Proudly serving you for 80 years

PEDERNALES ELECTRIC COOPERATIVE
2017 ANNUAL REPORT

Message from the Board President

Emily Pataki
President/District 2 Director

Eighty years ago, hardworking ranchers and farmers formed Pedernales Electric Cooperative with the noble purpose of electrifying the Texas Hill Country. Electric power in their homes and businesses meant not only an improved quality of life for themselves, but more importantly, it ensured a future for generations to come. Their vision made it possible for us to thrive and grow, and we have inherited a tremendous legacy from them — one of courage, commitment to principles and service to one another.

Since 1938, everything has changed and nothing has changed at PEC. By extending electric service to the Hill Country, we laid the groundwork for 80 years of growth and innovation in our communities. Now, with more than 300,000 accounts across our area that serve approximately 1 million Texans, we're proud to be the largest and fastest growing electric cooperative in the country.

No matter our size, though, we remain committed to our founding principles. We work hard to keep your rates low through comprehensive operations and cost control measures. We focus on the reliability of your electric distribution system, which is continually strengthened through upgrades and proactive maintenance. We defend you from electrical hazards, scams and other dangers with active communications, system safeguards and education. We're honored to volunteer in your neighborhoods and schools and give back to our communities through grants, scholarships and more.

We believe it is our duty and a privilege to carry forward the proud legacy of service set forth by the first PEC members eight decades ago. From the beginning, your cooperative has been committed to principles, not profit. We are an organization run by our members, for our members. We demonstrate the PEC difference in our commitment to service — where our cooperative values meet our rich history. As much as we cherish our past and our roots, we believe the best days at PEC are still to come. It is our pleasure to serve you and grow with you.

Thank you for making us PEC proud.

Message from the CEO

Julie C. Parsley
Chief Executive Officer

Last year was a year of incredible growth and success for our cooperative. Since arriving at PEC in December 2017, I have been repeatedly amazed at the pride our employees take in serving you, our members. It's incredibly inspiring, and I feel honored to have the opportunity to lead such a wonderful organization full of people striving for excellence.

I'm proud to report that throughout 2017 we maintained our commitment to serve you at the highest possible level. In terms of growth and reliability, we added more than 12,500 meters to our system and crossed the 300,000 active account mark. Even as our system grew at an incredible rate, we were able to drive down average unplanned outage time by more than 10 minutes, which places PEC's reliability ahead of every investor-owned utility in the Electric Reliability Council of Texas (ERCOT). We also worked to deliver immense value by distributing about $8.3 million in capital credits, giving away 2,500 trees as part of our Energy-Saving Trees program and launching Time-of-Use and Cooperative Solar Rate options.

Last year, our commitment to the Hill Country community was stronger than ever. We awarded $100,000 in scholarships to local high school seniors, donated $245,000 to local nonprofits through PEC United Charities and gave $24,000 to educational organizations. In addition, with the help of members like you, we awarded more than $28,000 in community grants through our Power of Change program.

At PEC, we take pride in being good citizens of our community and our industry. During Hurricane Harvey in August 2017, our staff worked more than 2,000 continuous hours to keep the lights on in Central Texas, and we sent 20 employees to assist Jackson Electric Cooperative with service restoration near the Texas coast. In true cooperative spirit, we also sent 22 employees to Florida to help Talquin Electric Cooperative and Clay Electric Cooperative restore power after Hurricane Irma.

Due to the above achievements and successes, combined with our continued commitment to excellence, J.D. Power ranked us 10th in residential customer satisfaction at year end.

It's our commitment to service, rooted in both our pride in being a cooperative and our rich, 80-year heritage, that drives us to continue growing and improving — all in service of you.

PEC employees are known for their dedication and the pride they take in serving our community. Here's what they said when we asked, "What makes you PEC proud?"

Because it's my job to design service extensions, I get to see projects go from empty tracts of land to finished developments. The excitement that a member feels to flip the light switch for the first time is the best part of my job.

Eric Villanueva (pictured above)
Senior Electrical Distribution Designer
4 years of service

