the threat of terrorism require the government to take extra measures to protect the public welfare, the act notes that the commission's decision on the prudence of a security expenditure should, "not be based on standard regulatory principles and methods of recovery and shall take fully into account the findings and intent of the legislature."[47]

The implications for other state commissions considering a closed proceeding include:

- How procedures may be designed to allow consumer groups access to information.
- That authority may be established that allows a commission to use nonstandard regulatory principles due to critical infrastructure protection concerns.
- That confidentiality may be awarded regarding the amount requested and allowed to a utility for critical infrastructure protection costs.

Deferral (Balancing) Accounts

Deferral accounts were commonly used by state commissions in conjunction with a number of other cost recovery mechanisms in order to allow a utility to accumulate costs that could then be subsequently recovered in a rate case hearing. One interesting example of this occurred in Michigan, where the Michigan legislature amended its Public Utility Chapter that, among other things, defined "enhanced security costs", effectively established deferral accounts, and authorized a security cost recovery factor.[48]

Enhanced security costs include increases in the cost of insurance that are attributable to an increased terror related risk and the costs of maintaining or restoring electric service as the result of an act of terrorism.[49] Michigan's definition allows for costs in response to federal or state requirements.

> ***The Michigan statute defines "enhanced security costs" as reasonable and prudent costs of new and enhanced security measures incurred before January 1, 2006 for an electric generating facility by a covered utility that are required by federal or state regulatory security requirements issued after Sept. 11, 2001 or determined to be necessary by the commission to provide reasonable security from an act of terrorism.*** (See Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (17) (c)).

Once these costs have been identified by the utility, the utility may apply to the commission to recover enhanced security costs for an electric generating facility through a security recovery factor. Due to the implementation of a rate cap, allowed cost recovery is to be accrued and deferred until the rate cap is removed. Allowed security costs can only be incurred between Sept. 11, 2001 and January 1, 2006. The Michigan commission then retains the oversight authority to determine which costs in the deferral account are to be recovered, as described in more detail in the following section.

The implications for other states considering using deferral accounts include that:

- Deferral accounts are a well established and widely used regulatory cost recovery method.
- Deferral accounts allow costs to be identified and accounted for, but may not necessarily bind a commission on how the identified costs will be treated.
- Deferral accounts are only appropriate in instances where the commission will consider cost recovery.

Security Recovery Factor Charges

Michigan's security recovery factor allows the commission to decide if identified security costs will be eligible to be included in rates for retail customers. In determining the security recovery factor, the commission shall only include costs that the commission determines are reasonable and prudent and that are jurisdictionally assigned to retail customers of the covered utility in this state. The costs included shall be net of any proceeds that have been or will be received from another source, including, but not limited to, any applicable insurance settlements received by the covered utility or any grants or other emergency relief from federal, state, or local governmental agencies for the purpose of defraying enhanced security costs. In its order, the commission shall designate a period for recovery of enhanced security costs, including a reasonable return on the unamortized balance, over a period not to exceed 5 years. The security recovery factor shall not be less than zero.

The statute allows a "covered utility" utility to seek recovery. A "covered utility" is further defined as an incumbent utility subject to the rate cap provision of the statute amendment.[50] Allowable costs must be recovered through an unbundled "security recovery factor" on retail customers of the covered utility.

The implications for other states relative to line item charges are that:

- Insurance and federal or state governmental funds may need to be considered before a cost request is made.
- A presumption may exist that a utility should have a record that shows that they have examined the use of insurance or governmental funding.
- Commissions apply cost recovery standards that may include various combinations of used and useful, prudence, just and reasonable tests, and compliance with governmental decrees.
- There are no distinctions between capital investments and expense items.
- A recovery time period may be specified.

