FitchRatings

Public Finance
Public Power
United States

Pedernales Electric Cooperative, Inc., Texas

Fitch Ratings' affirmation of the 'AA–' ratings reflects its expectation that Pedernales Electric Cooperative, Inc.'s (PEC) financial performance will return to historically very strong levels in 2022 despite weaker performance in 2021 as a result of significantly higher purchased power costs related to the February 2021 winter storm event. PEC's ratings also continue to reflect very strong revenue defensibility and a very low operating cost burden.

Fitch's removal of the Negative Watch is based on PEC's maintenance of sufficient liquidity. The Negative Outlook reflects the structural weaknesses in the Electric Reliability Council of Texas (ERCOT) market. The affirmation of PEC's 'F1+' short-term rating is based on its correspondence with PEC's 'AA–' Issuer Default Rating (IDR).

Key Rating Drivers

Revenue Defensibility: 'aa'; High Growth Retail Electric Cooperative with Rate Flexibility: Fitch assesses PEC's revenue defensibility as very strong based on the monopolistic characteristics of the cooperative's customer base, service area characteristics and its rate flexibility.

Operating Risk: 'a'; Very Low Operating Costs; Weakened Operating Cost Flexibility: Fitch's 'a' assessment of PEC's operating risk profile and weaker operating cost flexibility reflect ERCOT market structural deficiencies revealed during the February storm. PEC's 'aa' operating cost burden is based on its very low operating costs, primarily driven by its power supply costs.

Financial Profile: 'aa'; Financial Profile Stable Through the Cycle: PEC's net leverage remained consistently low at about 6.4x over the past five years. Fitch's base and stress scenario leverage ratios should return to pre-storm levels by 2022. Liquidity is weak based on days cash on hand, but is supported by PEC's external liquidity facilities.

Rating Sensitivities

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

- Stabilization of the Negative Outlook will depend on actions by the state and market regulators to reduce financial risk to ERCOT market participants, and resolution of the approximately $3 billion net short amount that remains unpaid to ERCOT;
- Sustained net leverage below 6.0x in Fitch's base and stress cases;
- A sustained liquidity cushion above 90 days, including cash on hand above 30 days.

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 IDR below 'AA–' could pressure the cooperative's short-term 'F1+' rating, depending on PEC's internal liquidity available to support the CP program.

FACT Tools

Ratings

Long-Term Issuer Default Rating	AA–

Outstanding Debt

CP Notes	F1+
First Mortgage Bonds	AA–

Rating Outlook

Negative

Applicable Criteria

U.S. Public Power Rating Criteria (April 2021)

Public Sector, Revenue-Supported Entities Rating Criteria (February 2021)

Related Research

Public Power - Fitch Analytical Comparative Tool (FACT) - 2021 (June 2021)

U.S. Public Power -- Peer Review (June 2021)

Fitch Ratings 2021 Outlook: U.S. Public Power and Electric Cooperatives (December 2020)

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Credit Profile

PEC is the largest electric distribution cooperative in the U.S. based on meters served, and continues to grow at a rapid pace. The cooperative serves approximately 358,300 accounts as of June 2021 and more than one million people. PEC's service area spans 8,100sq miles and includes all or part of 24 counties and 45 cities in a noncontiguous and diverse region encompassing suburban areas near Austin, TX, 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 and receives the majority of its power from the Lower Colorado River Authority (LCRA) under a long-term contract through 2041.

Winter Storm Uri

PEC incurred net additional storm costs of $160 million, $150 million of which represents power supply costs, an amount equivalent to almost half the cooperative's annual purchased power costs. The remaining $10 million represents storm restoration costs, recoverable in part through expected reimbursement from the Federal Emergency Management Agency.

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.

The 24-month winter storm power cost surcharge effective Oct. 1, 2021 represents a temporary increase of 8.75% to the typical PEC residential bill. A separate delivery charge rate adjustment to address significant cost increases for materials, trucks, equipment, labor and contractor expenses incurred in the normal course of business is also effective Oct. 1, 2021 and represents an increase of 1.607% to a typical PEC residential bill.

PEC implemented a variety of operating and capital actions, totaling more than $100 million in savings through 2023, to mitigate incremental storm costs. Some of these actions required board approval, including updates to PEC's line extension policy, which will provide estimated savings of $27 million per year, fully effective in 2022 and thereafter. The PEC board also reduced capital credit distributions and will continue to evaluate future distributions through 2023.