2018
80
YEARS

2017 by the numbers

12,816
new accounts added

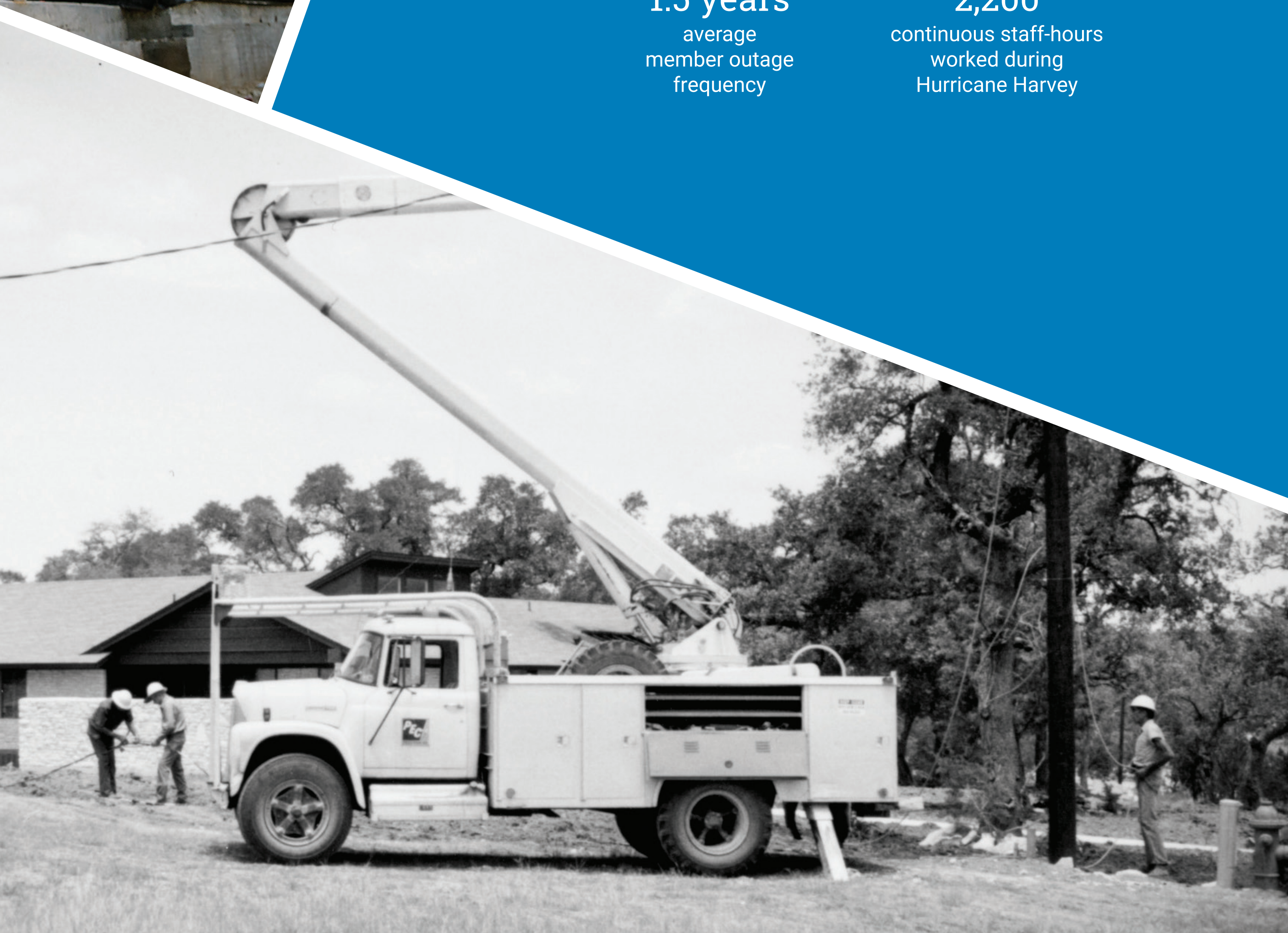
4.46 percent
growth in accounts

Exceeded
300,000
active accounts

Built nearly
369 miles
of new distribution line

1.5 years
average member outage frequency

2,200
continuous staff-hours worked during Hurricane Harvey



My pride in PEC is two-fold: both as a member and as a committed employee. Giving our members the care, concern and professionalism I would want as a member gives me great satisfaction each day.

Sanjeanette McCants (pictured above)
Member Services Agent 4
24 years of service

2017 by the numbers

No. 10 in J.D. Power
residential customer satisfaction for all U.S. electric utilities
(July-December 2017)

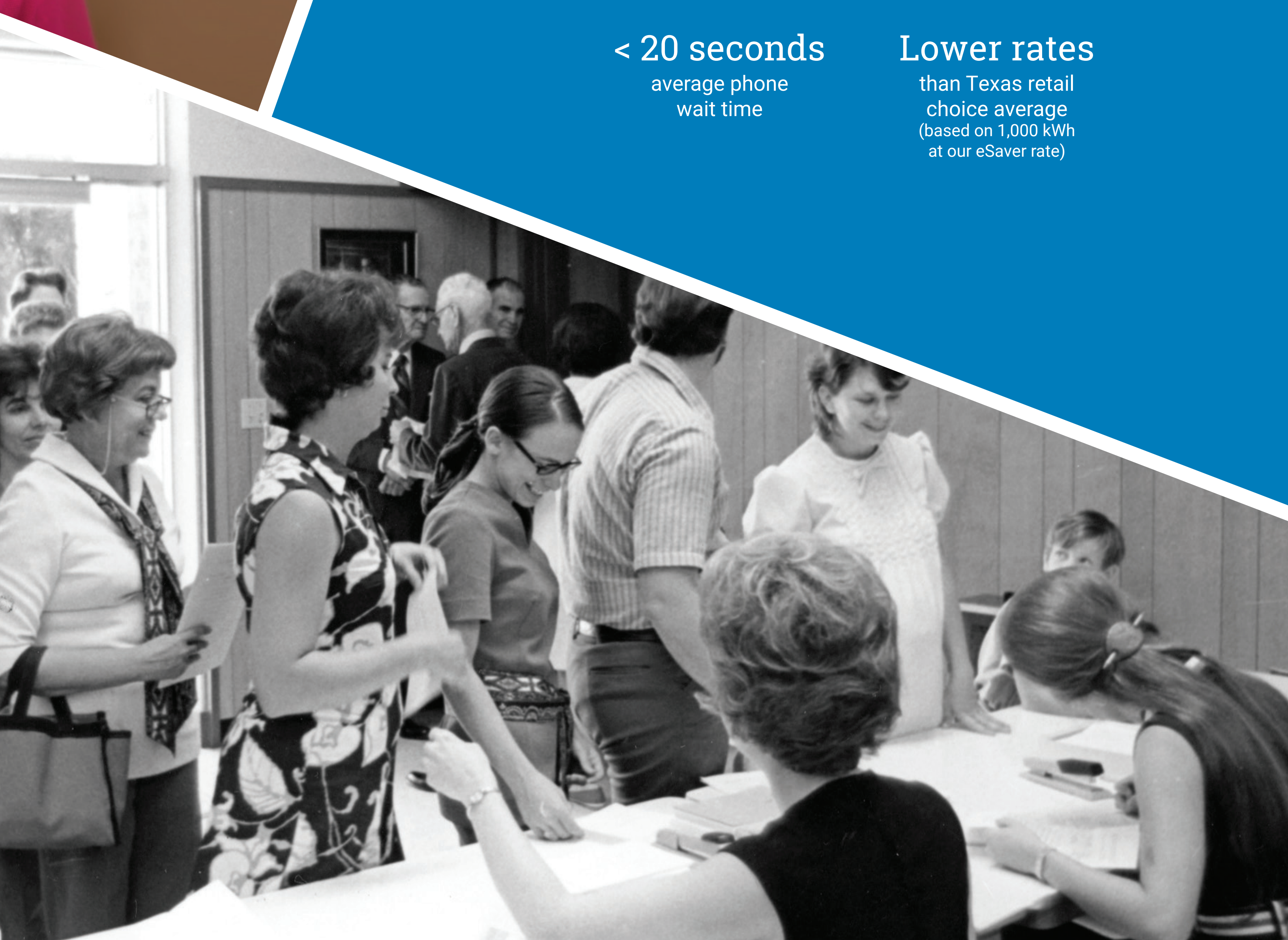
$8.3M
in capital credits distributed to members

2
new rate options

Made the National Cooperative Bank
Co-op 100
list

< 20 seconds
average phone wait time

Lower rates
than Texas retail choice average
(based on 1,000 kWh at our eSaver rate)



I'm proud to serve the community in which I live and raise my family. PEC's high standards and strong morals make it a great place to work.