Other Cost Recovery Mechanisms

Several other cost recovery efforts have been identified. These include the following:

- **Notice of Inquiry.** The Oklahoma Corporation Commission (OCC) initiated a Notice of Inquiry approach to address a number of critical infrastructure issues, including cost recovery.[51] The inquiry covered electric, natural gas, water, and telephone utilities and is now being continued as a Notice of Proposed Rulemaking. While not a unanimous consensus, there appeared among the utilities a preference for rulemaking rather than legislation to address cost recovery. The inquiry approach allowed the OCC to formally and publicly have specific cost recovery questions answered by an array of stakeholders. It did not bind the commission, but provided a forum to hear concerns.

- **Ongoing Dialogue.** New Jersey, through the New Jersey Infrastructure Advisory Committee, has established utility industry working groups that meet regularly and discuss a number of issues, including how utility infrastructure protection is being financed. Through an examination of best practices, New Jersey has created comprehensive guidelines for security, incorporating state and federal standards. Ohio notes it has informally polled utilities as they file rate cases, finding that the smaller companies have not reported doing anything extraordinary regarding security. In two larger utilities security costs were an issue only for one, and the issue centered on disclosure of security sensitive information.

- **Special Infrastructure Cost Recovery Proceeding.** The Connecticut legislature enacted Public Act No. 02-94 to ensure that ratemaking considerations included the "reasonable costs of security assets, facilities and equipment that are incurred solely for the purpose of responding to security needs associated with the terrorist attacks of Sept. 11, 2001, and the continuing war on terrorism."[52] This statute was subsequently amended to include gas and electric utilities rate plans that have earnings sharing mechanisms. Two companies applied to the Connecticut Department of Public Utility Control for cost recovery: Connecticut Natural Gas Corporation (CNG) and The Southern Connecticut Gas Company (CSG).[53] CNG requested recovery of $219,899 in actual and $1,281,078 in forecasted, annualized and on-going expenditures. CSG requested recovery of $137,636 in actual and $564,062 in forecasted, annualized and on-going expenditures.

  The Department found the actual costs to be reasonable and allowed recovery in each company's next rate case proceeding.[54] The Department found that the proposed forecasted costs were not known and measurable at this time. Accordingly, these expenditures could not be deemed reasonable and prudent and further review will be undertaken in the next rate cases. The Department also denied the companies' request to reopen their respective rate case proceedings in order to implement a proposed rate rider to recover post-September 11 security-related enhancements.

Action here by Connecticut has implications for other states that include:

- Affirmation that cost recovery explicitly requires a finding of prudence.
- A single-purpose proceeding on critical infrastructure cost recovery is feasible.
- Reliance on a rate case for actual recovery.
- A cost-recovery approach for utilities with earnings sharing plans can be designed.
- Both a legislative and regulatory focus on critical infrastructure cost recovery.
- Results that seem to indicate that incremental infrastructure costs may be significant but are not overwhelming.

13. SUMMARY

The cost recovery protocols and cost recovery mechanisms identified in this report clearly show that state regulatory commissions have acted to allow cost recovery of prudently incurred critical infrastructure protection costs. Four important summary observations are:

1) Cost recovery activities have occurred and been allowed in both traditionally regulated states as well as in restructured states.
2) Cost recovery mechanisms employed have been nested in rate cases.
3) State legislatures have enacted legislation, but in no case did the legislation override a commission's underlying obligation to ensure that only prudent or reasonable, costs were eligible for cost recovery.
4) An expectation exists that insurance should be part of a utility's cost recovery planning.

In some states, security costs were examined in a regulatory proceeding and allowed without a lot of elaboration. In other instances, commissions had more documentation on their cost recovery rationale. In both approaches, state regulators unmistakably affirmed their support for ensuring that critical utility infrastructure is protected. Unlike other policy debates where cost recovery issues become debating points for opposing sides, no significant regulatory debates were observed, once the reasonableness or prudence of the costs was established. Regulators have a long tradition of examining, selecting, and using the most appropriate cost recovery mechanisms available to them. This report shows that regulators have used a variety of cost recovery mechanisms, both in restructured and traditionally regulated states. While difficult to document, the post 9/11-security costs appear incremental. These cost mechanisms are similar to those identified by the National Conference of State Legislatures (NCSL) shown in Appendix C. They have not been big-ticket expenditures, and state regulators have largely seen them as prudent and eligible for cost recovery.