Revenue Defensibility

PEC derives its revenue from the provision of retail electric services to a largely residential customer base. PEC's electric generation services are provided almost entirely to an exclusive customer base because retail electric choice is not in place throughout the PEC service area. PEC estimates less than 3% of its service territory provides options for customers to select an electric power provider upon initiation of service, generally in areas within the Texas cities of Georgetown, Walburg, Florence and Junction.

The cooperative receives a small amount of revenues from its owned transmission assets (2% in 2020). Transmission rates are regulated by the Public Utility Commission of Texas and collection timeliness from utilities across ERCOT and full cost recovery have been consistent.

PEC's service area characteristics include favorable median household income and unemployment. Customer account growth is very strong, as measured by 4.8% CAGR over the five years ending December 2020. The most rapid customer account growth is along the Interstate 35 (IH-35) corridor. Of the 24 counties served, the combination of Williamson County (AAA/Stable) and Hays County (AA/Stable) contribute more than half of PEC revenues. Williamson and Hays Counties' median household incomes (MHI) represent 139% and 109% of the 2019 U.S. average MHI, respectively, and their unemployment rates are 73% and 78% of the 2020 U.S. average, respectively.

Williamson County lies to the north of Austin. Its economic base includes technology, manufacturing, government, education, retail and agribusiness. The county benefits from an abundance of high-technology firms, and its diversified employment base and the stabilizing influence of education, government and healthcare among top employers make it less

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Negative	8/26/21
AA–	Affirmed	RWN	2/24/21
AA–	Revised	Stable	4/30/10
A+	Downgraded	Stable	3/16/09
AA–	Affirmed	Stable	12/8/04
AA–	Assigned	—	9/24/02

IDR – Issuer Default Rating.
RWN – Rating Watch Negative.
Source: Fitch Ratings.

susceptible to cyclical technology sector downturns and associated layoffs. The county continues to see new business entrants and expansion in the commercial, retail, manufacturing, medical and education sectors.

Hays County is situated between Austin and San Antonio and is among the fastest growing counties in the state and nation. The county experienced rapid urbanization over the past decade. Commercial development followed the county's high pace of residential growth, particularly along the IH-35 corridor, with further growth anticipated based on residential, commercial and retail developments underway.

PEC has the independent ability to change electric distribution rates. PEC's total retail electric rates approximate the state average and its residential rates represent 88% of the 2019 state average. PEC's base power rate passes its wholesale power costs through to customers in a timely manner, mitigating the risk of fuel and purchased power volatility. The cooperative's rates are highly affordable, representing just 1.8% of median household income in 2019.

The residential portion of PEC's fiscal 2019 electric revenue and sales account for a high 77% and 73%, respectively, of the total. PEC's top 10 direct customers are represented by a single industrial load, school districts, and grocery and retail concerns, and accounted for a low 5.7% of total fiscal 2019 revenue. The cooperative's sizable residential load and lack of concentration contributed to an only modest coronavirus pandemic impact on sales in its service area.

Operating Risk

Fitch's 'a' assessment of PEC's operating risk profile takes into consideration actions underway that are directed by the Texas legislature to address ERCOT market deficiencies. Fitch assesses PEC's electric operating cost burden as very low, calculated at 8.8 cents/kWh in 2020. The cooperative's energy costs reflect low wholesale power costs, including through its agreement with LCRA. The LCRA costs reflect diverse LCRA generation assets and contracts, including coal- and gas-fired generation, and six hydroelectric plants that provide hydropower from the Lower Colorado River. PEC's operating cost burden also reflects a purchased power pass-through cost from LCRA, against which LCRA's ancillary market and off-system sales revenue has been netted.

The weaker operating cost flexibility reflects Fitch's assessment of a heightened risk applicable to ERCOT market participants considering ERCOT structural deficiencies have not yet been completely remediated.

PEC's full requirements wholesale power agreement was executed in 2008 and requires LCRA to meet PEC's full energy requirements on a load-following basis, including system growth over time, subject to load release. PEC accounts for about half of LCRA generation sales. The contract terms represent limited operational risk to PEC as a distribution utility, although the risk and resulting costs of operational issues, should they arise in connection with an LCRA asset, would be passed through in the wholesale rates to PEC.

The LCRA wholesale power agreement allows PEC, through load release provisions, to source some of its power from non-LCRA suppliers. PEC exercised some load release with respect to its requirements over the next several years.

PEC's lifetime investment requirements are moderate based on Fitch's estimated five-year average age of plant as of Dec. 31, 2020. Annual capex are well in excess of depreciation, driven by strong service area growth.

