MOODY'S INVESTORS SERVICE

Rating Update: Moody's affirms A2 on Delaware Municipal Electric Corporation's Beasley project revenue bonds; outlook stable

Global Credit Research - 29 Oct 2015

Rating action affects $50 million Beasley Peaking Power Station Project Revenue Bonds

DELAWARE MUNICIPAL ELECTRIC CORPORATION
Joint Power/Action Agency (JPA)
DE

NEW YORK, October 29, 2015 --Moody's Investors Service has affirmed the A2 rating on Delaware Municipal Electric Corporation's (DEMEC) outstanding Beasley Peaking Power Station (Beasley) project revenue bonds. The outlook is stable.

SUMMARY RATING RATIONALE

The A2 rating reflects the A2 weighted average participant credit quality of the seven municipal electric systems whose 2001 and 2011 take-or-pay contracts with DEMEC secure the outstanding Beasley project bonds, solid historical operating and financial performance, especially with respect to the maintenance of strong debt service coverage ratios, in addition to DEMEC's, Beasley's JAA owner, strategy to meet peak demand growth while minimizing negative impacts of regional capacity market volatility. The rating also considers the importance of Beasley to DEMEC's power supply strategy and the pronounced integration of Beasley within DEMEC's operations, especially with respect to accessing DEMEC's liquidity. Lastly, the rating considers DEMEC's relatively low liquidity position when compared to A2 peers, which is balanced by access to DEMEC's full requirement members' liquidity on three-days'notice.

OUTLOOK

The stable outlook is based on Moody's expectation that Beasley will continue to be an essential component of DEMEC's power supply strategy, especially in light of current and forecasted capacity constraints in the Delmarva and PJM regions. The outlook also incorporates our anticipation for continued healthy financial performance of both DEMEC and Beasley, in addition to their collective municipal utility participants.

WHAT COULD MAKE THE RATING GO UP

- Improved weighted average credit quality of Beasley participants

- Given that all cash is restricted at the Beasley level, sustained increase in DEMEC liquidity to over 60 days cash on hand

- Continued ability for Beasley to provide reliable and competitively priced peak energy to its seven members

- Sustained increase in Beasley's PJM capacity payments that improve annual debt service coverage to north of 3.0-4.0x on a consistent basis

WHAT COULD MAKE THE RATING GO DOWN

- Deterioration in Beasley participants' weighted average credit quality

- Inability of Beasley to provide members with reliable and competitively priced peak energy, putting pressure on members to seek alternate peak power supplies

- Inability of DEMEC to access members' cash on short notice, or DEMEC liquidity below 30 days cash on hand

- Material and extended operational problems with either or both of the Beasley peaking units

STRENGTHS

- Beasley's take-or-pay power supply contracts, which have matching bond maturities with seven DEMEC full requirements participants that have a weighted average credit quality of A2, obligating members to pay rates sufficient to cover debt service and operating contingencies

- Importance of Beasley to DEMEC's power supply strategy and the pronounced integration of Beasley within DEMEC's operations, especially with respect to accessing DEMEC's liquidity

- Overall Beasley debt service requirements do not represent a significant share of members' overall power purchase expenditures and are considered O&M expenses (3-4% of members total annual O&M)

- Members are unregulated on the federal and state level and have the ability to pass through monthly fuel cost increases to customers

- In addition to providing members with a physical hedge against high peak power prices, Beasley provides DEMEC with PJM capacity payments

- DEMEC has access to members' liquidity on three-days' notice and demonstrated its willingness and ability to use this access in 2009

- DEMEC has successfully transitioned from relying almost exclusively on purchased power in 2008 to currently self-supplying roughly 40% of load via a diverse portfolio of wind, solar and gas assets that are fully integrated into the PJM market and are geographically dispersed throughout the PJM region

- Lack of coal in DEMEC's resource mix mitigates regulatory uncertainty in a region that is expected to face reliability issues due to base load coal unit retirements

CHALLENGES

- DEMEC's relatively low liquidity position when compared to A2 peers in addition to zero unrestricted liquidity at the Beasley level, somewhat mitigated by access to members' liquidity on three-days' notice, poses risks in event of increased collateral posting requirements or other material liquidity event

- Additional DEMEC liquidity of $30M provided by lines of credit, however access is subject to bank determined material adverse change clause

- Albeit decreasing, DEMEC's roughly 50-60% reliance on purchased power creates potential for challenges to financial stability