APPENDIX A

FERC ORDER 630 AND THE PROTECTION OF CRITICAL INFRASTRUCTURE INFORMATION

The Federal Energy Regulatory Commission (FERC) issued a Final Rule in Order 630 on Feb. 20, 2003 on the protection of critical energy infrastructure information. [55] FERC defines critical infrastructure broadly to include "existing and proposed systems and assets, whether physical or virtual, the incapacity or destruction of which would negatively affect security, economic security, public health or safety, or any combination of those matters." ***Though the context of FERC Order 630 is limited to the protection of critical energy infrastructure information in FERC's possession***, FERC's definition of critical energy infrastructure could be a useful basis for creating a definition that states could use to help determine whether an existing system or asset should generally be considered to be critical energy infrastructure.

However, some issues are raised if the broad definition is applied "as is" to cost recovery. The first issue is one of "existing" versus "proposed." The need to protect the sensitive information of a "proposed" critical infrastructure system or assets from unnecessary disclosure is easily understood. However, granting cost recovery for a "proposed" system or asset investment is a larger question and requires more consideration. Under this definition, a commission would be asked to essentially grant pre-approval for "proposed" expenditures to be made in the future. Assuming a state commission wishes to grant approval of the proposed expenditure, it may take one of several approaches. Three common approaches would include the following. It could approve the proposed expenditure as submitted and say nothing further regarding the approval of future similar requests. The commission could approve the expenditure and in its order make clear that the approval was based solely on the merits of the individual rate case and was not precedent setting for future recovery requests of "proposed" systems or assets. Or the commission could approve the expenditure subject to a true-up of the actual recoverable amount following a decision on the type of expenditure in a commission generic proceeding, or following the applicant's submission of actual expenditure records.

Deciding an issue such as recovery of for "proposed" systems or assets in a generic proceeding does offer a commission the opportunity to more broadly examine an issue. However, ***generic cases are generally very open and protracted proceedings***. This may make generic proceedings unsuitable for some critical infrastructure issues. Furthermore, a conditional approval subject to a generic proceeding or future true-up may not provide adequate certainty to an applicant. At best, it would provide a high degree of probability of some recovery, but would tell the applicant it may proceed, but should do so very cautiously.

The second issue with the FERC definition that a state commission must face is one of limiting the definition of what would "negatively affect security." Existing security and protection systems and assets whose loss would negatively affect security are clearly used and useful

critical infrastructure. However, it might be possible to argue that a current or proposed system that does not directly enhance some aspect of security by its operation or addition, will actually have this effect when incapacitated or destroyed. For example, it might be possible for an applicant to argue that a new roof on its executive building, while not directly enhancing security would, if destroyed, negatively affect security. A commission must ask the question: Can a system or asset be considered used and useful or prudent if it does not directly enhance some aspect of security? In a network composed of many joint and common costs, this may be difficult.

A commission must ask the question:

> ***Can an asset be considered used and useful or prudent if it does not directly enhance some aspect of security?***

APPENDIX B

RECOVERING CRITICAL INFRASTRUCTURE PROTECTION COSTS THROUGH ADJUSTMENT CLAUSES

The Florida Public Service Commission used the same cost recovery approach, with a few differences, in two cases. In one, the Florida Power Corporation (FPC) requested recovery of approximately $7.8 million for 2002 and 2003 security costs incurred in compliance with Nuclear Regulatory Commission Order No. EA-02-26. Approximately $4.1 million were costs that would normally be classified as capital items. Two parties opposed the request for the same reason noted above. The FPSC concluded stating "Finally we find that these costs shall be reassessed at the conclusion of the term of the Settlement and Stipulation approved in Order No. PSC-02-0655-AS-El to determine whether these costs should continue to be recovered through a cost recovery clause or would more appropriately be recovered through base rates." (See Order No. PSC-02-1761-FOF-El, Docket No. 020001-El, p. 11.) The $7.8 million was authorized for cost recovery.