A.J. Mann (pictured above)
Journeyworker
9 years of service

2018
80
YEARS

2017 by the numbers

$100,000
awarded in scholarships

$267,355
member and employee community donations

10
high school seniors sent to Washington, D.C, for Youth Tour

3
lineworkers helped extend electric service in a Bolivian village

7
staff volunteer events held in our community

42
employees sent to help after hurricanes Harvey and Irma

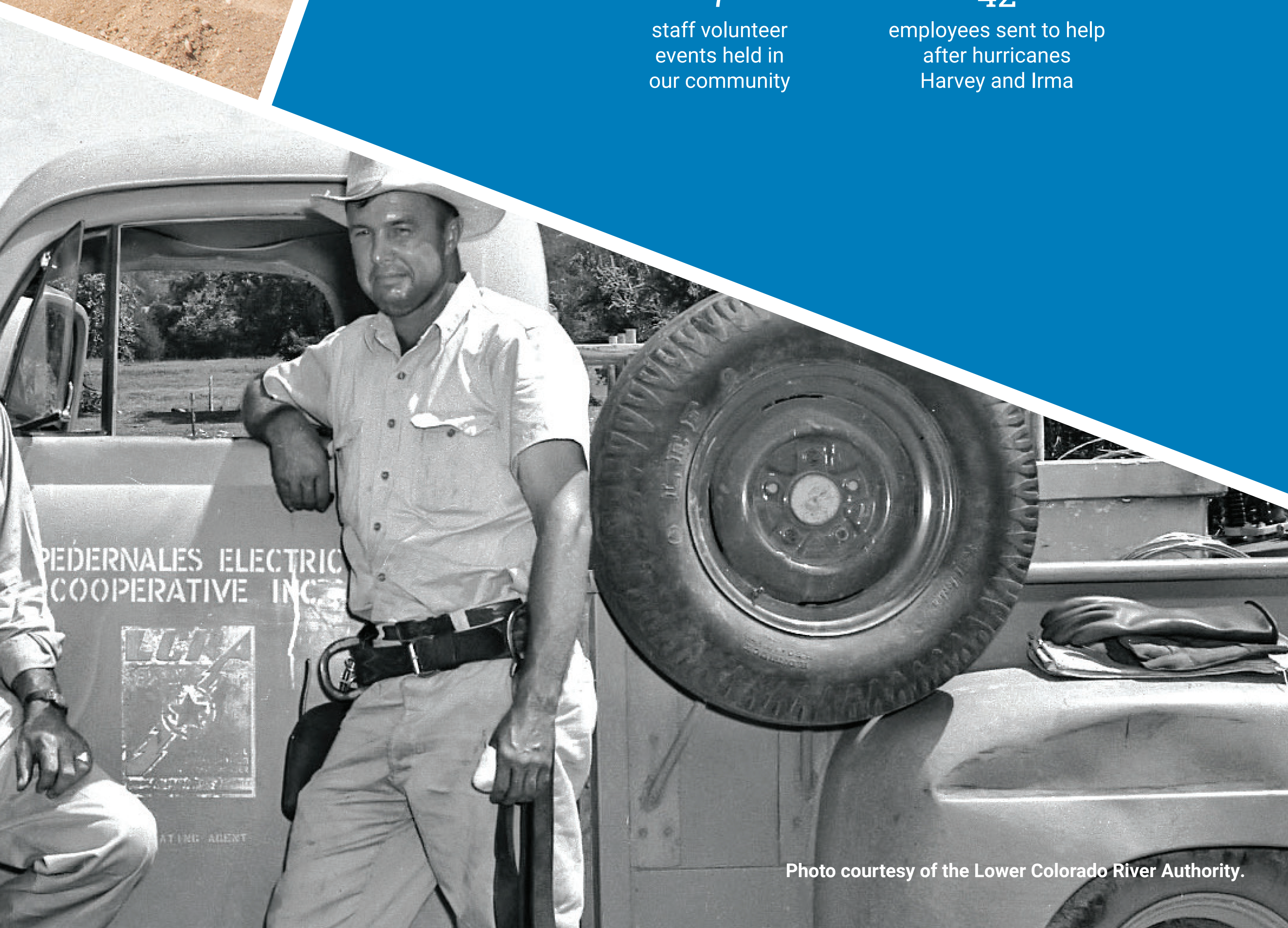


Photo courtesy of the Lower Colorado River Authority.

Board of Directors

Cristi Clement
District 1 Director

Emily Pataki
District 2 Director,
President

Randy R. Klaus
District 3 Director

Jim Powers
District 4 Director

James Oakley
District 5 Director

Paul Graf
District 6 Director,
Vice President

Amy Lea SJ Akers
District 7 Director,
Secretary-Treasurer

2018

80

YEARS

Since 1938, Pedernales Electric Cooperative has served its members, supported its communities and helped extend electric service throughout the Texas Hill Country. As a PEC member, you are an owner of this organization, its history and its future.

PEDERNALES ELECTRIC COOPERATIVE, INC.

JOHNSON CITY, TEXAS

FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

AND

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

LUBBOCK, TEXAS

PEDERNALES ELECTRIC COOPERATIVE, INC.

JOHNSON CITY, TEXAS

FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

AND

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

PEDERNALES ELECTRIC COOPERATIVE, INC.
JOHNSON CITY, TEXAS

FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

TABLE OF CONTENTS

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.
CERTIFIED PUBLIC ACCOUNTANTS
PHONE: (806) 747-3806
FAX: (806) 747-3815
8215 NASHVILLE AVENUE
LUBBOCK, TEXAS 79423-1954

Independent Auditor's Report

Board of Directors
Pedernales Electric Cooperative, Inc.
Johnson City, Texas

Report on the Financial Statements

We have audited the accompanying financial statements of Pedernales Electric Cooperative, Inc. (the Cooperative), which comprise the balance sheets as of December 31, 2017 and 2016, and the related statements of income, comprehensive income and patronage capital, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our December 31, 2017 audit in accordance with auditing standards generally acceptable in the United States of America. We conducted our December 31, 2016 audit in accordance with auditing standards generally acceptable in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pedernales Electric Cooperative, Inc. as of December 31, 2017 and 2016, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Bolinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

Lubbock, Texas

April 2, 2018

PEDERNALES ELECTRIC COOPERATIVE, INC.

BALANCE SHEETS
DECEMBER 31, 2017 AND 2016

ASSETS

	December 31, 2017	December 31, 2016
UTILITY PLANT AT COST		
Utility Plant in Service	$ 1,664,277,364	$ 1,591,444,290
Construction Work in Progress	86,569,719	58,035,313
	$ 1,750,847,083	$ 1,649,479,603
Less: Accumulated Provision for Depreciation	288,182,437	286,311,583
	$ 1,462,664,646	$ 1,363,168,020
OTHER PROPERTY AND INVESTMENTS - AT COST OR STATED VALUE		
Investments in Associated Organizations	$ 12,883,443	$ 12,179,047
CURRENT ASSETS		
Cash and Cash Equivalents	$ 21,930,694	$ 33,243,750
Accounts Receivable - Energy (Less allowance for uncollectibles of $403,932 in 2017 and $442,165 in 2016)	20,963,562	15,498,114
Accounts Receivable - Other (Less allowance for uncollectibles of $134,173 in 2017 and $604,357 in 2016)	3,700,291	2,299,935
Accrued Unbilled Revenue	26,364,202	24,083,511
Materials and Supplies Inventory	21,008,122	22,423,471
Other Current and Accrued Assets	2,724,203	2,272,875
Total Current Assets	$ 96,691,074	$ 99,821,656
DEFERRED CHARGES AND OTHER ASSETS	$ 70,071,971	$ 73,552,673
TOTAL ASSETS	$ 1,642,311,134	$ 1,548,721,396

