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Credit Opinion: Puget Sound Energy, Inc.

Global Credit Research - 31 Jul 2014

Bellevue, Washington, United States

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating	Baa1
First Mortgage Bonds	A2
Senior Secured	A2
Commercial Paper	P-2
Parent: Puget Energy, Inc.	
Outlook	Stable
Issuer Rating	Baa3
Senior Secured	Baa3
Puget Sound Energy, Inc. (Old)	
Outlook	No Outlook
Bkd First Mortgage Bonds	A2
Bkd Senior Secured	A2
Bkd Jr Subordinate	Baa2
Washington Natural Gas Company	
Outlook	No Outlook
Bkd First Mortgage Bonds	A2

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Key Indicators

[1]**Puget Sound Energy, Inc.**

	12/31/2013	**12/31/2012**	**12/31/2011**	**12/31/2010**	**12/31/2009**
CFO pre-WC + Interest / Interest	**4.7x**	**4.0x**	**4.2x**	**3.6x**	**4.3x**
CFO pre-WC / Debt	**23.7%**	**18.4%**	**19.4%**	**16.4%**	**21.8%**
CFO pre-WC - Dividends / Debt	**13.7%**	**14.2%**	**14.1%**	**11.3%**	**16.3%**
Debt / Capitalization	**44.6%**	**47.2%**	**48.0%**	**47.8%**	**44.5%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Low risk regulated electric and gas utility operations in supportive regulatory environment, a credit positive

Improved cost recovery provisions and financial metrics

High dividend payout constrains rating

Ring-fence type provisions help mitigate utility from highly levered parent company

Corporate Profile

Puget Sound Energy, Inc. (PSE), the primary subsidiary of Puget Energy, Inc. (PE), is an electric and natural gas utility serving about 1.1 million electric and over 773,000 natural gas customers in the State of Washington. In 2013, the company's electric and gas revenue contribution was divided at roughly 70/30 percent, respectively. PSE is regulated by the Washington Utilities and Transportation Commission (WUTC) and the Federal Energy Regulatory Commission (FERC).

PSE is part of a complex ownership structure since PE was acquired in 2009 by Puget Holdings LLC, which is indirectly owned by consortium of private equity investors led by a group of Macquarie infrastructure funds (45.5%), along with Canada Pension Plan Investment Board (31.6%), British Columbia Investment Management Corp (15.8%), and Alberta Investment Management Corp (7.1%).

SUMMARY RATING RATIONALE

PSE's Baa1 Issuer Rating reflects its low risk utility operations and an improving regulatory and financial profile. The rating also factors in the degree of permanent holding company leverage at PE and acknowledges the indirect ownership by private equity investors. While consolidated cash flow should benefit from an expected decline in utility capital expenditures, we anticipate that rising dividend payments to PE's owners will be paid over the near-term.

The two notch differential between PSE and PE is reflective of the degree of structural subordination that exists at PE, and dividend limitations imposed by the WUTC. As of June 30, 2014, PE had approximately $1.7 billion of standalone debt at the parent company (including $299 million of term loans entered into in June 2014), representing approximately 31% of total PE consolidated balance sheet debt.

DETAILED RATING CONSIDERATIONS

REGULATORY ENVIRONMENT AND COST RECOVERY PROVISIONS IMPROVING, BUT A DEGREE OF UNCERTAINTY REMAINS

PSE's most recent rate order, which included the WUTC approval of a $30.9 million increase in electric rates and a $2.0 million reduction in natural gas rates, the allowance of a decoupling of electric and natural gas rates (described below), and a series of predetermined annual delivery rate increases (i.e., 3% applied to electric delivery costs and 2.2% applied to natural gas delivery costs), is viewed favorably from a credit perspective. We regard the various features of the rate case outcome as credit supportive in that they reduce regulatory lag (i.e., the time between costs being incurred and recovered in rates) since the rate design is more forward looking and provides clarity to the future financial performance of the company.

The decoupling mechanism is credit supportive in that it allows PSE to defer the difference between its Allowed Delivery Revenue and Actual Delivery Revenue received through its tariff rates to cover delivery costs. The resulting accumulated deferred balances are trued-up annually through a surcharge or credit to customers' bills, subject to certain limitations. The decoupling mechanism includes a 3% "soft-cap" on rates. If the calculated rate adjustment exceeds 3% in a year, the amount in excess would carry over as a deferred balance and will be recoverable in the subsequent rate period subject to the same limits on potential rate increases. This mechanism helps PSE to have greater assurance in recovering fixed costs, even in a declining sales volume environment.

