EXHIBIT NO. ___(JLM-1T)
DOCKETS UE-17___/UG-17___
2017 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,** **Respondent.**	**Docket UE-17____** **Docket UG-17____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

JOEL L. MOLANDER

ON BEHALF OF PUGET SOUND ENERGY

JANUARY 13, 2017

PUGET SOUND ENERGY

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CONTENTS

I. INTRODUCTION 1

II. PSE'S OPERATING HISTORY AT SKC 2

III. PSE'S DECISION TO PURCHASE SKC 5

III. CONCLUSION 13

PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name, business address and present position with Puget Sound Energy.

A. My name is Joel L. Molander. My business address is 10885 N.E. Fourth Street Bellevue, WA 98004. I am currently the Director, IT Business Partner Engagement for Puget Sound Energy ("PSE"); however, my testimony provided herein reflects business activities undertaken in my prior role as Director, Corporate Shared Services.

Q. What is your educational and professional experience?

A. Exhibit No. ___(JLM-2) describes my educational and professional experience.

Q. What were your duties as Director, Corporate Shared Services?

A. My responsibilities included the management and oversight of PSE's portfolio of owned and leased facilities. In addition, I was responsible for PSE's corporate security, fleet, business continuity and emergency management functions.

Q. Please provide an overview of your testimony.

A. My testimony describes PSE's decision to acquire the South King Complex ("SKC") on August 31, 2016, located at 22828 68th Avenue South, Kent,

Washington 98032. I describe PSE's operating history at this location, its decision to acquire the property, and how asset ownership will eliminate operational and financial risk associated with future displacement to a higher-cost location.

II. PSE'S OPERATING HISTORY AT SKC

Q. Please describe the origin of SKC.

A. SKC is a 26-acre property that was originally owned and developed by AT&T (then Western Electric) in 1976 to support its central operation and warehouse functions. AT&T's improvements on the property accommodated both indoor and outdoor storage, materials receipt and distribution, and office space. The property was sold by AT&T in 1993 to Ranch Associates, a Washington state general partnership.

Q. How did PSE come to occupy SKC?

A. In 1993, PSE's predecessor, Puget Sound Power & Light, was in need of additional operating space and was looking for a facility suitable for its utility operations. AT&T's improvements on the property were ideal for PSE's operations. Accordingly, in 1993, PSE entered into an agreement with Ranch Associates to lease SKC. In 1994, PSE relocated its Renton Complex, Renton Service Center, and Business Office to SKC. In 1998, PSE also relocated its Central Stores to SKC.

Q. Please summarize PSE's lease terms with Ranch Associates prior to its acquisition of SKC in 2016.

A. PSE's initial lease with Ranch Associates was negotiated in 1993 at then market-based rates for a term of 10 years, expiring on February 29, 2004. In 2003, PSE negotiated an additional market-based 10-year lease term along with four five-year renewal options. On August 6, 2013, PSE exercised one of its four five-year renewal options, extending the lease term through February 2019. Annual lease payments to Ranch Associates included rent and base operating expenses. Tenant improvements were funded by PSE as part of its utility capital program and depreciated in accordance with FERC accounting rules for leased assets.

Q. Please summarize prior SKC tenant improvement investments made by PSE.

A. Shortly after taking occupancy of SKC in 1994, PSE initiated tenant improvements to further configure the site and facilities for its utility operations. Specifically:

- The exterior storage yard was configured to accommodate the storage of poles, transformers, street lights, wire spools and other large items.
- The office portion of the property was utilized to accommodate PSE routine business operations as well as planning for storms and other emergency situations.
- A new waste handling area (Moderate Risk Waste Handling Facility) was designed, permitted and constructed in order to store and process all of PSE's waste including contaminated dirt, used batteries, fluorescent light tubes,

aerosol products, transformers containing PCBs, and flammable waste, such as highway flares.

- Warehouse storage on the property was configured to accommodate the storage of items needed for PSE's electrical distribution system including racking and shelving, forklifts, overhead doors, meters, and dock levelers. Following PSE's merger in 1997, the warehouse began storing former Washington Natural Gas materials for its gas system, including meters.

Q. Please describe the operating functions currently located at SKC and how they support PSE's operating model.

A. As a result of PSE's aforementioned tenant improvements and the site's original utility orientation, SKC continues to be uniquely configured to support PSE's utility operations. Its design, central location, and accessibility to local and interstate highway systems by semi-tractor and "low-boy" delivery trailers for receipt and distribution of materials and large equipment make it ideal for PSE's operations. Importantly, SKC is also zoned to accommodate outdoor storage. Today, SKC supports numerous business functions performed by PSE on behalf of its customers including materials warehouse and central stores; gas and electric meters inventory management; waste handling; employee training; energy efficiency services; electric first response; engineering and project management; fleet onboarding and outfitting; and numerous other PSE functions. In addition to its utility-oriented design characteristics, SKC's central location enables efficient response to PSE's

customer base and the ability to quickly and efficiently onboard foreign crews during storm preparation and restoration work.