EQUITIES AND LIABILITIES

	December 31, 2017	December 31, 2016
EQUITIES		
Memberships	$ 12,165,328	$ 11,614,133
Patronage Capital	436,437,823	402,206,786
Other Equities	189,834,413	171,729,563
Total Equities	$ 638,437,564	$ 585,550,482
LONG-TERM DEBT		
Mortgage Bonds Less Current Maturities and Issuance Costs	$ 297,316,028	$ 310,140,888
CFC Mortgage Notes Less Current Maturities	415,512,960	360,369,031
Chase Notes Less Current Maturities	17,250,000	11,250,000
Total Long-Term Debt	$ 730,078,988	$ 681,759,919
ACCUMULATED PROVISION FOR PENSIONS AND BENEFITS	$ 118,738,568	$ 109,276,434
CURRENT LIABILITIES		
Current Maturities of Long-Term Debt	$ 43,546,071	$ 38,125,868
Purchased Power - Payable and Accrued	29,227,106	27,034,494
Accounts Payable - Other	22,208,381	25,721,569
Power Cost Adjustments - Over-Recovered	11,696,801	18,304,892
Tax Payable	10,273,183	9,041,122
Interest Payable	3,790,049	3,865,734
Member Deposits	6,261,953	5,890,880
Other Current and Accrued Liabilities	10,138,868	9,231,255
Total Current Liabilities	$ 137,142,412	$ 137,215,814
DEFERRED CREDITS	$ 17,913,602	$ 34,918,747
TOTAL EQUITIES AND LIABILITIES	$ 1,642,311,134	$ 1,548,721,396

See accompanying notes to financial statements.

PEDERNALES ELECTRIC COOPERATIVE, INC.

STATEMENTS OF INCOME, COMPREHENSIVE INCOME AND PATRONAGE CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

	December 31, 2017	December 31, 2016
OPERATING REVENUES		
Residential	$ 402,911,519	$ 394,673,693
Small Power	63,854,552	62,694,533
Industrial	8,291,167	8,027,092
Large Power	75,676,317	73,691,991
Public Authorities	878,320	698,778
Other Operating Revenues	27,362,544	27,505,058
Accrued Unbilled Revenue	2,280,690	1,013,817
Power Cost Adjustment	9,515,764	(2,546,272)
Total Operating Revenues	$ 590,770,873	$ 565,758,690
OPERATING EXPENSES		
Purchased Power	$ 340,336,300	$ 323,577,675
Transmission - Operation	644,178	559,320
Transmission - Maintenance	3,689,955	3,520,898
Distribution - Operation	35,702,368	34,137,812
Distribution - Maintenance	15,853,366	15,384,889
Consumer Accounts	23,663,671	23,762,962
Customer Service and Information	3,015,446	2,301,496
Sales	1,769,626	1,097,531
Administrative and General	27,575,134	29,425,083
Depreciation	48,966,498	43,048,303
Taxes	955,323	3,197,280
Other Deductions	428,184	473,734
Total Operating Expenses	$ 502,600,049	$ 480,486,983
OPERATING MARGINS - Before Fixed Charges	$ 88,170,824	$ 85,271,707
FIXED CHARGES		
Interest and Amortization on Long-Term Debt	$ 34,463,135	$ 32,673,181
Interest Charged to Construction	(2,984,935)	(1,943,730)
	$ 31,478,200	$ 30,729,451
OPERATING MARGINS - After Fixed Charges	$ 56,692,624	$ 54,542,256
Capital Credits	1,709,064	1,232,826
NET OPERATING MARGINS	$ 58,401,688	$ 55,775,082
NON-OPERATING MARGINS		
Interest and Dividend Income	$ 226,299	$ 165,080
Misc. Non-Operating Income	156,319	185,074
Disposal of Assets	1,909,904	672,494
	$ 2,292,522	$ 1,022,648
NET MARGINS	$ 60,694,210	$ 56,797,730
COMPREHENSIVE INCOME	$ 60,694,210	$ 56,797,730
PATRONAGE CAPITAL - BEGINNING OF YEAR	402,206,786	373,806,190
Patronage Capital Retired	(8,358,323)	(8,685,603)
Transfers to Other Equities	(18,104,850)	(19,711,531)
PATRONAGE CAPITAL - END OF YEAR	$ 436,437,823	$ 402,206,786

See accompanying notes to financial statements.

PEDERNALES ELECTRIC COOPERATIVE, INC.

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

	December 31, 2017	December 31, 2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Margins	$ 60,694,210	$ 56,797,730
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities		
Depreciation and Amortization Charged to Expense	49,231,638	43,313,443
Provision for Uncollectible Accounts	316,661	135,810
Capital Credits	(1,709,064)	(1,232,826)
Deferral/Accrual/Asset Activity for Pension/Post-Retirement Plans	8,745,576	8,379,731
Payments on Post-Retirement Benefits	(2,162,324)	(1,967,964)
Payments to Defined Benefit Plan	(9,000,000)	(9,600,000)
Changes in Assets and Liabilities:		
Accounts Receivable - Net	(7,182,465)	9,749,998
Accrued Unbilled Revenue	(2,280,691)	(1,013,817)
Power Cost Adjustments	(6,608,091)	14,832,130
Materials & Supplies	1,415,349	5,152,642
Prepayments & Other Current Assets	(451,328)	(590,967)
Deferred Charges & Other Assets	345,042	10,586,273
Accrued & Accounts Payable	(1,320,576)	(1,126,233)
Member Deposits	371,073	175,168
Accrued Taxes	1,232,061	1,410,069
Accrued Interest	(75,685)	529,657
Other Current Liabilities	907,613	1,870,075
Other Deferred Credits & Liabilities	(1,990,603)	(12,375,909)
Net Cash From Operating Activities	$ 90,478,396	$ 125,025,010
CASH FLOWS FROM INVESTING ACTIVITIES		
Net Additions to Property, Plant & Equipment	$ (148,463,124)	$ (150,321,192)
Capital Credit Retirements from Associated Organizations	1,004,668	794,953
Net Cash From Investing Activities	$ (147,458,456)	$ (149,526,239)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on Long-Term Debt	$ (39,525,868)	$ (29,130,944)
Advances on Long-Term Debt	93,000,000	95,000,000
Retirement of Patronage Capital	(8,358,323)	(8,685,603)
Increase in Memberships - Net	551,195	486,770
Net Cash From Financing Activities	$ 45,667,004	$ 57,670,223
CHANGE IN CASH AND CASH EQUIVALENTS	$ (11,313,056)	$ 33,168,994
CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR	33,243,750	74,756
CASH AND CASH EQUIVALENTS - END OF YEAR	$ 21,930,694	$ 33,243,750
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash Paid During the Year for:		
Interest on Long-Term Debt	$ 34,273,945	$ 31,875,889
Patronage Capital Retired by Noncash Discounting	$ 18,104,850	$ 19,711,531

See accompanying notes to financial statements.