- 25% step-up agreement remains insufficient to cover a total default by the City of Newark (Aa2 NOO), which contracts for 42.1% (on a blended share) of Beasley output, however Moody's believes this is highly unlikely due to Newark's strong credit profile

RECENT DEVELOPMENTS

Recent Developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

REVENUE GENERATING BASE

Delaware Municipal Electric Corporation, Inc. (DEMEC), a full-requirement Joint Action Agency (JAA), provides wholesale power and other services to nine municipally owned Delaware utilities. Seven of DEMEC's nine members, including the cities of Newark, New Castle, Milford, Seaford, and the towns of Clayton, Middletown, and Smyrna participate, via take-or-pay contracts, in DEMEC's two Beasley Peaking Power Station (Beasley) generating assets, Beasley CT Units I & II, located in Smyrna, DE. The take-or-pay contracts between DEMEC and the seven members secure DEMEC's Beasley Project Series 2011 Bonds. These take-or-pay participants have a weighted average participant credit quality of A2 and the contracts are authorized under Delaware statutes.

Payments on the outstanding Beasley revenue bonds represent a minor portion of members' budgets. The debt service payments tied to the take-or-pay contracts represent, on average, approximately 3-4% of the members' overall power purchase expenditures. The level debt service payments add stability to members' budgets, in contrast to the region's volatile energy market, though DEMEC has mitigated market volatility in recent years through increased participation in gas, wind and solar PPAs. The associated operating expense stability and minor percentage of members' financial resources affected show the members' ability to meet contract requirements in the event that either of the Beasley CT Units I or II would become inoperable for a period of time.

At the DEMEC full requirements level, which Beasley is materially integrated within, eight of the nine DEMEC members receive 100% of their power requirements from DEMEC and one member, Dover, receives partial requirements service. DEMEC supplies these requirements from a portfolio of owned generation assets, bilateral contracts with third-party suppliers and through participation in the PJM Interconnection, LLC (PJM, Aa3 Stable) regional markets. The seven DEMEC members who participate in Beasley, via take-or-pay contracts, also continue to be full requirements members of DEMEC. DEMEC's members have exclusive control over their service territories and establish their own rates and charges. The 1999 legislation that authorized retail competition in Delaware exempted municipal electric utilities from competition. Based on the most recent EIA data, average retail rates for Beasley members are comparable to the rates of the regional investor owned utility, Delmarva Power & Light (DPL, Baa1 Stable).

The nine DEMEC member utilities combined serve about 64,000 end-use meters and a population of about 126,000, with a combined peak demand of 441 MW in 2014. The DEMEC member distribution systems vary in size and character. The largest is Dover, with 23,100 meters, while the smallest, Clayton, has 1,300 meters. The members are primarily distribution utilities, but Dover owns 150MW of generation asset capacity.

Strong participant customers such as the University of Delaware (Aa1 Stable) in Newark, a customer for more than 50 years, represents a significant share of total energy sales, at roughly 11% of DEMEC's total 2014 energy sales. Given the lack of open choice to retail customers in DEMEC's service territory, unless elected city councils decide otherwise, such predominant reliance in one single customer is deemed acceptable when predicated on DEMEC's ability to continue to provide competitive prices to members. This notion is supported by DEMEC participants' similar cost of power compared with DPL, according to the most recent EIA data.

DEMEC's participants' ten largest customers accounted for close to 25% of total sales in FY14. Industrial customers accounted for 49.4% of the revenues, with residential and commercial accounting for 33.9% and 16.8% respectively. The composition of DEMEC's revenue share has changed somewhat with the installation of a few new energy intensive clients in the region, such as the Amazon Distribution Center in Middletown, which increased peak load by 7MW in FY14. The participants served by Beasley, the majority of whom are located in the northern part of Delaware in New Castle (Aaa Stable) and Kent (Aa1 NOO) counties, have experienced unemployment rates that are on par with the state average of 4.9%, as of July 2015.

FINANCIAL OPERATIONS AND POSITION

Beasley provides a physical hedge to high PJM locational marginal, or nodal, pricing during certain hours of the day. Additionally, as a capacity resource, it collects capacity revenues which can be used to offset the load capacity obligations of the members. Beasley also operates as a black start, reactive supply, voltage control and spinning reserve resource to PJM, which earns additional revenues from PJM. While transmission constraints have recently been reduced on the Delmarva Peninsula, significant transmission constraints still exist in PJM's Eastern Mid-Atlantic area of Maryland, DC, Southeastern Pennsylvania, Delaware and New Jersey.

