Puget Sound Energy, Inc.

Subsidiary of Puget Energy, Inc.

Rating Type	Rating	Outlook	Last Rating Action
Long-Term IDR	BBB+	Stable	Review - No Action 18 October 2017
Short-Term IDR	F2		Review - No Action 18 October 2017

Click here for full list of ratings

Financial Summary

(USDm)	Dec 2014	Dec 2015	Dec 2016	Dec 2017
Gross Revenue	3,116	3,093	3,165	3,460
Operating EBITDAR	1,155	1,203	1,354	1,387
Cash Flow from Operations	783	739	819	1,087
Capital Intensity (Capex/Revenue) (%)	15.8	19.0	21.5	27.8
Total Adjusted Debt With Equity Credit	3,912	4,033	4,151	4,262
FFO Fixed-Charge Coverage (x)	3.1	3.9	4.3	4.7
FFO-Adjusted Leverage (x)	4.3	3.7	3.6	3.4
Total Adjusted Debt/Operating EBITDAR (x)	3.4	3.4	3.1	3.1

Source: Fitch Solutions.

Puget Sound Energy's (PSE) rating and Outlook primarily reflect its low-risk fully regulated utility operations, the relatively restrictive regulation, and the progressive energy policies and customer base, in the state of Washington, as well as its ownership by Puget Energy, Inc. (PE; BBB–/Stable) and private equity investors.

Key Rating Drivers

Low-Risk Business Profile: PSE is a fully regulated integrated electric and gas utility in western Washington State, serving 1.1 million electric customers and 822,000 natural gas customers. Approximately 70% of the company's revenue is derived from electric service and 30% from natural gas service. The company is regulated by the Washington Utilities and Transportation Commission (WUTC).

Relatively Restrictive Regulation: Fitch Ratings views certain aspects of WUTC's regulations as restrictive. Revenue requirements in rate case proceedings are largely based on historical test years, partially mitigated by expedited rate filings in between general rate cases (GRCs) for certain investments. Authorized ROEs and equity ratios are relatively low. 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.

Rate Settlement Implemented: The WUTC approved a multi-party settlement reached in PSE's 2017 GRC on Dec. 5, 2017. As a result, the company was authorized an electric increase of $20.2 million (0.9%) and a net natural gas decrease of $35.5 million (negative 3.8%). 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 settlement 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.

Tax Reform: As a result of the Tax Cuts and Jobs Act of 2017, PSE will flow $132 million in benefits to customers. 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 GRC.

Tacoma LNG Development: PSE's parent, PE, is developing a liquefied natural gas (LNG) facility at the Port of Tacoma Washington (Tacoma LNG). The facility, along with an 8 million gallon storage tank, is to provide peak-shaving service to PSE's natural gas customers. Under WUTC order, 43% of the project's capital and operating costs are allocated to PSE, with the balance allocated to PE. The plant, which is currently under construction, was expected to be operational in 2019. However, an additional environmental study was requested by the Puget Sound Clean Air Agency before issuing the final permit, which will delay the in-service date. PSE has incurred construction work in progress of $87.2 million related to Tacoma LNG as of Dec. 31, 2017.

Credit Metrics Under Pressure: PSE's capex has been ramping up since 2017, which, along with the impact of tax reform, will pressure credit metrics in the next two to three years. PSE's FFO-adjusted leverage is expected to average in the mid-3.0x and FFO fixed-charge coverage around high-4.0x. In the next three years, PE plans to spend $2.6 billion in capex (mostly in PSE), an average of $861 million annually compared with $681 million average during the past four years. PSE will fund most of the capex from internal cash flow and the remaining with debt financing.

Notching Difference: The two-notch Issuer Default Rating (IDR) differential between PSE and PE reflects the substantial parent-level debt at PE (approximately 30%–40%), the ring-fencing mechanism and, to a lesser degree, the companies' ownership by a group of long-term infrastructure investors. PSE benefits from various ring-fencing measures put in place by the WUTC at the time of the 2009 buyout. However, PSE's ratings are upwardly constrained by PE. Fitch believes the ring-fencing restrictions are not sufficient to justify notching wider than two categories, as PSE is PE's sole funding source to service its parent-only debt. The private equity ownership is less favorable than public equity ownership from a credit perspective. However, Fitch considers the investor group's large and highly diversified portfolios, long-term investment horizon, and demonstrated behavior supporting the maintenance of PE and PSE's long-term financial health as mitigating factors.