The Order also included an annual earnings test that requires PSE to share with customers on an equal basis any earnings that exceed its authorized return. Moreover, PSE is not able to file its next general rate case before April 2015, but no later than April 2016. PSE is permitted, however, to seek rate increases through existing riders and trackers including power-cost-only rate case filings.

PSE continues to benefit from more traditional recovery mechanisms, such as the power cost adjustment (PCA) and purchased gas adjustment (PGA) mechanisms and power cost only rate case (PCORC). The PCA and PGA are allow the company to directly pass the costs of purchased power and natural gas through to customers within a year's time, while the PCORC allows PSE to revise electric rates after an expedited 6-month review of the company's power costs and new resources, instead of filing a traditional general rate case. Although more traditional, these mechanisms help to address some of the most significant risks that PSE faces, including variability in power supply and commodity costs, as well as hydrology levels.

In June, the Superior Court of the State of Washington issued a letter opinion regarding three areas of appeal that the industrial customer group and/or the State Attorney General's Office brought forward against WUTC decisions in PSE's rate plan. The three topics of the appeal were: 1) whether a full general rate case should have been undertaken, 2) the level of evidence needed to support the rate plan decision (specifically regarding the ROE decision), and 3) if the attrition adjustments, used in forward rate escalations, were appropriate. The Court found that the WUTC's decisions were appropriate for its actions regarding the choice to not enforce a full general rate case and use of attrition adjustments; however, the Court also remanded the case back to the WUTC and requires further evidence to support and justify rates and ROE level.

While still early in the process, the remand is a credit negative for PSE, as it introduces uncertainty into the ultimate revenue production of the company over the next two years. Greater clarity surrounding the process and timing of a WUTC decision is needed before determining any ratings implications; however, we feel that the significant progress made in the rate design of PSE (e.g., expedited rate decisions, forward looking attrition adjustments and the implementation of revenue decoupling) has improved the credit quality of the utility and supports a stable outlook. We incorporate a view that the WUTC will maintain revenue and ROE levels sufficient for PSE to recover its prudently evidenced costs going forward and that PSE's improved financial profile will remain intact. That said, if the revenue requirement is changed significantly downward, to a point where the company will produce CFO pre-WC to debt in the mid-teens on an ongoing basis, there could be negative outlook implications.

STABLE FINANCIAL METRICS AMIDST MANAGEABLE CAPTIAL SPENDING

With the completion of the Lower Snake River wind powered facility (149 wind turbines with a combined generating capacity of 343-megawatts at a cost of $750 million), the acquisition of the Ferndale gas-fired combustion turbine (270-megawatt Ferndale natural gas co-generation facility from Tenaska for $84 million in 2012) and the completion of hydroelectric upgrade projects at several generating units in 2013, PSE's new energy resource acquisition program has largely concluded. As a result, the Company is transitioning from being a net cash borrower, where in the past construction expenditures exceeded funds from operations, to being net cash neutral or even positive. Forecasted expenditures for the 2014-2016 timeframe total nearly $1.8 billion (versus $2.7 billion in the 2010-2012 timeframe) and represent more of a baseline spend without any significant planned new generation.

Reduced financing needs and pre-determined rate increases should add financial stability to PSE's financial profile over the next three years. While minor debt increases are expected, the company should be able to maintain key ratios, such as CFO pre-WC to debt around 20% through 2017. Year-to-year CFO variability may occur due to payment of deferred taxes associated with previous years' bonus depreciation, rate treatment of the gain on sale of its Jefferson County electric assets and the ultimate rate decision of the WUTC; however, we expect the company's intrinsic cash flow from operations production to be around $850 million, on average over the next three years versus an adjusted debt load of just under $4 billion.

We anticipate that a high level of dividends (i.e, greater than 100% of Net Income) will be paid given the reduced capital spending program, which could reduce its CFO pre-WC less dividends to debt ratio to be between 10% and the 14% that PSE exhibited LTM 2Q14. PSE's dividends are somewhat restricted by the maintenance of its equity layer to achieve maximum allowed returns as well as the minimum equity ratio of 44% imposed by ring-fencing provisions instituted during its 2009 acquisition.