These constraints continue to cause significant congestion costs to DEMEC's load and are somewhat mitigated by Beasley, which has had historical availability in excess of 95% and typically operates 5% to 10% of the hours of the year, during the highest demand hours. That said, Beasley's FY14 all-in cost of power was $117.57/MWh, while the maximum FY14 PJM's Delaware LMP cost of power was $1,865.96/MWh. The amount of FY14 hours that PJM's Delaware LMP cost of power was higher than Beasley's all-in cost of power was 621 hours, which illustrates Beasley's significant importance to DEMEC from a power cost stability perspective.

With respect to DEMEC's strategy to mitigate energy market exposure risk, DEMEC has transitioned from serving 5% of its load obligation with self-supply assets in FY08 to self-supplying roughly 41% of its full requirements load obligation in FY14. This shift to increasing self-supply resources has reduced DEMEC's market exposure risks and also contributed to the decrease in DEMEC's cost of delivered wholesale full requirements service to members by 20% over the past four years.

DEMEC owns a 100% share, via take and pay contract that does not obligate DEMEC to the project's debt, of the energy from the 69MW Laurel Hill Wind Farm, which is operated and developed by Duke Energy Renewables and located in north-central Pennsylvania. Through a similar take and pay contract, DEMEC owns a 100% share of the energy from Milford Solar Park, a 13MW solar facility in Milford, DE, operated by Juwi Solar. DEMEC is also the largest of 89 take-or-pay participants in AMP's Fremont Energy Center (A1 Stable), taking 92.25 MW, or roughly 13.5%, of capacity and energy from the facility for the next 35 years. AMP's Fremont Energy Center, a natural gas plant, has had an excellent operating record since it was acquired by American Municipal Power (AMP, A1 Stable) in 2012.

For the roughly 50-60% of DEMEC's power supply that it does not source via self-supply, the JAA relies on market purchases. In FY14, DEMEC used twenty-one market purchase suppliers that had credit ratings of "Baa" or better, or who posted collateral. DEMEC maintains staggered terms for power purchases, from one month to up to thirty-five years. DEMEC's price certainty goal is to achieve 95% price certainty for three years forward.

In 2014, approximately 40% of the total power DEMEC supplied to its members was obtained through three-year forward purchase contracts, 4% was obtained through two-year forward purchase contracts, 13% was obtained through one-year forward purchase contracts and 2% was obtained through spot purchases. The remaining 41% was generated via self-supply. DEMEC utilizes a power marketing third party service provider, ACES Power Marketing, and is a member of AMP.

DEMEC's nine members have complied with the May 2012 memorandum of understanding with the Governor of Delaware to lower retail electric rates by at least 10%. Additionally, Moody's believes DEMEC members' Renewable Portfolio Standard obligations of 25% of power supply from qualifying renewable generation resources by 2025 is attainable in light of recent and forecasted investments in wind, solar and hydro.

Liquidity

DEMEC's liquidity position has historically been relatively low when compared to A2 peers, as most excess revenues are returned to the participating municipalities on a monthly basis as a credit to bills, while refunds on over-collections are distributed on an annual basis, all after debt service. DEMEC's historically low liquidity position, relative to its A2 peers, is partially offset by DEMEC's ability to request cash from its members on a three-day notice for unforeseen contingencies pursuant to the power supply contracts, as well as access to a renewed $20M letter of credit facility with PNC Bank, N.A. expiring on September 30, 2016 (PNC, A2 Issuer Rating, P-1 short-term rating). Additionally, Beasley generated over $14M in excess revenue, after operating expenses and debt service, in FY14, which was returned to the participants.

DEMEC's three-day cash call provision was implemented in early 2009 to raise $7 million from members to meet a collateral posting requirement for one of its power purchase agreements. DEMEC's $20M letter of credit is weakened by a material adverse change (MAC) clause that allows the bank to terminate or call outstanding obligations if there has been a MAC in the financial condition, operations, assets or prospects of DEMEC. Additional liquidity is provided by a $10MM line of credit with PNC, containing a similar MAC clause, extended to September 30, 2016, for general operations. Moody's views DEMEC's low liquidity when compared to A2 peers, and zero unrestricted liquidity at the Beasley level, as a weakness to the A2 credit rating, only partially mitigated by DEMEC's ability to call on its full requirements members for cash on short-notice.