Rating Derivation Relative to Peers

Rating Derivation Versus Peers	
Peer Comparison	PSE and Cleco Power (BBB/Stable) are similar in that they are both owned by private equity investors, have substantial parent-level debt and are exposed to coal generation. PSE's FFO-adjusted leverage is expected to average in the mid-3.0x range. It compares favorably with Cleco Power, which has FFO-adjusted leverage of 3.9x. However, PSE's service territory in Washington is considered a less favorable jurisdiction than Cleco Power's service territory in Louisiana. PSE and Cleco Power's ratings are both upwardly constrained by their parent holding companies. However, PSE's IDR is two notches higher than PE, while Cleco Power is only one notch higher than its parent, Cleco Corporation (Cleco, BBB–/Stable) as Cleco has much higher parent-only debt of nearly 60% compared with PE's approximately 40%.
Parent/Subsidiary Linkage	PSE's ratings are upward constrained by its parent Puget Energy.

Source: Fitch Solutions.

Rating Sensitivities

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

- 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

- A downgrade at PE could lead to a downgrade at 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;
- If the outcome of future rating proceedings is materially unfavorable;
- If Washington's regulatory environment deteriorates materially.

Liquidity and Debt Structure

Adequate Liquidity: The company entered into a new $800 million credit facility in October 2017, which matures in October 2022. With the banks approval, the facility can be increased to up to $1.4 billion. Under the terms of the credit agreement PSE is required to maintain a total debt/total capitalization of less than 65%. PSE had no outstanding borrowings on the facilities and $371 million CP outstanding as of March 31, 2018. After repaying the $200 million June 2018 maturity, PSE does not have any significant maturities until 2027 when $300 million of senior secured notes are due.

Debt Maturities and Liquidity

Liquidity Summary	**Original**
	12/31/2017
(USD Mil.)	
Total Cash & Cash Equivalents	36
Short-Term Investments	
Less: Not Readily Available Cash and Cash Equivalents	(10)
Fitch-defined Readily Available Cash and Cash Equivalents	26
Availability under Committed Lines of Credit	797
Total Liquidity	823
EBITDA	1.352
FCF	(105)

Source: Fitch Solutions, company filings.

Scheduled Debt Maturities (As of July 19, 2018)	**Original**
(USD Mil.)	
2018	0
2019	0
2020	2.4
2021	17
Thereafter	3,557
Total Debt Maturities	3,577

Source: Fitch Solutions, company filings.

Key Rating Issues

The Issue	Washington utility regulation		
Our View	Fitch views the state of Washington's utility regulation somewhat restrictive, especially for the electric operations, although it is showing signs of improvement in certain aspects. Revenue requirements in rate case proceedings are largely based on historical test years. This is partially mitigated by expedited rate filings in between GRCs for certain investments. Authorized ROEs and equity ratios are relatively low (9.5% and less than 50%). Use of tracker/rider mechanisms is relatively limited. PSE's request in the 2017 GRC to establish an electric cost recovery mechanism was rejected. The mechanism is in effect for the natural gas operations which allows accelerated cost recovery for the pipe replacement program and adjust rates every November. 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 to 0.8% in 2017 from 6% in 2010. PSE currently enjoys full revenue decoupling for both electric and gas operations upon the approval of the 2017 GRC, which now allows electric fixed production energy costs to be decoupled and recovered on a monthly basis, in addition to the decoupling of the delivery revenues. The mechanism mitigates revenue fluctuation from weather and declining load growth. Prior to the approval of the 2017 GRC, decoupled rate increases were subject to a 3% cap of total revenue with excess revenue above to be included in the following year's decoupled rate. Rate increases occur May 1 of every year. However, in the 2017 GRC, PSE is allowed to increase the cap to 5% for natural customers, while the cap stays at 3% for electric customers. 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. Other mechanisms include a property tax tracker for both electric and gas, and 50% excess-earnings sharing above the authorized rate of returns with ratepayers. In its 2017 GRC, PSE requested expedited rate filing procedures to update delivery revenues after a GRC filing, which was granted. 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. The 2017 GRC approval 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 the two units in 2022.		
Timeline:	Intermediate term	Rating Impact:	Positive and Negative

