Memorandum

TO: MEMBERS OF THE MASSACHUSETTS GRID MODERNIZATION ADVISORY COUNCIL (GMAC)

FROM: TIM WOOLF, KYLE SCHULZ, BEN HAVUMAKI, MELISSA WHITED; SYNAPSE

DATE: FEBRUARY 21, 2025

Re: EDC Proposal for ESMP Interim Cost Recovery Mechanism

1. Introduction and Summary

The purpose of this memo is to review the Electric Distribution Companies' (EDCs) recent proposal for cost recovery of their Electric Sector Modernization Plan (ESMP) investments. We summarize the proposal, provide some background information on recent Department of Public Utilities (Department) orders related to cost recovery, and offer some observations.

The EDCs propose to recover ESMP investments through the ESMP factor (ESMPF), a reconciling mechanism that allows for recovery of ESMP investments between rate cases. The investments will be recovered the year after the projects are in service, and annual recovery will be subject to an Annual Revenue Cap that limits annual increases in rates, as well as a Term Cap that limits the term cost recovery to the proposed budgets in the approved ESMPs. The ESMP investments will be subject to a prudence review in the year after the projects are in service.

The EDCs propose an annual ESMP Cost Recovery Filing that includes documentation of the ESMP investments *made in the previous year*, including justification that the investments are eligible for recovery, incremental, prudently incurred, in service, and used and useful. The Cost Recovery Filings will also include a summary of *planned* ESMP investments, including anticipated revisions to and reprioritization of investments in the proposed 2024 ESMPs.

The Department has been clear that the 2024 ESMP proceedings were not intended to facilitate review of ESMP investments for cost recovery. That review will occur going forward as the EDCs propose to recover specific ESMP investments in their ESMP Cost Recovery Filings. Consequently, the Department and stakeholders have an opportunity to help mitigate ESMP costs during the annual ESMP Cost Recovery Filings.

The annual ESMP reviews would be most effective in mitigating costs if the Department were to significantly expand the analysis and review of the planned ESMP investments during one or more of the Cost Recovery Filings. These filings provide critical opportunities for updating load forecasts and cost estimates, responding to changing circumstances, obtaining stakeholder input, considering alternatives, and mitigating costs. This expanded analysis and review could include the following:

- Require that one or more of the Cost Recovery Filings include comprehensive analyses of alternative investments beyond non-wires alternatives, including alternative individual projects, systemwide programs, and rate designs.
- Require that one or more of the Cost Recovery Filings include benefit-cost analysis (BCA) of proposed ESMP investments and alternatives.

- Modify the EDCs' proposed Annual Revenue Cap and Term Cap so that they are based on any updated budgets in the annual Cost Recovery Filings, instead of the budgets in the 2024 ESMPs.
- Require that the Cost Recovery Filings explicitly account for updated goals and on-going activities in Massachusetts related to grid modernization and decarbonization.
- Require that the ESMP Cost Recovery Filings include a comprehensive set of metrics regarding planned ESMP investments and opportunities to mitigate costs.

An enhanced cost recovery review process will not only encourage cost containment during the current ESMP term, it will also provide the EDCs, the Department, and stakeholders with information, forecasts, and analytical practices that will lead to a more robust draft of the next ESMP.

2. The EDCs' Proposal for Recovery of ESMP Investments

The EDCs state that interim cost recovery between rate cases will be necessary to recover the increasing costs required to comply with the 2022 Clean Energy Act, G.L. c. 164, § 92B.[1] All three EDCs recommend the same ESMP cost recovery mechanism. The key elements are summarized below.

The ESMP investments will be recovered through the ESMPF, a reconciling mechanism. Reconciling mechanisms are typically used in Massachusetts (and elsewhere) for utility investments that are outside the EDCs' control, volatile in nature, hard to establish in base rate cases, and which are required to achieve policy objectives. The EDCs claim that the ESMP investments meet these criteria.[2]

The reconciling mechanisms will allow EDCs to recover both O&M and capital expenses associated with implementation of the approved ESMPs.[3]

The EDCs propose to submit annual ESMP Cost Recovery Filings to the Department on May 1 of each year, starting in 2026. The Cost Recovery Filings will include documentation of the ESMP investments made in the previous year, including justification that the investments are eligible, "incremental, prudently incurred, and, where applicable, fully in service, used and useful."[4] This information will be used by the Department to determine whether to allow recovery of ESMP investments made in the previous year.

