S&P Global Ratings

Research

Research Update:

Puget Energy Inc. And Puget Sound Energy Inc. Ratings Affirmed; Outlook Is Stable

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Overview

- Puget Sound Energy Inc. (PSE) recently announced that it commenced a tender offer to purchase any and all of the $250 million 6.974% series A enhanced junior subordinated notes due June 1, 2067 and that it will also terminate the replacement capital covenant dated June 4, 2007.
- We are lowering our equity content treatment from our financial ratio calculations for any remaining balance of the $250 million junior subordinated notes, treating the outstanding balance as debt. In addition, future junior subordinated notes issued either by PSE or parent Puget Energy Inc. (PE) are unlikely to receive equity treatment.
- We are revising PSE's stand-alone financial risk profile to significant from intermediate, reflecting our expectations of moderately weakening financial measures. We also revised our liquidity assessment for PSE and PE to adequate from strong.
- We are affirming the credit ratings on PSE and PE. This includes PE's 'BBB-' issuer credit rating and PSE's 'BBB' issuer credit rating. The rating outlooks for both entities are stable.
- The stable outlook reflects our expectations for modestly weaker financial measures at parent PE, demonstrating only minimal cushion at the present rating level. This is partially offset by our expectation that the company's continued focus on managing regulatory risk should result in financial measures that remain adequate for the rating.

Rating Action

On May 11, 2016, S&P Global Ratings affirmed its ratings on Bellevue, Wash.-based Puget Energy Inc. (PE) and Puget Sound Energy Inc. (PSE). This includes PE's 'BBB-' issuer credit rating, PSE's 'BBB' issuer credit rating, PE's 'BBB-' senior unsecured rating, and PSE's 'A-' first mortgage bond rating and 'A-2' short-term rating. The rating outlooks for both entities are stable.

Rationale

We are lowering our equity content treatment from our financial ratio calculations for any remaining balance of the $250 million junior subordinated notes (JSN), treating the outstanding balance as debt, reflecting PSE's decision to terminate the replacement capital covenant and its decision to purchase the outstanding JSNs. In addition, future JSNs issued either by PSE or by parent PE are unlikely to receive equity treatment because the company's offer to purchase the JSNs is inconsistent with our original understanding that the JSNs would represent a long-term permanent component of its capital structure.

Removing the JSNs' equity content modestly weakens PSE's stand-alone financial measures. We are revising our assessment of PSE's stand-alone financial profile to significant from intermediate. Under our base case scenario, we expect PSE's funds from operations (FFO) to debt to be about 21%, which is consistent with the significant financial risk profile.

We also revised our liquidity assessment of PE and PSE to adequate from strong. The funding requirements necessary to purchase the outstanding JSNs modestly weakens our assessment of the company's liquidity.

We base PE's and PSE's ratings on our assessment of their strong business risk profile and significant financial risk profile.

Our assessment of the business risk profile reflects the company's lower-risk vertically integrated electric and gas utility, and its management of regulatory risk that we view as about average compared with peers. PSE provides regulated distribution service to about 1.1 million electric customers and 800,000 gas customers. Our business risk assessment further reflects the company's strategy to focus exclusively on regulated utility operations in Washington. Offsetting this is the company's limited regulatory diversity and challenging regulatory environment that has historically affected PSE's ability to earn authorized returns. In addition, the company faces operational risks associated with its hydroelectric generation that are common in the Northwest. These challenges have collectively led to more volatile returns compared with the regulated utility industry average.

We assess PE's and PSE's financial risk profiles using our medial volatility table, reflecting the company's lower-risk regulated utility business model, offset by the higher operating risk of regulated generation that includes significant exposure to coal-fired generation.

Under our base case scenario that incorporates capital spending averaging about $800 million, annual dividends averaging about $190 million, and no equity credit content treatment on current and future junior subordinated notes, we expect PSE's financial measures to modestly weaken, reflecting FFO-to-debt of about 21%, consistent with the higher end of the significant financial risk profile category. In addition, we expect PE's financial measures to modestly weaken to the lower end of the significant financial risk profile category, reflecting FFO to debt of 13% to 14%, indicating very minimal cushion at the current rating level.

Under the group rating criteria, we assess the group credit profile (GCP) based on unrated parent Puget Holdings LLC (PH), the ultimate parent of the group.

We view PE as a core subsidiary of PH, reflecting our view that PH is highly unlikely to sell PE, PE is integral to the group's strategy, and PH has a strong long-term commitment to PE even under stressful conditions.

The issuer credit rating on PE is one notch higher than the GCP because we assess PE's stand-alone credit profile as higher than the GCP and because of the cumulative value of structural protections in place that insulate the subsidiary. We believe these restrictions would inhibit the subsidiary from supporting the group to an extent that would unduly impair the subsidiary's stand-alone creditworthiness.

Liquidity

We are revising PE's and PSE's liquidity assessments to adequate from strong. In our view, both entities can more than cover their needs for the next 12 months, even if EBITDA declines by 10%. We expect PE's and PSE's liquidity sources over the next 12 months to exceed uses by about 1.1x. Under our stress scenario, we do not expect that either entity would require access to capital markets during that period to meet liquidity needs.

Principal liquidity sources:

- Consolidated credit facility availability of about $1.8 billion.
- Consolidated FFO of about $880 million.
- Assumed minimal cash of less than $50 million.

Principal liquidity uses:

- Capital spending of about $800 million.
- Dividends of about $190 million.

Outlook

The stable rating outlook reflects our expectations for modestly weaker financial measures at parent PE, demonstrating only minimal cushion at the present rating level. This is partially offset by our expectation that the company's continued focus on managing regulatory risk should result in financial measures that remain adequate for the rating.

Downside scenario

We could lower the ratings over the next 12 to 18 months if PE's consolidated 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's business risk profile improves, which could occur if the company consistently demonstrates improved effective management of regulatory risk. Alternatively, we could also raise the rating if the group credit profile improves.

Ratings Score Snapshot

Corporate credit rating: BBB-/Stable/--

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

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: 'bbb'

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: 'bbb'
- Group credit profile: 'bb+'
- Entity status within group: Insulated (-1 notch from stand-alone credit profile)

Related Criteria And Research

Related Criteria
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed

Puget Energy Inc.	
Corporate Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-

Puget Sound Energy Inc.	
Corporate Credit Rating	BBB/Stable/A-2
Senior Secured	A-
Recovery Rating	1+
Junior Subordinated	BB+
Commercial Paper	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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.