

**EXHIBIT NO. ___(JLM-1HCT)
DOCKET NO. UE-06 ___/UG-06 ___
2006 PSE GENERAL RATE CASE
WITNESS: JOEL L. MOLANDER**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-06 ___
Docket No. UG-06 ___**

**PREFILED DIRECT TESTIMONY (HIGHLY CONFIDENTIAL) OF
JOEL L. MOLANDER
ON BEHALF OF PUGET SOUND ENERGY, INC.**

**REDACTED
VERSION**

FEBRUARY 15, 2006

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PUGET SOUND ENERGY, INC.

**PREFILED DIRECT TESTIMONY (HIGHLY CONFIDENTIAL) OF
JOEL L. MOLANDER**

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1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY (HIGHLY CONFIDENTIAL) OF**
3 **JOEL L. MOLANDER**

4 **I. INTRODUCTION**

5 **Q. Please state your name, business address, and position with Puget Sound**
6 **Energy, Inc.**

7 A. My name is Joel L. Molander. My business address is 10885 N.E. Fourth Street
8 Bellevue, WA 98004. I am the Manager Hydro Contracts for Puget Sound
9 Energy, Inc. ("PSE" or the "Company").

10 **Q. Have you prepared an exhibit describing your education, relevant**
11 **employment experience, and other professional qualifications?**

12 A. Yes, I have. It is Exhibit No. ___(JLM-2).

13 **Q. What are your duties as Manager Hydro Contracts for PSE?**

14 A. My responsibilities include the management and oversight of PSE's Mid-
15 Columbia contracts and contracts for hydroelectric qualifying facilities ("QFs").

16 **Q. What is the nature of your testimony in this proceeding?**

17 A. My testimony describes the Company's efforts to retain access to the power

1 output from Public Utility District No. 1 of Chelan County, Washington's (the
2 "District") Rocky Reach and Rock Island hydroelectric projects after PSE's
3 current long-term contracts expire in 2011 and 2012, respectively. I describe the
4 new power contract and a related new transmission contract that the Company has
5 recently entered into under which PSE will purchase and take delivery of
6 electrical output from these hydroelectric projects following expiration of the
7 existing contracts.

8 I explain how these contracts will help PSE reduce its projected long-term energy
9 and capacity deficit, to secure operational flexibility, and to achieve low overall
10 resource portfolio costs. As stated below and detailed in the testimony of
11 Mr. W. James Elsea, Exhibit No. ___(WJE-1HCT), PSE's estimated 20-year
12 levelized costs under the new contract are \$ [REDACTED]/MWh, including imputed debt
13 associated with this PPA, with a net present value benefit to PSE's electric
14 portfolio of approximately \$360 million.

15 **II. THE COMPANY'S EFFORTS TO RETAIN OUTPUT FROM**
16 **THE ROCKY REACH AND ROCK ISLAND HYDROELECTRIC**
17 **PROJECTS FOLLOWING EXPIRATION OF THE CURRENT**
18 **CONTRACTS**

19 **Q. Please describe the current contracts between PSE and the District for the**
20 **Rocky Reach and Rock Island hydroelectric projects.**

21 A. PSE currently purchases approximately 43% (830 MW capacity) of the District's

1 aggregate output from its Rocky Reach and Rock Island hydroelectric projects on
2 the Columbia River.

3 PSE's existing long-term power purchase agreement for 38.9% of the District's
4 Rocky Reach hydroelectric project was entered into on November 14, 1957, and
5 expires on October 31, 2011. PSE's existing long-term power purchase
6 agreement for the District's Rock Island hydroelectric project was entered into on
7 June 19, 1974, and expires on June 7, 2012.

8 PSE currently has contractual rights to 50% of the Rock Island I generating
9 facility and 55% of the Rock Island II generating facility. The District will make
10 its one remaining withdrawal from PSE's share of Rock Island II effective
11 November 2006, which will reduce PSE's share of Rock Island II from 55% to
12 50%. PSE's contract right will remain at 50% of Rock Island for the rest of the
13 contract term.

14 **Q. Please describe the events that led to the Company negotiating a new power**
15 **contract with the District.**

16 A. Beginning in mid-2002, the District and PSE engaged in periodic conversations
17 about a possible new power contract. Extensive discussions did not commence
18 until July 8, 2005, when the District delivered to PSE a term sheet that outlined
19 proposed terms and conditions for a new power contract. At the same time, the
20 District informed PSE of its desire to complete negotiations on the new contract

1 and transmission agreement by the end of 2005. The District explained that
2 PSE's contract would represent the first new long-term contract for Chelan Power
3 System output and, as such, would serve as a model for negotiations with other
4 prospective purchasers. Negotiations became continuous after that, culminating
5 in an agreement in principle on key commercial terms in late November 2005.