The Cost Recovery Filings will also include a summary of planned *future* ESMP investments, as well as anticipated revisions to and reprioritization of proposed ESMP investments. The Cost Recovery Filings will also include discussion of the alternative investments considered, including but not limited to Non-Wires Alternatives.[5]

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1 Direct Testimony of Ashley Botelho and Jennifer Shilling on behalf of Eversource Energy, Docket DPU 24-10, December 18, 2024 (Eversource Testimony), pages 5-6. Throughout this memo we cite only the Eversource Testimony for simplicity; the testimony of the other EDCs contains the same cost recovery proposal.

2 Eversource Testimony, page 6.

3 The EDCs propose that O&M costs be collected starting on January 1, 2025 and capital costs be collected starting July 1, 2025. Eversource Testimony, page 8.

4 Eversource Testimony, pages 13-14.

5 Eversource Testimony page 14. The EDC proposal does not specify whether the discussion of alternatives will address ESMP investments made in the previous calendar year or proposed for the next year.

The Department will conduct annual prudence reviews of ESMP investments.[6] Each company's ESMP investments "should be reviewed as to whether they were reasonable and prudent based on the information known by the Company at the time of investment and whether the investments were consistent with the approved ESMP."[7] These prudence reviews will take place when the Department reviews the ESMP Cost Recovery Filings.

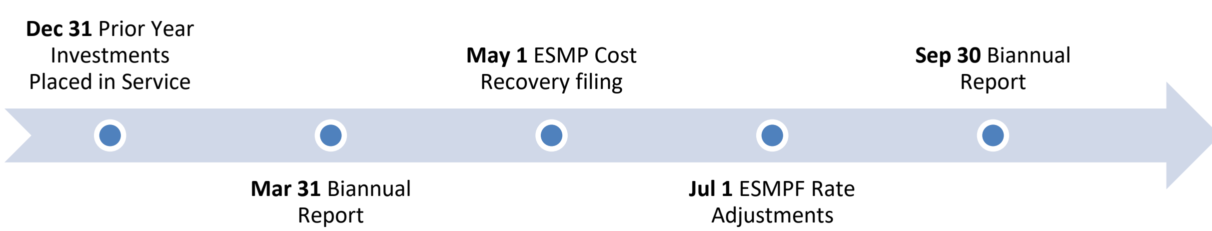
In addition to the Cost Recovery Filings, the EDCs will submit ESMP Biannual Reports to DPU and GMAC? on March 31 and September 30 each year. These will include information on the ESMP investments made in the previous calendar year, including results of performance metrics. They will also include changes and reprioritization of ESMP investments proposed in the 2024 ESMPs, a comparison of forecasted versus actual demand, summaries of outside funding sources, and more.[8]

The EDCs will seek to control costs through their planning and budgeting processes. In addition, they will implement two caps on ESMP spending:

- An Annual Revenue Cap, which will limit annual changes in the ESMPF to 3% of each company's annual total revenue. This is designed to limit the year-to-year increases in customers' bills. If the annual costs are exceeded in an investment year, then the company can request recovery of the excess through the ESMPF in a future year.[9]
- A Term Cap, which will limit total cumulative ESMP investment recovery to the cumulative costs proposed in each company's approved ESMP over a term of [state duration].[10] If the Term Cap is exceeded in a term, then the company can request recovery of the excess in the next base distribution rate case.[11]

National Grid intends to propose a performance incentive mechanism (PIM) for non-wires alternatives projects comprised of assets owned by third parties or customers that receive payments through the Grid Services Compensation Fund. National Grid will propose this PIM through a separate filing.[12]

The figure below summarizes the annual ESMP filing and review process.



[6] Eversource Testimony, page 19.

[7] Eversource Testimony, page 22.

[8] Eversource Testimony, page 14.

[9] Eversource Testimony, pages 10-11.

[10] Eversource tariff, section 7.1.

[11] Eversource tariff, Section 7.2.

[12] Direct Testimony of A. Schneller, A. Gumbus, and M. Little, Docket DPU 24-11, on behalf of National Grid December 18, 2024, page 28.

