FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Pedernales Electric Coop., TX's FMBs at 'AA-'; CP Program at 'F1+'; Outlook Stable

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Fitch Ratings - Austin - 25 May 2023: Fitch Ratings has affirmed the following Pedernales Electric Cooperative (PEC), TX ratings:

--$39.8 million first mortgage bonds (FMBs) series 2002A at 'AA-';

--$200 million private placement commercial paper (CP) program at 'F1+'.

In addition, Fitch has affirmed PEC's Issuer Default Rating (IDR) at 'AA-'.

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

Pedernales Electric Cooperative, Inc. (TX)	LT IDR	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
Pedernales Electric Cooperative, Inc. (TX) /First Mortgage/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
Pedernales Electric Cooperative, Inc. (TX) /Self-Liquidity/1 ST	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

PEC's 'AA-' debt ratings reflect a very strong financial profile in relation to a low operating risk profile and very strong revenue defensibility. The utility enjoys stable, strong demand and rate setting flexibility. PEC's very low operating costs reflect the benefits of a diversified power supply, largely provided through an economic all-requirements wholesale power agreement with the Lower Colorado River Authority (LCRA; AA-/Stable) as well as through renewable contracts.

PEC has maintained very low leverage through the severe Februrary 2021 winter storm and ensuing ERCOT market disruptions as well as through a more than doubling of global gas prices during 2022, which escalated power costs. PEC's realization of net adjusted debt to adjusted funds available for debt service (leverage ratios) of 7.1x and 6.3x in 2021 and 2022, respectively, reflect the cooperative's enactment of rate adjustments combined with cost reductions, incremental debt and expanded liquidity.

PEC's 'F1+' short-term rating is based on the rating correspondence to its 'AA-' IDR.

SECURITY

Bonds are payable from PEC's net revenue and are secured by a lien on substantially all of the cooperative's assets. The CP notes are unsecured and will rank equally to the issuer's other existing and future unsecured debt obligations.

KEY RATING DRIVERS

Revenue Defensibility - 'aa'

High Growth Retail Electric Cooperative with Rate Flexibility

PEC serves a retail load in the Texas Hill Country across 8,100 square miles, nearly the size of New Jersey. The cooperative has realized a very strong 5.1% compound growth of its accounts over the past five years. Service area demand characteristics are very strong as represented by median household income (MHI) at 137% and unemployment at 81% of national averages. The service area is without material competition.

PEC has the independent legal ability to adjust rates without external approvals. The cooperative's total retail rates are comparable to the state average, with residential rates at 87% of the 2021 state average. 2021 residential rates are very highly affordable at 1.6% of MHI. PEC expects its rates to remain competitive with enactment of a 1% permanent distribution rate increase and a temporary winter storm surcharge effective Oct. 1, 2021 through Sept. 30, 2023 to pay debt associated with storm costs.

Operating Risk - 'a'

Very Low Operating Costs; Weakened Operating Cost Flexibility

Fitch has assessed the operating risk profile and operating cost flexibility of electric cooperatives and municipal electric utilities operating within the Electric Reliability Council of Texas (ERCOT) organized power market at 'a' and 'weaker', respectively, following the market dislocation experienced during the week of Feb. 14, 2021 from Winter storm Uri and the ongoing exposure to ERCOT market counter party risks.

PEC's 'aa' operating cost burden reflects its very low operating costs averaging 8.5 cents/kWh in 2018 through 2020. Operating costs are primarily power supply costs, predominantly from the LCRA, and net of an apportionment of PEC's share of LCRA's off-system sales and ancillary revenues. PEC's 2021 operating costs of 11.4 cents/kWh reflect PEC's current year recognition of $150 million in Storm Uri costs. The cooperative's 2022 costs of 9.8 cents/kWh are considered very low within Fitch's framework but remain elevated in relation to PEC's historical trends, reflecting significantly higher gas prices throughout most of 2022. Operating costs reflect the benefit of resource diversity, including renewable energy, representing 11% of 2022 sales.

PEC's operating costs also reflect actions undertaken to mitigate storm costs. The combination of operating and capital cost reductions, combined with temporarily reduced patronage distributions through 2023 provided PEC and its members with approximately $100 million in savings through 2023.

Capital Planning and Management

PEC projects manageable five-year capital spending of $994 million and $27 million in annual line extension savings representing costs transferred from PEC to third parties. The capital budget reflects ongoing distribution system growth and PEC transmission projects pursuant to the transfer of transmission service operations to PEC from the LCRA, fully effective in 2024.