6 **Q. Why did the Company decide to negotiate a new power contract now, more**
7 **than five years in advance of the expiration dates of PSE's current contracts**
8 **with the District?**

9 A. Output from the District's Rocky Reach and Rock Island hydroelectric projects
10 has for decades been the backbone of PSE's existing resource base, providing
11 seasonal and daily load shaping energy and capacity benefits in addition to
12 necessary ancillary services. This output helps to ensure PSE's ability to meet
13 base-load, daily and seasonal peaking requirements, integrate existing and/or
14 incremental wind or other variable production resources into the Company's
15 supply portfolio, and provides increased certainty related to modeling and
16 determination of PSE's future resource needs and supply alternatives.

17 Given these important attributes and PSE's extensive electric supply resource
18 needs, as described in the testimony of Mr. Eric Markell, PSE has understood for
19 some time that continued access to the output of the District's projects would
20 likely be a critical component of PSE's long-term electric portfolio management
21 strategy. However, PSE's existing long-term contracts with the District do not

1 contain provisions for any right of first refusal, right of first offer or extension
2 beyond their current terms.

3 When the District informed PSE of its desire to reach an agreement in principle
4 with PSE by the end of 2005, PSE essentially had no choice but to undertake
5 negotiations with the District and to work toward the District's deadline if PSE
6 wished to have the opportunity to retain access to the project output.

7 **Q. Please describe the District's initial proposal to PSE regarding renewal of the**
8 **contracts for the Rocky Reach and Rock Island hydroelectric projects.**

9 A. Unlike the expiring contracts, the District's proposal aggregated the output from
10 the Rocky Reach and Rock Island projects into a single system "slice," including
11 energy, capacity and ancillary services from both projects. The District initially
12 offered PSE a 20% slice of its Rocky Reach and Rock Island hydroelectric
13 projects, referred to collectively as the Chelan Power System, and indicated that it
14 would retain 40% for its own current and prospective needs. The District also
15 indicated that the Aluminum Company of America, Inc. had asked for a 20%
16 slice, and that the District would allocate the remaining 20% of its system to other
17 existing or new purchasers. The District also proposed a 20-year contract.

18 In addition, the District demanded an up-front reservation charge per each one
19 percent share of output for the Company to reserve the rights under the District's
20 proposed contract.

1 **Q. Did the Company accept the District's initial offer?**

2 A. No. Throughout the 2005 negotiations, PSE representatives stressed the
3 Company's need for power and its desire for a larger share of the output, as well
4 as for a longer term contract. PSE counter-offered to purchase between a 25%
5 and 30% share of the District's system output. Ultimately, PSE was successful in
6 obtaining a larger share of system output than originally offered by the District.

7 **Q. Did the Company negotiate with respect to price, as well?**

8 A. PSE's long-term hydroelectric project contracts have historically been cost-based.
9 While the District's proposed term sheet also proposed a cost-based pricing
10 structure, certain aspects of the District's proposal were negotiated, including the
11 amounts per year that the District could charge PSE under its "pay-as-you-go"
12 capital financing program, the District's debt administrative charge and the
13 capacity reservation charge. Beyond these specific charges, price negotiations
14 were not paramount to the process due to the cost-based nature of the output
15 contemplated under the new power contract. Rather, PSE focused on developing
16 its understanding and estimates of the District's future costs, as well as
17 possibilities for power cost volatility caused by reliability and regulatory and/or
18 license-related expenditures.

1 **III. THE NEW CONTRACTS**

2 **Q. What was the ultimate outcome regarding the contract negotiations?**

3 A. On November 8, 2005, PSE and the District reached an agreement-in-principle on
4 new long-term power purchases of 25% of the Chelan Power System output,
5 commencing upon or shortly after expiration of PSE's current contracts with the
6 District.¹ The agreement containing all the terms and conditions regarding such
7 purchase was executed on February 3, 2006. A copy of the power sales
8 agreement is provided as Exhibit No. ___(JLM-3).