3. The Attorney General's Testimony on the EDC Cost Recovery Proposal

The Attorney General's Office submitted testimony on the EDC cost recovery proposal on January 30, 2025. It includes the following recommendations to the Department.[13]

1. Exclude substation and distribution line investments from eligibility for recovery through the ESMP cost recovery mechanism.
2. Reduce the Annual Revenue Cap to 3% of EDC's distribution revenues.
3. Direct the EDCs to propose annual spending plans, including budgets, as a supplement to the ESMP five-year Term Cap.
4. Establish annual spending caps based on a review of each EDC's proposed annual spending plans.
5. Order that ESMP costs for which recovery is deferred due to the annual cap earn interest at the same interest rate the EDCs pay on customer deposits.
6. Require that the EDCs perform risk-informed benefit-cost analyses for resiliency and all network investments and submit these analyses as part of the EDCs' documentation requirements.

4. Recent Department Orders on Cost Recovery

Department Orders on ESMP Cost Recovery

In the ESMP order, the Department is clear that it views the 2024 ESMPs as strategic plans.[14] Consequently, the "Department is not pre-approving or preauthorizing any proposed ESMP investments or related costs identified by the Companies" in the 2024 ESMPs.[15] Department review for cost recovery and prudency will occur at a later date.[16] (The EDCs propose that this review for cost recovery and prudence occur as part of the Annual ESMP Cost Recovery Filings.)

In the ESMP order, the Department proposes to allow short-term targeted cost recovery for ESMP costs in Phase II of the ESMP dockets. The Department intends to investigate later in a separate proceeding innovative approaches for long-term ESMP cost recovery with a goal of transitioning from short-term cost recovery to recovery through base distribution rates.[17]

In the procedural notice for Phase II, the Department explained that it wants to investigate (1) the costs eligible for recovery, (2) cost containment, (3) documentation, and (4) a planned sunset of the cost

[13] Direct Testimony of Paul Alvarez and Dennis Stephens, on behalf of the Office of the Attorney General, DPU 24-10/11/12, January 30, 2025, page 40.

[14] Massachusetts Department of Public Utilities, *Petition of the EDCs for Approval by the Department of the ESMPs*, Dockets DPU 24-10/11/12, August 29, 2024 (Department ESMP Order), pages 27-28.

[15] Department ESMP Order, page 65.

[16] Department ESMP Order, page 65.

[17] Department ESMP Order, pages 443-444.

recovery mechanism.[18] The Department notes that it seeks to explore "cost containment provisions such as budget or revenue caps and consideration of possible mechanisms to encourage innovative approaches designed to minimize costs for ratepayers."[19]

Department Orders on Grid Modernization Cost Recovery

Beginning with Docket DPU 12-76, the Department has required the EDCs to prepare and implement grid modernization plans. These plans are the precedents to the ESMPs. They were developed prior to the 2022 Clean Energy Act and cover the period up to December 2024. Grid modernization investments proposed for 2025 and beyond are included in the ESMPs.

The Department has allowed the EDCs to recover grid modernization investments between rate cases through a Grid Modernization Factor (GMF), a reconciling mechanism.[20] The investment can be recovered after the year in which the project is placed in service. Interest will be applied to any over- or under-recovery of costs between the time they are incurred and the time they are recovered.[21]

The Department conducts periodic reviews of the EDC grid modernization plans. As a part of these reviews, the Department preauthorizes those investments that meet the Department's standards and grid modernization goals. For investments that are preauthorized, "the Department will not revisit whether the company should have proceeded with the investment as proposed. The Department will, however, review the prudence of a company's implementation of the preauthorized investments."[22]

In addition, in order to be eligible for recovery through the GMF, grid modernization investments must also meet the Department's used and useful standard requiring that the project (a) is in service and (b) provides "net economic benefits" to ratepayers.[23]

The Department established a spending cap on the GMF equal to the planned budgets included in the three-year grid modernization plans. Any spending above the cap is not eligible for cost recovery between rate cases.[24] (This cap is comparable to the Term Cap in the EDC cost recovery proposal.)

