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 - 07 Jun 2024: Fitch Ratings has affirmed the following Pedernales Electric Cooperative (PEC), TX ratings:

--$36.8 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

Pedernales Electric Cooperative, Inc.'s (PEC) 'AA-' debt ratings reflect a very strong financial profile supported by robust demand, rate setting flexibility and very low operating costs. It benefits from a diversified power supply, largely provided through an economic all-requirements wholesale power agreement with the Lower Colorado River Authority (LCRA; AA-/Stable) and through renewable contracts. The 'AA-' rating also reflects a very low operating risk that considers the return of PEC's operating cost flexibility to neutral from weaker.

Fitch had designated the operating cost flexibility of utilities operating in ERCOT as weaker based on the widely recognized severity of market dislocation associated with storm Uri in February 2021. Fitch has revised its assessment of PEC's operating cost flexibility back to neutral. The Public Utility Commission of Texas (PUCT), ERCOT and market members have implemented measures to reduce systemic risks. Fitch does not expect capacity constraints during peak conditions (such as those that occurred during the summer of 2023) to result in the large scale catastrophic physical and financial outcomes experienced during and after Storm Uri.

PEC achieved very low three-year average leverage of 6.6x through 2023, measured as net adjusted debt to adjusted funds available for debt service. The cooperative enacted rate adjustments, cost reductions and expanded external liquidity to address stress resulting from severe market disruption associated with winter storm Uri in 2021, gas price spikes during 2022 and rising inflation throughout 2023. Furthermore, PEC replaced its temporary storm surcharge with a base energy rate adjustment in order to align rates with the inflationary costs now embedded in utility operations. Additionally, the board adopted an automated mechanism to assist in the annual alignment of rates with power costs.

PEC's 'F1+' short-term rating is based on the rating correspondence with its 'AA-' Issuer Default Rating (IDR) and supported by access to liquidity facilities totaling over $550 million.

SECURITY

Bonds are payable from PEC's net revenue and are secured by a lien on substantially all 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'

PEC serves a retail load in the Texas Hill Country across 8,100 square miles, an area nearly the size of New Jersey. The cooperative has realized a very strong 5.0% compound growth in accounts over the past five years through 2023. 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 82% of the 2022 state average. Residential electric costs in 2022 were very highly affordable at 1.7% of MHI. PEC expects its rates to remain competitive with enactment of the base power cost increase replacing the expiring temporary storm surcharge. PEC estimates the net impact will increase the average 1,250kWh/month residential bill by 6%.

Operating Risk - 'aa'

Very Low Operating Costs; Return to Neutral Operating Cost Flexibility

Transition to 'aa' operating risk captures the consistency of PEC's very low ('aa') operating cost burden and return of the cooperative's operating cost flexibility to 'aa' from 'a'. Fitch had 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 counterparty risks.

The operating cost flexibility revision to neutral is based on PUCT and ERCOT measures that limit future operational and financial risk to utilities. These have included additional winterization requirements, a robust inspection program, increased attention on the timing of scheduled plant outages, large-load demand response incentives, protocols to strengthen grid operations and reserve availability, improved communication regarding conservation during tight conditions, and a reduction in the market price cap (from $9,000/MWh to $5,000/MWh) as well as a limitation on the duration of the high system wide cap. ERCOT and third party analyses identify many of these measures as instrumental in moderating risks during ERCOT peak demand days in August 2023.

Additionally, the Texas Legislature passed multiple bills during its 2023 legislative session aimed at improving ERCOT system reliability and resiliency, most notably, authorizing the use of $10 billion in state surplus through the PUCT administered Texas Energy Fund to support a loan program for dispatchable generation projects. ERCOT also continues to work with stakeholders to develop additional tools in support of reliability and market efficiency. While ERCOT may still face tight supply or even outages during short-term extreme weather periods, the risk of market dislocation and financial impacts of the magnitude experienced in 2021 appear to be materially reduced.

PEC's 'aa' operating cost burden reflects its very low operating costs, which averaged 8.5 cents/kWh in 2018 through 2020, and a higher 10.5 cents/kWh during the three years ending 2023. Operating costs represent 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 recognition of $150 million in Storm Uri costs.

The cooperative's costs of 9.8 cents/kWh and 10.3 cents/kWh in 2022 and 2023 respectively are very low within Fitch's framework but remain elevated in relation to PEC's historical trends, as a result of significantly higher gas prices throughout most of 2022 and inflationary trends. Operating costs further reflect the benefit of resource diversity, including renewable energy that represented 9.3% of 2023 sales.

Capital Planning and Management

PEC projects manageable five-year capital spending of $1 billion. 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, that became fully effective in 2024.

Financial Profile - 'aa'

Financial Profile Stable Through the Cycle

PEC completed 2023 with leverage ratio of 6.6x, consistent with its five-year average leverage. Liquidity is weak at fiscal year-end 2023 based on the cooperative's cash on hand of only five days, but supplemented by external liquidity facilities that provided a liquidity cushion of 281 days at year end 2023, up 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 stress or rating case scenario indicates leverage peaking at 7.2x before moderating to 6.8x within five years, reflecting moderate rate adjustments that PEC would likely enact to mitigate reduced sales introduced in the stress scenario to maintain its very strong financial profile.

PEC's debt profile is neutral to the rating and consists primarily of $1.0 billion 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 two syndicated revolving credit lines led by Bank of America, which would provide for available borrowing capacity sufficient to pay the principal of the commercial paper in the event necessitated by market conditions.

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 over 8.0x in Fitch's rating case;

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

-- 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.

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

-- Sustained net leverage below 5.0x in Fitch's rating case scenario;

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

PROFILE

PEC provides electric distribution service to approximately 400,000 meters at FYE 2023 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 to operating 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.

ERCOT Market Interdependency and Winter Storm Uri

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 as widely recognized throughout ERCOT during Storm Uri.

PEC incurred net storm costs of $160 million. 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.

New EPA Power Plant Standards

PEC owns no fossil generation, but is exposed to the potential for higher costs associated with enactment of the New EPA Power Plant Standards as a large wholesale customer of the LCRA.

In 2024, the Environmental Protection Agency released final standards regarding the regulation of carbon emissions for existing coal and gas-fired power plants. The regulations require the closure or significant modification of existing coal-fired power plants by 2032. LCRA management currently has no plans to decommission its coal-fired baseload plant, the Fayette Power Project, which will continue to operate while they remain economic. New ancillary service requirements introduced in ERCOT in 2023 provide additional revenue opportunities to a plant like Fayette with dependable, dispatchable capacity, particularly during peak usage time periods.

The EPA carbon standards are facing legal challenges that could delay, alter or prevent their implementation. LCRA management will assess available options and work with state and regional authorities. Should the EPA standards withstand the legal challenges, the potential mandate to close or repower the Fayette units, and or the capacity owned and purchased from Sandy Creek, could dictate higher costs to LCRA and its wholesale customers over the next decade.

Sources of Information

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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Public Power Rating Criteria (pub. 08 Mar 2024) (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

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