Financial Profile - 'aa'

Financial Profile Stable Through the Cycle

PEC's 2022 leverage ratio of 6.3x reflects improvement from 7.1x the year prior, incorporating a full year of rate actions implemented toward the end of 2021. Liquidity is weak at fiscal year-end 2022 as measured by days cash on hand, but supplements from external liquidity facilities provide a liquidity cushion of 305 days, increased from 97 days in 2018.

Fitch's analysis indicates that PEC will maintain a strong financial profile through its base and stress case scenarios and assumes strong ongoing sales growth and timely recovery of costs through rate actions. Fitch's base and stress scenarios indicate leverage peaking at 7.1x and 7.3x respectively in the base and stress scenarios before moderating to 6.4x across both scenarios by year five of the analysis.

PEC's debt totaling $1 billion at FYE 2022 is neutral to the rating and consists primarily of long-term fixed rate debt. The cooperative launched a $200 million privately placed commercial paper (CP) program during 2021 to provide low cost interim capital project funding with the expectation to term out the paper every 12 to 18 months. The CP program is supported by internal liquidity, particularly with two syndicated revolving credit lines in which Bank of America is the lead bank, which would provide for available borrowing capacity sufficient to pay the principal of the commercial paper in the event necessitated by market conditions. B of A Securities, Inc. (AA/Stable) serves as the dealer and U.S. Bank National Association (AA-/Stable) as the depositary, issuing and paying agent for the CP program.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations affected the rating outcome.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Sustained net leverage above 8.0x in Fitch's base and stress cases;

--Reduced liquidity, as measured by a liquidity cushion consistently below 90 days;

--Legislative or regulatory changes that impose material new operating or capital costs for utilities;

--A downgrade of PEC's Long-Term Issuer Default Rating below 'AA-' could pressure the cooperative's short-term 'F1+' rating, depending on PEC's internal liquidity available to support the CP program.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Sustained net leverage below 5.0x in Fitch's base and stress cases;

--A sustained liquidity cushion above 90 days, including cash on hand above 30 days.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

PROFILE

PEC provides electric distribution service to 385,869 meters at FYE 2022 making it among the largest electric distribution cooperative in the U.S., based on number of meters served. While continuing a rapid pace of distribution service expansion consistent with rates of regional growth, PEC has begun to transition into the operation of its own transmission assets.

PEC's service area spans 8,100-square miles and includes all or part of 24 counties and 45 cities in a non-contiguous and diverse region that encompasses suburban areas within proximity to Austin, and more sparsely populated areas west of Austin and north of San Antonio.

PEC was formed in 1938 pursuant to the Rural Electrification Act to provide electricity to what was rural central Texas at the time. PEC is predominantly a distribution utility with a growing transmission business and receives the majority of its power from LCRA under a long-term power supply contract with a term through 2041.

Interconnectivity with ERCOT

PEC participates in the ERCOT market through its qualified scheduling entity (QSE), LCRA. ERCOT is regulated by the Public Utilities Commission of Texas (PUCT) and governed by deregulated market principles established by the Texas legislature. Participation in ERCOT exposes its participants to price volatility and counterparty risk, with the potential to share in counterparty default costs. These market risks were highlighted during the extreme Texas storm event that occurred in February 2021. Although market reforms have been and continue to be made by the state legislature, the PUCT, ERCOT and individual utilities, PEC's required participation in the ERCOT market still poses the potential for price volatility and counterparty risk outside of its control.

PEC incurred net additional storm costs of $160 million as a result of the storm. Of that amount, $150 million represented power supply costs, an amount equivalent to almost half of the cooperative's annual purchased power costs. The remaining $10 million represented storm restoration costs, recoverable in part through expected reimbursement from the Federal Emergency Management Agency (FEMA).

The cooperative reports funding approximately $30 million of net incremental storm costs with cash and the remainder through the issuance of about $130 million in debt. PEC expects to pay off the debt within three years using incremental cash flow generated by a combination of revenues from a 24-month temporary storm surcharge and reduced spending.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

PEC's ESG Relevance Score of '4' for Exposure to Environmental Impacts due to the effects of the 2021 winter storm is revised to '3' as a result of state-wide power market reforms that have occurred since the storm, which are expected to reduce the utility's potential financial exposure during extreme weather events.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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APPLICABLE CRITERIA

U.S. Public Power Rating Criteria (pub. 03 Mar 2023) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Apr 2023) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Pedernales Electric Cooperative, Inc. (TX)	EU Endorsed, UK Endorsed

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