S&P Global
Ratings

Research

Research Update:

Puget Energy Inc. And Subsidiary Ratings Affirmed; Outlooks Revised To Negative On Weakening Financial Measures

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Rating Action Overview

- Bellevue Wash- based, Puget Sound Energy Inc. (PSE) recently revised its Expedited Rate Filing (ERF) petition, requesting a lower revenue increase, after its initial ERF request was retracted earlier this year.
- This follows last year's rate case decision, which resulted in a modest net rate decrease, higher depreciation rates, and an end in PSE's ability to implement annual preset revenue increases each subsequent year.
- These developments taken together, suggest the potential for regulatory lag, which could constrain the company's ability to timely recover its costs, considering PSE's elevated capital spending, and the effects of U.S. tax reform.
- As a result, we expect parent, Puget Energy Inc. financial measures to weaken, indicating minimal cushion at the current rating level. We are affirming our ratings on Puget Energy Inc. and Puget Sound Energy Inc.
- We are revising the outlooks on both entities to negative from stable.
- The negative outlooks reflect our expectation for weaker consolidated financial measures, reflecting funds from operations (FFO) to debt of about 13.5%, indicating minimal cushion at the current rating level and broader concerns about the company's ability to effectively mitigate regulatory lag.

Rating Action Rationale

On Dec. 14, 2018, S&P Global Ratings affirmed its ratings on Puget Energy Inc. (PE), including the 'BBB-' issuer credit rating and 'BBB-' issue-rating. At the same time, we affirmed our credit ratings on subsidiary Puget Sound Energy Inc. (PSE), including our 'BBB' issuer credit rating, our 'A-' first mortgage bond rating, and our 'A-2' short term rating on the company. The outlooks are revised to negative from stable.

The outlook revisions reflect our expectation that PE's consolidated financial measures will weaken, resulting in minimal financial cushion at the current rating level. We expect PE's FFO to debt to weaken to about 13.5% through 2020, down from 16.4% in 2017. The weakening financial measures incorporate our base case expectations of elevated capital spending, U.S. tax reform, and the potential for increased regulatory lag.

While the company has taken some steps to gradually improve its management of regulatory risk, we view the regulatory environment in Washington as generally less constructive compared to other jurisdictions, in part reflecting the lack of consistency in the regulatory construct in the state. Previously, PSE benefitted from annual preset rate increases and annual revenue decoupling adjustments under its 2013 rate plan. With the expiration of this rate plan in 2017, PSE will need to seek cost recovery using more frequent Expedited Rate Filings (ERF) or general rate cases to recover its costs. This approach introduces more regulatory risk, since adverse or delayed outcomes from these filings may introduce regulatory lag, potentially constraining the company's ability to receive timely recovery its of costs. In addition, after incorporating the company's elevated capital spending, and the effects of U.S. tax reform, we expect PE's financial measures to weaken, resulting in minimal cushion for the current rating level.

We assess PE's business risk profile as excellent and its financial risk profile as significant.

Our assessment of PE's business risk incorporates the company's mostly lower-risk, regulated utility business, its management of regulatory risk, and its large customer base of about 1.8 million customers, most of whom are residential customers. The company has been gradually improving its management of regulatory risk, evidenced by its effectiveness in mitigating key risks associated with shutting down Colstrip Unit 1 and 2 by 2022. PSE historically benefitted from a constructive rate plan for five years from 2013 to 2017. However, the expiration of this rate plan reintroduces a degree of uncertainty in the company's ability to timely recover costs. Partially offsetting the company's business risk profile is the company's Tacoma Liquefied Natural Gas (LNG) project, which exposes PE to counterparty credit, volumetric, commodity, and additional operational risks. However, the LNG project is relatively small and represents less than 5% of consolidated PE at completion.

We assess PE's financial risk using our medial volatility table, reflecting the company's mostly lower-risk, regulated business and its management of regulatory risk that is consistent with peers. Our base-case assumes capital spending averaging close to $900 million annually through 2020, and dividends of about $60 million. After incorporating the effects of U.S. tax reform, lower ERF revenues, and a net rate decrease in 2018, we expect FFO to debt of about 13.5%, down from 16.4% in 2017.