DEBT AND OTHER LIABILITIES

The Beasley project outstanding debt of approximately $58M, as of December 31, 2014, is fixed rate and has no debt-related derivatives, swaps or auction rate securities. Beasley's debt service schedule is level. DEMEC, at the full-requirement agency level, has a rate levelization loan with AMP, with roughly 18.5M outstanding as of December 31, 2014.

Pensions and OPEB

Pensions and OPEB are not a major factor in the rating methodology. DEMEC's employees are covered by a 457b governmental retirement plan administered by ICMA-RC. Total contributions to the plan by DEMEC for the years ended December 31, 2014, 2013, and 2012 were $61,887, $53,352, and $47,222, respectively.

MANAGEMENT AND GOVERNANCE

DEMEC is governed by a nine-member Board of Directors, with one director from each of the nine member municipal electric utilities, and nine alternate directors currently appointed. The responsibility for day-to-day operations of DEMEC resides with the President and CEO, who is appointed by the Board. The President and CEO directs the efforts of the staff members and manages various contractual relationships in place to meet the service requirements of the members.

KEY STATISTICS

Average power cost to full-requirement members (Dollars/MWh), FY14, (FY13): $84.15 ($81.75)

Beasley all-in cost of power (Dollars/MWh), FY14, (FY13): $117.57, ($93.25)

Maximum PJM's Delaware LMP cost of power (Dollars/MWh), FY14 $1,865.96

Hours PJM's Delaware LMP cost of power was higher than Beasley all-in cost of power, FY14: 621 Hours

Beasley Unit Availability, FY14, (FY13): 96.3%, (98.6%)

FY14 Beasley Debt Outstanding: $58.0M

OTHER CONSIDERATIONS: Mapping to the Take-or-Pay Projects Factor Grid

FACTOR 1 - Participant Credit Quality and Cost Recovery Framework (45%): A2

FACTOR 2 - Asset Quality (15%): Baa

FACTOR 3 - Competitiveness (15%): A

FACTOR 4a) 3-yr Avg Adjusted days liquidity (10%): B (0 days; although there is zero unrestricted liquidity at the Beasley project level, this is partially mitigated by the pronounced integration of Beasley within DEMEC's operations, especially with respect to liquidity. Additionally, Beasley generated over $14M in excess revenue, after operating expenses and debt service, in FY14, which was returned to the participants. Both are factored into the rating with a +1/2 notch)

FACTOR 4b) 3-yr Avg Debt ratio (5%): Baa (111.7%)

FACTOR 4c) 3-yr Avg Fixed charge coverage ratio (10%): Aaa (3.41x)

Grid Indicated Rating: A2

Notching: Contractual Structure and Legal Environment, +1/2 Notch (importance of Beasley to DEMEC's power supply strategy and the pronounced integration of Beasley within DEMEC's operations, especially with respect to liquidity. Additionally, Beasley generated over $14M in excess revenue, after operating expenses and debt service, in FY14, which was returned to the participants.)

Scorecard Indicated Rating: A2

OBLIGOR PROFILE

DEMEC is a public corporation constituted as a joint action agency and a wholesale electric utility. DEMEC represents and provides power supply and related services to nine municipal electric distribution utilities located in Delaware. DEMEC, which was incorporated in July 1979, members comprise all the major towns in Delaware except Wilmington. Seven of DEMEC's nine members, including the cities of Newark, New Castle, Milford, Seaford, and the towns of Clayton, Middletown, and Smyrna participate, via take-or-pay contracts, in DEMEC's 2 Beasley Peaking Power Station generating assets, Beasley CT Units I & II, located in Smyrna, DE. The take-or-pay contracts between DEMEC and the seven members secure DEMEC's Series 2011 Beasley Bonds. The take-or-pay participants have a weighted average participant credit quality of A2 and the contracts are authorized under Delaware statutes.

LEGAL SECURITY

The Electric Revenue Bonds Series 2011 are secured by a pledge of the net revenues from both the 2001 and 2011 take-or-pay contracts with the same seven all-requirement participants. The security package also includes a pledge of the administrative charges from DEMEC's full requirements' contracts. A debt service reserve fully funded at the minimum of [i] maximum annual debt service, [ii] 1.25x average annual debt service, or [iii] 10% of Par, and a 1.1x debt service coverage ratio covenant. The contracts provide that if a participant defaults in its payment obligation, the remaining participants must pay their respective pro rata share of the defaulted amount, provided that a participant's liability not exceed 125% of its initially contracted pro rata share.

USE OF PROCEEDS

N/A

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PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Joint Action Agencies published in October 2012. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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