MOODY'S
INVESTORS SERVICE

CREDIT OPINION
1 September 2017

Update

Rate this Research

RATINGS

**Puget Sound Energy, Inc.**

| | |
|---|---|
| Domicile | Bellevue, Washington, United States |
| Long Term Rating | Baa1 |
| Type | LT Issuer Rating - Dom Curr |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*

Contacts

Ryan Wobbrock 212-553-7104
*VP-Senior Analyst*
ryan.wobbrock@moodys.com

Jim Hempstead 212-553-4318
*MD-Utilities*
james.hempstead@moodys.com

# Puget Sound Energy, Inc.

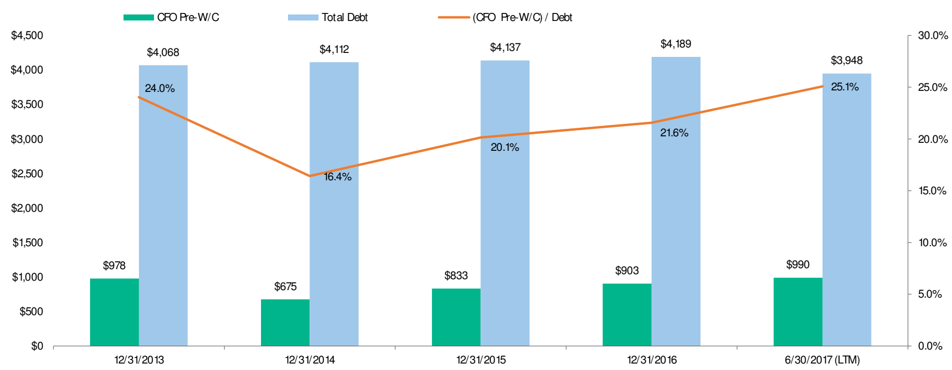
## Update to credit analysis

## Summary

Puget Sound Energy, Inc's (PSE Baa1 stable) credit profile reflects its low risk utility operations, strong financial profile and cooperative relationship with its primary regulator, the Washington Utilities and Transportation Commission (WUTC).

PSE's credit profile is constrained by holding company leverage at its parent, Puget Energy, Inc. (PE, Baa3 stable), and evolving changes to stakeholder demands and power supply resources.

Exhibit 1
**PSE's adjusted CFO Pre-WC, Total Debt and CFO Pre-WC to Debt**




*Source: Moody's Investors Service*

## Credit Strengths

» Supportive regulatory environment provides broad suite of timely recovery mechanisms

» Solid financial performance expected to continue

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

## Credit Challenges

» PSE's dividends are required to service $1.6 billion of holding company debt

This report was republished on 1 September 2017 with corrected operating statistics for Colstrip on page 4.

- Significant capital expenditures over the next 12-18 months
- Long-term uncertainty pertaining to Washington's Clean Air Rule

## Rating Outlook

The stable outlook reflects PSE's cooperative relationship with the WUTC and its stable and predictable cash flow. The outlook also incorporates a view that the current general rate case proceeding in Washington will allow the company to maintain its current financial profile, including a ratio of cash flow from operations before changes in working capital (CFO pre-WC) to debt above 20% over the next 12-18 months.

## Factors that Could Lead to an Upgrade

- CFO pre-WC to debt in excess of 25%
- CFO pre-WC less dividends to debt in the mid-to-high teens on a sustainable basis
- Reduced leverage at parent holding company

## Factors that Could Lead to a Downgrade

- Less supportive regulatory decisions by the WUTC
- Retained Cash Flow to debt metrics below 10% or a material change in financial policies
- Stranded investments that are not recovered and degrade financial metrics

## Key Indicators

Exhibit 2

**KEY INDICATORS [1]**

**Puget Sound Energy, Inc.**

| | 12/31/2013 | 12/31/2014 | 12/31/2015 | 12/31/2016 | 6/30/2017(L) |
|---|---|---|---|---|---|
| CFO pre-WC + Interest / Interest | 4.8x | 3.6x | 4.4x | 4.8x | 5.2x |
| CFO pre-WC / Debt | 24.0% | 16.4% | 20.1% | 21.6% | 25.1% |
| CFO pre-WC – Dividends / Debt | 13.8% | 8.4% | 13.5% | 15.3% | 20.4% |
| Debt / Capitalization | 44.4% | 46.2% | 45.5% | 44.4% | 41.8% |

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

## Profile

Puget Sound Energy, Inc. (PSE), the primary subsidiary of Puget Energy, Inc. (PE), is an electric and natural gas utility serving about 1.2 million electric and around 790,000 natural gas customers in the State of Washington.