9 **Q. Please summarize the key terms under the new power contract and the**
10 **related transmission agreement.**

11 A. The key terms are as follows:

Term	The term of the new contract is for 20 years, commencing on November 1, 2011, for the Rocky Reach hydroelectric project and on July 1, 2012, for the Rock Island hydroelectric project. The new contract will expire on October 31, 2031.
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¹ The current Rock Island contract expires on June 7, 2012 and the District's proposed new Power Sales Agreement takes effect on July 1, 2012 for Rock Island Output, resulting in a 23 day gap between contracts. This is a desirable outcome as it 1) cleanly separates the terms and conditions from the expiring contract from those of the new Power Sales Agreement and 2) occurs during a time of year when PSE is normally surplus or the region has excess hydropower.

Output	The 25% share of Chelan Power System output provides PSE with approximately 487 MW of capacity and approximately 243 aMW of energy. In addition, PSE will receive specified ancillary services under the new contract.
Scheduling	The new contract preserves PSE's dynamic scheduling rights for the purpose of requesting and receiving output and tracking actual deliveries from the Chelan Power System, contributing to PSE's real-time load following resource capability.
Coordinated Operation	The new contract contemplates the continued participation by both PSE and the District in the hourly coordination of projects on the mid-Columbia River. PSE's rights to project output under the new power contract and PSE's receipt and delivery rights under the related transmission agreement are intended to support such participation in hourly coordination by PSE.
Transmission Points of Receipt and Transmission Points of Delivery	The new contract preserves PSE's access to critical transmission paths necessary to deliver Chelan Power System output to PSE's control area. Transmission points of receipt include (i) the Rocky Reach Switchyard 230 kV Bus Bar for Rocky Reach project output; and (ii) the McKenzie Switchyard 115 kV Bus Bar for Rock Island project output. Transmission points of delivery are specified for (i) the White River – Rocky Reach Transmission Line; (ii) the Anderson Canyon – Beverly Transmission Line; (iii) the Maple Valley - Rocky Reach Transmission Line; (iv) the Chelan Rocky Reach – Columbia #2 Transmission Line; (v) the BPA Rocky Reach – Columbia #1 Transmission Line; (vi) the Rocky Reach – Douglas Tie Transmission Line; and (vii) the BPA Valhalla Substation.
Type	"Take or pay." Under the new power contract, PSE will pay 25% of Chelan Power System costs as defined in the new contract and generally bear the risk of output, similar to the expiring contracts. Under the related transmission agreement, PSE will pay approximately 25% of the costs of the District's transmission system.
Cost Based	Pricing under the new contract is cost-based and provides the District with additional flexibility related to funding for future capital expenditures. In addition, the District demanded, and PSE has agreed to pay, an upfront capacity reservation charge of \$89 million to be paid in 2006.

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Audit Rights	The new contract provides PSE with annual power cost audit and verification rights. In addition, the District will meet with PSE semi-annually, at a minimum, to provide information concerning past and future expenditures, budgets, operations, maintenance, capital projects and other matters related to the Chelan Power System. PSE may also make recommendations to the District concerning the operation and maintenance of, and repairs, renewals, additions, improvements and replacements to, the Chelan Power System.
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IV. PROJECTED COSTS UNDER THE NEW CONTRACTS

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Q. What is the estimated cost of the new contract to PSE?

4

A. PSE's estimated levelized costs under the new contract are as follows:

Operating Cost per MWh	\$ [REDACTED]
Imputed Debt	\$ [REDACTED]
Total Cost per MWh	\$ [REDACTED]

5

These levelized costs compare favorably to alternatives recently acquired by PSE or contemplated through its portfolio planning and analysis activities. For example, the new contracts are a lower cost alternative than the lowest cost project to emerge from the Company's recent WAC 480-107 competitive bidding process -- the Hopkins Ridge wind project, which had a 20-year levelized cost of \$ [REDACTED]/MWh.

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Details regarding the calculation of the estimated levelized costs associated with the new power contract, analysis of the benefits to PSE resource supply portfolio,

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1 and comparison with other resource alternatives are provided in the testimony of
2 Mr. James Elsea.

3 **Q. How did the Company develop its projection of future costs under the new**
4 **power contract?**

5 A. Evaluation of the new power contract requires an understanding of the types of
6 costs that will be charged to PSE. To perform that evaluation, PSE projected and
7 accumulated cost components and forecasts more than 25 years into the future.
8 Generally, the costs payable under the contract consist of operation and
9 maintenance (O&M), debt service related to unamortized debt at expiration of the
10 current contracts, debt service and “pay-as-you-go” charges related to capital
11 costs incurred during the term of the new power contract, and working capital.

12 PSE’s projection of future O&M costs and capital expenditures used past results,
13 budgets, estimated facility service lives, feasibility and condition assessment
14 reports, and information about future investment plans gathered during meetings
15 with District personnel. Further, PSE’s financial model of the District’s future
16 cash requirements took into account the “pay-as-you-go” funding approach
17 contemplated in the new Power Sales Agreement.