Department Orders in Recent EDC Rate Cases

One of the key issues in each of the three recent rates cases is the recovery of increasing capital costs between rate cases. Under performance-based ratemaking (PBR), EDCs are allowed to recover costs between rate cases in two ways:

- Through base rates using formulas that account for changing costs between rate cases. These formulas are not tied to the actual costs incurred. Instead, they are rough approximations based

[18] Department of Public Utilities, *Phase II Procedural Notice*, Docket No. DPU 24-10/11/12, November 21, 2014 (Phase II Procedural Notice).

[19] Phase II Procedural Notice, page 4.

[20] Department Order on Eversource GMF, Docket DPU 24-58, June 28, 2024, page 3.

[21] Department Order on Grid Mod, Dockets DPU 15-120/121/122, May 10, 2018, page 225.

[22] Department Order on Grid Mod, Dockets DPU 15-120/121/122, May 10, 2018, page 110.

[23] Department Order on Eversource GMF, Docket DPU 23-49, June 30, 2023, page 14.

[24] Department Order on Grid Mod, Dockets DPU 15-120/121/122, May 10, 2018, page 113.

on historical expenses. The difference between the formulas and EDC's actual expenditures creates incentive for EDCs to operate efficiently and minimize costs.

- Through reconciling mechanisms that allow for recovery of actual costs incurred for certain types of investments, including those that are volatile, likely to increase between rate cases, or primarily driven by policy goals.

For each EDC, the Department recently approved mechanisms that allow for recovery of capital costs that are expected to be higher than historical capital costs. These mechanisms are summarized below.

Eversource and Unitil

For both Eversource and Unitil, the Department approved a "K-bar" as part of the PBR formula. The K-bar mechanism allows for recovery of capital costs in excess of what is included in the test year, on the grounds that the companies will need to significantly increase capital expenditures between rate cases to "keep pace with the Commonwealth's growing electrification needs and ambitious climate targets."[25] The K-bar is calculated each year to allow the EDC to recover capital costs equal to the rolling average of actual capital costs incurred in the past five years.[26]

The K-bar is subject to an annual cap on the capital costs that may be included in the K-bar, equal to ten percent of the forecasted budget. The investments can be included in the K-bar without a prudence review at the time.[27] For Unitil, if the Department determines in Phase II of the ESMP docket that Unitil may recover ESMP costs through base rates, it may include future ESMP investments in the rolling average K-bar calculation.[28]

National Grid

For National Grid, the Department approved the Infrastructure, Safety, Reliability, and Electrification (ISRE) mechanism for recovering capital costs between rate cases.[29] The ISRE is a reconciling mechanism that includes the following features:

- National Grid can recover core (i.e., non-ESMP) investments in the year after the project is put into service.
- The ISRE investments are not preauthorized by the Department.[30]

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[25] The Department of Public Utilities, *Petition of Unitil for an Increase in Base Distribution Rates*, DPU 23-80, June 28, 2024 (Unitil Rate Case Order), page 43. The Department of Public Utilities, *Petition of Eversource for an Increase in Base Distribution Rates*, DPU 22-22, November 30, 2022 (Eversource Rate Case Order), page 60.

[26] Unitil Rate Case Order, page 44. Eversource Rate Case Order, page 61.

[27] Unitil Rate Case Order, page 46. Eversource Rate Case Order, page 63.

[28] Unitil Rate Case Order, pages 47-48.

[29] The Department of Public Utilities, *Petition of National Grid for an Increase in Base Distribution Rates*, DPU 23-150, September 30, 2024 (National Grid Rate Case Order). The Department declined National Grid's request to include ESMP in the ISRE mechanism at the time of the rate case, saying that the recovery of ESMP costs would be addressed in the Phase II ESMP docket (page 42).

[30] Preauthorization is applied only the categories of investments applicable to the proposed investment cap and recovered through the ISRE mechanism. National Grid Rate Case Order, page 21.

- There is a cap on annual increases in revenue requirements equal to three percent of National Grid's total annual revenue. Any investments above this amount can be recovered in the next rate case.[31] The Department may review and modify this cap over the course of the ISRE filings.
- National Grid is not allowed to collect interest between the time the costs are incurred and the time they are recovered in rates. This introduces a partial form of regulatory lag.[32]

5. Consultant Observations

Comparison of Cost Recovery Options

Table 1 provides a summary of the cost recovery options discussed above, with a focus on those features of each option that help mitigate costs. The energy efficiency cost recovery mechanism is included in the table because the energy efficiency investments share similarities to grid modernization and ESMP investments.