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Pedernales Electric Cooperative, Inc. (the Cooperative) is a non-profit corporation organized to provide electric service at the retail level to primarily residential and commercial accounts in a designated service area. As of December 31, 2017, the Cooperative served approximately 300,238 meters.

Power delivered at retail is purchased wholesale from the Lower Colorado River Authority (LCRA) and other third-party wholesale power suppliers. Any revenues earned in excess of costs incurred are allocated to members of the Cooperative and are reflected as patronage capital on the balance sheet.

Regulatory Accounting

The Cooperative utilizes the Uniform System of Accounts established by the Rural Utilities Service (RUS). In accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980, Regulated Operations, the Cooperative records certain assets and liabilities in accordance with the economic effects of the rate making process.

Utility Plant

Plant is stated at the original cost of construction which includes the cost of contracted services, direct labor, materials, overhead items and capitalized interest. Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

When property, which represents a retirement unit, is replaced or removed, the average cost of such property as determined from the continuing property records is credited to electric plant and such cost, together with cost of removal less salvage, is charged to the accumulated provision for depreciation.

Maintenance and repairs, including the renewal of minor items of plant not comprising a retirement unit, are charged to the appropriate maintenance accounts, except that repairs of transportation and service equipment are charged to clearing accounts and redistributed to operating expense and other accounts.

Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and short-term investments are considered cash and cash equivalents.

Accounts Receivable

In the normal course of business the Cooperative recognizes accounts receivable for energy delivered and billed. The Cooperative provides a statement with a due date that will not be less than 16 days after the statement date. Payments not received by the due date are considered delinquent.

The Cooperative provides an allowance for uncollectible accounts to recognize the portion of receivables considered uncollectible. The allowance is estimated based on historical trends, aging of receivables, and review of potential bad debts. Accounts remaining unpaid 120 days after the due date of the final bill are written off.

Accrued Unbilled Revenue

At December 31, 2017 and 2016, the Cooperative had $26,364,202 and $24,083,511 of unbilled revenue consisting of its revenue accrued for power delivered but not billed and its revenue accrued attributable to purchased power.

Materials and Supplies Inventory

Materials and supplies inventories are valued at average unit cost.

Electric Revenues

The Cooperative records electric revenues as billed to customers on a monthly basis. Revenue is accrued for power delivered but not billed at the end of each month.

The Cooperative's tariffs for electric service include adjustment clauses under which billings to customers are adjusted to reflect changes in the cost of purchased power. In order to match power cost and related revenues these amounts to be billed to consumers in subsequent periods are included with the revenue accrual described above.

In December 2016, the Cooperative rebated 2016 revenue by applying a $0.01561 credit to consumer bills. This resulted in a revenue rebate of approximately $6.1 million.

Federal Income Taxes

The Cooperative is exempt from federal income taxes under Section 501(c)(12) of the Internal Revenue Code. More than 85% of the gross income is collected from members.

The Cooperative follows the “uncertain tax positions” provisions of accounting principles generally accepted in the United States of America. The primary tax position of the Cooperative is its filing status as a tax exempt entity. The Cooperative determined that it is more likely than not that its tax positions will be sustained upon examination by the Internal Revenue Service (IRS) and that all tax benefits are likely to be realized upon settlement with taxing authorities.

The Cooperative files income tax returns in the U.S. federal jurisdiction. The Cooperative is no longer subject to examinations by federal taxing authorities for years before 2014. In 2017 and 2016, the Cooperative did not incur tax related interest or penalties.

Group Concentration of Credit Risk

The Cooperative's headquarters facility is located in Johnson City, Texas. The service area extends into 24 counties in the Central Texas region. The Cooperative records a receivable for electric revenues as billed on a monthly basis. The Cooperative may require a deposit from new members upon connection which is applied to unpaid bills and fees in the event of default. The deposit accrues interest annually and is returned to residential accounts along with accrued interest after one year of prompt payments. As of December 31, 2017 and 2016, deposits on hand totaled $6,261,953 and $5,890,880, respectively.

The Cooperative maintains its cash balances in institutions insured by the Federal Deposit Insurance Corporation (FDIC). The cash balances exceeded applicable insurance coverage at times during 2017 and 2016.

Patronage Capital Certificates

Patronage capital from associated organizations is recorded at the stated amount of the certificate.

Pension Benefit Plans and Other Post-Retirement Benefits

The Cooperative has a defined benefit pension plan (the Plan) for employees meeting eligibility requirements. In 2005, the Plan was amended to close entry to new participants after January 1, 2006. The benefit is based on years of service and the average of the employee's highest 36 months of compensation. The Cooperative also has a defined contribution (401(k) Plan) for employees eligible to participate.

The Cooperative also sponsors a health care plan for retirees who satisfy eligibility requirements. The cost of the Cooperative's obligation is actuarially determined based on certain weighted-average assumptions.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Assets Pledged

Substantially all assets are pledged as security for the long-term debt due to Bank of New York (BONY) and National Rural Utilities Cooperative Finance Corporation (CFC).

3. Utility Plant

The major classes of utility plant are as follows:

	December 31, 2017	December 31, 2016
Transmission Plant	$ 101,597,553	$ 100,303,273
Distribution Plant	1,405,044,718	1,344,293,316
General Plant	157,635,093	146,847,701
Total Utility Plant in Service	$ 1,664,277,364	$ 1,591,444,290
Construction Work in Progress	86,569,719	58,035,313
Total Utility Plant	$ 1,750,847,083	$ 1,649,479,603

Provision for depreciation of utility plant is computed using straight-line rates as follows:

	2017	2016
Transmission Plant	1.74% - 2.02%	1.74% - 2.02%
Distribution Plant	1.85% - 20.00%	1.85% - 20.00%
General Plant	2.38% - 20.00%	2.50% - 20.00%

Depreciation for the years ended December 31, 2017 and 2016, was $52,019,851 and $46,099,629, respectively, of which $48,966,498 and $43,048,303 was charged to depreciation expense and $3,053,353 and $3,051,326 was allocated to other accounts. Depreciation rates on transmission and distribution plant were changed effective January 1, 2016 based on a depreciation study conducted by an independent consulting firm. General plant rates were updated January 1, 2017 based on the same study.