The Issue	Progressive service territory		
Our View	Washington State is one of the most progressive states that impose stringent state-level environmental regulations. Many large businesses operating in metro areas and load centers strongly favor renewable energy suppliers. Progressive policies and customers, as well as their oppositions, cause uncertainties in environmental compliance costs, cost recovery prospects, declining load and lengthy legal challenges. The state of Washington adopted both the renewable portfolio standards and greenhouse gas legislations. The state targets to reduce total emission by 25% below the 1999 level to 66 million metric tons by 2035. Research estimates that total emission in 2025 could reach 94 million metric tons. With the help of Washington's Clean Air Rule (CAR), enacted in September 2016, total emission could reduce to 74 million metrics tons, which means more actions need to be taken to reach the target. The CAR sets a cap on greenhouse gas emissions from utilities, which will decrease by 5% every three years. PSE estimates 43% of its greenhouse gas emissions (approximately 4.6 million metric tons) are associated with its ownership and contractual interests in Colstrip. A judge invalidated the CAR in December 2017 on the grounds that the Department of Ecology (DOE) has no authority to impose CAR without legislative approval. However, the DOE submitted a brief on severability that will enforce CAR on electric power generating facilities, as they are the direct source of emission, while natural gas distributors are exempt. A final court order is pending and appeals can be made after the final order and regarding the severability. Washington customers' strong support for clean energy also poses long-term pressure on load growth and cost sharing. Microsoft Corporation and PSE reached an agreement in July 2017 that will allow Microsoft to directly purchase its clean energy from third parties for an exit fee of $23.6 million, which will be fully passed through to customers. The exit fee mitigates the impact on the remaining PSE customers. However, continued substantial reduction in customer load over the long term will likely heighten the risk of inability to recover past and future investments.		
Timeline:	Intermediate term	Rating Impact:	Negative

Key Assumptions

Fitch's key assumptions within our rating case for the issuer include:

- Electric customer growth on average 1% and gas customer growth 1%;
- 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;
- Cash shortfall is funded by debt.

Financial Data

(USDm)	Historical			
	Dec 2014	Dec 2015	Dec 2016	Dec 2017
SUMMARY INCOME STATEMENT				
Gross Revenue	3,116	3,093	3,165	3,460
Revenue Growth (%)	-2.2	-0.7	2.3	9.3
Operating EBITDA (Before Income From Associates)	1,124	1,175	1,322	1,352
Operating EBITDA Margin (%)	36.1	38.0	41.8	39.1
Operating EBITDAR	1,155	1,203	1,354	1,387
Operating EBITDAR Margin (%)	37.1	38.9	42.8	40.1
Operating EBIT	569	656	775	749
Operating EBIT Margin (%)	21.0	20.8	24.5	21.6
Gross Interest Expense	-265	-248	-243	-240
Pretax Income (Including Associate Income/Loss)	326	430	556	532
SUMMARY BALANCE SHEET				
Readily Available Cash and Equivalents	38	42	28	26
Total Debt With Equity Credit	3,752	3,810	3,897	3,981
Total Adjusted Debt with Equity Credit	3,912	4,033	4,151	4,262
Net Debt	3,715	3,768	3,869	3,955
SUMMARY CASH FLOW STATEMENT				
Operating EBITDA	1,124	1,175	1,322	1,352
Cash Interest Paid	-259	-250	-237	-235

