

## Research

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### Research Update:

# Puget Sound Energy Inc. 'BBB' Rating Affirmed; Outlook Stable

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## Overview

- Bellevue, Wash.-based Puget Sound Energy Inc. (PSE) recently received an order from the Washington Utilities and Transportation Commission (WUTC) on its general rate case, including an overall rate decrease and a plan to recover costs associated with PSE's closure of two coal plants by 2022.
- We are affirming our ratings on PSE, including the 'BBB' issuer credit rating. The outlook is stable.
- We are revising our business risk assessment on PSE to excellent from strong, resulting in a revised stand-alone credit profile (SACP) for PSE to 'bbb+' from 'bbb'.
- In addition, we are revising our management and governance (M&G) assessment of the company to satisfactory from fair.
- The stable outlook reflects a modest improvement in the company's business risk, which mitigates our assessment of parent Puget Energy Inc.'s (PE) consolidated financial measures, including funds from operations (FFO) to debt of about 14.5%, indicative of the lower end of the range for the company's financial risk profile category.

## Rating Action

On Dec. 13, 2017, S&P Global Ratings affirmed its ratings on Puget Sound Energy Inc. (PSE), including the 'BBB' issuer credit rating on PSE, and 'A-' issue rating on PSE's first mortgage bond. The outlook is stable. Our 'A-2' short-term rating for PSE is unchanged.

In addition, we revised our stand-alone credit profile for PSE to 'bbb+' from 'bbb'. We also revised our M&G assessment on the company to satisfactory from fair.

## Rationale

The affirmation follows a recent regulatory order by the WUTC for PSE that approves recovery of costs related to the future closure of the company's coal-fired generating units, Colstrip Units 1 and 2, despite the overall rate decrease.

Our revised business risk assessment for PSE takes into account a modest improvement to PSE's business risk reflecting the continued use of constructive regulatory mechanisms such as decoupling and various riders that we expect will provide stability to the company's profit measures going

forward. In addition, our revised M&G assessment on the company to satisfactory from fair reflects management's effectiveness in mitigating key regulatory risks associated with shutting down Colstrip Unit 1 and 2 by 2022.

PSE sells electric and gas service to about 1.1 million electric customers, and about 800,000 gas customers, the vast majority of whom are residential customers, reflective of a mostly stable customer base that supports the company's credit quality.

We assess PSE's financial measures using more moderate financial benchmarks compared with the typical corporate issuer. This reflects PSE's lower-risk, regulated business, and its management of regulatory risk. Under our base-case scenario that includes capital spending of about \$920 million in 2018 and dividends of about \$210 million, we expect FFO to debt of about 22%, consistent with the higher end of the range for PSE's financial risk profile category.

Our ratings on PSE are lower by one notch to reflect our view of PSE's business risk that we assess toward the lower end of the excellent category. PSE is susceptible to regulatory lag and unfavorable regulatory decisions, which dims our view of the company's overall management of regulatory risk in the state.

Our ratings on PSE also reflect our assessment of Puget Holdings LLC (PH; not rated), as the ultimate parent of PSE. We view PSE as a core subsidiary of PH, reflecting our view that PH is highly unlikely to sell PSE, that PSE is integral to the group's strategy, and that PH has a strong long-term commitment to PSE even under stressful conditions.

Our issuer credit rating on PSE is two notches higher than the group credit profile because of the cumulative value of structural protections in place that insulate PSE, including dividend restrictions, and a non-consolidation opinion that make it unlikely that PSE's assets and liabilities would be substantively consolidated into those of PH in the event of a parent company's bankruptcy.

## **Liquidity**

PSE has adequate liquidity in our view, and can cover its needs for the next 12 months, even if EBITDA were to decline by 10%. We expect the company's liquidity sources over the next 12 months will exceed uses by more than 1.1x. Under our stress scenario, we do not expect PSE would require access to the capital markets to meet its liquidity needs during this period. Our assessment also reflects the company's generally prudent risk management, sound relationships with banks, and a generally satisfactory standing in the credit markets.

Principal liquidity sources:

- Credit facility availability of about \$800 million;
- Cash FFO of about \$980 million; and

- Minimal cash

Principal liquidity uses:

- Capital spending of about \$920 million in 2018;
- Dividends of about \$210 million; and
- Debt maturities of about \$200 million in 2018.

## Outlook

The stable outlook reflects a modest improvement in the company's business risk, which mitigates our assessment of parent PE's consolidated financial measures, including FFO to debt of about 14.5%, indicative of the lower end of the range for the company's financial risk profile category.

### Downside scenario

We could lower the ratings over the next 12 to 18 months if PE's financial measures consistently weakened to the aggressive financial risk profile, reflecting FFO to debt of less than 13%. This could occur if the company's management of regulatory risk weakens.

### Upside scenario

We could raise the rating over the next 12 to 18 months if PE consistently improves its management of regulatory risk by further reducing regulatory lag. Alternatively, we could also raise the rating if the group credit profile improves.

## Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1)

Stand-alone credit profile: bbb+

- Group credit profile: bb+
- Entity status within group: Insulated (-1 notch from SACP)

## Issue Ratings

### Capital structure

PSE's capital structure consists of close to \$4 billion of debt, including about \$3.4 billion of first-mortgage bonds, and \$250 million of junior subordinated notes.

### Analytical conclusions

We rate PSE's first-mortgage bonds 'A-' based on the issuer credit rating and our '1+' recovery rating for this debt (see recovery analysis below). PSE's junior subordinated notes are rated 'BB+' as a hybrid security--one notch for the deferability of its interest payments and one notch for its subordination to senior debt.

## Recovery Analysis

We assign recovery ratings to first-mortgage bonds (FMB) issued by U.S. utilities, which can result in issue ratings being notched above the issuer credit rating on a utility depending on the rating category and the extent of the collateral coverage. The FMBs issued by U.S. utilities are a form of "secured utility bond" (SUB) that qualify for a recovery rating as defined in our criteria (see "Collateral Coverage And Issue Notching Rules for '1+' And '1' Recovery Ratings on Senior Bonds Secured by Utility Real Property," published Feb. 14, 2013).

The recovery methodology is supported by the ample historical record of 100% recovery for secured bondholders in utility bankruptcies in the U.S. and our view that the factors that enhanced those recoveries (limited size of the creditor class and the durable value of utility rate-based assets during and after a reorganization given the essential service provided and the high replacement cost) will persist.

Under our SUB criteria, we calculate a ratio of our estimate of the value of the collateral pledged to bondholders relative to the amount of FMBs outstanding. FMB ratings can exceed the issuer credit rating on a utility by up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories, depending on the calculated ratio.

Puget Sound Energy's FMBs benefit from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral coverage of more than 2x supports a recovery rating of '1+' and an issue rating two notches above the issuer credit rating.

## Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

## Ratings List

### Ratings Affirmed

Puget Sound Energy Inc.  
Corporate Credit Rating

BBB/Stable/A-2

Puget Sound Energy Inc.  
Senior Secured  
Recovery Rating  
Junior Subordinated  
Commercial Paper

A-  
1+  
BB+  
A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action

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