4. Investments in Associated Organizations

Investments in associated organizations consisted of:

	December 31, 2017	December 31, 2016
CFC		
Capital Term Certificates	$ 4,887,296	$ 4,887,296
Patronage Capital	4,645,336	4,054,246
Texas Electric Cooperative		
Patronage Capital	2,869,701	2,869,254
Other	481,110	368,251
	$ 12,883,443	$ 12,179,047

5. Materials and Supplies Inventory

Materials and supplies inventories consist of construction materials and supplies. The ending balances for materials and supplies at December 31, 2017 and 2016 were $21,008,122 and $22,423,471, respectively.

6. Deferred Charges and Other Assets

Deferred charges and other assets included the following:

	December 31, 2017	December 31, 2016
Regulatory Asset - Defined Benefit Plan	$ 61,047,338	$ 64,183,498
Debt Application Costs	75,045	45,045
Regulatory Asset - LCRA FPCRF	1,161,535	2,664,786
Regulatory Asset - GIS Inventory	5,298,646	5,740,200
Regulatory Asset - TCOS Under-Recovery	1,820,938	
LCRA Radio Services	668,469	919,144
	$ 70,071,971	$ 73,552,673

The Cooperative recognizes a regulatory asset for the portion of its pension and other post-retirement benefit plans that has not been recognized as a component of net periodic pension and other post-retirement benefit costs. Accordingly, no amounts have been recorded in other comprehensive income. The unrecognized portion is being amortized into pension and other post-retirement benefit costs over the average future service of current active plan participants expected to receive benefits (see Note 13).

The LCRA fuel & power cost recovery factor (FPCRF) represents the amount that the Cooperative will be billed by LCRA in future periods for electricity previously purchased. Since this amount will be collected from members in the future through the power cost adjustment (PCA), it is classified as a regulatory asset. A corresponding liability is also recorded for the same amount.

The GIS Inventory regulatory asset represents the deferral of costs incurred by the Cooperative in performing a GPS survey and field inventory of the transmission and distribution system. The deferral of the cost through the ratemaking process was approved by the Cooperative's Board of Directors and will be recovered over a period of up to 15 years. Amortization in 2017 and 2016 was $441,554 and $2,772,766, respectively.

The TCOS under-recovery represents the TCOS component of power cost not yet recovered from customers.

The Cooperative has an agreement in place to utilize LCRA's trunked radio system in the Junction district. The associated costs were paid upon initiation of the agreement. The costs have been capitalized and are being amortized over the contract term, which ends in August 2020.

7. Patronage Capital and Other Equities

Patronage capital represents the Cooperative's accumulated retained net margins that have been allocated annually to its members. Distributions to members are made at the discretion of the Board of Directors in accordance with the bylaws, subject to the covenants contained in the long-term debt agreements.

The loan agreements contain provisions that must be met for the Cooperative to make patronage capital retirements. These provisions include maintaining debt service coverage ratios of 1.15 for the BONY bonds and 1.35 for CFC debt. The Cooperative is in compliance with these provisions at December 31, 2017 and 2016.

Under certain circumstances, the Board of Directors may choose to retire patronage capital earlier than the Cooperative's current approximate 30 year retirement schedule. In these instances, the Cooperative retires and pays the net present value of patronage capital to a member or former member before the time the Cooperative anticipates normally retiring and paying patronage capital.

Patronage capital totaling $8,358,323 and $8,685,603 was distributed to members during 2017 and 2016, respectively.

Patronage capital assigned and assignable at December 31, 2017 and 2016, is as follows:

	December 31, 2017	December 31, 2016
Assigned to Date	$ 647,387,778	$ 591,603,865
Assignable	84,777,415	79,867,118
	$ 732,165,193	$ 671,470,983
Less: Retirements to Date	105,892,957	97,534,634
Less: Discounted Patronage Capital to Permanent Equity	189,834,413	171,729,563
	$ 436,437,823	$ 402,206,786

The Cooperative's bylaws provide that amounts received by the Cooperative in excess of costs and expenses shall, insofar as permitted by law, (a) be used to offset any losses incurred during the current or any prior fiscal year and, (b) to the extent not needed for that purpose, be allocated to its members on a patronage basis.

Other equities at December 31, 2017 and 2016, are as follows:

	December 31, 2017	December 31, 2016
Discounted Capital Credits	$ 189,834,413	$ 171,729,563

8. Long-Term Debt

At December 31, 2017 and 2016, long-term debt consisted of the following:

	December 31, 2017	December 31, 2016
First Mortgage Bonds, 2002 Series A; 5.952%; due 2022		
Interest Payable Semi-Annually on May 15 and November 15;	$ 73,625,000	$ 85,980,000
First Mortgage Bonds, 2002 Series A; 6.202%; due 2032		
Interest Payable Semi-Annually on May 15 and November 15;		
Principal Payments Begin 2023	239,500,000	239,500,000
CFC Loan; 3.85%; due 2043		
Interest and Principal Payable Quarterly		
Principal Payments Began 2012	207,086,105	211,957,535
CFC Loan; 3.95%; due 2045		
Interest and Principal Payable Quarterly		
Principal Payments Began 2016	24,198,098	24,663,070
CFC Loan; 2.75%; due 2020		
Interest and Principal Payable Quarterly		
Principal Payments Began 2016	50,566,812	66,519,294
CFC Loan; 3.80%; due 2046		
Interest and Principal Payable Quarterly		
Principal Payments Began 2017	78,518,016	80,000,000
CFC Loan; 4.15%; due 2047		
Interest and Principal Payable Quarterly		
Principal Payments Begin 2018	80,000,000	
Chase Loan; 2.50%; due 2021		
Interest and Principal Payable Quarterly		
Principal Payments Began 2016	10,500,000	14,250,000
Chase Loan; 3.80%; due 2022		
Interest and Principal Payable Quarterly		
Principal Payments Began 2017	12,350,000	
Less: Bond Issue Costs	(2,718,972)	(2,984,112)
	$ 773,625,059	$ 719,885,787
Less: Current Maturities	43,546,071	38,125,868
Total Long-Term Debt	$ 730,078,988	$ 681,759,919

The Cooperative has $6,800,000 available on long-term loan commitments from CFC. These loans are available for drawdown through 2019.

The Cooperative has $100,000,000 available on long-term loan commitments from CoBank.

At December 31, 2017, the Cooperative has a loan application pending with RUS in the amount of $68,180,000.

Annual maturities of long-term debt for the next five years and thereafter are as follows:

2018	$	43,546,071
2019		45,101,037
2020		46,742,230
2021		29,143,811
2022		28,289,511
Thereafter		582,521,374

9. Short-Term Borrowing

The Cooperative has a line of credit at a variable interest rate with CFC not to exceed $100,000,000. There was no balance outstanding at December 31, 2017 and 2016. The line of credit agreement requires the Cooperative to pay down the balance to zero annually and automatically renews unless either party gives a 90 day notice.

