

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'.

Contact:

Primary Analyst  
Julie Jiang  
Director  
+1-212-908-0708  
Fitch Ratings, Inc.  
33 Whitehall St.  
New York, NY, 10004

Secondary Analyst  
Barbara Chapman  
Senior Director  
+1-646-582-4886

Committee Chairperson  
Shalini Mahajan, CFA  
Managing Director  
+1-212-908-0351

Date of Relevant Rating Committee: May 26, 2017

Media Relations: Alyssa Castelli, New York, Tel: +1 (212) 908 0540, Email:  
alyssa.castelli@fitchratings.com.

Additional information is available on [www.fitchratings.com](http://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](#)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE  
READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK:

[HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT [WWW.FITCHRATINGS.COM](http://www.fitchratings.com). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a

rating or forecast was issued or affirmed.

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

---

**ENDORSEMENT POLICY** - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant



---

to the terms of the EU Regulation with respect to credit rating agencies, can be found on the [EU Regulatory Disclosures](#) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.