FitchRatings

10 Oct 2018 | Affirmation

Fitch Affirms Puget Energy at 'BBB-' and Puget Sound Energy at 'BBB+'; Outlook Stable

Fitch Ratings-New York-10 October 2018: Fitch Ratings has affirmed Puget Energy Inc. (PE)'s Long-Term Issuer Default Rating (LT IDR) at 'BBB-' and Puget Sound Energy Inc. (PSE)'s LT IDR at 'BBB+'. The Rating Outlook is Stable.
Approximately $6 billion debt is affected by these actions. A full list of rating actions 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. PSE's revenue represents almost 100% of PE's consolidated revenue. PE is developing a LNG facility with 8 million gallon storage tank at the Port of Tacoma Washington (Tacoma LNG) that will provide peak-shaving service to PSE's natural gas customers (regulated portion) and provide LNG as fuel to transportation customers primarily in the marine market (unregulated portion). The unregulated portion (57%) of the LNG is not expected to material relative to total revenue after completion in 2020. Approximately 50% of the unregulated capacity is subscribed by Tote Maritime, and 50% is currently open.

Restrictive Regulation

PE and PSE's rating and Outlook take into consideration the relatively restrictive regulation in the state of Washington.

Revenue requirements in rate case proceedings are largely based on historical test years. Authorized ROEs and equity ratios are relatively low. Expedited rate filing (ERF) allows recovery of delivery revenues between general rate cases (GRCs). However,
PSE recently withdrew its ERF filing in order to work through the details with the commission and staff, a process that Fitch will monitor closely. Additionally, a court order related to a peer utility has cast doubts on the continuation of attrition adjustments for rate base calculation.

On the positive side, PSE benefits from full revenue decoupling for both electric and gas operations that mitigates revenue fluctuation from weather, conservation and changes in energy usage patterns. PSE also benefits from trackers and recovery mechanisms for power costs, conservation, property taxes, pipeline replacement, purchased gas and low income.

GRC Approval

Fitch views the results of the 2017 GRC as mixed. The Washington Utility and Transportation Commission (WUTC) approved a multi-party settlement reached on Dec. 5, 2017. PSE was authorized to make an electric increase of $20.2 million (0.9% increase) compared with a requested $67.9 million, and a net natural gas decrease of $35.5 million (-3.8%) compared with a requested net decrease of $29.3 million. Both awards were based upon an ROE of 9.5% and equity ratio of 48.5%. The company's last rate decision in 2012 was based upon an ROE of 9.8% and equity ratio of 48.0%.

The approval extended the decoupling mechanism and allowed electric fixed production energy costs to be decoupled and recovered on a monthly basis, in addition to the decoupling of the delivery revenues. PSE is also allowed to increase the decoupled rate increase cap to 5% for natural gas customers, while the cap stays at 3% for electric customers. However, the decoupling revenue can only be updated through a GRC or ERF instead of annually. The GRC approval also included modifications to the depreciation schedule for the Colstrip units, and allowed PSE to utilize approximately $400 million production tax credits and treasury grants to pay for the remediation costs, mitigating the risk of stranded investment from the planned shut-down of coal units 1 and 2 in 2022. Coal units 3 and 4 will be fully depreciated in 2027. PSE's request to establish an electric cost recovery mechanism (CRM) was denied. Its intended use was to receive accelerated recovery for specific electric reliability projects.

Progressive Service Territory

PE and PSE's ratings and Outlook consider that Washington State is one of the most progressive states and imposes stringent environmental regulations and aggressive renewable goals. Many large businesses operating in load centers strongly favor renewable energy providers. Progressive policies and customers, as well as their opponents, could cause uncertainties in environmental compliance costs, recovery mechanism, declining load and lengthy legal challenges.

Credit Metrics Consistent with Ratings

PSE and PE's credit metrics continue to be consistent with their ratings despite the sizeable capex and tax reform. PSE's FFO-adjusted leverage is expected to average in the mid-3.0x and FFO fixed-charge coverage around 4.8x in the next three years. PE will produce FFO adjusted leverage in the low-5x range and FFO fixed charge coverage of 3.2x on average during the same period.

Tax Reform

As a result of the Tax Cuts and Jobs Act of 2017, the effect of the change in tax rate to 21% from 35% has begun to be passed back to customers since May 1, 2018 through a $73 million cut in base rates for electric and a $24 million cut in base rates for natural gas. The $35 million benefit from the first four months of this year has been deferred until the next rate case. The excess deferred income taxes, including approximately $88 million of unprotected and $725 million protected, are also being deferred until the next rate case. Fitch estimates the impact of the tax reform could affect the FFO adjusted leverage by up to 0.4x in the next two to three years.