In another case, Tampa Electric Company (TECO) requested recovery of approximately $1.2 million for incremental operation and maintenance expenses associated with 2001, 2002, and 2003 security costs. TECO's witness noted these costs were not in compliance with any government mandate, but were consistent with guidelines developed by Presidential Homeland Security directives and North American Electric Reliability Council actions. A TECO witness indicated that TECO anticipated moving these costs into base rates at TECO's next traditional rate case. The PSC indicated that it found such treatment reasonable and approved recovery of the $1.2 million through the capacity cost recovery clause. The costs are to be treated as current year expenses and shall be separately accounted for auditing purposes. (See Order No. PSC-02-1761-FOF-EI, Docket No. 020001-EI, p. 15.)

APPENDIX C
NATIONAL COUNCIL OF STATE LEGISLATURES[1]

PAYING FOR ENERGY SECURITY

Energy security may be costly and will require energy companies to make new investments in energy facilities that they had not previously expected. Some of these investments may be for new equipment and others may be for additional employees and security personnel. Some companies –such as oil companies- that operate in competitive markets and are not price-regulated, will make the investments as they see fit and will seek to lower costs and increase efficiency elsewhere in their business or perhaps raise prices to the extent the market allows. Companies that operate in regulated, monopoly markets –including gas, telecommunications, electric and some water companies- operate in a more public environment where state or federal officials oversee the rates they can charge.

How Much Detailed Oversight and Approval Should Utility Commissions Have Over Cost Recovery?

State policymakers, primarily through their utility commissions, must balance the need to oversee the utilities they regulate with the desire to allow them to manage the details of their security measures. Utilities do this with some assurance that the regulatory commissions will approve their prudently incurred costs. Each state will need to develop its own approach to how it allows utilities to recover their security-related costs. In every situation, it may be prudent for the state and the regulated utilities to collaborate and to determine a common strategy for addressing security issues. This common strategy could make utilities more certain that they would later be able to recover their costs.

Table 3. NCSL Solution Menu

Condition	Solution Menu
Regulated utilities, no rate cap or freeze	1. Address security costs in next rate case. 2. Allow commission to allow quick pass-through of security costs through normal regulatory process. 3. Enact legislation to ensure recovery of security-related costs, with specified commission oversight.

[1] The National Conference of State Legislatures is the bipartisan organization that serves the legislators and staffs of the states, commonwealths and territories. The material in this appendix is an except from Matthew H. Brown, Christie Rewey, and Troy Gagliano, *Energy Security* (Washington, D.C., 2003), pp. 48-52.

Regulated utilities with soft rate cap	1. Address security costs in next rate case. 2. Allow commission to allow quick pass-through of security costs through a special surcharge. 3. Enact legislation to ensure recovery of security-related costs, with specified commission oversight.
Regulated utilities with hard cap	1. Enact legislation to ensure recovery of security-related costs, with specified commission oversight. 2. Allow commission, through regulatory process, to set up a "deferral" account for utility to recover prudent costs at a later time.

ENDNOTES

[1] The National Association of Regulatory Utility Commissioners (NARUC) Ad Hoc Committee on Critical Infrastructure's Cost Recovery Workshops took place in Denver, Colorado, June 28, 2003, and in Washington, D.C., October 23-24, 2003.

[2] It may be that September 11 is not the key date for drawing a comparison in utility security expenditures. In 1998 the President's Commission on Critical Infrastructure Protection involved utilities and regulators in its outreach activities. In preparation for Y2K, the Federal Emergency Protection Agency (FEMA) conducted ten regional workshops that included utilities and state regulators.

[3] Price caps generally have an exogenous adjustment factor that allows a utility to request cost recovery for extraordinary expenditures caused by circumstances outside the control of the utility. However, exogenous adjustments are unusual because all costs of a utility (those that have increased and those that have decreased) since base price caps were established would likely have to be examined. Incremental security cost increases, while significant, may not have reached the extraordinary cost threshold.

