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Ratings

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Pedernales Electric Cooperative, Texas; CP

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Credit Highlights

- S&P Global Ratings affirmed its 'A-1' short-term rating on Pedernales Electric Cooperative (PEC), Texas' $200 million taxable commercial paper (CP) notes.

Security

The $200 million in authorized CP notes are unsecured and on parity with PEC's other existing and future unsecured, unsubordinated debt. Note proceeds are used for general corporate purposes, including capital spending. The CP resolution limits CP issuance and draws from revolving credit agreements, to $305 million. Liquidity support for the CP, although not dedicated only to CP repayment (also available for general corporate purposes), is provided by a combined $305 million in unsecured revolving credit facilities, consisting of a $200 million, three-year revolving credit facility with lenders Bank of America N.A., CoBank ACB, and JPMorgan Chase Bank N.A. maturing on Dec. 4, 2023, and a $105 million 364-day revolving credit facility with the same lenders maturing on Dec. 1, 2023.

Based on the provisions in the resolution on short-term debt limits, any amount borrowed under one type of short-term debt product effectively reduces the amount PEC can borrow under the other (although if PEC draws $105 million or less from the revolving facilities, PEC can still issue the maximum $200 million in CP). These provisions ensure that any issuance of CP will always have a corresponding amount of liquidity available on the revolving facilities such that PEC is able to repay CP in the event PEC does not have market access or is otherwise unable to refinance the CP.

We do not publicly rate PEC's long-term debt or credit quality, and have not assigned PEC a public long-term rating or issuer credit rating in connection with the short-term rating, although we have internally assessed PEC's long-term credit quality.

All-in liquidity facilities total $505 million, but net of $133 million outstanding in CP as of Dec. 31, 2022, the net available amount was $372 million (not including $9 million in cash on hand). PEC plans to refinance CP with long-term debt when CP balances reach $100 million to 200 million.

PEC's debt outstanding totaled $1 billion as of Dec. 31, 2022.

Credit overview

We determined the PEC short-term rating by applying our "Methodology for Linking Long-Term and Short-Term Ratings" criteria, published April 7, 2017, on RatingsDirect, and PEC's long-term general creditworthiness by applying our "U.S. Municipal Retail Electric And Gas Utilities: Methodology And Assumptions" criteria, published Sept. 27, 2018.

The rating reflects our view of PEC's:

- Consistently healthy fixed-charge coverage (FCC) that we believe will remain at 1.3x to 1.4x over the next five years, supported by continued strong load growth;
- Diverse and primarily residential customer base that represents 73% of retail revenue, providing PEC with significant revenue stability and predictability;
- Favorable and mostly firm power supply contracts, including the diversity of power supply resources that the contract with the Lower Colorado River Authority (LCRA) provides;
- Competitive rates and good rate-setting practices; and
- Robust liquidity position consisting primarily of lines of credit, net of draws, totaling $372 million, but also $9 million in unrestricted cash for a combined $381 million (equivalent to 217 days) as of Dec. 31, 2022, which is critical to manage operating risks related to operation within the Electric Reliability Council of Texas (ERCOT) market.

Partly offsetting the above strengths, in our view, are PEC's:

- Operating risks related to the ERCOT market, where utilities and wholesale power providers remain somewhat exposed to power price spikes and/or volatility given extreme temperature changes and peaks in demand, which climate change likely exacerbates. We believe inherent ERCOT market design limitations remain, including limited interconnectedness with adjoining states and only adequate incentives for the construction of surplus firm capacity.
- Very high debt burden for a non-vertically integrated distribution and transmission utility, with 55% debt to capitalization as of fiscal 2022
- Significant capital needs associated with PEC's rapidly growing customer base and demand, totaling almost $1 billion over the next five years, approximately 60% of which management intends to finance with additional debt

In our view, PEC has been operationally and financially sound over the past two years since the North American winter storm of Feb. 13-17, 2021 (unofficially known as Uri), hit the region hard, and led to significant unbudgeted costs for many utilities. The total impact for PEC was approximately $160 million: $150 million related to increased purchased power costs and $10 million related to storm restoration costs. PEC's load is typically hedged by virtue of its contracts with LCRA and other power suppliers, although at times during Uri certain assets underlying these contracts were not fully available and PEC had to procure power on the ERCOT market at elevated wholesale prices. Higher-than-normal gas prices also led to higher costs. PEC reports that peak loads rose to 2,074 megawatts (MW) during the event, 19% above the previous winter peak of 1,738 MW from 2018. Over the final 32 hours of the event (Feb. 18 and a portion of Feb. 19), ERCOT ordered utilities to stop load-shedding. The return of PEC's full load when market pricing remained at the $9,000-per-MW-hour cap produced most of the $150 million in energy cost impact.