1 **A. Projected Costs Associated With PSE's Pro Rate Share of the Chelan**
2 **Power System**

3 **Q. What are the projected expenses under the new power contract?**

4 A. PSE would pay a pro rata (25%) share of costs associated with the District's
5 Chelan Power System, which consist of the following:

6 **1. Licensing Costs**

7 The Rocky Reach project license expires in 2006, and the District reached a
8 multi-party settlement in December 2005, which is estimated to cost
9 approximately \$ [REDACTED] (nominal O&M and capital costs) during the contract
10 term. Major components of the settlement are described in greater detail in
11 Exhibit No. ___(JLM-4C). The Rock Island project license expires in 2028. PSE
12 has used the Rocky Reach process and expected settlement agreement as a proxy
13 for future cost requirements, which are estimated at approximately \$ [REDACTED]
14 (nominal O&M and capital) during the contract term.

15 **2. Rehabilitation/Modernization Costs**

16 PSE estimates future rehabilitation and modernization costs of approximately
17 \$ [REDACTED] and \$ [REDACTED] (nominal capital costs) for Rocky Reach and Rock
18 Island, respectively, during the contract term. PSE based its estimates on past
19 results and budgets, estimated equipment service lives, feasibility and condition

1 assessment reports, and information gathered during meetings with District
2 personnel. Major rehabilitation and modernization estimates are described in
3 greater detail in Exhibit No. ___(JLM-4C).

4 **3. Operation and Maintenance Expense**

5 PSE has evaluated historical O&M budgets for both Rocky Reach and Rock
6 Island and, using a 2.0% real growth rate and a 2.5% escalation factor, estimates
7 future O&M costs of \$ [REDACTED] and \$ [REDACTED] for Rocky Reach and Rock
8 Island, respectively, during the contract term.

9 **4. Existing (Non-incremental) Debt Service Obligations**

10 Existing Rocky Reach debt service obligations total \$ [REDACTED] for Rocky
11 Reach and \$ [REDACTED] for Rock Island during the new contract term.

12 **B. Additional Costs and Charges**

13 **Q. Are there other costs associated with the new power contract?**

14 A. Yes. Under the terms of the new power contract, PSE will pay the additional
15 costs and charges described below.

16 **1. Capacity Reservation Charge**

17 PSE's current contracts with the District simply expire at the end of their term.

1 The current contracts do not provide PSE with rights of first refusal, first offer, or
2 any extension. As a consequence, the District has demanded, and PSE has agreed
3 to pay, a non-refundable capacity reservation charge of \$89 million for PSE's
4 25% slice, payable 30 days after the last needed regulatory or board approval is
5 obtained. The \$89 million capacity reservation charge payment will not be
6 credited against any future payment obligations under the contract and the funds
7 may be used by the District, as determined in its sole discretion, for any lawful
8 purpose.

9 **Q. Was the District's demand for a capacity reservation charge unreasonable?**

10 A. The capacity reservation charge concept is not unreasonable under the
11 circumstances. The District has elected to allocate a significant share of its
12 projects' output more than five years in advance of expiration of the current long-
13 term contracts, foregoing any potential benefits associated with a future allocation
14 and locking in benefits for its customers today. Moreover, PSE has no
15 contractual rights to output beyond the term of these expiring contracts and is
16 resource deficit on a current and prospective basis. Securing output and valuable
17 ancillary services from the District's projects sooner rather than later helps PSE
18 lower its prospective portfolio costs and provides more certainty related to
19 resource planning requirements.

20 PSE believes there is additional basis for this demand charge. PSE's current

1 contracts with the District require the District to fund capital projects with the
2 proceeds of debt issued by the District, which has created a misalignment of costs
3 paid for and benefits received from the District's hydroelectric projects. PSE
4 estimates that practice will result in an outstanding District hydroelectric system
5 principal debt of approximately \$ [REDACTED] at 2011/2012, when the current
6 contracts expire. In the course of the 2005 negotiations, the District informed
7 PSE that it would not repeat such a circumstance in any new contract. In the
8 interim, the District's demand for an up-front capacity reservation payment as a
9 condition of entering into the new contracts appears to stem from a desire to
10 reduce its overall outstanding debt levels, including debt associated with its
11 distribution system.