Table 1. Summary of Cost Recovery Mechanisms

Cost Mitigation Feature	ESMPF	GMF	ISRE	K-bar	Energy Efficiency
Preauthorization	-	yes	-	-	yes
Cost recovery cap	Term Cap: Based on 2024 ESMP budgets Annual Cap: Equal to 3% of total annual revenues	~~Based on~~Equal to preauthorized costs	Equal to 3% of total annual revenues	~~Based on~~Equal to 10% of annual budget forecast	No cap. But PIMs create pressure to stay near~~Based on~~ preauthorized costs
Prudence review[33]	full	partial	full	full	partial
Regulatory lag~~[34]~~	~~-~~yes	~~-~~yes	~~partial~~yes	~~full~~yes	-
BCA	-	-	-	-	yes
Financial incentives	-	-	-	-	PIMs

One of the key differences between the cost recovery mechanisms is whether costs are preauthorized. When investments are preauthorized, there is a detailed regulatory review of the investment prior to

[31] National Grid Rate Case Order, pages 49-50.

[32] National Grid Rate Case Order, pages 52-53. Under traditional ratemaking, regulatory lag includes two components. First, there is a risk that some capital costs incurred between rate cases will not be included in the test year in the next rate case. Second, there is time value of money due to the difference between when the cost is incurred and when the cost is recovered in rates. The ISRE includes only the second aspect of regulatory lag.

[33] Some of the mechanisms are subject to a "full" prudence review, which means that both the decision to make the investment and the implementation of the investment will be reviewed for prudence. Some are subject to a "partial" prudence review, which means that only the implementation of the investment will be reviewed for prudence.

~~[34] The K-bar mechanism results in full regulatory lag, which means that the company is at risk of not recovering a portion of the investment and is not able to recover interest associated with the time lag between incurring the cost and recovering it. The ISRE results in partial regulatory lag, which means that the company will not be able to recover interest associated with the time lag between incurring the cost and recovering it, but it will be able to recover the full amount of costs incurred.~~

them being made. This regulatory review provides some assurance that decisions to make the investments are reasonable and the investments will provide sufficient benefits to customers. In addition, the Department can have more confidence that full recovery of the exact amount of investment is warranted.

The fact that the ESMP costs are not preauthorized suggests that it is necessary to apply more detailed regulatory review after investments are made, including a full prudence review of whether the investment decision was appropriate at the time. However, the opportunities for a full prudence review will be limited under the EDC cost recovery proposal.

- There will be very little time for stakeholders and the Department to fully investigate the complicated issues related to prudence in the period between the Cost Recovery Filing on May 1 and the time the rates go into effect on July 1.
- A thorough demonstration that investments are prudent, used, and useful requires that alternatives to investments be considered, and that the investment was estimated to provide net benefits – when the decision was made to make the investment. The EDC ESMP cost recovery proposal does not specify how alternatives will be considered and does not include any requirement for the EDCs to demonstrate conduct a BCA prior to the investment being made. In addition, many alternatives can take several years to implement, which means that they should be evaluated several years before the ESMP investment is needed.
- Since the Term Cap is based on the budgets in the 2024 ESMPs, the EDCs could logically argue that investments made within that cap are prudent, at least in terms of the decision to make the investment.

Further, the two caps on cost recovery are not likely to protect customers from unreasonable costs. The annual Revenue Caps are relatively large and not connected to the proposed or actual ESMP investments; the Term Caps only limit the spending up to the budgets in the 2024 ESMPs that were not reviewed for cost recovery; and the EDC proposal allows them to recover costs in excess of these caps later.

<u>Regulatory Oversight of the ESMP Cost Recovery Filings</u>

In sum, the EDC cost recovery proposal (a) does not provide the EDCs with adequate incentive to optimize investments and mitigate costs, and (b) limits the extent to which the Department and stakeholders can provide regulatory oversight needed to mitigate costs.

These concerns, however, can be mitigated by expanding the analysis and review of planned ESMP investments between now and the next ESMP filing. This could occur during each of the ESMP Cost Recovery Filings. The annual ESMP reviews provide critical opportunities for updating load forecasts, updating cost estimates, responding to changing circumstances, obtaining stakeholder input, considering alternatives, and thereby mitigating costs.