III. PSE'S DECISION TO PURCHASE SKC

Q. Please describe the events that led to PSE's acquisition of SKC in 2016.

A. As a general practice, PSE evaluates its facilities and real estate portfolio as lease termination or extension dates approach for key operating assets, of which SKC is one. These evaluations consider changing market conditions, the availability of replacement properties, the facilities' condition and performance against current and prospective operating requirements, and other contributing factors such as employee commute and regional traffic implications. In May 2015, PSE was informed by Ranch Associates that it had received a purchase offer of $28 million from the adjacent property owner, Prologis, a warehousing and distribution company interested in expanding its operations. During the course of negotiations between Ranch Associates and Prologis, Ranch Associates informed PSE of its willingness to sell SKC to PSE for an amount equal to its Prologis counteroffer price of $30 million. When Ranch Associates and Prologis failed to reach a commercial agreement, Ranch Associates informed PSE of its intent to sell SKC upon receipt of an acceptable offer. This potential for change in lessor ownership and longer-term lessee implications prompted PSE to evaluate alternatives involving SKC-based resources, including lease extension and associated risk, acquisition and relocation.

Q. Describe the resources PSE employed in evaluating its facilities portfolio and SKC alternatives.

A. In addition to PSE's internal real estate and facilities management, engineering and construction resources, PSE sought external commercial real estate brokerage and consulting expertise through a competitive Request for Qualification process. In June 2015, the real estate firm CBRE was selected to provide portfolio consulting and brokerage services. In addition, PSE retained the services of MENG Analysis ("MENG"), PCS Structural Solutions ("PCS"), and GeoEngineers to provide targeted portfolio analytic and pre-purchase due diligence support.

Q. Please explain how the Prologis offer and the potential for future third-party purchase offers factored into PSE's decision to evaluate potential acquisition of SKC.

A. The SKC building currently utilizes only 25% of the property's developable land and PSE uses the remainder for outdoor equipment and material staging and storage. Outside of utility use, warehouse and distribution facility densification represents a higher-value alternative use of the property that would yield a larger income stream and return on investment for a prospective owner. Sale of the SKC property to a new owner such as Prologis or another interested buyer would likely result in PSE's forced relocation to an alternate site upon lease expiration.

Alternatively, future lease extensions, if possible, between PSE, Ranch Associates or another landowner, would be subject to significant price risk based on the

property's higher-value alternative use as described above. Both PSE and CBRE believe this future lease price risk is highly probable given the scarcity of alternative sites for warehousing and distribution expansion. Such land scarcity would also be reflected in the cost of replacement land in the event PSE were forced to relocate SKC, notwithstanding the cost to design, permit and construct replacement facilities, and to relocate employees, materials and other equipment currently located at SKC.

Q. Please describe the scenarios evaluated by PSE involving the SKC asset.

A. PSE retained CBRE to develop and evaluate SKC alternatives as described below:

1) **Purchase SKC in 2016:** This scenario involves the purchase of SKC in 2016 for $30 million and continued operation along with future investments based on age, condition and performance of the SKC assets.
2) **Build and own alternative property for relocation in 2019:** This scenario involves the acquisition, design, permitting and construction of an alternative location comparable to PSE's current SKC operation. Investment and development activities would begin in 2017 in order to deliver the asset upon SKC lease expiration in 2019.
3) **Purchase SKC at end of lease options in 2029:** This scenario defers until 2029 the purchase of SKC from Ranch Associates, presuming its availability as currently purposed. Neither PSE nor CBRE believe this is a valid assumption given Ranch Associates' stated intent to sell the property; however, this

scenario is included to ensure evaluation of PSE's current lease rights against alternative scenarios.

4) **Build and own alternative property for relocation in 2029:** This scenario defers the acquisition, design, permitting and construction of an alternative location comparable to PSE's current SKC operation to 2029. Investment and development activities would begin no later than 2027 in order to deliver the asset upon SKC lease expiration in 2029. However, land acquisition may occur in the interim based on identification of, and opportunity to purchase, suitable property to be held for future use.

5) **Lease alternative property in 2029:** This scenario involves relocation in 2029 to an alternative leased site equivalent to PSE's current SKC operation.

Q. Describe the key factors and considerations involved in the lease versus purchase analysis.

A. The following key factors and considerations contributed to the SKC analysis and are further described in Exhibit No. ___(JLM-3); specifically:

- **Viability of long-term lease extension at SKC:** As previously discussed, neither PSE nor CBRE consider a long-term lease extension a viable alternative based on Ranch Associates' stated intent to sell the property and the potential redevelopment of the site for densified warehousing and distribution.

- **Scarcity of alternative properties that are zoned for utility use and outdoor storage:** CBRE evaluated alternative properties that may be suitable to support

the operational requirements that SKC currently supports. Equivalent land of similar size that would accommodate PSE's needs (i.e., by proper zoning) was available in sparse quantity and no utility-specific replacement assets were identified. Were replacement land to be identified and acquired in the future, new construction or significant site retrofitting would be required in advance of any potential relocation. CBRE's analysis of replacement properties indicated that PSE would pay approximately $23.1 million or higher in land alone based on the current market price per acre for available land.

