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Ratings

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Summary:

Pedernales Electric Cooperative, Texas; CP

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Credit Profile		
Pedernales Electric Cooperative Inc priv placement of commercial paper nts due 12/31/2099		
Short Term Rating	A-1	Affirmed

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, 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 from Bank of America, consisting of a $200 million revolving credit facility expiring Dec. 1, 2026, and a $105 million revolving credit facility expiring Nov. 29, 2024.

Based on the provisions in the resolution on short-term debt limits, CP issuances or direct borrowings under revolving lines of credit facilities reduce the amount available under the lines (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 entail a corresponding amount of liquidity available on the revolving facilities such that PEC is able to repay CP in the event that PEC lacks 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 $85 million outstanding in CP as of Dec. 31, 2023, the available amount was $420 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 $1.1 billion as of Dec. 31, 2023.

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:

- Diverse and primarily residential customer base that contributes 73% of retail revenue, providing significant revenue stability and predictability;
- Robust liquidity position consisting primarily of lines of credit, net of draws, totaling $430 million inclusive of $9 million in unrestricted cash, equivalent to a combined 226 days as of Dec. 31, 2023, which is critical to managing operating risks within the Electric Reliability Council of Texas (ERCOT) market;
- Healthy fixed-charge coverage (FCC) that we believe will remain at 1.35x to 1.45x over the next five years, supported by the expectation of continued strong annual load growth averaging 3%;
- Favorable and mostly firm power supply contracts, including the diversity of power supply resources that the contract with the Lower Colorado River Authority (LCRA; A/Stable') provides; and
- Competitive retail rates that we believe provide financial flexibility and are affordable given above-average income levels in the service territory; and
- Strong and proactive management team with good rate-setting practices that have provided ample cost recovery in recent years.

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, periodic strained resource adequacy, 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 56% debt to capitalization as of fiscal 2023
- Significant capital needs associated with a rapidly growing customer base and demand, totaling $1 billion over the next five years, approximately 60% of which management plans to finance with additional debt.

PEC has managed market exposure and performed well operationally and financially since the North American winter storm (informally known as Uri) of February 2021, which cost it an unbudgeted $160 million when PEC had to procure high-priced replacement power on the ERCOT market. PEC recovered the costs with a two-year storm surcharge and other adjustments. Since Uri, the region has experienced record summer heat in 2022 and 2023 and three severe cold snaps during the winters of 2022-23 and 2023-24, including a significant ice storm during Jan. 31 to Feb. 2, 2023. During these subsequent weather events, the assets underlying PEC's power supply were resilient and PEC was not exposed to sustained high market prices. We attribute this to PEC's power supply diversity, improved weatherization of assets and fuel by power providers, mostly firm power supply contracts (including LCRA's generation portfolio), overall strong resource position, minimal exposure to intermittent renewable energy resources, conservative forecasting, and proactive power supply planning. We also note PEC has strong load management programs in place to reduce demand during peak events.

However, we believe PEC may continue to deal with 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 (which provides at least 65% of PEC's energy supply), as with many other Texas utilities, could continue to face challenges associated with the ERCOT market's relative price volatility, periodic strained resource adequacy, extreme temperature and demand fluctuations, and weaker grid interconnectivity than that of grids in other states. The rating could come under pressure if 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.

Our A/Stable long-term rating on LCRA reflects 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 based on its risk management practices. LCRA is expanding its peaking generating capacity through the addition of two 190-megawatt (MW) gas-fired peaking generation facilities, expected to launch in 2025 and 2026. LCRA's total capacity of 3,515 MW provides adequate cushion against extreme demand scenarios. Historical summer peaks for LCRA's wholesale customers have approximated 3,000 MW, though the authority's 2023 summer peak demand (including customers who provide their own power) reached 3,574 MW.

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 temperatures in Texas against the backdrop of ERCOT's aforementioned limitations. In addition to Uri in February 2021, the region has since seen record heat and significant cold snaps. 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 2023 that was, on an energy basis, 48% coal, 51% natural gas, and less than 1% hydro. Thus, PEC could indirectly face higher energy transition risks related to carbon emissions regulations. Such measures could directly and indirectly affect public power and electric cooperative utilities' operations, costs of doing business, retail rates, financial flexibility, and credit quality.

We believe PEC's exposure to social factors is largely credit neutral given competitive and affordable rates, and management reports that accounts receivable and delinquencies have not been materially higher as a result of the inflationary environment. PEC's affluent service area, in part, has supported strong collections. Nonetheless, we are monitoring the strength and stability of electric utilities' revenue streams for evidence of delinquent payments or other revenue erosion. Inflation as measured by the Consumer Price Index has exceeded 3% in recent months, and S&P Global Economics forecasts elevated interest rates at least until December. (See "Persistent Above-Target Inflation Will Delay The Start Of Rate Cuts In The U.S.," published May 1, 2024, on RatingsDirect.) In addition, Bureau of Labor Statistics data shows that electricity price inflation continues to outpace the overall Consumer Price Index. The amalgam of material increases in delinquent consumer, credit card, and auto loans, along with the resumption of student loan payments and drawdowns of household savings garnered during the pandemic, will likely compound the financial pressures facing electricity consumers.

In our view, governance is a moderate credit risk given that the environment in which PEC operates requires strong liquidity, proactive planning, hedging, and financial flexibility, which come at a cost. Notwithstanding these issues, we believe management's policies, proactive planning, liquidity, and sophistication are credit supportive. We also believe cyber and physical security practices are sound.