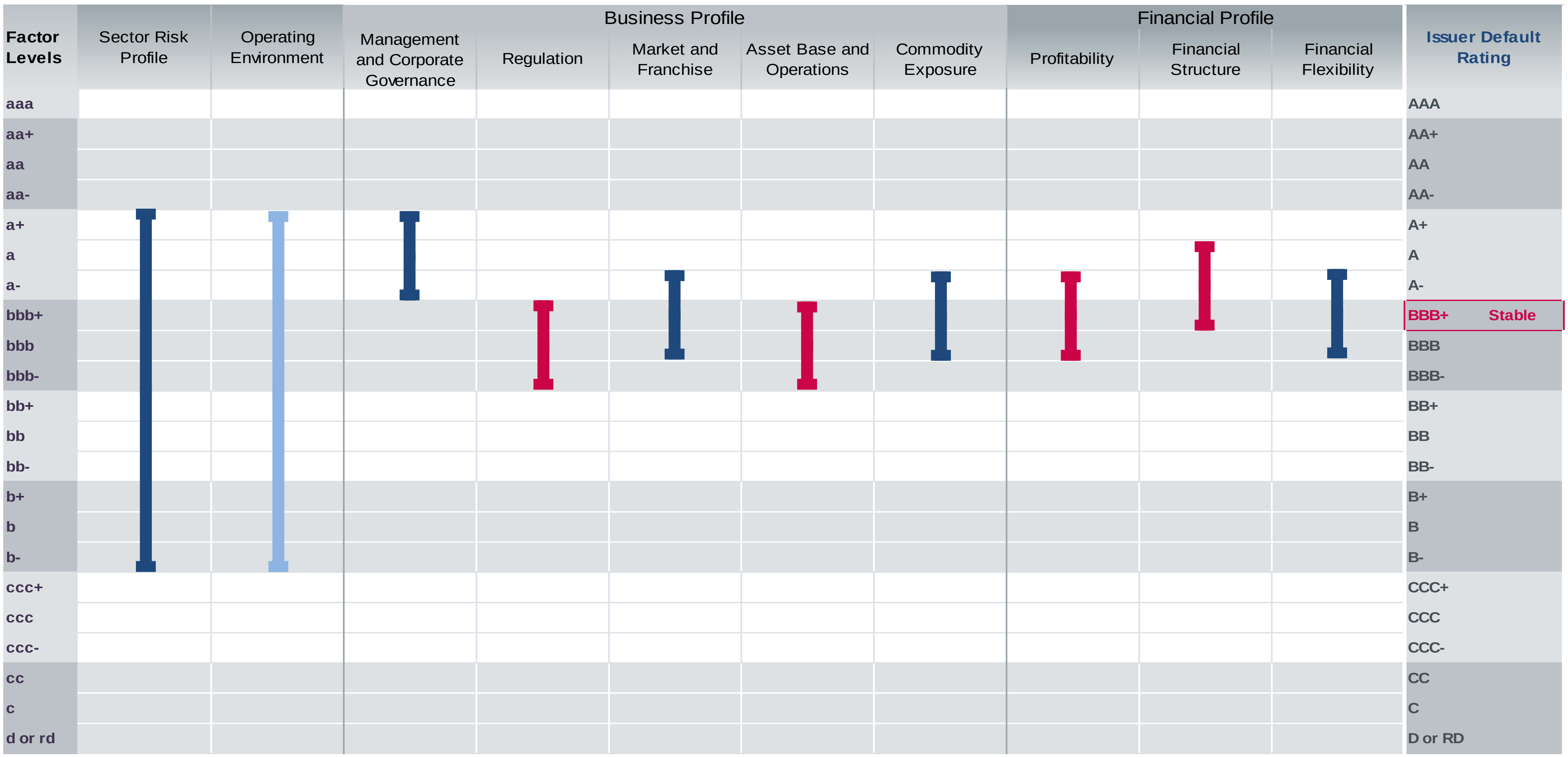
Cash Tax	0	0	0	-3
Dividends Received Less Dividends Paid to Minorities (Inflow/(Out)flow)	0	0	0	0
Other Items Before FFO	-247	-118	-190	-114
Funds Flow From Operations	617	807	896	1,000
Change in Working Capital	165	-68	-77	87
Cash Flow From Operations (Fitch Defined)	783	739	819	1,087
Total Non-Operating/ Nonrecurring Cash Flow	0	0	0	0
Capex	-493	-587	-681	-964
Capital Intensity (Capex/Revenue) (%)	15.8	19.0	21.5	27.8
Common Dividends	-323	-270	-257	-228
FCF	-34	-119	-120	-105
Net Acquisitions and Divestitures	20	0	0	0
Other Investing and Financing Cash Flow Items	85	65	19	18
Net Debt Proceeds	-78	58	87	84
Net Equity Proceeds	0	0	0	0
Total Change in Cash	-7	5	-13	-3
ADDITIONAL CASH FLOW MEASURES				
FFO Margin (%)	19.8	26.1	28.3	28.9
Calculations for Forecast Publication				
Capex, Dividends, Acquisitions and Other Items Before FCF	-796	-857	-938	-1,191
FCF After Acquisitions and Divestitures	-14	-119	-120	-105
FCF Margin (After Net Acquisitions) (%)	-0.4	-3.8	-3.8	-3.0
COVERAGE RATIOS				
FFO Interest Coverage (x)	3.4	4.2	4.8	5.2
FFO Fixed-Charge Coverage (x)	3.1	3.9	4.3	4.7

