FitchRatings

Fitch Affirms Delaware Muni Electric Corp's Electric Revs at 'A'; Outlook Stable

Fitch Ratings-New York-14 September 2016: Fitch Ratings affirms the 'A' rating on the following Delaware Municipal Electric Corporation's (DEMEC) bonds:

--$52 million electric utility revenue bonds, series 2011.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a first lien on net revenues, which are principally derived from power sales contracts (PSC) between DEMEC and the electric enterprise funds of seven project participants related to the Beasley Power Station. Other net revenues include administrative charges derived from full requirements contracts with the same seven participants, but annual amounts are nominal.

KEY RATING DRIVERS

SMALL JOINT ACTION AGENCY: DEMEC is a project-based joint-action agency providing power to seven electric distribution systems located in Delaware. The agency's lone generating asset is the Beasley Power Station, consisting of two natural gas-fired simple-cycle combustion turbine generation units (Units 1 and 2), each with 45 MW of capacity.

TAKE-OR-PAY OBLIGATION: Bondholders are secured by PSCs requiring the seven project participants to satisfy project payment obligations as an operating expense of their city electric systems. The PSCs remain in effect as long as the bonds are outstanding.

STABLE CREDIT FUNDAMENTALS OF PARTICIPANTS: The credit quality of the seven participants underpins the project rating. Fitch expects participants' generally sound financial and debt metrics and service territory characteristics to continue.

DIRECT BONDHOLDER EXPOSURE: A 25% step-up provision included in the PSCs provides additional bondholder protection from a default of one or more participants with the exception of Newark, DE, whose 42.1% entitlement share in the project would not be sufficiently covered by the other participants. However, Fitch believes the solid credit characteristics exhibited by Newark's electric utility adequately mitigate the direct exposure.

LARGE GENERAL FUND TRANSFERS: The participants are required under the PSCs to pay project debt service as an operating expense paid prior to making general fund transfers to their respective host cities and satisfying any direct debt obligations. The first claim on participant revenues somewhat offsets concerns over the sizeable transfers made by each of the utilities, which prevent the accumulation of stronger levels of liquidity and net assets at the participant level.

RATING SENSITIVITIES

CHANGE IN PARTICIPANT CREDIT QUALITY: Meaningful changes in the credit fundamentals of the

Delaware Municipal Electric Corporation Beasley Project participants would likely trigger a rating review to consider a corresponding rating action.

CREDIT PROFILE

DEMEC is a joint action agency serving nine municipal electric utilities located in the state of Delaware. Members include Newark (GO bonds rated 'AA+'/Stable Outlook), New Castle, Middletown, Dover (electric revenue bonds rated 'AA-', Stable Outlook), Smyrna, Seaford, Lewes, Clayton and Milford. The member utilities provide electric distribution service to nine of the 10 largest cities in the state and on a combined basis serve nearly 67,000 customer accounts and a total population of about 126,000.

The seven participants in the Beasley Project are required to pay their proportional share of the project costs from electric system revenues pursuant to power sales contracts. The contractual obligation of each participant is take-or-pay, requiring the payment of all costs (including debt service) whether or not the project is operating or operable. The power sales contract also contains a step-up provision requiring each participant to purchase up to 125% of its original purchase obligation if another participant were to default on its obligation.

SOLID PROJECT MEMBERS

The credit quality of the Beasley Project's participants continues to sufficiently support the project rating. Each participant generally exhibits healthy cash flow, minimal to no debt and in some instances, cash reserves consistent with the project rating. Weaker liquidity with remaining participants is a result of sizeable general fund transfers typically used in Delaware to keep property tax rates low.

Newark's utility system routinely generates strong operating margins in excess of 20%, providing positive cash flow after covering its full obligations, including purchase power costs and a sizeable 20% transfer to the city's general fund after satisfying operating expenses and debt service obligations. The system's 62 days of cash on hand is low, but is nonetheless acceptable given the utility's limited role as a distribution only system and its ability to automatically recover the vast majority of its operating expenses from a power cost adjustment that can be made on a monthly basis if needed.

