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Credit Opinion: Puget Sound Energy, Inc.

31 Jul 2015

Bellevue, Washington, United States

Ratings

Category	Moody's Rating
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

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Key Indicators

[1]**Puget Sound Energy, Inc.**

	3/31/2015(L)	12/31/2014	12/31/2013	12/31/2012
CFO pre-WC + Interest / Interest	3.5x	3.5x	4.8x	4.1x
CFO pre-WC / Debt	16.3%	16.5%	24.1%	18.7%
CFO pre-WC - Dividends / Debt	7.7%	8.5%	13.9%	14.5%
Debt / Capitalization	44.1%	45.0%	44.3%	47.0%

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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Stable rate regulated utility operations generate stable and predictable revenue, underpinning credit quality

Supportive regulatory environment provides broad suite of timely recovery mechanisms

High leverage, financial engineering and shareholder dividend policies constrain rating

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

Corporate Profile

Puget Sound Energy, Inc. (PSE), the primary subsidiary of Puget Energy, Inc. (PE), is an electric and natural gas utility serving about 1.1 million electric and over 785,000 natural gas customers in the State of Washington. In 2014, the company's electric and gas revenue contribution was divided at roughly 70/30 percent, respectively. PSE is regulated by the Washington Utilities and Transportation Commission (WUTC) and the Federal Energy Regulatory Commission (FERC).

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%).

SUMMARY RATING RATIONALE

PSE's Baa1 Issuer Rating reflects its low risk utility operations with supportive regulatory oversight from the WUTC. Despite several one-time events and challenges in 2014, over the next few years, the Baa1 rating incorporates a view that PSE will produce cash flow coverage of debt metrics around 20%. The rating also factors in the ownership by private equity investors, which has been characterized by adding permanent leverage at PE, a more aggressive dividend policy than the typical strategic owner, and certain financial decisions based on providing shareholder rewards.

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. Following financing activity in May, PE had approximately $1.8 billion of standalone debt at the parent company, representing approximately 32% of total PE consolidated balance sheet debt.

DETAILED RATING CONSIDERATIONS

RATE PLAN PROVIDES REGULATORY STABILITY AMONGST OTHER UNKOWNS

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. This plan includes a series of predetermined annual rate increases, with an allowed ROE of 9.8% on an equity layer of 48%. Prospectively, we think the authorized ROE will fall, but that the credit supportiveness of the WUTC will remain unchanged. One of the more credit positive features of the suite of recovery mechanisms is the decoupling mechanism, which allows PSE to defer the difference between its allowed and actual per-customer delivery revenue, with a true-up implemented over the next year's rates (up to 3% for electric customers and 2.2% for natural gas customers). This mechanism helps PSE to have greater assurance in recovering fixed costs in both its electric and gas segments, even in the current declining sales volume environment. The order also included a property tax and conservations 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.

We view the rate plan to be an improvement on historical rate design, since it is based on more forward looking expenditures, which reduces regulatory lag (i.e., the time it takes between making expenditures and receiving recovery through rates) and helps to provide clarity in the future financial performance of the company.

PSE also continues to receive timey recovery for its most significant costs, through the power cost adjustment (PCA), purchased gas adjustment (PGA), and power cost only rate case (PCORC). The PCA and PGA are allow the company to directly pass the costs of purchased power and natural gas through to customers within a year's time, while the PCORC allows PSE to revise electric rates after an expedited 6-month review of the company's power costs and new resources, instead of filing a traditional general rate case. These are positive to PSE's credit in that they help to address some of the highest and most volatile costs that PSE faces, including variability in power supply and commodity costs, as well as hydrology levels.

PSE's rate plan provides a ballast in the midst of a myriad of unresolved issues for the company, including: state-wide efforts to retire a portion of Colstrip (PSE owns a total interest of nearly 680 MW of the four-unit, about 2,100 MW coal-fired Montana power plant), litigation around environmental liabilities for Colstrip; PSE's expressed interest in joining the California Energy Imbalance Market next year; and the potential construction of a liquefied natural gas (LNG) facility to support gas storage. Furthermore, PSE is required to file its next general rate case no later than April 2016, so the developments surrounding these issues and future rate design will be key to the company's financial and credit profile going forward.

