16 Jun 2017 | New Rating

Fitch Assigns First-Time 'BBB-' IDR to Puget Energy Inc. and 'BBB+' IDR to Puget Sound Energy Inc.

Fitch Ratings-New York-16 June 2017: Fitch Ratings has assigned a first-time Long-Term Issuer Default Rating (LT IDR) of 'BBB-' to Puget Energy Inc. (PE) and a first-time LT IDR of 'BBB+' to Puget Sound Energy Inc. (PSE). PE's senior secured debt rating is 'BBB'. PSE's Short-Term IDR is 'F2' and senior secured debt rating is 'A'. The Outlook for all ratings is Stable. A complete list of ratings follows at the end of this release.

KEY RATING DRIVERS

Predominantly Regulated Business:

PE's rating and Outlook reflect its low business-risk profile as a utility holding company with predominantly regulated gas and electric utility operations through PSE. PSE is a fully regulated integrated electric and gas utility in western Washington and its revenue will represent nearly all of PE's consolidated revenue in the next five years. PE is also developing a liquefied natural gas (LNG) facility with an 8 million gallon storage tank at the Port of Tacoma Washington (Tacoma LNG) which will provide peak-shaving service to PSE's natural gas customers (regulated portion 43%) and provide LNG as fuel to transportation customers (unregulated portion 57%). Approximately 50% of the unregulated capacity is subscribed by Tote Maritime and 50% is currently open.

Washington State Regulation Restrictive but Improving:

Certain aspects of Washington Utilities and Transportation Commission (WUTC) regulation are restrictive, in Fitch's view. 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. Use of tracker/rider mechanisms is limited.

However, WUTC has shown signs of improvement in the last several years and allowed PSE to narrow the gap between authorized ROE and actual ROE from 6% in 2010 to 0.9% in 2016.

PSE benefits from partial revenue decoupling for both electric and gas operations that mitigates revenue fluctuations from weather, conservation, and changes in energy usage patterns. The multi-year rate plan (K-factor) in 2013 allows decoupling revenue for electric and gas customers to increase 3% and 2.2% per year subsequently. The decoupling rate increase for customers is capped at 3% of total revenue. In 2016, decoupling revenue added $82 million to compensate for lower usage due to warmer weather and conservation. Other mechanisms from the 2013 order include a property tax tracker and 50% excess-earnings sharing above the authorized rate of returns with ratepayers. PSE's existing ROE of 9.8% was approved in 2012 and is higher than the ROE authorized in recent cases in the state (9.5%). The 9.8% ROE was upheld in 2015 by the WUTC after certain parties challenged and the court remanded the authorized ROE issue to the WUTC for reconsideration.

PSE has power cost adjustment (PCA) mechanisms but is required to share the increases and decreases in costs with customers on a graduated scale. However, large increases in fuel costs (over $40 million) are mostly borne by customers (90%). Pursuant to a PCA Settlement approved on Aug. 7, 2015, PSE's fixed power costs in the PCA mechanism have been recovered from the decoupling mechanism since Jan. 1, 2017. The WUTC allows PSE to file power cost-only rate cases, allowing expedited rate review on new power procurement investments.

In its 2017 general rate case (GRC), PSE requested expedited rate filing (ERF) procedures to update delivery revenues after a GRC filing. PSE also sought to establish an electric cost recovery mechanism (CRM) which allows PSE to obtain accelerated cost recovery on specified electric reliability projects such as cable replacement, similar to its existing natural gas CRM. These mechanisms, if approved, could further reduce regulatory lag.

Senate Bill 3248 was signed into law in April 2016 allowing PSE to set aside a retirement account to pay for the decommissioning and remediation cost of closing Colstrip 1 and 2 but did not specify on the timing of shutdown.

2017 General Rate Case:

PSE filed its GRC with the WUTC in January 2017 followed by an updated filing in April 2017 requesting a 48.5% equity ratio with a return on equity of 9.8%, compared to its existing 48% equity ratio and an ROE of 9.8%. If approved the filing could result in a net increase for electric tariffs of $68.3 million, or 3.2%, annually, and for natural gas tariffs, a net decrease of $29.3 million, or -3.2%, annually. PSE's GRC filing also included its plan to retire two coal generation units in Montana Colstrip Units 1 and 2 by July 1, 2022. Additionally, PSE's filing contains requests for two new mechanisms to reduce regulatory lag aforementioned. An order is expected at the end of this year.

