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Summary:

Pedernales Electric Cooperative, Texas; CP

Primary Credit Analyst:
Paul J Dyson, Austin + 1 (415) 371 5079; paul.dyson@spglobal.com

Secondary Contact:
Jenny Poree, San Francisco + 1 (415) 371 5044; jenny.poree@spglobal.com

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Credit Profile		
Pedernales Elec Coop Inc priv placement of commercial paper nts due 05/17/2022		
Short Term Rating	A-1	Affirmed, Removed from CreditWatch

Rating Action

S&P Global Ratings affirmed its 'A-1' short-term rating on Pedernales Electric Cooperative (PEC), Texas' $200 million taxable commercial paper (CP) notes and removed the rating from CreditWatch, where it had been placed with negative implications on April 7, 2021.

The CreditWatch removal reflects PEC's governance within our environmental, social and governance (ESG) analysis, including our view of various recent actions that PEC's board and management team have taken, including a two-year, approximately 7% rate increase and removal of its $2,000-per-line extension allowance that we believe will preserve PEC's credit quality by materially improving cash flow and mitigating the $160 million impact of the Feb. 13-17, 2021, North American winter storm (unofficially referred to as Winter Storm Uri). The CreditWatch removal also reflects our view that PEC will likely be able to manage its exposure to the Electricity Reliability Council of Texas's (ERCOT) potential market price volatility for the remainder of this summer and coming winter because of its diverse, mostly firm, load-following generation resources, overall expected strong resource position, minimal exposure to intermittent renewable energy resources, power and gas supply remediation plans (either directly or by its power suppliers), and improved system liquidity.

Despite the action, 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, Lower Colorado River Authority (LCRA), as with many other Texas utilities, could continue to face challenges associated with asset winterization costs, the ERCOT market's relative price volatility (especially pertaining to inflated ancillary service charges as well as heightened gas price volatility and supply reliability risks), extreme temperature and demand fluctuations, and weaker grid interconnectivity as compared with 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.

The $200 million in authorized CP notes are unsecured and on parity with PEC's other existing and future unsecured, unsubordinated debt. Note proceeds will be used for general corporate purposes, including capital spending. The CP resolution limits short-term debt outstanding, which includes both CP issuance and draws from revolving credit agreements, to $305 million. Liquidity support for the CP, although not specifically 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. 3, 2021. Based on the provisions in the resolution on short-term debt limits, any amounts borrowed under one type of short-term debt product effectively reduces the amount PEC can borrow under the other. (Except if PEC draws $105 million or less from the revolving facilities, PEC can still issue the maximum $200 million in CP.) These provisions ensure 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.

All-in liquidity facilities total $505 million, although net of $90 million outstanding in CP, PEC considers the net available to be $415 million (not including $14 million in cash on hand). At the end of each year, PEC forecasts it will have $100 million to $140 million in CP outstanding.

PEC's debt outstanding totaled $793 million as of Dec. 31, 2020, and is projected at slightly more than $1 billion for Dec. 31, 2021.

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.

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.

PEC's long-term credit quality reflects our view of its:

- Diverse and primarily residential customer base that represent 75% of retail revenues, which provides it with significant revenue stability and predictability;
- Generally favorable power supply, including the diversity of power supply resources that contracts with LCRA and others provide;
- Competitive rates and good rate-setting practices;
- Very strong liquidity position consisting primarily of lines of credit, net of draws, totaling $415 million but also $14 million in unrestricted cash for a combined $429 million (equivalent to 222 days) as of Aug. 24, 2021, which is critical to manage operating risks related to operation within the ERCOT market; and
- Strong and consistent fixed-charge coverage (FCC) that we believe will remain at 1.2x to 1.4x over the next five years, supported by reduced debt service and continued strong meter growth.