[4] A working group created by Commissioner Connie Hughes immediately following 9/11 has, for example, continued to function as a workable way to talk about critical infrastructure issues.

[5] See Florida Public Service Commission, Order No. PSC-02-1761-FOF-El and Florida Public Service Commission, Order No. PSC-01-2516-FOF-El.

[6] See 2003 Kansas HB 2374, codified as Kansas Statute Nos. 66-1234, 66-1235, and 66-1236.

[7] Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (17) (c).

[8] See Oklahoma Corporation Commission, Case No. PUD 200300624.

[9] *FY 2005 Congressional Performance Budget Request*, FERC, February 2004, p. 34. Report is available at http://www.ferc.gov/about/strat-docs/FY05-Budg.pdf.

[10] Ibid., p. 85.

[11] Greg Frank, Frank Cox, Ray Dominquez, "*Homeland Security – Battelle's Capabilities*," presented to The Ohio State University, March 5, 2002, p. 2.

[12] For more information on cost allocation issues, see Robert Burns, et al., *Regulating Electric Utilities with Subsidiaries*, No. 85-16 (Columbus: NRRI, 1986).

[13] See Florida Public Service Commission, Ibid.

[14] State of Connecticut Public Act 02-94, codified as Connecticut General Statute 16-19e(a)(4): subsequently amended to include a new subsection g.

[15] Joe McGarvey and John Wilhelm, *NARUC/NRRI 2003 Survey of Critical Infrastructure Security,* No. 04-01, (Columbus: NRRI, 2004), p. 9-10.

[16] Duquesne Light v. Barash, 488 U.S. 299 (1989).

[17] For more on the prudence test, see Robert Burns, et al., *The Prudent Investment Test in the 1980s,* No. 84-16 (Columbus: NRRI, 1985).

[18] Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d.

[19] Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (13).

[20] In the NARUC Cost Recovery Workshops the distinction between standards and guidelines was drawn. Standards are mandatory, but increase the probability of cost recovery. Guidelines permit regional flexibility, but as they permit more leeway, may have less cost recovery certainty.

[21] *Security Guidelines for the Electricity Sector,* North American Electric Reliability Council, issued June 14, 2002, available at http://www.esisac.com/publicdocs/Guides/SecurityGuidelinesElectricitySector-Version1.pdf; and *Urgent Action Standard 1200 – Cyber Security,* North American Electric Reliability Council, issued August 13, 2003, available at ftp://ftp.nerc.com/pub/sys/all_updl/standards/Urgent-Req-CyberStnd-3-3121.pdf.

[22] *Pipeline Security Information Circular* and *Pipeline Security Contingency Planning Guidance*, Department of Transportation, Office of Pipeline Safety, issued September 5, 2002; these documents are not publicly available.

[23] In its guidelines, OPS notes that in addition to its *Pipeline Security Information Circular* and *Pipeline Security Contingency Planning Guidance* documents, it also relies on the industry consensus security guidance documents for purposes of evaluating the security plans of pipeline operators. Specifically, the American Petroleum Institute's *Guidelines for Developing and Implementing Security Plans for Petroleum Pipelines,* issued July 2002, are used in reference to hazardous liquid pipelines, and the American Gas Association and Interstate Natural Gas Association of America's *Security Guidelines: Natural Gas Industry, Transmission, and Distribution,* issued September 2002, are used to help evaluate natural gas transmission and distribution lines. The above documents are not publicly available.

[24] *NRIC Best Practices,* The Network Reliability and Interoperability Council, issued various years, available at http://www.bell-labs.com/cgi-user/krauscher/bestp.pl.

[25] See "National Drinking Water Advisory Council's Water Security Working Group Meeting Announcement," *Federal Register,* Vol. 69, No. 118, (June 21, 2004), p. 34351, available at

http://frwebgate.access.gpo.gov/cgi-in/getdoc.cgi?dbname=2004_register&docid=fr21jn04-42.pdf.