Large Capex Program:

In the next three years, PE plans to spend $2.9 billion in capex, an average of $958 million annually compared to $596 million in the past three years. Peak spending of $1.1 billion will occur in 2017. The total spend includes approximately $300 million on Tacoma LNG. PE will fund most of the capex from internal cash flow and the remaining using debt financing. Fitch expects the upstream dividend at both entities to moderate in the next three years to accommodate the large capital investment program.

Credit Metrics:

PE's funds from operations (FFO) adjusted leverage is expected to range from high 4x to low 5x for the next three years. The FFO fixed-charge coverage is expected to average at around mid-3x during the same period. PSE's FFO adjusted leverage is expected to average in the high-3x and FFO fixed-charge coverage around 4x. These credit metrics incorporate the large capex program, the expected reduced upstream dividend, and a reasonable GRC order.

Rating Notching Between PE and PSE:

The two-notch differential between the IDRs of PSE and PE reflects PE's relatively weaker credit profile due to over 30% of PE-only debt, as well as the ring-fencing measures that are in place as conditions to receive Washington commission's approval of PE's 2009 buyout by a consortium of investors.

The ring-fencing measures include a non-consolidation opinion, and a requirement that at least one of PSE's directors is an independent director. Without the unanimous vote of all directors including the independent director, PSE will not consent to the institution of bankruptcy proceedings or the inclusion of PSE in any bankruptcy proceeding by PE or its affiliates. PSE is prohibited from lending or pledging utility assets to PE or upstream owners without the permission of the commission and there will be no cross-subsidization by PSE customers for unregulated activities. PSE is prohibited from making upstream distributions if the common equity ratio is less than 44%. Dividends are also restricted if PSE's issuer rating is below investment grade. If PSE is downgraded below investment grade, while its EBITDA interest coverage is equal to or greater than 3x on an annualized basis, PSE is allowed to distribute dividends only up to an amount that is sufficient to service debt at PE, and to satisfy financial covenants in the credit facilities of PE. Under this scenario, PE is prohibited from distributing to its equity owners.

Conversely, PSE's ratings are upwardly constrained by PE as Fitch believes that the distribution restrictions are not sufficient to justify notching that is wider than two categories.

Private Equity Ownership a Modest Constraint:

PE and PSE's ratings take into consideration that their dividend policy is relatively aggressive. PE is indirectly owned by a group of long-term infrastructure investors including Macquarie Infrastructure Partners, FSS Infrastructure Trust, Canadian Pension Plan Investment Board, British Columbia Investment Management Corporation, and the Alberta Investment Management Corporation.

PE and PSE's average dividend pay-out ratios in the past several years were substantially higher than those of most of their utility peers. However, as mentioned, during the high capex period, dividend from both entities will likely be substantially lower the next three years. In Fitch's view, PE and PSE's long-term rating stability will continue to depend upon dividend and balance sheet discipline.

Although the private equity ownership is less favorable than public equity ownership from a credit perspective, Fitch believes that as these investors have large and highly diversified portfolios and a long-term investment horizon, they do not depend on PE's dividend distribution, and that maintaining the long-term financial health of PE and PSE is in their best interest.

KEY ASSUMPTIONS

--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;
--Tacoma LNG comes online in 2019 and 2020 is the first full year of operations;
--Cash shortfall is funded by debt.

RATING SENSITIVITIES

Positive: Future developments that may, individually or collectively, lead to a positive rating action include:

PE

--A positive rating action could be driven by PE's commitment to adhere to a less aggressive financial policy, including decreasing holdco leverage or reducing its dividend pay-out after the high capex period.

PSE
--Absent an upgrade at PE, it is unlikely that PSE's ratings will be upgraded in the foreseeable future.

Negative: Future developments that may, individually or collectively, lead to a negative rating action include:

PE
--A continued aggressive dividend policy largely funded by debt after the high capex period resulting in FFO adjusted leverage above 5.5x on a sustained basis could pressure ratings;
--Adverse rating action at PSE will likely lead to a downgrade at PE.

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, or if the GRC outcome is materially unfavorable, negative rating action could occur.

Fitch has assigned the following first-time ratings, with a Stable Outlook:

Puget Energy Inc.

--Long-Term IDR at 'BBB-';
--Senior secured at 'BBB'.

Puget Sound Energy Inc.

--Long-Term IDR at 'BBB+';
--Short-Term IDR and CP at 'F2';
--Senior secured notes at 'A';
--Junior sub notes at 'BBB'.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)

Non-Financial Corporates Hybrids Treatment and Notching Criteria (pub. 27 Apr 2017)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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