11 Jun 2018 | New Issue

# Fitch Rates Puget Sound Energy's Senior Secured Notes 'A'

Fitch Ratings-New York-11 June 2018: Fitch Ratings has assigned an 'A' rating to Puget Sound Energy Inc.'s (PSE; Issuer Default Rating 'BBB+') offering of $600 million senior secured notes due 2048. The Rating Outlook is Stable. The proceeds will be used to pay at maturity $200 million 6.74% due June 15, 2018, pay down a portion of outstanding commercial paper, and for general corporate purposes.

KEY RATING DRIVERS

Low-Risk Business Profile: PSE is a fully regulated integrated electric and gas utility in western Washington State, serving 1.1 million electric customers and 822,000 natural gas customers. Approximately 70% of the company's revenue is derived from electric service and 30% from natural gas service. The company is regulated by the Washington Utilities and Transportation Commission (WUTC).

Somewhat Restrictive Regulation: Fitch views certain aspects of WUTC's regulations as restrictive. Revenue requirements in rate case proceedings are largely based on historical test years (partially mitigated by expedited rate filings in between general rate cases for certain investments). Authorized returns on equity (ROEs) and equity ratios are relatively low. PSE benefits from full revenue decoupling for both electric and gas operations that mitigates revenue fluctuation from weather, conservation, and changes in energy usage patterns. PSE also benefits from trackers and recovery mechanisms for power costs, conservation, property taxes, pipeline replacement, purchased gas and low income.

Rate Settlement Implemented: On Dec. 5, 2017, the WUTC approved a multi-party settlement reached in PSE's 2017 general rate case (GRC). As a result, the company was authorized an electric increase of $20.2 million (0.9%) and a net natural gas decrease of $35.5 million (-3.8%). Both awards were based upon an ROE of 9.5% and equity ratio of 48.5%. The company's last rate decision in 2012 was based upon an ROE of 9.8% and equity ratio of 48.0%. The settlement also included modifications to the depreciation schedule for the Colstrip units, mitigating the risk of stranded investment from the planned shut-down of coal units 1 and 2 in 2022. Coal units 3 and 4 will be fully depreciated in 2027.

Impacts of Tax Reform: As a result of the Tax Cuts and Jobs Act of 2017, PSE will flow $132 million in benefits to customers. The effect of the change in tax rate from 35% to 21% will be passed back to customers beginning May 1, 2018 via a $73 million cut in base rates for electric and a $24 million cut in base rates for natural gas. The $35 million benefit from the first four months of this year has been deferred until the next GRC.

Tacoma Liquefied Natural Gas Facility: PSE's parent, Puget Energy, Inc. (PE, BBB-/Stable) is developing a liquefied natural gas (LNG) facility at the Port of Tacoma Washington (Tacoma LNG). The facility, along with an 8 million gallon storage tank is planned to provide peak-shaving service to PSE's natural gas customers. As per WUTC order, 43% of the project's capital and operating costs are allocated to PSE, with the balance allocated to PE. The plant, which is currently under construction, was expected to be operational in 2019; however an additional environmental study was requested by the Puget Sound Clean Air Agency before issuing the final permit, which will delay the in-service date. As of Dec. 31, 2017, PSE has incurred construction work in progress of $87.2 million related to Tacoma LNG.

Credit Metrics: PSE's capex has been ramping up since 2017, which, along with the impact of tax reform, will pressure credit metrics in the next two to three years. PSE's FFO adjusted leverage is expected to average in the mid-3x and FFO fixed-charge coverage around high-4x. In the next three years, PE plans to spend $2.6 billion in capex (mostly in PSE), an average of $861 million annually compared to $595 million average during the past four years. PSE will fund most of the capex from internal cash flow and the remaining using debt financing.

Notching: The two-notch IDR differential between PSE and PE reflects the substantial parent-level debt at PE (approximately 40%), the ring-fencing mechanism, and to a lesser degree, the companies' ownership by a group of long-term infrastructure investors. PSE benefits from various ring-fencing measures put in place by the WUTC at the time of the 2009 buyout. However, PSE's ratings are upwardly constrained by PE. Fitch believes that the ring-fencing restrictions are not sufficient to justify notching wider than two categories as PSE is PE's sole funding source to service its parent-only debt. The private equity ownership is less favorable than public equity ownership from a credit perspective. However, Fitch considers the investor group's large and highly diversified portfolios, long-term investment horizon, and demonstrated behavior supporting the maintenance of PE and PSE long-term financial health as mitigating factors.

DERIVATION SUMMARY

PSE and Cleco Power (BBB/Stable) are similar in that they are both owned by private equity investors, have substantial parent level debt and are exposed to coal generation. PSE's FFO-adjusted leverage is expected to average in the mid-3x range. It compares favorably with Cleco Power, which has FFO-adjusted leverage of 3.9x. However, PSE's service territory in Washington is considered a less favorable jurisdiction than Cleco Power's Louisiana. PSE and Cleco's ratings are both upwardly constrained by their parent holding companies. However, PSE's IDR is two notches higher than PE, while Cleco Power is only one notch higher than its parent, Cleco Corporation (Cleco, BBB-/Stable) as Cleco has much higher parent-only debt of nearly 60% compared with PE's approximately 40%.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Electric load growth on average 0.5% and gas load growth 0.4%;
- O&M escalates at an average of 1.5% per year from 2018 to 2021;
- Net book value of Colstrip 1 and 2 recovered through 2022 per prior precedent; decommissioning cost and remediation costs are recovered through offsetting production tax credits and treasury grants per Washington state legislation;
- Cash shortfall is funded by debt.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action
-Absent an upgrade at PE, it is unlikely that PSE's ratings will be upgraded in the foreseeable future.

Developments that May, Individually or Collectively, Lead to Negative Rating Action
-A downgrade at PE could lead to a downgrade at PSE;
-After the heavy capex period, if FFO adjusted leverage sustains above 4.8x, negative rating pressure could mount;
-If PSE is not able to recover the majority of the stranded and remediation costs associated with Colstrip unit 1 and 2, if the outcome of future rating proceedings is materially unfavorable, or if Washington's regulatory environment deteriorates materially, negative rating action could occur.

LIQUIDITY

Fitch deems PSE's liquidity adequate. In October 2017, the company entered into a new $800 million credit facility, which matures in October 2022. With the banks approval, the facility can be increased to up to $1.4 billion. Under the terms of the credit agreement PSE is required to maintain a total debt to total capitalization of less than 65%. As of March 31, 2018, PSE had no outstanding borrowings on the facilities and $371 million in commercial paper. Absent the $200 million June 2018 maturity, PSE does not have any significant maturities over the forecast period.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

**Applicable Criteria**

Criteria for Rating Non-Financial Corporates - Effective from 10 March 2017 to 7 August 2017 (pub. 10 Mar 2017)

Non-Financial Corporates Hybrids Treatment and Notching Criteria - Effective from 27 April 2017 to 27 March 2018 (pub. 27 Apr 2017)

**Additional Disclosures**

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