RING-FENCE-LIKE PROVISIONS AFFORD PROTECTION TO PSE's CREDITORS

Due to the significant level of debt residing at PE and PSE being the sole source of cash flow to support PE's debt service, regulatory protections and credit insulation are an important aspect of the analysis of PSE.

Key among the ring-fence-like mechanisms established when the WUTC approved the change in ownership, in 2009, are: a required "golden share" vote to address concern about potential substantive consolidation of PSE in any parent bankruptcy or any voluntary filing by PSE; minimum required levels of PSE common equity to be maintained; and limits on PSE and parent distributions under certain circumstances. For example, dividend restrictions would apply if PSE's common equity ratio, calculated on a regulatory basis, is 44% or below except to the extent a lower equity ratio is ordered by the WUTC, and if PSE's issuer rating falls below investment grade. If

PSE's credit rating is below investment grade, PSE's ratio of EBITDA to interest expense for the four most recently ended fiscal quarters prior to such date must be equal to or greater than 3.0x. PSE's common equity ratio, calculated on a regulatory basis, was 48.1% at June 30, 2014 and the EBITDA to interest expense was 4.5x for the 12 months then ended.

Liquidity

Over the next twelve months, we expect PSE's internal cash position to consist of over $850 million of cash flow from operations, compared to about $580 million of capex (based upon amounts disclosed in its SEC filings) and dividends level around the $411 million distributed in 2013.

To supplement internal cash flow, PSE relies on two five-year committed credit facilities aggregating $1.0 billion. The facilities include a $650 million revolver to support working capital and act as backup to its commercial paper program and a $350 million revolver to support its energy hedging program, both of which were recently extended and expire in February 2019. As of June 30, 2014 PSE had no amounts outstanding under any of these sources of liquidity.

The $650 million working capital revolver has a $75 million sublimit for same day borrowings and the facilities do not require material adverse event representation for new money borrowings. There is a financial covenant (debt / capitalization cannot exceed 65%) and PSE is comfortably compliant. Additionally, PE has access to a $800 million credit facility, also extended in 2014, due April 2018. The company's next material debt maturity is in October 2015, when $150 million matures.

Rating Outlook

The stable outlook reflects a steady improvement in PSE and PE's key financial metrics and our view that Washington regulation will continue to provide for the adequate and timely recovery of prudently incurred costs, despite the potential revision to certain aspects of the company's recent rate order.

What Could Change the Rating - Up

A rating upgrade could be triggered by continued regulatory support and evidence of PE's ability to achieve consolidated interest coverage and CFO pre-WC to debt in excess of 25% on a sustainable basis.

What Could Change the Rating - Down

A rating downgrade is not anticipated over the near-term, given the recent rate increase and implementation of the revenue decoupling mechanism. However, should the rate case appeal and WUTC review result in a significant change to the company's ability to recover costs or earn expected returns, such that CFO pre-WC were to fall to the mid-teens range, a negative ratings trajectory would result. Furthermore, if PSE were to pay higher than anticipated dividends to its private equity owners, the ratings could have negative pressure.

Rating Factors

Puget Sound Energy, Inc.

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current LTM 12/31/2013**		**[3]Moody's 12-18 Month Forward ViewAs of July 2014**	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	A	A	A	A
b) Consistency and Predictability of Regulation	A	A	A	A
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	A	A	A	A
b) Sufficiency of Rates and Returns	Baa	Baa	Baa	Baa
Factor 3 : Diversification (10%)				
a) Market Position	Baa	Baa	Baa	Baa

b) Generation and Fuel Diversity	A	A	A	A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	4.3x	Baa	4.0x - 4.5x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	20.5%	Baa	18%- 22%	Baa
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	14.0%	Baa	13% - 17%	Baa
d) Debt / Capitalization (3 Year Avg)	46.5%	Baa	45% - 50%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		A3		A3
HoldCo Structural Subordination Notching	n/a	n/a	n/a	n/a
a) Indicated Rating from Grid		A3		A3
b) Actual Rating Assigned		Baa1		Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2013(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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