FITCH UPGRADES DELAWARE MUNI ELECTRIC CORP'S ELECTRIC REVS TO 'A'; OUTLOOK TO STABLE

Fitch Ratings-New York-16 September 2014: Fitch Ratings has upgraded the following Delaware Municipal Electric Corporation's (DEMEC, or the agency) rating:

--$55.5 million electric utility revenue bonds, series 2011 to 'A' from 'A-'.

The Rating Outlook is revised to Stable from Positive.

SECURITY
The bonds are secured by a first lien on net revenues, which are principally derived from power sales contracts (PSC) between DEMEC and its seven 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

DELAWARE JOINT ACTION AGENCY: DEMEC is a project-based joint-action agency providing power to seven electric distribution systems located in Delaware pursuant to take-or-pay power sales contracts that remain in effect as long as the bonds are the series 2011 bonds remain outstanding. .

CREDIT FUNDAMENTALS OF PARTICIPANTS: The rating upgrade reflects the project's strong performance, as well as the demonstrated stability and expected continuation of the participants' generally sound financial and operational characteristics. Power sales contracts (PSC), the credit quality of the seven participants in DEMEC's Beasley Power Station project (the project), and each participant's self-regulation of rates continue to underpin the project rating.

LARGEST PARTICIPANT 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 (GO bonds rated 'AA+'/Outlook Stable), whose 42.1% entitlement share of project output 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:
Members have historically paid sizable general fund transfers to their host cities, but payment levels have moderated and been managed well. . Although the sizable transfers have prevented the accumulation of more acceptable levels of liquidity and net assets, the project's first claim on participant revenues somewhat offsets some concern.

VALUABLE GENERATING ASSET: The project's single 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. The units operate during the highest demand hours, have maintained a historical availability in excess of 95%, and provide an important hedge against peak power prices and PJM's volatile capacity market. The increasing value of the units continues to drive solid growth in capacity payments to DEMEC, ultimately limiting rates charged for the project to the participants.

RATING SENSITIVITIES

CHANGE IN OFF-ATAKER CREDIT QUALITY: Changes in the credit fundamentals of the project participants, particularly those driven by changes in general fund transfer practices, would trigger a rating review.

CREDIT PROFILE

DEMEC is a joint action agency serving nine municipal electric utilities located in the state of Delaware. Members include Newark, 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 60,000 customer accounts and a total population of about 114,000.

The seven participants in the Beasley Project are required to pay their proportional share of the project costs 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.

CONTINUED STABILITY IN CREDITWORTHINESS OF PROJECT MEMBERS

The participants in general exhibit healthy cash flow, minimal leverage and satisfactory cash balances that offset sizeable general fund transfers and sufficiently support the project rating. The demonstrated stability of the participant's overall creditworthiness is reflected in the Rating rating Upgrade upgrade to 'A'.

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 large transfer to the city's general fund. The system's 45 days of cash on hand is somewhat 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.

Financial metrics of the remaining participants are also sound. Milford, the second largest member, ended fiscal 2013 with strong debt service of 2.3x and nearly 165 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 a credit concern, but operating margins have averaged a strong 23% 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, and the total obligations are nominal.

SOLID SERVICE TERRITORY

Economic and demographic indicators vary for each member city, but metrics in general appear stable. Newark, DEMEC's largest participant, benefits economically from the presence of the Christiana Care Health System and the University of Delaware (UD), which enrolls almost 22,000 students. The two employers have a combined workforce of almost 15,000.

Newark's July 2014 unemployment rate of 6.3% remains in line with state and national averages and 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 indicators 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, located a short distance south 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 bases.

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 2.9x 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 incurring operating losses and related debt service coverage of well below 1.0x over the prior two years 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 finance a short-term increase in capacity costs scheduled to last through May 2014 with a $33 million fixed rate, low interest borrowing. While Fitch calculated debt service coverage (that does not include funds provided by the financing) was below 1.0x in fiscals 2013 and 2012, there were a portion of the operating costs that were paid from this financing.

Sufficient revenues will be collected from members beginning in July 2014 when capacity costs declined considerably. Positive operating results are expected in fiscal 2015 and should provide surplus revenue needed to repay the short-term loan. Fitch views the RSP as credit neutral given the relatively short tenor of the loan and its intended use to prevent a temporary three year rate increase. The loan will be repaid by 2017.

DEMEC continues to target a modest 30 days of unrestricted cash on hand and instead provide project participants with annual rebates from surplus revenues. A $3 million working capital line of credit, a $35 million liquidity facility for collateral posting requirements and DEMEC's ability to access members' liquidity on three days noticedays' notice through interim billing all provide sufficient cushion.

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Applicable Criteria and Related Research:
--'U.S. Public Power Peer Study -- June 2014' (June 13, 2014);
--'U.S. Public Power Peer Study Addendum - June 2014' (June 13, 2014);
--'U.S. Public Power Rating Criteria' (March 18, 2014).

Applicable Criteria and Related Research:
U.S. Public Power Peer Study -- June 2014
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749789
U.S. Public Power Peer Study Addendum - June 2014
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750283
U.S. Public Power Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=740841