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**Research Update:**

## Puget Energy Inc.'s Corporate Credit Rating Remains On CreditWatch With Negative Implications

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## Rationale

The 'BBB-' corporate credit rating on Puget Energy Inc. (Puget) and Puget Sound Energy Inc. (PSE) remains on CreditWatch with negative implications, pending the requisite approvals for final outcome of regulatory approval proceedings. The ratings reflect the excellent business profile of PSE, a regulated, vertically integrated electric and gas utility, and the consolidated financial risk profile of Puget.

Bellevue, Wash.-based Puget had roughly \$3.1 billion of total debt outstanding as of Dec. 31, 2007.

The CreditWatch listing reflects the possibility that debt ratings for Puget and PSE could be lowered contingent on the final outcome of regulatory merger approval proceedings. Importantly, the company's credit profile has been improving, which provides financial flexibility to accommodate the proposed capital structure at the current rating level. Still, Puget's expected consolidated credit measures post-transaction will be stretched and the final regulatory order could weaken anticipated cash flow coverage metrics.

Standard & Poor's Ratings Services placed the ratings of holding company Puget Energy Inc. and its electric and gas utility subsidiary Puget Sound Energy Inc. on CreditWatch with negative implications on Oct. 26, 2007. The action followed the announcement that Puget Energy has agreed to sell itself to a consortium of private investors led by Macquarie Infrastructure Partners, an affiliate of Macquarie Group Ltd. (A-/Stable/A-2) for \$7.4 billion. The proposed transaction is to be financed with a significant amount of debt at the holding company and is expected to increase debt leverage on a consolidated basis.

Puget's business risk profile is "excellent," reflecting the combined electric and gas utility business of PSE, which is subject to regulation by the Washington Utilities and Transportation Commission (WUTC). The regulatory environment in Washington and how the company manages its relationship with the WUTC are key drivers of credit quality, especially in light of PSE's high capital needs and commodity price exposure. The company's most recent general rate case granted PSE a 10.4% return on equity on a hypothetical 44% equity layer, as well as permission to recover costs for recent plant additions and for short-term financing needs related to power supply hedging. The commission did not approve the company's requests for a gas "decoupling" mechanism, a depreciation tracker, and a modification to its power cost adjustment (PCA) mechanism. An electric case is currently pending for a \$174 million, or 9.5%, rate increase and a gas case for \$56.8 million, or 5.3%, annually. Both are expected to be finalized by November.

Puget's cost recovery mechanisms also support credit quality. The company has a great degree of flexibility in implementing rate changes through its PCA, but the threshold it must meet to update rates is high and deferred costs are not automatically collected. Each year, uncollected costs are subject to defined sharing bands, allowing the company to defer certain portions for collection from customer. However, the PCA mechanism does not trigger a rate increase until a minimum deferral balance is reached. Puget is also able to update rates for changes in projected costs by filing a power cost only rate case (PCORC), which gives it the flexibility to file for changes in variable and fixed costs whenever there is a projected deferral balance of \$30 million or more. The PCORC functions as a "mini" rate case that takes about five months and is especially useful for new plant additions or contracts.

Puget's financial risk profile is "aggressive" under Standard & Poor's corporate risk matrix. Financial measures have been adequate for the rating, although cash flow coverage metrics have been mixed and are expected to weaken if the pending acquisition by Macquarie is completed. Adjusted funds from operations (FFO) to interest coverage was approximately 3.2x, while FFO to average total debt was at about 16.1% for the 12 months ended Dec. 31, 2007. Adjusted debt leverage -- including debt adjustments for operating leases, purchased power, and hybrid equity -- was approximately 56.6% as of Dec. 31, 2007, and was bolstered by a private equity placement of about \$300 million with Macquarie Infrastructure. Although this transaction has strengthened the balance sheet, Puget's consolidated credit measures post-transaction will be weaker, assuming successful completion of the merger.

Capital requirements are very high at PSE, with capital expenditures of \$2.7 billion planned for 2008 through 2009 related to system upgrade needs, customer growth, and further resource additions. Ongoing periodic debt and equity funds are expected to finance this growth.

### **Short-term credit factors**

PSE's short-term rating is 'A-3'. Overall liquidity at PSE was adequate, with \$384 million in available capacity as of Dec. 31, 2007, under its \$500 million committed unsecured bank credit agreement at PSE that expires April 15, 2012, and a fully available \$350 million facility to support hedging activities. Secondary liquidity resources at PSE include a \$200 million receivables securitization facility with \$48 million available as of Dec. 31, 2007. Liquidity requirements will remain high at PSE due to a high level of planned capital spending and potential collateral requirements related to the company's electric and gas supply arrangements. Debt maturities are manageable, with about \$179 million due in 2008 and \$158 million due in 2009. We expect Puget to internally fund about 50% of capital expenditures in order to maintain a stable capital structure.

## **Ratings List**

Ratings Remain On CreditWatch  
Puget Energy Inc.

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Corporate credit rating	BBB-/Watch Neg/--
Puget Sound Energy Inc. Corporate credit rating	BBB-/Watch Neg/A-3
Puget Sound Energy Inc. Commercial Paper	
Local Currency	A-3/Watch Neg
Junior Subordinated	
Local Currency	BB/Watch Neg
Preferred Stock	
Local Currency	BB/Watch Neg
Senior Secured	
Local Currency	BBB+/Watch Neg

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