Alternatively, the expanded regulatory oversight of planned ESMP investments could occur at one of the annual ESMP Cost Recovery Filings, e.g., the 2027 filing. This one-time review could include an expanded schedule to allow increased stakeholder input and review, including sufficient time for discovery and testimony.

Regardless of the timing, this expanded analysis and review could be achieved with the following modifications to the EDC cost recovery proposal.

- Alternatives. The Department could require one or more of the ESMP Cost Recovery Filings to include a comprehensive analysis of alternative investments. The alternatives considered could be more than just non-wires alternatives, which are focused on specific projects and geographic locations and are subject to planning criteria and constraints. The alternatives could also include individual projects, such as utility-scale batteries, as well as systemwide programs such as demand response, energy efficiency, net metering, and distributed storage programs. They could also include rate design alternatives, including generic time-varying rates and technology-specific rates such as managed EV charging rates.
- Benefit-Cost Analysis. The Department could require one or more of the ESMP Cost Recovery Filings to include prospective benefit-cost analysis (BCA) of selected, key proposed investments and alternatives. BCA is necessary to ensure that the ESMP investments are cost-effective, will mitigate costs, and will minimize impacts on customers. In the context of DPU 20-80, a stakeholder process has been established to evaluate non-pipe alternatives, including a BCA framework for evaluating cost-effectiveness.[35] A similar approach could be used for ESMP investments, and the two BCA practices could be coordinated to ensure consistent planning and decision making across gas and electric utilities and resources.
- Cost Recovery Caps. The Department could modify the EDCs' proposed Annual Revenue Cap and Term Cap to reflect any updates from the ESMP Cost Recovery Filing. The Annual Revenue Cap could be set to some percentage of the proposed investments for the subsequent year. The Term cap could be modified to reflect any changes in planning budgets. These modifications create more accurate caps that are more likely to incentivize the EDCs to mitigate costs.
- Related Goals and Activities. The Department could require the EDCs to explicitly account for updated goals and on-going activities in Massachusetts related to grid modernization and decarbonization that will, or should, affect planned ESMP investments. These include, for example, activities of the Energy Transition Advisory Board, the EV Infrastructure Coordinating Council, the Energy Efficiency Advisory Council, the Clean Energy Center's grid services study, the Interagency Rates Working Group, and the Joint Working Group on Integrated Energy Planning (IEP). The Department could require one or more of the ESMP Cost Recovery Filings to describe how the ESMPs will meet decarbonization, heat pump and EV adoption goals from these activities, as well as from updated versions of the Massachusetts Clean Energy and Climate Plans and Decarbonization Roadmap.
- Metrics and Reporting. The Department could require the EDCs to include in one or more of the Cost Recovery Filings a comprehensive set of metrics regarding planned investments and opportunities to mitigate costs. This could include, for example, metrics regarding updated load forecasts, proposed investments, BCA results, and actual historical spending relative to proposed spending.

An enhanced cost recovery review process will not only encourage cost containment during the current ESMP term, it will also provide the EDCs, the Department, and stakeholders with information, forecasts, and analytical practices that will lead to a more robust draft of the next ESMP.

[35] See, for example, *NPA Framework Slide Deck*, prepared by Eversource, National Grid, Unitil, Berkshire Gas, and Liberty, January 15, 2025.

An enhanced cost recovery review process is consistent with the Department's finding that the 2024 ESMPs are strategic plans.[36] Since the five-year ESMPs are strategic plans and were not intended to review ESMP cost recovery, then the Cost Recovery Filings are the venue for detailed analysis of ESMP investments, including analysis of opportunities to optimize investments and mitigate costs.

An enhanced cost recovery review process will also provide an opportunity for the EDCs to integrate practices, proposals, and lessons from the IEP process required by the Department in docket 20-80. The EDCs were not able to include IEP concepts into the 2024 ESMPs due to timing, but IEP will have important implications for ESMP investments well before the next ESMPs are prepared.

The biannual ESMP reports could be designed to support an enhanced cost recovery review process. The biannual reports could comprehensively include the detailed information on historical and planned ESMP investments, while the ESMP Cost Recovery Filing could focus on the information required for demonstrating that the investments are prudent and that the EDCs have sufficiently mitigated the costs of those investments.

[36] Department ESMP Order, pages 66-67.