Operating EBITDAR/Interest Paid + Rents (x)	4.0	4.3	5.0	5.1
Operating EBITDA/Interest Paid (x)	4.3	4.7	5.6	5.7
LEVERAGE RATIOS				
Total Adjusted Debt/Operating EBITDAR (x)	3.4	3.4	3.1	3.1
Total Adjusted Net Debt/Operating EBITDAR (x)	3.4	3.3	3.0	3.1
Total Debt with Equity Credit/Operating EBITDA (x)	3.3	3.2	2.9	2.9
FFO-Adjusted Leverage (x)	4.3	3.7	3.6	3.4
FFO-Adjusted Net Leverage (x)	4.3	3.7	3.5	3.3

Rating Navigator

Puget Sound Energy, Inc.

Corporates Ratings Navigator
US Utilities



FitchRatings

Puget Sound Energy, Inc.

Corporates Ratings Navigator
US Utilities

Operating Environment

aa-	Economic Environment	a	Strong combination of countries w here economic value is created and w here assets are located.
a+	Financial Access	a	Strong combination of issuer specific funding characteristics and of the strength of the relevant local financial market.
	Systemic Governance	aa	Systemic governance (eg rule of law , corruption; government effectiveness) of the issuer's country of incorporation consistent w ith 'aa'.
b-			
ccc+			

Management and Corporate Governance

aa-	Management Strategy	a	Coherent strategy and good track record in implementation.
a+	Governance Structure	a	Experienced board exercising effective check and balances. Ow nership can be concentrated among several shareholders.
a	Group Structure	aa	Transparent group structure.
a-	Financial Transparency	a	High quality and timely financial reporting.
bbb+			

Regulation

a-	Degree of Transparency and Predictability	bbb	Generally transparent and predictable regulation w ith limited political interference.
bbb+	Timeliness of Cost Recovery	bbb	Moderate lag to recover capital and operating costs.
bbb	Trend in Authorized ROEs	bbb	Average authorized ROE.
bbb-	Mechanisms Available to Stabilize Cash Flows		
bb+	Mechanisms Supportive of Creditworthiness		

Market and Franchise

a	Market Structure	bbb	Established market structure but some level of uncertainty in price-setting mechanisms.
a-	Consumption Growth Trend	bb	Exposure to declining usage or volumes or self-generation.
bbb+	Customer Mix	a	Favorable customer mix.
bbb	Geographic Location		
bbb-	Supply Demand Dynamics		

Asset Base and Operations

a-	Diversity of Assets	bbb	Good quality and/or reasonable scale diversified assets.
bbb+	Operations Reliability and Cost Competitiveness	bbb	Reliability and cost of operations at par w ith industry averages.
bbb	Exposure to Environmental Regulations	bb	Significant exposure to environmental regulations.
bbb-	Capital and Technological Intensity of Capex		
bb+			

Commodity Exposure

a	Ability to Pass Through Changes in Fuel	bbb	Limited exposure to changes in commodity costs.
a-	Underlying Supply Mix	bbb	Low variable costs and moderate flexibility of supply.
bbb+	Hedging Strategy		
bbb			
bbb-			