FINANCIAL METRICS SHOULD REVERT TO A MORE STABLE LEVEL

PSE's financial profile became rather volatile over the past year with a $52.7 million one-time refund to customers which was triggered when PSE sold assets located in the Jefferson County Public Utility District, compounded by roughly $60 million of lower revenue due to lower volumes sold. As such, the company's CFO pre-WC to debt fell to under 17% for both year-end 2014 and LTM 1Q15. The Jefferson County event is a one-time occurrence, but the volume reduction continues for the company. However, due to the decoupling mechanism, we expect for the company to produce predictable gross profit and stable cash flow, on average, over time, since lost revenue from lower annual sales gets recovered in the subsequent year. Therefore, we expect PSE to produce cash flow from operations between $800 and $850 million, on average, versus an adjusted debt load approaching $4.0 billion, or around 20%.

Based on financial statement disclosure, we expect for PSE's utility capital expenditures to be manageable over the next eighteen months, with a ramp-up in the 2017 timeframe to address replacement of expiring power purchase agreements (e.g., 251 MW capacity from the Douglas County PUD). For example, PSE's 2013 Integrated Resource Plan had identified replacement generation options that include wind and base load natural gas-fired generation, with an update to this plan expected in November. In the meantime, based on the company's 10Q disclosure, PSE will spend around $1.3 billion, through 2016, on traditional utility generation up-rates and transmission and distribution system hardening. Variations to PSE's total capital program could occur, depending on the results of developments such as the construction of the LNG facility.

RING-FENCE-LIKE PROVISIONS AFFORD PROTECTION TO PSE's CREDITORS

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 of the analysis of PSE.

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.

Liquidity

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 were recently extended and expire in April 2019. As of March 31, 2015, PSE had no amounts outstanding under any of these sources of liquidity.

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 credit facility due April 2018.

As previously mentioned, we expect PSE's internal cash position to approach $850 million of cash flow from operations, compared to about $630 million of average capex (based upon amounts disclosed in its SEC filings) over the 2015 - 2016 timeframe. PE's ownership has a relatively aggressive financial policy, so we expect that PSE's dividend distributions will continue to outpace net income, just as it has in four out of the past five years; therefore, we estimate that PSE will have at least $150 million in negative free cash flow. That said, 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.

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

Rating Outlook

The stable outlook reflects PSE's credit positive multi-year rate plan and utility operations that typically produce stable and predictable cash flow. The outlook also incorporates a view that the WUTC will remain supportive to long term credit quality.

What Could Change the Rating - Up

A rating upgrade could be triggered by continued support from the WUTC which helps to improve CFO pre-WC to debt in excess of 25% and CFO pre-WC less dividends to debt in the mid-to-high teens on a sustainable basis.

What Could Change the Rating - Down

If ownership were to continue to extract dividends to the point that PSE's RCF to debt remains under 10%, then a negative rating action would ensue. Additionally, should the degree of regulatory support from the WUTC result in a diminished ability for PSE to recover costs or earn expected returns (e.g., CFO pre-WC to debt were to be sustained in the mid-teens range), a downgrade could result.

Rating Factors

Puget Sound Energy, Inc.

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current LTM 3/31/2015**		[3]**Moody's 12-18 Month Forward ViewAs of Date Published**	
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)	4.1x	Baa	4x - 4.5x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	20.4%	Baa	18% - 22%	Baa
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	12.6%	Baa	13% - 17%	Baa
d) Debt / Capitalization (3 Year Avg)	44.1%	A	45% - 50%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa1		Baa1
HoldCo Structural Subordination Notching	n/a	n/a		n/a
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 3/31/2015(L); Source: Moody's Financial Metrics [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.

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