Newark's continued practice of making sizeable transfers to its general fund from its electric utility remains a concern. The transfer amount has remained at or close to $10 million over the prior five fiscal years, equal to almost 20% of the utility's annual gross income. By comparison, the median transfer percentage for similarly rated utilities is 4%.

Financial metrics of the remaining participants are also sound. Milford, the second largest member, ended fiscal 2015 with strong debt service of 5.24x and nearly 160 days of unrestricted cash on hand. Middletown's practice of transferring all of its excess operating cash flow to the city's general fund is of some concern, but operating margins have averaged a strong 24% over the prior three years and the system has no long-term debt obligations. Fitch notes that only four of the seven participants have long-term debt obligations, with total obligations being nominal.

LIMITED BUT STABLE SERVICE TERRITORY

Economic and demographic indicators vary somewhat for each member city, but metrics in general appear stable. Newark's economy is anchored by a significantly sized healthcare and education sector. Christiana Care Health System, one of the largest private employers in Delaware, and the University of Delaware (UD), enrolling approximately 21,000 students at the Newark campus, are key employers.

Newark's June 2016 unemployment rate of 5.3% remains nominally higher than state and national rates, but has trended downward in recent years. The city's employment prospects should benefit going forward by the UD's recent purchase and continued development of a former Chrysler assembly plant that was shuttered in 2008 amid the economic recession. UD is in the midst of developing the 272-acre site into a science, technology and advanced research campus in connection with several notable firms, including Thomas Jefferson University, Dow Chemical and E.I. Dupont de Nemours and Company.

Wealth measures for Newark rank somewhat lower than state and national indicators, likely reflecting the city's large student population. Nevertheless, Newark's electric utility continues to record low customer receivables and minimal write-offs. Both Milford and Middletown exhibit stronger wealth and employment indicators. Both cities have grown considerably since 2000; Milford, which lies immediately outside of Dover, the state capital, increased in population by 42% while Middletown nearly tripled in size. The proximity to Wilmington and to a lesser extent, Philadelphia, provides Middletown with good access to sizeable employment centers.

STRONG PROJECT FINANCIAL PERFORMANCE

Beasley Project debt service coverage is required to equal no less than 1.1x, per the bond indenture. However, increased energy sales and significantly higher capacity market revenues have provided for considerably stronger debt service coverage ratios averaging about 3.45x over the prior five years. With level debt service going forward, Fitch expects coverage of project debt service will remain at a healthy level.

SATISFACTORY FINANCIAL PROFILE AT THE AGENCY LEVEL

The agency's financial profile on a consolidated basis remains sound, despite a recent trend of incurring operating losses that led to debt service coverage of well below 1.0x as a consequence of implementing a rate stabilization plan (RSP). DEMEC, beginning in January 2012, elected to forego wholesale rate increases as part of the RSP and instead offset a short-term increase in capacity costs scheduled to last through May 2014 with a $33 million fixed rate, low interest borrowing from AMP's line of credit.

The over collection of revenue from members since then, beginning in July 2014 when capacity costs declined considerably and wholesale rates were held relatively constant, yielded positive operating results beginning in fiscal 2014 and provided for surplus revenue needed to repay the loan from AMP by 2017. Fitch views the RSP as credit neutral given the relatively short tenor of the loan.

DEMEC continues to target a modest 30 days of unrestricted cash on hand and instead provide project participants with annual rebates from surplus revenues. The dividend paid to members in fiscal 2015 totaled $7.7 million. A $10 million working capital line of credit, a $20 million liquidity facility for collateral posting requirements and DEMEC's ability to access members' liquidity on three days notice through interim billing all provide sufficient cushion. The series 2011 bonds have a cash funded debt service reserve fund equal to maximum annual debt service.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014) (https://www.fitchratings.com/site/re/750012)
U.S. Public Power Rating Criteria (pub. 18 May 2015) (https://www.fitchratings.com/site/re/864007)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1011704)
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