Profitability

a	Free Cash Flow	bbb	Structurally neutral to negative FCF across the investment cycle.
a-	Volatility of Profitability	a	Higher stability and predictability of profits relative to utility peers.
bbb+			
bbb			
bbb-			

Financial Structure

a+	Lease Adjusted FFO Gross Leverage	a	3.5x
a	Total Adjusted Debt/Operating	a	3.25x
a-			
bbb+			
bbb			

Financial Flexibility

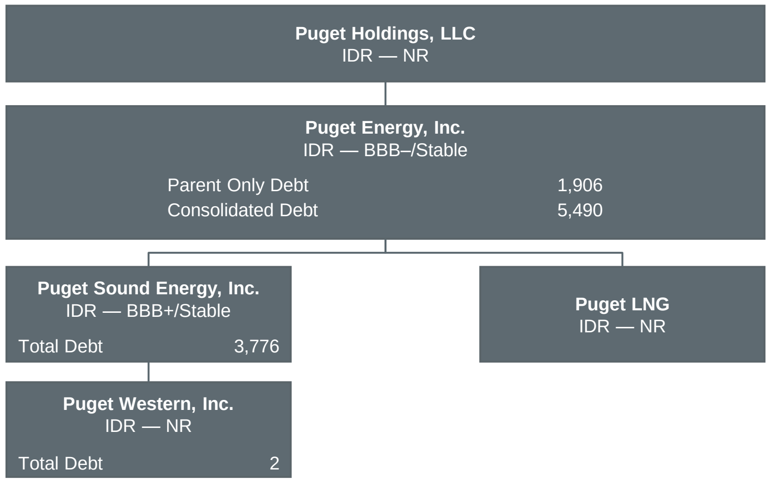
a	Financial Discipline	bbb	Less conservative policy, but generally applied consistently.
a-	Liquidity	a	Very comfortable liquidity. Well-spread maturity schedule of debt. Diversified sources of funding.
bbb+	FFO Fixed Charge Cover		
bbb			
bbb-			

How to Read This Page: The left column shows the three-notch band assessment for the overall Factor, illustrated by a bar. The right column breaks down the Factor into Sub-Factors, with a description appropriate for each Sub-Factor and its corresponding category.

Navigator Version: RN 1.44.3.0

Simplified Group Structure Diagram

Organizational and Debt Structure
($ Mil., As of Dec. 31, 2017)



NR – Not rated. Note: Amounts reflect only public outstanding debt amount and exclude discount, issuance cost and other.
Source: Company filings, Fitch.

Peer Financial Summary

Company	Date	Rating	Gross Revenue (USDm)	Operating EBITDAR (USDm)	Total Adjusted Debt With Equity Credit (USDm)	Cash Flow from Operations (USDm)	Capital Intensity (Capex/Revenue)
Puget Sound Energy, Inc.	2017	BBB+	3,460	1,387	4,262	1,087	27.8
	2016	BBB+	3,165	1,354	4,151	819	21.5
	2015	BBB+	3,093	1,203	4,033	739	19.0
Cleco Power LLC	2017	BBB	1,164	432	1,404	269	20.2
	2016	BBB	1,139	421	1,277	199	16.4
	2015	BBB	1,186	434	1,256	351	13.2
Washington Gas Light Company	2017	A	1,167	357	1,399	204	34.6
	2016	A+	1,071	331	1,064	237	36.5
	2015	A+	1,328	325	824	372	24.3

Source: Fitch.

Full List of Ratings

	Rating	Outlook	Last Rating Action
Puget Sound Energy, Inc.			
Long-Term IDR	BBB+	Stable	Review - No Action 18 October 2017
Short-Term IDR / CP	F2		Review - No Action 18 October 2017
Senior Secured	A		Review - No Action 18 October 2017
Junior Subordinated	BBB		Review - No Action 18 October 2017

Related Research & Criteria

Parent and Subsidiary Rating Linkage (July 2018)

Corporate Rating Criteria (March 2018)

Corporates Notching and Recovery Ratings Criteria (March 2018)

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