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

- Operating risks related to the ERCOT market, where a recent extreme weather event has demonstrated the extent to which PEC's primary power supplier (and other power providers in the region) is vulnerable to severe temperature changes and peaks in demand (the ERCOT market design also has very limited interconnectedness with adjoining states and insufficient incentives for the construction of surplus capacity, while rewarding the provision of low-priced power at the expense of asset stewardship);

- Very high debt burden for a non-vertically integrated distribution and transmission utility, with 52% debt to capitalization as of fiscal 2020, although PEC plans to reduce leverage over the next few years; and
- Significant capital needs associated with PEC's rapidly growing customer base and demand, totaling approximately $705 million over the next five years, approximately one-third of which management intends to finance with additional debt.

In terms of the financial and operational effects of the Feb. 13-17, 2021, North American winter storm on PEC's creditworthiness, management now estimates a total impact of approximately $160 million, revised upward from $120 million as of April 2021 given a delay in final fuel billings. A total of $150 million represents increased purchased power costs, and $10 million relates to storm restoration costs. In addition, PEC faces an estimated $10 million in exposure related to socialization of ERCOT costs (the "uplift mechanism"), which is triggered when ERCOT market participants default on payment obligations for purchased power. Given legislative approval for the securitization of storm costs, the actual exposure could be less.

PEC's load is typically hedged by virtue of its contracts with LCRA and other power suppliers, although at times during the storm 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% higher than its 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.

On Aug. 20, 2021, the board approved several actions that we believe will improve cash flow, reduce the impact of the storm, and preserve credit quality. Management has also recently made other adjustments to improve its financial condition. 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 (about 8% increase to residential rates). The seven-mill storm recovery surcharge is set to expire after two years. Management forecasts that the rate actions will generate $114 million in additional cash flow over three 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. PEC also plans to cut capital spending by $63.0 million and operating expenses by $18.4 million over the next three years. Management also amended and extended its CoBank short-term credit facility to a 364-day revolver and increased the availability under this facility to $100 million from $80 million. In total, PEC now has a gross $505 million in credit facilities available versus 2019, when they totaled just $180 million. The board also canceled payment of a special capital credit distribution of $6 million in April and is likely to reduce future capital credit distributions to reduce leverage.

In the future, to mitigate the impact of an event like the recent winter storm, management reports that it will consider actions to reduce market and financial risks and is working with key power suppliers, including LCRA, to harden assets, where needed, against extreme weather events. It also may seek additional fixed-price power purchase agreements, invest in voltage control and load management tools, and seek opportunities to capitalize on the sale of ancillary services. Separately, we understand LCRA is considering several of its own remedial actions, including diversifying the location of gas purchase agreements, adjusting maintenance timing, adding kerosene heaters, and hedging gas prices further, depending on availability and pricing.

Environmental, social, and governance (ESG) factors

February's severe winter event has brought into sharper focus a spectrum of ESG-related risks that may inform our credit analyses and ratings over the longer term. In our view, the specter of climate change may weigh more heavily as a credit risk factor than previously for Texas utilities. In particular, we expect to consider the adequacy of management's counterbalancing measures to plan for, mitigate, or adapt to risks associated with extreme weather conditions that could disrupt power generation and transmission. Among these considerations are exposures under hedging arrangements, plans relating to power plant weatherization and redundancy, and capital and liquidity sufficiency. In our opinion, PEC and many other Texas utilities face greater environmental risk than do most peers nationally. While PEC is not a generating utility, LCRA, from which PEC derives at least 65% of its power supply, had a fuel mix in 2020 that was, on an energy basis, 44% coal, 51% natural gas, and 1% hydro. Thus, PEC could indirectly face higher environmental risk related to carbon emissions regulations. Also, given wide fluctuations in temperatures and rainfall in PEC's territory, the cooperative, as with many Texas-based peers, faces heightened risk related to climate change.

We believe PEC's exposure to social factors (including health and safety issues related to COVID-19) are in line with those of other rated utilities. In our view, the economic effects of the pandemic thus far have not affected PEC's financial position. Nevertheless, S&P Global Ratings believes that uncertainty remains elevated, albeit moderating, about the evolution of the coronavirus pandemic, including the delta variant, and its economic effects. Vaccine production continues and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic. As the situation evolves, we will update our assumptions and estimates.