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 Macquarie Infrastructure Funds (41.8%), along with Canada Pension Plan Investment Board (31.6%), British Columbia Investment Management Corp (15.8%), Alberta Investment Management Corp (7.1%), and FSS Infrastructure Trust (3.7%).

The term of Macquarie's fund ownership is scheduled to end at year-end 2017. We expect that any potential change in ownership will be credit neutral for PSE and PE, since the majority of ownership would remain with the existing consortium owners. We also note that in Macquarie's other recent utility divestments (e.g., Aquarion Water Company of Connecticut (Baa1 stable) and Duquesne Light Company (A3 stable), their interest was either sold to strategic uti

## Detailed Credit Considerations

### Cooperative regulatory relationships provides cost recovery and credit support

Recent developments have highlighted the cooperative relationship PSE maintains with the WUTC, a significant credit positive since it provides important cost recovery for the utility.

For example, in 2016 PSE postponed the filing of its general rate case in order to accommodate stakeholder concerns about coal-fired emissions generated from its ownership interest in Colstrip Units 1 and 2. Subsequent to the postponement, Senate Bill 6248 was signed into law in Washington, which allows PSE to collect decommissioning funds for the possible retirement of the two units. Furthermore, PSE and co-owner of Units 1 and 2, Talen Energy Supply LLC (B1 stable), reached a settlement agreement with environmental groups to retire Units 1 and 2 by no later than July 2022 (see section below for more information on Colstrip).

Another example of stakeholder cooperation became evident in July 2017 when the WUTC approved a settlement allowing PSE's largest industrial customer, Microsoft Corporation (Aaa negative), tariff buyout, in order to source its own renewable generation. While this event is credit negative for PSE, the utility was able to negotiate a settlement with Microsoft, other customers and the WUTC in order to recover certain fixed costs that remain with the system. PSE received a one-time exit fee of nearly $24 million and Microsoft agreed to maintain contributions to various PSE programs.

The rate design and regulatory support offered by the WUTC is the primary ratings driver for PSE, which continues to operate under a three year rate plan, initiated in 2013 and extended through this year (see section below). This plan includes a series of predetermined annual rate increases, with an allowed ROE of 9.8% on an equity layer of 48%. Forward-looking rate plans are positive, since it provides a degree of assurance and predictability into PSE's financial performance. Moreover, the last rate case included fixed escalation factors of 3% for electric and 2.2% for gas rates, which help to recover inflationary costs - another forward-looking attribute of the regulatory environment.

PSE's revenue decoupling mechanism is also credit supportive, since it helps PSE to have greater fixed cost recovery in both its electric and gas segments, even in the current declining sales volume environment. The rate plan also included a property tax and conservation riders, as well as an annual earnings test that requires PSE to share with customers on an equal basis any earnings that exceed its authorized return.

### General rate case outcome is expected to maintain financial profile

We believe that PSE will continue to produce ratios of cash flow from operations before changes in working capital (CFO pre-WC) to debt around 20% over the next 12-18 months as decoupling corrects the 25% ratio through 1H17, which resulted from higher 1H17 customer demand. Longer-term, we estimate that PSE will produce CFO pre-WC to debt in the high-teens to 20% ratio as the cash benefits from bonus depreciation fade. Our expectations are based on its recent rate case filing and recovery of, and on, around $2.6 billion of capital investment made since the last rate order.