PEC projects five-year capital spending of about $700 million, similar to that of the preceding five-year total. The plan reflects investment to support growth that would have caused total five-year spending to approach $835 million except for PEC identified savings, including those provided by the adoption of PEC's updated line extension policy.

Financial Profile

Fitch continues to assess PEC's financial profile at 'aa', reflecting the cooperative's consistent and very strong financial performance. Leverage remained steady over the last five years, ranging between 6.2x and 6.3x through 2019, with an incremental uptick to 6.7x in 2020 associated primarily with modest debt growth to support long-term system growth. PEC's history of stable leverage reflects growth in annual cash flow from adding new customers that support increased debt over the period used to finance a portion of the system's rapid growth.

Liquidity is weak as measured by days cash on hand of eight days at the end of 2020, but is neutral as measured by a broader liquidity cushion ratio of 330 days, reflecting the cooperative's access to bank lines of credit and revolving credit facilities. Fitch calculates coverage of full obligations at 1.3x in fiscal 2020, down from 1.4x in prior years.

Fitch Analytical Stress Test (FAST) — Base and Stress Cases

Fitch expects PEC's financial position to remain very strong. Fitch's base-case scenario assumes moderate load growth that incorporates rising conservation and energy efficiency, as customer growth continues at a rapid pace. Revenues reflect recently adopted rate increases, while purchased power costs, other operating expenses and the $705 million five-year capital spending assumptions are based on PEC's long-term forecast, which Fitch considers reasonable. Both the base and stress scenarios incorporate storm-mitigating capital and operating savings that total more than $100 million throughout fiscals 2021–2023.

Fitch's base case indicates PEC's leverage ratio peaking at 13.7x and 15.0x in 2021 for the base and stress scenarios, respectively. However, the leverage ratio quickly moderates in 2022 and stabilizes thereafter to about 6.8x and 7.7x in the base and stress scenarios, respectively. Coverage and liquidity levels are expected to similarly stabilize in the range of historical levels.

Fitch's standard stress case imposes lower system energy sales for two years, followed by a recovery based on PEC's historical energy sales trends. The stress case does not incorporate additional cost savings above and beyond those incorporated in the base case, nor additional electric rate adjustments. Leverage trends slightly higher in this scenario, but remains below 8.0x and supportive of the rating.

PEC's debt profile is neutral to the rating. The cooperative's long-term fixed-rate debt includes first mortgage bonds, National Rural Utilities Cooperative Finance Corporation (CFC) loans and JPMorgan Chase Bank, N.A. (AA/Negative) loans totaling $804 million at fiscal YE 2020. The cooperative's liquidity facilities included $100 million of CFC and $80 million of CoBank, ACB credit facilities at fiscal YE 2020. PEC expanded its liquidity facilities during 2021 to $505 million, adding a $105 million syndicated 364-day credit facility and a $200 million three-year credit facility, both administered by Bank of America, and expanding its $80 million facility with CoBank to $100 million.

The cooperative issued $310 million of series 2021A first mortgage bonds in February 2021 to defease a portion of its series 2002A first mortgage bonds for debt service savings, and issued an additional $90 million of series 2021B bonds in August 2021 to fund capital projects.

CP Program

PEC's $200 million CP program is supported by internal liquidity, including its three-year syndicated revolving credit facility, which by amendment allows the respective loan proceeds to be used for the payment of debt service on the CP notes. BofA 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.

PEC's privately placed CP provides a low-cost interim funding source for its capital projects, which total about $700 million through fiscal 2025, and its share of storm costs incurred during the February 2021 winter weather event. The CP notes carry a maturity of less than 397 days. PEC plans to refund the CP notes with fixed-rate long-term debt every 12–18 months.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating determination.

ESG Considerations

PEC has an ESG Relevance Score of '4' for Exposure to Environmental Impacts due to the effects of recent severe winter weather and structural aspects of the ERCOT organized market that resulted in extraordinary energy cost increases, which could collectively have a negative impact on credit quality and is relevant to the ratings in conjunction with other factors.

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.