12 **Q. Please continue with your description of other costs associated with the new**
13 **power contract.**

14 A. PSE will also pay the following:

15 **2. Working Capital Charge**

16 The contract requires a non-refundable payment of \$2.5 million per project (stated
17 in 2004 dollars) to be paid on the date on which each project is available for
18 output deliveries under the new power contract, to provide the projects with an
19 adequate working capital balance. The District may increase this amount during
20 any Contract Year, on a pro rata basis by Purchaser percentage, as determined by

1 the District in accordance with prudent utility practice.

2 **3. Coverage Fund Charge**

3 The contract requires a non-refundable coverage fund charge payment calculated
4 by applying a formula to the outstanding District debt obligations each year. PSE
5 forecasts a total coverage fund charge obligation of approximately \$ [REDACTED]
6 (nominal) during the contract term.

7 **4. Prepayment Charge**

8 Throughout negotiations, the District indicated that it would be very attentive to
9 the credit quality of its purchasers and demanded security against a late or missed
10 payment under the Power Sales Agreement or Transmission Agreement. As a
11 result, PSE negotiated a prepayment amount of \$18,500,000, which will be
12 refunded to PSE, without interest, by applying the funds to PSE’s final power cost
13 bills at the end of the contract term.

14 **5. Debt Reduction Charge and Capital Recovery Charge**

15 The contract implements two funds that are designed to facilitate the “pay-as-you-
16 go” approach the District has adopted for future capital items for the projects. In
17 particular, the contract imposes a Debt Reduction Charge and a Capital Recovery
18 Charge, each and both intended to permit the District to purchase, redeem or

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1 debt of the Chelan Power System, to fund deposits to reserve and
2 contingency accounts or to fund capital improvements related to the Chelan
3 Power System. The Debt Reduction Charge and the Capital Recovery Charge are
4 both non-refundable, and are calculated by formulas set forth in the contract.
5 Charges imposed as Debt Reduction Charges or Capital Recovery Charges must
6 be spent on the Chelan Power System. Together the charges are subject to an
7 adjusted annual cap that applies to unspent funds in the accounts. That cap is
8 initially set at \$25 million per year stated in 2004 dollars.

9 **6. Debt Administrative Charge**

10 The contract requires a Debt Administrative Charge as compensation for the
11 District's provision of credit to PSE, and is calculated through a formula set forth
12 in the contract. PSE estimates that this payment will average approximately
13 \$ [REDACTED] annually during the contract term. All Debt Administrative Charge
14 payments are non-refundable.

15 **Q. Are transmission services also contemplated in connection with the new**
16 **power contract?**

17 A. Yes. In a transmission contract, the District agrees to provide transmission
18 services adequate to deliver the project output to the PSE system or other agreed
19 upon points of delivery. As part of that obligation, the District acknowledges and
20 agrees to accommodate compliance with the Mid-Columbia hourly coordination

1 agreement as well as other obligations such as returning Canadian Entitlement
2 energy and/or complying with the Pacific Northwest Coordination Agreement. In
3 general, these agreements define operating parameters across the mid-Columbia
4 hydroelectric projects, including federal facilities, and make operation of those
5 projects unique and interrelated. The agreements also require or presume multi-
6 directional movement of power, depending upon real-time conditions. As such,
7 the Transmission Agreement will be unique; however, it will also be consistent
8 with the transmission service the District has provided to PSE for the last several
9 decades. The agreement was executed on February 3, 2006. A copy of the
10 definitive transmission agreement is provided as Exhibit No. ___(JLM-5).

11 **Q. Is the Company projecting additional costs for such transmission services?**

12 A. Yes. The Transmission Agreement calculates PSE's transmission charges
13 through a formula that assesses the share of the Chelan Transmission System that
14 was needed or used by PSE for delivery of output in each preceding year. The
15 charges imposed are payable monthly, are non-refundable, and are included in the
16 estimated 20-year levelized cost of \$ [REDACTED]/MWh (2006) presented above. PSE
17 estimates these annual charges to be approximately \$ [REDACTED] on a nominal
18 basis.

1 **V. CONCLUSION**

2 **Q. Please summarize the benefits of the new power contracts to PSE and its**
3 **electric customers.**

4 A. Historically, the output from the Rocky Reach and Rock Island hydroelectric
5 projects has been foundational to PSE's long-term energy supply portfolio and its
6 daily operational flexibility. By entering into the new power contract and related
7 transmission agreement with the District, PSE has secured continued access to
8 these resources. Moreover, PSE has done so at a cost that is lower than other
9 alternatives available to the Company.

10 **Q. Does that conclude your testimony?**

11 A. Yes, it does.

12 [BA060430006]