The Cooperative has a line of credit at a variable interest rate with CoBank not to exceed $200,000,000. There was no balance outstanding at December 31, 2017 and 2016.

10. Deferred Credits

Deferred credits include the following:

	December 31,			
		2017		2016
Patronage Capital - Pre-Escheat	$	7,974,828	$	8,160,716
Regulatory Liability - LCRA FPCRF		1,161,535		2,951,190
Post-Retirement Medical Benefits Regulatory Liability		8,777,239		23,791,781
Unclaimed Property Payable				15,060
	$	17,913,602	$	34,918,747

The patronage capital pre-escheat component represents unclaimed patronage capital checks that do not meet escheat criterion. The liability is recorded as unclaimed patronage capital as the checks are voided. As the funds are claimed or reach escheat status, the liability is reduced.

During 2017 and 2016, the Cooperative realized a gain for post-retirement medical benefits. The Cooperative recognized a regulatory liability for the net amount of the unrecognized gain (see Note 14).

11. LCRA Fuel & Power Cost Recovery Factor (FPCRF)

The Fuel and Power Cost Recovery Factor represents over or under-recovered cost adjustments for electricity purchased from LCRA. During 2017, there were two components of the FPCRF that were recorded. The amount under-recovered by LCRA as of June 30, 2017 was recorded separately from the adjustments that occurred from July 1, 2017 – December 31, 2017.

The FPCRF activity that occurred from July 1, 2017 – December 31, 2017 represents an over-recovery by LCRA of $1,161,535, which is classified as a receivable on the balance sheet.

12. Commitments and Contingencies

Power Supply Contracts

The Cooperative entered into contracts for the purchase and delivery of electric energy to satisfy its electric energy requirements. In 2017 and 2016, the Cooperative purchased energy from the Lower Colorado River Authority (LCRA) and other third party wholesale power suppliers. LCRA was the primary wholesale electric energy supplier, while the other suppliers provided electric energy to serve a portion of the electric energy requirements for the Cooperative’s delivery points within LCRA’s service territory and the full electric energy requirements for delivery points outside of LCRA’s service territory. All of the electric energy purchased by the Cooperative is procured through term contracts of varying durations. As these terms expire, they may or may not be replaced with new agreements.

Transmission Lease Contracts

LCRA leases and operates certain transmission facilities and equipment owned by the Cooperative. Payments for the leased facilities vary from year to year and are based on the original cost of the facilities, adjusted for depreciation, and are updated annually to reflect additions, retirements and depreciation. The terms of the lease are perpetual, but may be terminated by LCRA or the Cooperative upon five years written notice. The Cooperative’s transmission lease revenues totaled $5,357,862 and $5,846,710 in 2017 and 2016, respectively.

Litigation

The Cooperative may be involved in various claims and litigation arising in the normal course of business. Although management is unable to predict the outcome of such proceedings, management and the Cooperative's legal counsel do not believe that the resolution of any claims or litigation involving the Cooperative will have a material adverse effect on the Cooperative's results of operations and financial condition.

13. Pension Benefits

The Cooperative has a defined benefit plan covering eligible employees. The cost of the plan is determined by an independent actuary and is funded in amounts sufficient to meet the minimum funding requirements under applicable regulations.

Contributions paid to the defined benefit plan for the years ended December 31, 2017 and 2016, were $9,000,000 and $9,600,000, respectively.

NOTES TO FINANCIAL STATEMENTS

The measurement date used for the current valuation is December 31, 2017.

The following weighted-average assumptions were used to develop the accumulated post-retirement benefit obligation for 2017 and 2016:

	2017	2016
Discount Rate	3.60%	4.15%
Rate of Compensation Increase	4.27%	4.84%

The following weighted-average assumptions were used to determine the net benefit cost for 2017 and 2016:

	2017	2016
Discount Rate	4.15%	4.40%
Rate of Compensation Increase	4.84%	4.00%
Expected Long-Term Return on Plan Assets	6.50%	6.50%

Amounts recognized in the Cooperative's financial statements and funded status of the plan are as follows:

	December 31, 2017	December 31, 2016
I) Net Periodic Benefit Cost		
Service Cost	$ 5,461,578	$ 5,043,651
Interest Cost	9,190,158	8,972,846
Amortization	5,035,078	5,054,789
Return on Assets	(10,994,103)	(10,188,686)
	$ 8,692,711	$ 8,882,600
II) Projected Benefit Obligation (PBO) Reconciliation:		
PBO Balance at Beginning of Year	$ 225,456,075	$ 207,835,865
Actuarial (Gain)/Loss	17,724,155	11,170,806
Interest Cost/Service Cost	14,651,736	14,016,497
Benefits Paid	(7,868,086)	(7,567,093)
Projected Benefit Obligation at Year End	$ 249,963,880	$ 225,456,075
III) Reconciliation of Funded Status		
Projected Benefit Obligation	$ 249,963,880	$ 225,456,075
Fair Value of Assets	196,670,633	168,719,379
Funded Status at Year End	$ (53,293,247)	$ (56,736,696)
IV) Regulatory Asset		
Actuarial Loss - Beginning of Year	$ 64,183,498	$ 58,626,574
Amortization of Loss/Remeasurement	(5,035,078)	(5,054,789)
Actuarial (Gain)/Loss	1,898,918	10,611,713
	$ 61,047,338	$ 64,183,498

The accumulated benefit obligation for the plan was $221,754,888 and $197,851,561 at December 31, 2017 and 2016, respectively.

Plan Asset Information

Information related to fair value hierarchy measurements are disclosed in Note 16. The defined benefit plan asset fair value measurements are substantially Level 1.

Fair value of plan assets at December 31, 2017 and 2016 and asset allocation follows:

	December 31, 2017	December 31, 2016
Cash and Cash Equivalents	$ 3,924,361	$ 5,223,794
Government Agencies, Bonds and Notes	70,931,557	63,436,373
Mutual Funds	103,517,691	85,444,912
Other	18,297,024	14,614,300
Total	$ 196,670,633	$ 168,719,379

	December 31, 2017	December 31, 2016
Mutual Funds and Equity Securities	53%	51%
Debt Securities	36%	38%
Other	11%	11%
Total	100%	100%

Benefit payments for the next ten years are estimated as follows:

2018	$ 8,531,053
2019	8,940,773
2020	9,523,060
2021	10,116,818
2022	10,776,171
2023-2027	64,471,082

The estimated 2018 plan year minimum required contribution is $9,000,000.