In our view, governance risk is heightened given that the environment in which PEC operates increasingly requires stronger liquidity, proactive planning, hedging and financial flexibility, which could be costly, versus most utilities in other regions where these risks are lower.

Credit Opinion

PEC is the largest electric distribution cooperative in the U.S. and provides retail electricity services to more than 350,000 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, relocating headquarters and employees from other states or adding facilities to the region. In addition, the increasing ability to work remotely during the pandemic 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 3% of revenue and with the leading 10 customers representing just 9%. PEC serves about 15 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, which promotes 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 2019, PEC's weighted average system rate competitiveness (based on relative customer classes' revenue contributions) was 93% of the state average. We expect PEC's rates to remain competitive despite the pending 1% permanent and 7% two-year rate increase because management's financial forecast does not assume additional base-rate increases, and because many other utilities in the state are also raising rates. PEC's average residential bill declined to about $105 per month (1,000 kilowatt-hours) during the 2014-2016 period from about $128 in 2014, largely as a result of PEC's passing through power cost decreases related to lower prices for natural gas. Since 2017, monthly residential bills have remained virtually unchanged at about $126 per month, on average.

PEC's power supply is based largely on an agreement with LCRA that runs through 2041 and covers about 65% of PEC's requirements. PEC's cost of power is closely tied to LCRA's generation cost and benefits, with LCRA's power supply consisting primarily of coal, gas-fired, and a small amount of hydro generation. PEC meets an additional sizable portion 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. PEC meets the small remaining portion of load through various purchase power agreements consisting of wind, solar, and other unidentified resources ranging from two to 25 years, mostly at fixed prices. In a typical year, PEC meets 100% of load through these contracts. We understand that PEC is meeting environmental regulations. S&P Global Ratings expects the Biden Administration 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.

While senior management is relatively new to PEC, officials have significant industry experience and financial management has been sound over the past few years. Recent activity has focused on restructuring the balance sheet and defeasing debt. 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 1.3x since fiscal 2016, including an estimated 1.2x in fiscal 2020. In fiscal 2020, FCC fell slightly as a result of higher debt service and vegetation maintenance costs as well as reclassification of some capital costs into operations and maintenance. 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 it will likely maintain FCC ranging from 1.3x to 1.4x, higher than recent levels, largely as a result of reduced debt service requirements and continued strong growth. We believe management's forecast assumptions are reasonable by assuming customer base growth of 3% to 5% annually, no rate increases, and plans to cash-fund roughly two-thirds of the capital improvement plan over the next five years.

We consider PEC's liquidity position robust when its undrawn committed lines of credit are included. PEC had $11 million in unrestricted cash and investments and $430 million in available lines of credit as of Dec. 31, 2020, representing 320 days' operating cash. Liquidity as of Aug. 24, 2021, was $429 million. Management's financial forecast reflects maintenance of very strong available liquidity through fiscal 2025 at no less than $366 million. At the current rating, we view maintenance of liquidity as critical given the operating risks that PEC faces within the ERCOT market.

We consider PEC's debt burden very high for a distribution cooperative with a debt-to-capitalization ratio of 52% in fiscal 2020. Management expects to debt-finance roughly one-third of its identified capital needs totaling $705 million through 2025, with the majority of capital spending related to distribution system projects. Historically, PEC has used loans from the National Rural Utilities Cooperative Finance Corp. to fund system expansions and upgrades. It also priced $400 million in first mortgage bonds, issuing $310 million in February 2021 to defease various debt outstanding; PEC recently completed a delayed funding of its February 2021 bond offering that generated $90 million in cash that it used to pay down CP. PEC plans to issue CP from time to time for capital projects, largely related to systemwide growth. Once CP outstanding grows to a certain level, management intends to refinance it with long-term debt.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020