To recover these costs, the board approved several actions in August 2021 that, in our view, preserved credit quality. The board approved a rate increase of eight mills (seven mills for storm recovery and one for distribution) effective Oct. 1, 2021, which is approximately 0.8 cents per kilowatt-hour (kWh; about an 8% increase to residential rates). The seven-mill storm recovery surcharge is set to expire after two years. The board also agreed to revise PEC's line extension policy to remove the $2,000-per-line extension allowance, and this, based on meter growth of about 15,000 annually, equates to a forecast $30 million in savings per year. Meter growth has actually exceeded 15,000 annually

with about 19,000 in 2021 and 18,600 in 2022. PEC also cut capital spending and operating costs, and amended and extended its CoBank short-term credit facility to a 364-day revolving facility and increased the availability under this facility to $100 million from $80 million. In total, PEC has a gross $505 million in credit facilities available versus 2019, when credit facilities totaled just $180 million.

PEC has since managed its exposure to ERCOT potential market price volatility, especially during record summer heat in 2022 and two severe cold snaps during the winter of 2022-23, including the significant ice storm during Jan. 31 to Feb. 2, 2023. We attribute this in part to PEC's diverse, mostly firm power supply contracts including LCRA's generation portfolio, overall expected strong resource position, minimal exposure to intermittent renewable energy resources, power and gas supply remediation, conservative forecasting, and proactive power supply planning. However, we believe PEC may continue to face uncertainty and adversity related to many factors facing utilities throughout the state, including an uncertain regulatory environment and exposure to ERCOT-related risks. We believe PEC and its primary power provider, LCRA, as with many other Texas utilities, could continue to face challenges associated with winterization costs, the ERCOT market's relative price volatility, extreme temperature and demand fluctuations, and weaker grid interconnectivity as compared with that of grids in other states. Rating pressure exists to the extent PEC or LCRA is unable to manage the risks associated with participation in the ERCOT market, if our view of PEC's economic base and competitiveness deteriorates, or if PEC's predominantly carbon-based power supply exposes it to extraordinary costs, including regulatory mandates.

Separately, we revised the outlook to stable from negative and affirmed our 'A' long-term rating on LCRA on Sept. 26, 2022, reflecting our view that LCRA is sufficiently positioned to manage its exposure to ERCOT market price volatility based on its long power supply position, which enables it to meet demand spikes through its owned generation and other power supply contracts, and also given our view of LCRA's risk management practices. LCRA's total capacity of 3,560 MW provides adequate cushion against extreme demand scenarios. Historical summer peaks for LCRA's customers (on load served by LCRA and others) have approximated 3,000 MW, with 2022 summer peak demand reaching 3,160 MW. LCRA also announced in January 2023 it plans to build a 190 MW gas-fired peaking power plant in Caldwell County. For more information regarding LCRA, please see our report published Feb. 3, 2023.

Environmental, social, and governance

In our view, physical environmental risks are elevated given the pattern of increasing extreme weather events, especially with regard to extreme temperature changes in Texas against the backdrop of ERCOT's aforementioned limitations. We consider the adequacy of management's risk management toolkit to plan for, mitigate, or adapt to these exposures that have the potential to disrupt power supply and increase costs, including the practical limits of power supply planning and hedging strategies. In addition to Uri in February 2021, the region has since seen record heat in summer 2022 and two significant cold snaps over the past winter, including a severe ice storm that led to significant but manageable tree and power line damage and outages. Also, while PEC is not a generating utility, LCRA, from which PEC derives at least 65% of its power supply, had a fuel mix in fiscal 2022 that was, on an energy basis, 50% coal, 43% natural gas, and less than 1% hydro. Thus, PEC could indirectly face higher energy transition risks related to carbon emissions regulations as S&P Global Ratings expects the Biden Administration to continue to pursue tightening environmental regulations governing the electric industry and its fuels. Such measures could directly and indirectly affect public power and electric cooperative utilities' operations, costs of doing business, retail rates, and

financial flexibility, and possibly our ratings.