In January 2017, PSE filed a general electric and gas rate case, requesting a rate increase of approximately $149 million (9.8% return on equity (ROE)) for electric and a $24 million increase (7.74% ROE) for gas operations. The company subsequently re-filed in April 2017, proposing a net electric rate increase of $68 million and gas decrease of $29 million. The company also included in the filing requests for recovery on decommissioning of Colstrip Units 1 and 2 and rate recovery mechanisms, such as an Electric Cost Recovery Mechanism (ECRM) and Expedited Rate Filing (ERF) process.

On 8 August, the WUTC staff recommended an electric base rate decrease of around $35 million, premised on a 9.2% ROE. The commission staff also recommended a reduction in gas rates by about $48 million based on a 9.2% ROE.

Given the aforementioned support provided by the WUTC, we expect that the outcome of this rate filing will allow PSE to maintain its current financial profile and continue to recover costs on a timely basis. The continuation of the decoupling mechanism, in particular, would provide for stable and predictable cash flow for the PSE.

### Longer-term challenges exist with evolving stakeholder demands and power supply

Several utilities in the Pacific Northwest are experiencing changing operational dynamics based on the environmental agendas of various stakeholders. For PSE, this has evidenced itself in multiple ways, including the targeted early closure of Colstrip, Microsoft's tariff agreement and even in Washington's statewide effort to reduce carbon emissions. Each of these provide unique execution challenges for PSE, that require the company to adapt to, and incorporate, thrid party preferences in utility decision making - mainly regarding its power supply portfolio. Each of these topis is discussed below.

#### Washington Clean Air Rule (CAR)

Perhaps the most pervasive change to PSE's operations could be prompted by Washington's CAR. In September 2016, the Washington State Department of Ecology adopted the CAR which establishes emission standards for green house gas (GHG) emissions from certain sources in the state, including power plants and natural gas distributors.

The plan calls for a reduction of GHG emissions over time, at a pace of 1.7% annually until 2035; however, the base level has not been set by the Department of Ecology.

Exactly how, and at what cost, the rule might affect PSE's power plant generation and natural gas distribution is currently unclear. Under the rule, PSE can comply by simply reducing emissions or providing Emission Reduction Units (ERUs) - a mechanism within Washington state borders, which has yet to be administered.

We view the ability to reduce emissions from owned generation as more feasible than from natural gas deliveries - which are primarily based on customer needs and generally outside the control of the company - since the company only acts as a conduit for natural gas deliveries. Therefore, if PSE is held financially accountable for the emissions of around 106 billion cubic feet of transportation and distribution gas deliveries per year, rates and customer bills could rise with no added benefit of service - a credit negative.

The first compliance period ranges from 2017 to 2020, giving PSE time to incorporate a compliance strategy. We note that several parties, including PSE, filed a joint action in the US District Court for the Eastern District of Washington challenging the CAR; thus, a prolonged litigation period will likely ensue.

#### Microsoft tariff buyout

In July 2017, the WUTC approved a settlement agreement which allows Microsoft to directly purchase clean energy to power its 15 million-square-foot campus in the Puget Sound region, in exchange for a $24 million buyout of its existing tariff agreement with PSE. According to Microsoft, the agreement covers approximately 80 percent of the company's total energy load in the Puget Sound area; the remaining 20 percent will continue to be serviced by PSE. As part of the settlement, Microsoft agreed to continue to contribute toward PSE's conservation programs and low-income customer support.

The development is negative for PSE, since it erodes the monopoly service paradigm which is fundamental to regulated utilities. While the pricing of the agreement was structured in an effort to avoid cost-shifting to remaining customers and the WUTC made comments that the decision was not intended to be precedent-setting for other customers, it still creates a degree of uncertainty for whether other industrial customers (e.g., The Boeing Company (A2 stable), Kroger Co. (Baa1 stable) and refineries) could follow suit. We expect that the WUTC would continue to address any stranded costs for PSE derived from customer defection and note that any degree of stranded costs would be a credit negative for PSE.