- **Replacement site development costs:** Through CBRE's independently operated subsidiary construction company, the Trammel Crow Company, CBRE coordinated the development of design, permitting and construction costs for replacement grounds and facilities for all applicable scenarios. PSE contributed to this estimate by providing the cost of furniture, fixtures and equipment based on recent installation experience and costs. The cost of improvements, utility and relocation expense was estimated at $69.8 million, resulting in a total replacement cost, including land acquisition, of approximately $83.9 million in 2016 dollars. CBRE escalated these costs at 3% per year to coincide with the timing of each lease/purchase scenario.

  The magnitude of this estimate was independently corroborated by MENG as part of its Facility Condition Assessment Report, wherein MENG indicated an all-in replacement cost of $92.7 million.

- **Lessor cost-modeling and rate of return expectations:** CBRE developed the 2029 SKC replacement site cost by escalating the 2016 estimated value using the historic SKC growth rate as well as a more conservative annual growth rate to "book-end" the analysis. In addition, CBRE provided a capitalization rate estimate of 6.75% based on current investor return expectations for development of similar assets within geographic proximity of SKC. This capitalization rate was multiplied against the total cost to acquire and develop the property in order to determine the annual rent for cash flow modeling purposes.

- **Location/logistical and permitting considerations:** SKC is centrally located with very good access to major highways connecting PSE's service territory and, as previously discussed, similarly located/configured replacement properties are not readily available. In addition, SKC is zoned for outdoor equipment storage and permitted and equipped to accommodate hazardous materials in connection with certain electrical and mechanical equipment. PSE's Moderate Risk Waste Handling Facility was constructed by PSE at the property in 1997 and PSE maintains Spill Prevention, Containment and Countermeasure plans and processes in compliance with all local, state and federal jurisdictions.

- **Pre-purchase facilities condition assessment and need for incremental improvements:** As part of pre-purchase due diligence, PSE retained MENG to

perform a facilities condition assessment ("FCA"). The FCA addressed mechanical, electrical and building envelope aspects of SKC. In addition, MENG subcontracted the services of PCS to perform a structural assessment of SKC. Both the MENG and PCS analyses identified current deficiencies and opportunities for future improvements consistent with buildings similar in age and operating use. These improvements ranged from $30-45 million and were recommended irrespective of lease or ownership in order to ensure the safe and effective performance of the asset. These potential costs are incorporated in the cost/benefit analysis discussed later in my testimony.

- **Pre-purchase environmental due-diligence:** As a precondition to executing the purchase and sales agreement with Ranch and Associates, PSE retained GeoEngineers to perform a comprehensive Phase 1 and 2 environmental assessment of the SKC property in order to understand and account for potential environmental clean-up exposure preceding PSE's operating history at the SKC site. GeoEngineers found no contaminants in the soil or groundwater during exploration activities conducted at the South King Facility in 2016.

Q. Describe the results of the financial analysis.

A. CBRE performed a GAAP-based cash flow analysis of the alternative scenarios, the modeling and results of which are documented as part of Exhibit No. ___(JLM-3). In its report, CBRE states the following:

Based on modeled inputs and assumptions, purchasing SKC, or an alternative property, in the near term has the best cash NPV and GAAP benefit in relation to all other scenarios analyzed.

PSE then modeled the SKC cash flows developed by CBRE to reflect the cost of each scenario to its customers, the results of which are depicted in Table 1 below and further documented as part of Exhibit No. ___(JLM-4).

TABLE 1

Scenario	**35 Year NPV Revenue Requirement**	**NPV Customer Savings**
1) Purchase SKC in 2016	($67,841,000)	--
2) Build and own alternative property for relocation in 2019	($87,131,000)	$19,290,000
3) Purchase SKC at end of lease options in 2029	($69,986,000)	$2,145,000
4) Build and own alternative property for relocation in 2029	($97,397,000)	$29,556,000
5) Lease alternative property in 2029	($88,933,000)	$21,092,000

As Table 1 depicts, Scenario 1) Purchase SKC in 2016, achieves the lowest cost outcome and best business value to PSE's customers, reflecting the acquisition of SKC in 2016 for a purchase price of $30 million and the future operating and capital cost estimates provided by MENG and PCS.

Purchasing SKC was approved by PSE senior management based on the following:

- Financial benefits of ownership versus leasing on a cash, GAAP basis and regulated revenue requirement basis;
- Lack of viability of a continued long-term lease at the current SKC location based on the probable sale of SKC to a third party for the purpose of site redevelopment;

- Scarcity of comparable industrial land in the area to accommodate PSE's relocation; and
- Cost to replicate the South King Complex and relocate all PSE employees, material and equipment.

Q. Has PSE completed the purchase of SKC?

A. Yes, PSE closed on the purchase on August 31, 2016.

III. CONCLUSION

Q. Does this conclude your testimony?

A. Yes, it does.