Credit Opinion

PEC is the largest electric distribution cooperative in the U.S. and provides retail electricity services to more than 400,000 mostly residential customers across Central Texas in the Hill Country region. PEC's service territory includes 45 cities across 24 counties, including western portions of the greater Austin metropolitan statistical area and the northern portion of the greater San Antonio metropolitan statistical area. Austin and San Antonio, as well as many cities in between, have experienced extremely strong growth over the past few years that is expected to continue. Management's projections indicate annual new meter growth of about 18,000, or about 4%, and 3% annual load growth. PEC is not seeing a proliferation of data centers in its service territory given prohibitive real estate costs within its service territory compared with other areas of Texas.

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 also provide for significant economies of scale, although a higher customer count increases exposure during stress events, such as in the case of higher power costs during the 2021 winter storm. The customer base is very diverse, with no customer representing more than 0.6% of revenue and with the leading 10 customers representing just 3.6%. PEC serves about 16 customers per line-mile, which is above average for a cooperative utility and which allows it to spread fixed costs over a greater number of customers, promoting lower retail rates.

We believe PEC's competitive and affordable rates provide it with revenue-raising flexibility. Generally, PEC has been able to maintain low rates by scaling its business and controlling costs. Management has historically used a power cost adjustment mechanism to help insulate 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 2022, PEC's weighted average system rate competitiveness (based on relative customer classes' revenue contributions) was 94% of the state average. We expect PEC's rates to remain competitive despite the 6.2% net rate increase effective Oct. 1, 2023 (stemming from elimination of the two-year storm surcharge and an increase in the base power charge), because many peer utilities in ERCOT are also raising rates; no other immediate rate increases are planned. The rate increase will address higher power costs PEC paid in 2023, which were common in ERCOT; management reports increased ancillary service and congestion costs.

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 its 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 series of block-and-shape supply contracts, whereby capacity varies hour to hour over the term, 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 more 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. PEC meets 100% of load through these contracts in a typical year and doesn't intend on participating in the ERCOT real-time market. PEC has no plans to add batteries or renewables.

Senior leadership at PEC has significant direct PEC and industry experience, and financial management has been sound over the past few years even in light of the challenges of the pandemic, significant storms and heat waves, and a high interest rate and inflationary environment. We believe PEC's rate-setting practices and management's annual updates to its five-year financial forecast and capital plan are credit supportive. Management targets debt service coverage of no less than 1.7x, which we consider sound, but actual debt service coverage has exceeded 2.0x in recent years.

In our view, FCC has been in a relatively tight range of about 1.2x to 1.5x since fiscal 2016, including 1.5x in fiscal 2022 and 1.4x in fiscal 2023, improving from 1.3x in prior years largely as a result of strong revenue growth and relatively lower debt service. 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, largely as a result of continued strong growth and not including base rate increases. We believe management's other forecast assumptions are reasonable, including customer base growth of 4% annually (only slightly below recent trends), 3% average annual load growth, and inflation of 3% to 4% per year.

We consider PEC's liquidity position robust. All-in liquidity consists primarily of lines of credit, net of draws, totaling $430 million inclusive of $9 million in unrestricted cash, equivalent to a combined 226 days as of Dec. 31, 2023. Management's financial forecast reflects maintenance of very strong available liquidity through fiscal 2028 at no less than $385 million. We view such liquidity as critical given the operating risks that PEC faces within the ERCOT market. We understand PEC is considering raising CP capacity to $300 million to increase flexibility, better manage capital costs, and allow for more time between long-term debt issuances.

While we consider PEC's debt to capitalization very high for a distribution cooperative utility without owned generation, at 56% as of fiscal 2023, we also view it as manageable. Management expects to debt-finance roughly 60% of its identified capital needs totaling $1 billion through 2028, with the majority of capital spending related to distribution system projects. Debt to capitalization is forecast to hold through 2028. 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 plans to issue CP from time to time for capital projects largely related to systemwide growth.

Pedernales Electric Cooperative key credit metrics

	--Fiscal year ended Dec. 31--		
	2023	**2022**	**2021**
Operational metrics			
Electric customer accounts	403,712	385,868	367,289
% of electric retail revenue from residential customers	73	74	60
Top 10 electric customers' revenues as % of total electric operating revenue	4	3	4
Service area median household effective buying income as % of U.S.	N.A.	100	98

Pedernales Electric Cooperative key credit metrics (cont.)			
	--Fiscal year ended Dec. 31--		
	2023	**2022**	**2021**
Weighted average retail electric rate as % of state	N.A.	94	95
Financial metrics			
Gross revenues ($000s)	878,878	836,372	827,714
Total operating expenses less depreciation and amortization ($000s)	694,203	643,670	676,817
Debt service ($000s)	67,767	68,594	61,785
Debt service coverage (x)	2.7	2.8	2.4
Fixed-charge coverage (x)	1.4	1.5	1.3
Total available liquidity ($000s)*	429,583	381,362	412,042
Days' liquidity	226	216	222
Total on-balance-sheet debt ($000s)	1,126,109	1,035,155	1,030,160
Debt to capitalization (%)	56	55	57

*Total available liquidity includes available committed credit line balances, where applicable. Debt service coverage--Revenues 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). N.A.--Not available.

Related Research

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.