We believe PEC's exposure to social factors are largely credit neutral given competitive rates, and management reports accounts receivable and delinquencies have not been materially higher as a result of the current inflationary environment. Nonetheless, S&P Global Ratings projects that the U.S. economy will likely fall into a shallow recession in 2023, tempered by generally strong labor demand. (See "Economic Outlook U.S. Q2 2023: Still Resilient, Downside Risks Rise," published March 27, 2023.) Consequently, we are monitoring the strength and stability of the revenue streams of cooperative electric utilities for evidence of delinquent payments or other revenue erosion because rising consumer prices and interest rates are whittling discretionary incomes.

In our view, governance is a moderate credit risk given that the environment in which PEC operates increasingly requires stronger liquidity, proactive planning, hedging, and financial flexibility, which come at a cost, versus most utilities in other regions where these risks are lower. Notwithstanding these issues, we believe management's policies, proactive planning, and sophistication are credit-supportive.

Credit Opinion

PEC is the largest electric distribution cooperative in the U.S. and provides retail electricity services to more than 385,000 customers across Central Texas in the rapidly growing Hill Country region. PEC's service territory includes 45 cities across 24 counties, including western portions of the greater Austin metropolitan statistical area, the northern portion of the greater San Antonio metropolitan statistical area, and rural areas near Junction and Rocksprings. Austin and San Antonio have experienced extremely strong growth over the past few years that is expected to continue, with many major employers, especially technology companies (e.g., Tesla and Samsung), relocating headquarters and employees from other states or adding facilities to the region. In addition, the increasing ability to work remotely during the height of the pandemic and even now has led to higher demand for new housing outside of major metro areas.

Residential customers account for approximately three-fourths of PEC's load and revenue, providing PEC with considerable financial stability and revenue predictability. PEC's large size and scope provide for significant economies of scale, although we also recognize that a higher customer count translated into higher power costs during the recent winter storm. The customer base is very diverse, with no customer representing more than 1% of revenue and with the leading 10 customers representing just 3%. PEC serves about 16 customers per line-mile, which is above average for a cooperative utility, and this greater density allows its fixed costs to be spread over a greater number of customers, promoting lower retail rates.

We believe PEC's competitive rates and strong income levels for the majority of its customers provide it with revenue-raising flexibility. Management has historically used a power cost adjustment mechanism to help insulate PEC members from market price volatility, but, as all-in rates remained unchanged for several years, PEC rolled the adjustment into the base rate. Based on the U.S. Energy Information Administration's latest available data, from 2021, PEC's weighted average system rate competitiveness (based on relative customer classes' revenue contributions) was 95% of the state average. We expect PEC's rates to remain competitive despite the recent 1% permanent, and 7%

two-year rate increase. We believe PEC will continue to adjust rates as it deems necessary to maintain solid financial metrics, and we note that many other utilities in the state are also raising rates. PEC's average residential bill declined to about $105 per month (1,000 kWh) in 2016 from about $128 in 2014, largely as a result of PEC's passing through power cost decreases related to lower prices for natural gas. Average residential bills were about $137 in 2022, up from $106 in 2020; the winter storm Uri surcharge alone added approximately $8 to monthly bills from October 2021 through September 2023.

PEC's power supply is based largely on a load-following agreement with LCRA that runs through 2041 and covers at least 65% of PEC's requirements, and PEC also pays LCRA to provide firming for as much as 15% of PEC's intermittent, renewable energy. PEC's cost of power is closely tied to LCRA's generation cost. PEC meets an additional 20% of load through a fixed-price contract with another regional supplier that will run through June 30, 2023; management reports very favorable pricing associated with this contract. This contract will be replaced with a block-and-shape supply contract, whereby capacity varies hour to hour over the term length, running from July 2023 through December 2025. While the price is higher than that of the previous contract, and it is not load-following, management reports that it offers favorable pricing than a traditional hourly load-following contract. PEC meets the remaining 15% of load through various purchase power agreements consisting of wind, solar, and other unidentified resources ranging from two to 25 years, almost all at fixed prices. In a typical year, PEC meets 100% of load through these contracts. We understand that PEC is compliant with environmental regulations that apply to its operations.