Our ratings on PE are lower by one notch to reflect our negative ratings analysis modifier. This is in line with our view of both the company's financial and business risk profiles that we view as consistently reflecting the lower end of the range for their categories. Looking forward, PSE may be susceptible to regulatory lag and unfavorable regulatory decisions, which dims our view of the company's overall management of regulatory risk in the state.

Group Influence

Our ratings for PE also reflect our assessment of Puget Holdings LLC (PH; not rated) as the ultimate parent of PE. We view PE as a core subsidiary of PH, reflecting our view that PE is highly unlikely to be sold, PE is integral to the group's strategy, and that PH has a strong long-term commitment to PE even under stressful conditions.

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

Outlook

The negative outlook reflects our expectation for weaker consolidated financial measures, reflecting FFO to debt of about 13.5%, indicating minimal financial cushion at the current rating level, and broader concerns about the company's ability to effectively mitigate regulatory lag.

Downside scenario

We could lower the ratings by one notch over the next 12 months if PE's financial measures consistently weaken, reflecting FFO to debt of less than 13%. This could occur if adverse or delayed rate decisions impede the company's efforts to effectively reduce regulatory lag.

Upside scenario

We could revise the outlook to stable over the next 12 months if PE demonstrates a clear path to reducing the risk of regulatory lag. This could occur if the company consistently receives timely and constructive rate orders that supports its credit quality, or if the regulatory construct in Washington materially improves and results in more regulatory consistency and predictability. We could also revise the outlook to stable if the company materially improves its financial measures such that FFO to debt consistently reflects 14%-15%.

Company Description

PE is an intermediary holding company whose regulated utility subsidiary PSE represents the vast majority of its operations. Through its regulated utility subsidiary, PE engages in electric transmission, distribution, generation, and natural gas distribution in the state of Washington and serves about 1.1 million electric customers and about 830,000 gas customers. PE also has a wholly-owned non-regulated subsidiary, Puget LNG, LLC (Puget LNG).

Our Base-Case Scenario

- Constructive regulatory outcomes on outstanding ERFs and future general rate cases at PSE.
- Negative cash flow impacts as a result of tax reform.
- Capital spending averaging close to $900 million annually.
- Dividend payments of about $60 million.
- Tacoma LNG project enters service by the end of 2020.

Liquidity

PE has adequate liquidity, in our view, and can more than cover its needs for the next 12 months, even if EBITDA declines by 10%. We expect the company's liquidity sources over the next 12 months will exceed uses by more than 1.1x, the minimum threshold for this liquidity assessment under our criteria. Under our stress scenario, we do not expect PE would require access to the capital markets to meet its liquidity needs during this period. Our assessment also reflects the company's generally prudent risk management, sound relationships with banks, and a generally satisfactory standing in the credit markets.

Principal liquidity sources:

- Consolidated credit facility of about $1.6 billion;
- FFO of about $800 million; and
- Minimal cash on hand.

Principal liquidity uses:

- No long-term debt maturities in 2019, short-term debt of about $206 million;
- Capital spending of close to $900 million; and
- Dividends of about $60 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

PE's consolidated capital structure consists of about $5.9 billion of debt, including about $3.8 billion of first-mortgage bonds at PSE.

Analytical conclusions

- We rate PE's senior secured debt 'BBB-', the same as the the issuer credit rating on the company. PE's senior secured debt is rated the same as the issuer credit rating because of regulatory restrictions for PE that inhibit the company from supporting the group in a manner that unduly impairs PE's credit quality, mitigating subordination risk.

- PSE's first mortgage bonds are rated 'A-' because it benefits from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral provides coverage of more than 1.5x, supporting a '1+' recovery rating and an issue-level rating two notches above the issuer credit rating.
- PSE's short term rating is 'A-2', reflecting our issuer credit rating on the company, consistent with our criteria.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/--

Business risk: Excellent

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1)

Stand-alone credit profile: bbb+

- Group credit profile: bb+
- Entity status within group: Insulated (-2 notches from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Puget Energy Inc.		
Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--
Puget Sound Energy Inc.		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2

Ratings Affirmed; Recovery Ratings Unchanged

Puget Energy Inc.		
Senior Secured	BBB-	

Puget Sound Energy Inc.	
Senior Secured	A-
Recovery Rating	1+
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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.