The Cooperative has a defined contribution plan (401(k) plan) for employees that are eligible to participate. For employees that are also eligible to participate in the defined benefit plan, the maximum contribution is six percent of the employee's base annual salary. For employees not eligible for the defined benefit plan, the 401(k) plan contribution cost is a maximum of ten percent of the employee's base annual salary. These costs are funded each pay period as accrued. The Cooperative's contributions to the 401(k) plan (net of forfeitures) were $3,533,870 and $3,791,971 in 2017 and 2016, respectively.

14. Post-Retirement Benefits Other than Pensions

The Cooperative provides post-retirement medical benefits for eligible employees through a plan with a third-party insurance provider. For purposes of this statement, the written plan in effect is the substantive plan and is considered a defined benefit plan. The Cooperative contributes varying amounts dependent on retirement date, age, and years of service.

Benefits are paid on behalf of retirees and are a function of medical insurance costs and number of retirees. Benefits paid (excluding reimbursements) for the years ended December 31, 2017 and 2016, were $2,468,105 and $2,195,755, respectively.

The Cooperative's policy for contributions is to contribute the amount of the current benefits in that year.

The measurement date used for the current valuation is December 31, 2017.

The weighted-average discount rate used to develop the accumulated post-retirement benefit obligation for the years ended December 31, 2017 and 2016, were 3.60% and 4.05%, respectively. The assumed health care cost trend rate is 8.00% percent for 2018, declining to an ultimate level of 5.00% over ten years.

Amounts recognized in the Cooperative's financial statements and funded status of the plan are as follows:

	December 31, 2017	December 31, 2016
I) Net Post-Retirement Benefit Cost		
Service Cost	$ 472,659	$ 478,080
Interest Cost	2,036,045	2,163,769
Amortization	(2,455,339)	(3,144,718)
	$ 53,365	$ (502,869)
II) Accumulated Post-Retirement Benefit Obligation (APBO) Reconciliation:		
APBO Balance at Beginning of Year	$ 52,539,738	$ 55,988,670
Actuarial (Gain)/Loss	12,559,203	(4,122,817)
Interest Cost / Service Cost	2,508,704	2,641,849
Employer Contributions Net of Participant Amounts	(2,162,324)	(1,967,964)
Net Post-Retirement Benefit Liability at Year End	$ 65,445,321	$ 52,539,738
III) Reconciliation of Funded Status		
APBO	$ 65,445,321	$ 52,539,738
Accrued Post-Retirement Benefit Cost	$ 65,445,321	$ 52,539,738
IV) Regulatory Liability		
Actuarial Loss/(Gain) - Beginning of Year	$ (23,791,781)	$ (22,813,682)
Amortization	2,455,339	3,144,718
Current Year Net (Gain)/Loss	12,559,203	(4,122,817)
	$ (8,777,239)	$ (23,791,781)

The estimated actuarial amount for the post-retirement medical benefit plan that will be amortized into net post-retirement benefit cost over the next fiscal year is expected to be a gain of $288,463.

The Cooperative has not funded any plan assets as of December 31, 2017 or 2016. Estimated future benefit payments for the next ten years are as follows:

2018	$	2,636,137
2019		2,794,976
2020		2,940,906
2021		3,153,982
2022		3,273,107
2023-2027		17,615,546

15. Recently Issued Accounting Pronouncements

In February 2016, the FASB issued Accounting Standards Update 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be clarified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The new standard is effective for nonpublic entities for fiscal years beginning after December 15, 2019. The Cooperative is evaluating the impact of the new standard on the financial statements.

16. Disclosures About Fair Value of Financial Instruments

Many of the Cooperative's financial instruments lack an available market with similar terms, conditions, and maturities as those reflected in the carrying amount recorded. Accordingly, significant assumptions, estimations, and present value calculations were used for purposes of this disclosure.

Estimated Fair Value has been determined by calculating the present value of financial instruments using the best data available.

Fair Value for some amounts carried on the financial statements has not been calculated for the following reasons:

Patronage Capital from Associated Organizations – The right to receive cash is an inherent component of a financial instrument. The Cooperative holds no right to receive cash since any payments are at the discretion of the governing body for the associated organizations. As such, Patronage Capital from Associated Organizations are not considered financial instruments.

CFC Capital Term Certificates and Member Capital Securities – It is not practicable to estimate fair value for these financial instruments given the lack of a market and their long holding period. Relevant information with respect to these is as follows:

	AMOUNT	INTEREST RATE	MATURITY
$	960,968	3.00%	2020-2030
	1,715,690	0.00%	2043
	2,210,638	5.00%	2070-2080

Cash and Short-Term Investments - The recorded book value approximates fair value given the short period to maturity.

Long-Term Debt - Estimated by computing the present value by individual note to maturity, using currently quoted or offered rates for similar issues of debt. The year-end CFC fixed interest rate for long-term debt was used in the calculation for all fixed rate long-term debt. These are the only financial instruments of the Cooperative that have a difference in Fair Value and Carrying Value.

The carrying values of the Cooperative's financial instruments and debt and the estimated fair values are as follows:

	December 31, 2017		December 31, 2016	
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE
Assets:				
Cash and Cash Equivalents	$ 21,930,694	$ 21,930,694	$ 33,243,750	$ 33,243,750
Short-Term Investments	-	-	-	-
Long-Term Investments	-	-	-	-
Liabilities:				
Long-Term Debt	776,344,031	733,716,462	722,869,899	650,487,273

Fair Value Hierarchy

The Fair Value Measurements Topic of the FASB Accounting Standards Codification establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1 - inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Cooperative has the ability to access at the measurement date.

Level 2 - inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 - inputs are unobservable inputs for the asset or liability.

Long-Term Debt valuations are considered Level 2.

17. Subsequent Events

The Cooperative has evaluated subsequent events through April 2, 2018, the date which the financial statements were available to be issued.

COMPLIANCE SECTION

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LETTER TO BOARD OF DIRECTORS REGARDING POLICIES CONCERNING AUDITS OF CFC BORROWERS

Board of Directors
Pedernales Electric Cooperative, Inc.
Johnson City, Texas

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheets of Pedernales Electric Cooperative, Inc. (the Cooperative) as of December 31, 2017 and 2016, and the related statements of income and patronage capital, and cash flows for the years ended, and have issued our report thereon dated April 2, 2018.

In connection with our audit, nothing came to our attention that caused us to believe that the Cooperative failed to comply with the terms of Article V of the National Rural Utilities Cooperative Finance Corporation Loan Agreement insofar as they relate to accounting matters. However, our audits were not directed primarily toward obtaining knowledge of such incompliance.

This report is intended solely for the information and use of the Boards of Directors and management of Pedernales Electric Cooperative, Inc. and the National Rural Utilities Cooperative Finance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

Bolinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

Lubbock, Texas

April 2, 2018