Financial Summary — Pedernales Electric Cooperative, Inc., Texas

($000, Audited Fiscal Years Ended Dec. 31)	2016	2017	2018	2019	2020
Net Adjusted Debt to Adjusted FADS (x)	**6.28**	**6.33**	**6.29**	**6.20**	**6.69**
Net Adjusted Debt Calculation					
Total Current Maturities of Long-Term Debt	38,126	43,546	45,101	48,740	34,673
Total Long-Term Debt	681,760	730,079	736,743	744,479	804,419
Total Debt	**719,886**	**773,625**	**781,844**	**793,219**	**839,092**
+ Capitalized Fixed Charge — Purchased Power and Gas	776,586	816,807	879,773	807,259	856,486
+ Total Pension Obligation (GASB Fitch-Adjusted NPL + FASB PBO)	11,645	3,300	6,792	0	946
- Total Unrestricted Cash	33,244	21,931	2,355	769	11,459
Net Adjusted Debt	**1,474,874**	**1,571,802**	**1,666,055**	**1,599,710**	**1,685,065**
Adjusted FADS for Leverage Calculation					
Total Operating Revenue	565,759	590,771	638,547	617,917	643,059
Total Operating Expenses	480,487	502,600	544,988	527,455	575,055
Operating Income	**85,272**	**88,171**	**93,559**	**90,462**	**68,004**
+ D&A	43,313	49,232	53,657	57,885	69,929
+ Interest Income	165	226	267	279	158
FADS	**128,750**	**137,629**	**147,484**	**148,626**	**138,091**
+ Adjustment for Purchased Power	97,073	102,101	109,972	100,907	107,061
+ Pension Expense	8,883	8,693	7,527	8,391	6,721
Adjusted FADS for Leverage	**234,706**	**248,422**	**264,983**	**257,925**	**251,873**
Coverage of Full Obligations (x)	**1.44**	**1.37**	**1.36**	**1.38**	**1.28**
FADS	128,750	137,629	147,484	148,626	138,091
+ Adjustment for Purchased Power	97,073	102,101	109,972	100,907	107,061
Adjusted FADS for Coverage	**225,824**	**239,730**	**257,456**	**249,534**	**245,152**
Full Obligations Calculation					
Cash Interest Paid	31,876	34,274	36,239	35,432	36,295
Prior-Year Current Maturities	28,381	38,126	43,546	45,101	48,740
Total Annual Debt Service	**60,257**	**72,400**	**79,785**	**80,533**	**85,036**
+ Adjustment for Purchased Power	97,073	102,101	109,972	100,907	107,061
Total Fixed Obligations	**157,330**	**174,501**	**189,757**	**181,441**	**192,097**
Liquidity Cushion (Days)	278	259	97	134	330
Unrestricted Cash (Days)	28	18	2	1	8
Liquidity Calculation					
+ Total Unrestricted Cash	33,244	21,931	2,355	769	11,459
+ Total Borrowing Capacity	300,000	300,000	180,000	180,000	445,000
- Amounts Unavailable	0	0	51,500	8,200	0
Total Liquidity	**333,244**	**321,931**	**130,855**	**172,569**	**456,459**
Cash Operating Expense Calculation					
Total Operating Expense	480,487	502,600	544,988	527,455	575,055
- D&A	43,313	49,232	53,657	57,885	69,929
Cash Operating Expenses	**437,174**	**453,368**	**491,330**	**469,569**	**505,126**

FADS – Funds available for debt service. PBO – Pension benefit obligation. D&A – Depreciation and amortization.
Source: Fitch Ratings; Fitch Solutions; Lumesis; EIA; Pedernales Electric Cooperative, Inc., Texas.

Key Definitions

Terms	Definition	Significance
Issuer Default Rating (IDR)	An expression of overall enterprise risk and relative vulnerability to default.	Provides an opinion of the relative ability of an entity to meet financial commitments, expressed as an ordinal measure of credit risk.
Standalone Credit Profile (SCP)	An expression of overall enterprise risk.	Provides an opinion of the credit quality of an entity on a standalone basis, irrespective of its relationship with, or the credit quality of, its related municipality.
Net Adjusted Debt	Adjusted debt – unrestricted cash – funds restricted for debt service	Provides an inclusive evaluation of long-term liabilities offset by funds available for debt service.
Adjusted FADS	EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions + pension expense	Provides an indication of cash flow available for the payment of debt service, adjusting for purchased power, operating lease and pension obligations.
Net Adjusted Debt to FADS	Net adjusted debt/adjusted FADS	Provides an indication of net total leverage position against available operating cash flow.
Full Obligations	Cash interest paid + scheduled long-term principal payments + 30% of purchase power expense	Provides an indication of inclusive fixed and debt service obligations.
Coverage of Full Obligations	(EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions)/full obligations	Provides an indication of the relative cushion of operating cash flow to fixed charges.
Base Case	The expected forward-looking case in the current macroeconomic environment.	Provides the analytical starting point in the forward-looking analysis, and also informs the stress case.
Stress Case	The potential performance under a common set of assumptions.	Illustrates how cycles affect individual issuers differently, and informs the level of rating stability and credit resiliency.

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