[26] Public Law 107-188, 107th Congress, 2nd Session, (June 12, 2002), Sec. 401.

[27] McGarvey and Wilhelm, *NARUC/NRRI 2003 Survey of Critical Infrastructure Security,* p. 3.

[28] Ibid., p. 9-10.

[29] Scott Potter, *After the Freeze: Issues Facing Some State Regulators as Electric Restructuring Transition Periods End*, No. 03-18 (Columbus: NRRI, 2003).

[30] McGarvey and Wilhelm, *NARUC/NRRI 2003 Survey of Critical Infrastructure Security,* p. 3.

[31] Several states have frozen retail service rates during specified periods of transition to competitive markets. A rate freeze or cap may be any or all components of a retail rate. For example, in Ohio a stipulation approved with Dayton Power & Light froze transmission and distribution rates and capped generation rates through 2008; see Public Utilities Commission of Ohio, Case No. 02-2779-EL-ATA. For a summary of electric restructuring transition period details see Scott Potter, *After the Freeze: Issues Facing Some State Regulators as Electric Restructuring Transition Periods End*, No. 03-18 (Columbus: NRRI, 2003).

[32] Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (4).

[33] That is to say the large utilities subject either to the rate cap and/or a previous orders in Michigan Public Service Commission cases U-11181-R and U-12204. See Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (17) (b) and (d).

[34] States surveyed reporting pending electric and natural gas rate cases include Arizona, Maine, Ohio, New Hampshire, and Pennsylvania.

[35] In Ohio and New Jersey, water utility rate cases have had a stipulation settlement that effectively made it difficult to link specific security costs to the specific, approved rate items. In a Pennsylvania investor-owned water utility, incremental security costs were approved, but the case is on appeal by the consumer advocate. The Missouri Commission approved a two-year deferral of security costs for a water utility.

[36] See Iowa Utilities Board, Docket No. RPU-02-2.

[37] Ibid., Docket Nos. RPU-02-3 and RPU-02-8. In addition, Iowa American Water Company was granted recovery of $900,781 in operating expenses as part of a rate case, RPU-01-04. The security measures were presented to the Iowa Board at the end of the case and were allowed to constitute a portion of the negotiated settlement only after sufficient notice had been given to customers. The Iowa Board did not receive any comments or objections.

[38] See Florida Public Service Commission, Ibid.

[39] Ibid., Order No. PSC-02-1761-FOF-El, p. 3-4.

[40] Ibid., Docket Nos. 001148-EI and 000824-El.

[41] See Ibid., Order No. PSC-02-0501-AS-El.

[42] See Ibid., Order No. PSC-01-2516-FOF-El.

[43] Ibid., Order No. PSC-02-1761-FOF-El, Docket No. 020001-El, p. 7.

[44] Kansas Statue No. 66-1233.

[45] Kansas Corporation Commission, Docket No. 03-GIMX-431-GIV.

[46] See 2003 Kansas HB 2374, codified as Kansas Statute Nos. 66-1234, 66-1235, and 66-1236.

[47] Ibid., Sec. 3(8)(b).

[48] Michigan Compiled Law, Chapter 460, Act 3 of 1939, Section 460.10d (17) (c).

[49] Ibid., Section 460.10d (17) (c).

[50] Ibid., Section 460.10d (17) (b).

[51] See Oklahoma Corporation Commission, Case No. PUD 200300624.

[52] See State of Connecticut Public Act 02-94, codified as Connecticut General Statute 16-19e(a)(4).

[53] See Connecticut Department of Public Utility Control, Docket No. 03-06-17.

[54] The California Commission rejected a water utility request for a memorandum account for security costs, preferring to address the issue in a general rate case. See California Public Utility Commission Decision D0310070 on Proceeding A0308009.

[55] United States of America Federal Energy Regulatory Commission 18 CFR Parts 375 and 388 (Docket Nos. RM02-4-000, PL02-1-000; Order No. 630), issued February 21, 2003.