Parent-Sub Linkage

Generally, Fitch considers PSE to be stronger than PE due to its lower leverage and lower operating risks as a regulated utility. High level of parent-only debt (approximately 30%) results in weaker credit metrics at PE. The absence of guarantees and cross-defaults, and dividend restrictions among other factors render legal ties weak between PE and PSE. While operational and strategic ties are strong, a prescribed regulatory capital structure for PSE lead to moderate linkage with PE, allowing for PSE to be notched above PE. Fitch has applied a bottom-up approach in rating PSE and PE. PSE's ratings reflect its stand-alone credit profile as well as its linkage with PE, while PE's ratings reflect a consolidated credit profile. Fitch typically rates the IDR of PSE a maximum of two notches above the IDR of PE.

The two-notch differential between the IDRs of PSE and PE also reflects the ring-fencing measures that are in place as well as Fitch's belief that maintaining the credit quality of PSE is the in the best interest of PE and the 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.

Change in Ownership

In August 2018 Macquarie Infrastructure Partners (Macquarie) agreed to sell its 44% equity stake in PE to a group of investors. The new group of owners after the sale will be comprised of existing

owners Canadian Pension Plan Investment Board (31.6%), British Columbia Investment Management Corporation (20.9%), and the Alberta Investment Management Corporation (13.6%). The new investors will be OMERS Infrastructure Management Inc. (23.9%), an investor for Ontario municipal pension fund, and PGGM Coooperatie UA, a Dutch pension fund (10%).

Fitch believes that the new ownership will not alter the management strategy in a meaningful way as the majority of the new owners remain the same. Additionally, these investors have large and highly diversified portfolios and a long-term investment horizon, and they do not depend on PE's dividend distribution. Fitch believes that maintaining the long-term financial health of PE and PSE is in the best interest of the owners. Application for approval for the sale has been filed with FERC and the utility commission.

DERIVATION SUMMARY

PE is reasonably well positioned among its peers Cleco Corp. (Cleco, BBB-/Stable), IPALCO Enterprises (IPACO; BB+/Positive) and DPL Inc. (DPL; BBB-/Stable), all of which are holding companies operating one primary utility. PE's utility PSE operates an electric and gas utility with a larger customer base and gross revenue than Cleco, IPALCO and DPL. All four companies have sizeable parent-only debt. PE has approximately 30% parent-only debt, which is similar to IPALCO and lower than Cleco and DPL.

Fitch considers PE's service territory as less favorable than that of Cleco, DPL and IPALCO as it is subject to restrictive regulation and competition from progressive energy goals in Washington State. However, as an offset, PE's FFO adjusted leverage ratio is expected to be in the low 5x range, which is stronger than its peers, especially Cleco. Leverage ratios for DPL and IPALCO are expected to strengthen as they recently obtained authorized rate relief.

PSE, Cleco Power (BBB/Stable) and Indianapolis Power and Light (IPL, BBB-/Positive) are exposed to coal generation, but PSE has the lowest percentage of energy generated from coal plants. Dayton Power and Light (DP&L, BBB/Stable) is a transmission and distribution utility with lower operating risk. PSE's FFO adjusted leverage of 3.4x in 2017 is weaker than that of DP&L but stronger than Cleco Power and IPL. The strong credit metrics partially offset the more restrictive regulation in the State of Washington PSE operates within, compared with Cleco Power's Loiusiana, DP&L's Ohio and IPL's Indiana. Similar to its peers, PSE's standalone credit metrics are strong for its rating but it is upwardly constrained by its parent PE.

KEY ASSUMPTIONS

Fitch's key assumptions within its rating case for the issuers include:

--Incorporates 2017 GRC order which authorized 9.5% ROE and 48.5% equity ratio;
--Electric customer count growth on average 1.3% and gas customer count growth 1.2%;
--O&M growth rate $1.5%;
--$4.2 billion capex investment from 2018 to 2022;
--Net book value of Colstrip 1 and 2 recovered through 2027; decommissioning cost and remediation costs are recovered through offsetting PTCs and TGs per WA legislation;
--Tacoma LNG comes online in 2020.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

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.
- PE can be upgraded if it can achieve, on a sustained basis, FFO adjusted leverage below 4.5x.

PSE

- Due to the moderate linkage with PE, absent an upgrade at PE, it is unlikely that PSE's ratings will be upgraded in the foreseeable future.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

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

- Failure to achieve reasonable ERF and GRC outcomes on a timely manner;
- After the heavy capex period, if FFO adjusted leverage sustains above 4.8x, negative rating pressure could increase.

Fitch has affirmed the following 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 Street
New York, NY 10004

Secondary Analyst
Barbara Chapman
Senior Director
+1-646-582-4881

Committee Chairperson
John Culver
Senior Director
+1-312-368-3216

Media Relations: Elizabeth Fogerty, New York, Tel: +1 212 908 0526, Email: elizabeth.fogerty@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub. 27 Mar 2018)

Corporate Rating Criteria (pub. 23 Mar 2018)

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)

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