Senior leadership at PEC has significant industry experience and financial management has been sound over the past few years even in light of the challenges of a pandemic, significant storms and heat waves, and now an inflationary environment and possible recession. Recent activity has focused on restructuring the balance sheet and defeasing debt, which we believe provides some capacity for a more capital-intensive five-year period ahead. We believe PEC's rate-setting practices and management's annual updates to its five-year financial forecast and capital plan support credit. Management targets debt service coverage (and not S&P Global Ratings-calculated FCC) of no less than 1.7x, which we consider sound.

In our view, PEC's FCC has been consistent and strong at about 1.2x to 1.4x since fiscal 2016, including 1.4x in fiscal 2022, improving from 1.3x largely as a result of reduced purchased power costs, higher summer temperatures, and solid expense management. FCC is our internally adjusted coverage metric that imputes onto PEC certain costs that power suppliers bear, in lieu of an explicit capacity or demand charge. After consideration of 50% of projected purchased power costs as fixed debtlike obligations, PEC's financial projections indicate that it will likely maintain FCC near 1.4x, consistent with recent levels, largely as a result of continued strong growth. We believe management's forecast assumptions are reasonable by assuming customer base growth of 5% annually (consistent with recent trends), 3% average load growth, and minimal rate increase(s). The forecast also conservatively assumes inflation at a high 11% in 2023 but a more normal range of 1.6% to 3.0% during fiscal years 2024 to 2027.

We consider PEC's liquidity position robust when its undrawn committed lines of credit are included. PEC had $9 million in unrestricted cash and investments and $372 million in available credit facilities as of Dec. 31, 2022, representing 217 days' operating cash. As of Jan. 31, PEC had $16.2 million cash on hand and $505 million in liquidity available under its revolving lines of credit. Management's financial forecast reflects maintenance of very strong

available liquidity through fiscal 2025 at no less than $321 million. At the rating, we view maintenance of liquidity as critical given the operating risks that PEC faces within the ERCOT market.

While we consider PEC's debt to capitalization very high for a distribution cooperative utility at 55% as of fiscal 2022, we also view it as manageable. Management expects to debt-finance roughly 60% of its identified capital needs totaling $987 million through 2027, with the majority of capital spending related to distribution system projects. Historically, PEC has used loans from CoBank, the National Rural Utilities Cooperative Finance Corp. and other financial institutions to fund system expansions and upgrades, and PEC plans to issue CP from time to time for capital projects largely related to systemwide growth. Based on load growth and the outlook for interest rates, management estimates it will not issue long-term debt until late 2024 or early 2025.

Pedernales Electric Cooperative key credit metrics			
	--Fiscal year ended Dec. 31--		
	2022	2021	2020
Operational metrics			
Electric customer accounts	385,868	367,289	348,280
% of electric retail revenue from residential customers	73	60	74
Top 10 electric customers' revenues as % of total electric operating revenue	3	4	4
Service area median household effective buying income as % of U.S.	126	126	126
Weighted average retail electric rate as % of state	95	95	93
Financial metrics			
Gross revenue ($000s)	833,704	827,714	643,753
Total operating expenses less depreciation and amortization ($000s)	640,674	676,817	504,269
Debt service ($000s)	68,593	61,785	85,036
Debt service coverage (x)	2.8	2.4	1.6
Fixed-charge coverage (x)	1.4	1.3	1.2
Total available liquidity ($000s)*	381,362	412,042	438,721
Days' liquidity	217	222	318
Total on-balance-sheet debt ($000s)	1,035,155	1,035,705	941,089
Debt to capitalization (%)	55	57	55

*Includes available committed credit line balances, where applicable. Debt service coverage--Revenue minus expenses divided by debt service. Fixed-charge coverage--Sum of revenue minus expenses minus total net transfers out plus capacity payments (or their proxy), divided by the sum of debt service plus capacity payments (or their proxy).

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

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