#### Closure of Colstrip 1 and 2

The 2,100 MW, four unit, coal-fired power generation plant in Rosebud County, MT (PSE owns a 50% stake in Units 1 and 2) had been receiving increased criticism from environmental groups in and around the state of Washington, with Units 1 and 2 facing increasing pressure for early retirement, due to emissions generated from the facility.

As previously mentioned, Washington's Senate Bill 6248 allows PSE to collect decommissioning funds for the possible retirement of the two units and PSE and Talen Energy Supply have reached an agreement with environmental groups to retire Units 1 and 2 by no later than July 2022. The settlement does not impact Units 3 and 4 (PSE's owns 25% of both units).

We view the developments surrounding Colstrip to be credit supportive to PSE, since it provides a funding mechanism for the decommissioning of relatively old units, which will support the company's financial position as it addresses an uncertain liability. We also view the closure as a credit positive from an environmental, sustainability and governance perspective, since the two units (only half of which are owned by PSE) are collectively over 650 megawatts of nameplate generating capacity, which produced over 3,600 megawatt hours of electricity and emitted approximately 4.6 million tons of carbon in 2016. The closure of these units mitigates some of PSE's future environmental risk.

However, we also acknowledge that the process will continue to be politicized, since the units exist in Montana where Colstrip provides local tax revenue and jobs.

## Liquidity Analysis

PSE's internal liquidity consists of cash flow from operations, which we expect to be above $950 million for 2017. This will be insufficient to cover relatively high capex of around $1.0 billion in the next twelve months and dividends to PE, which were around $180 million through LTM 2Q17. We expect that PSE's negative free cash flow of around $230 million will be funded with an even mix of debt and equity.

PE's upstream dividend policy for PSE has been aggressive, historically, with a five year average payout of 94% for the utility. However, 2016 dividends were less than we had anticipated, at a 68% payout and LTM 2Q17 has shown further reduction to a 54% payout ratio, due to the high capex demands in 2017. 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.

PSE's external liquidity consists of 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 expire in April 2019. As of 30 June 2017, PSE had no borrowed amounts outstanding and only $5 million of commercial paper issued.

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 senior secured credit facility due April 2018. Given the short-term nature of this facility, we do not consider it as available for our liquidity analysis.

The company's next material debt maturity is in June 2018, when $200 million matures.

## Structural Considerations

The two notch rating differential between PSE and its parent, PE, reflects the structural subordination that exists at PE, and dividend limitations imposed by the WUTC. As of 30 June 2017, PE had approximately $1.8 billion of standalone debt at the parent company, representing approximately 32% of total PE consolidated balance sheet debt.

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 PSE's analysis.

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.

## Methodology and Scorecard

Exhibit 3

| Rating Factors | | | | |
|---|---|---|---|---|
| Puget Sound Energy, Inc. | | | | |
| Regulated Electric and Gas Utilities Industry Grid [1][2] | **Current LTM 6/30/2017** | | **Moody's 12-18 Month Forward View As of date published [3]** | |
| **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) | 4.4x | Baa | 4.4x - 4.5x | Baa |
| b) CFO pre-WC / Debt (3 Year Avg) | 21.0% | Baa | 18% - 22% | Baa |
| c) CFO pre-WC – Dividends / Debt (3 Year Avg) | 15.0% | Baa | 13% - 17% | Baa |
| d) Debt / Capitalization (3 Year Avg) | 43.1% | A | 45% - 50% | Baa |
| **Rating:** | | | | |
| Grid-Indicated Rating Before Notching Adjustment | | Baa1 | | Baa1 |
| HoldCo Structural Subordination Notching | | 0 | 0 | 0 |
| a) Indicated Rating from Grid | | Baa1 | | Baa1 |
| 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 6/30/2017(L)
[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
*Source: Moody's Investors Service*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **PUGET SOUND ENERGY, INC.** | |
| 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 |
| First Mortgage Bonds | A2 |
| Senior Secured | A2 |
| Jr Subordinate | Baa2 |
| **WASHINGTON NATURAL GAS COMPANY** | |
| Outlook | No Outlook |
| Bkd First Mortgage Bonds | A2 |

*Source: Moody's Investors Service*

REPORT NUMBER 1084180