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Summary:

Delaware Municipal Electric Corp.; Wholesale Electric

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Summary:

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Credit Profile		
Delaware Municipal Electric Corp. rev bnds		
Long Term Rating	A/Stable	Affirmed

Rationale

Standard & Poor's Rating Services has affirmed its 'A' rating on Delaware Municipal Electric Corp.'s (DEMEC) series 2011 electric revenue bonds. The outlook is stable. Debt outstanding amounts to $54.4 million.

About $30 million of the 2011 bonds funded construction of a 45 megawatt (MW) combustion turbine unit (CT II) at the existing Beasley Power Station, bringing total owned capacity to 90 MW. Proceeds also refunded the $25 million remaining from the debt issued in 2001 to construct CT I; refunded the remainder of $982,120 issued in 2008 to acquire and renovate an administrative building and land in participant Smyrna's business park; and funded a $3.9 million debt reserve and a $1.2 million capitalized interest fund, equal to eight months of interest expense.

The rating reflects several factors, which we view as positive:

- DEMEC management expects strong coverage of project debt will continue, at about 3x.
- Take-or-pay power sales contracts with the agency and seven municipal electric utilities remain in effect until all project debt is paid, and include a 25% step-up should a participant default.
- Strong operating record of the Beasley units provides a hedge against peak power costs in the PJM market.

Although Newark, Del., accounts for almost half of the project revenue, and a 25% step-up by the other six participants would not replace the city's revenue in the event it defaulted on its payment, we believe the strength of Newark utility's credit metrics and business profile make a default highly unlikely.

DEMEC is a joint action agency formed in 1979 to supply electricity to seven Delaware municipalities, which have all-requirements contracts. The seven full-requirements members are Newark (entitled to 41.25% of the Beasely Power Station combined output from CT I and CT II), Milford (16.1%), New Castle (8.05%), Smyrna (8.6%), Seaford (8.6%), Middletown (11.65%), and Clayton (1.7%), Del.

Lewes, Del., is now also a full requirements member, and Dover, Del., is a partial requirements customer, but neither participates in the Beasley project.

DEMEC historically buys power for its members from independent power producers, power marketers, and the PJM Interconnection LLC power pool. To limit the impact of peak power costs and rising transmission costs in the Mid-Atlantic region, DEMEC built CT I, a 45 MW, gas-fired generating unit in Smyrna, to supply local power requirements at times of peak demand. A second unit, CT II began operating in mid-2012. Both units are operated by

NRG Thermal LLC. The two units have kept production costs low and availability high at more than 90%. The units have helped reduce wholesale rates to the members by reducing peak power purchases from the PJM pool, which has allowed DEMEC's seven participants to maintain relatively competitive retail rates, especially for residential customers. The units also earn revenue selling capacity and energy into the PJM market, which helps lower wholesale rates for the participants. In addition, the sale of spinning reserves are especially valuable as the PJM system adds more intermittent resources such as wind and solar.

DEMEC is also a member of American Municipal Power (AMP), a joint-action agency based in Ohio, and has signed a 30-year contract to take 92 MW of power from the Fremont plant, a 675 MW natural gas combined cycle unit. That unit dispatches power into PJM's western side. The Fremont and Beasley assets provide 182 MW of capacity, representing 61% of the seven participants' 2013 peak load of 264 MW, and 35% of all nine members' 453 MW peak demand. Management has achieved its goal of owning and self-supplying at least 50% of capacity needed for its full-requirements members. The Beasley and Fremont capacity will help lower PJM power and congestion costs, as will additional transmission lines that are under construction. DEMEC is working with AMP to plan for power requirements, including building additional transmission lines.

DEMEC purchases about 1% from the PJM spot market, and the rest is purchased with one-year, two-year, and multiyear contracts. It contracts with the Alliance for Cooperative Energy Services Power Marketing LLC to manage contracts and credit exposure, evaluate counterparties, model member requirements, bid and dispatch the Beasley unit, and execute near- and medium-term transactions.

A key factor in our analysis is the take-or-pay project participation contracts, which are in effect until generating unit debt is repaid. The contracts require participants to pay their pro rata share of project costs, including debt service on the bonds. Payments to DEMEC are an operating obligation, so they rank before any debt service that the utility might have. (Only three participants have debt, and the amounts are relatively small.) The rate covenant requires net revenue to be at least 1.1x total debt service. The 25% step-up provision provides additional protection to bondholders if one of the smaller participants fails to pay. The step-up would not cover the Newark utility's share, which accounts for almost half of project revenue, but we believe the strength of the utility's credit metrics and business profile make default highly unlikely. If there were a default, that member's share would be offered to the other participants or sold to an outside buyer. If there are no buyers, the 25% step-up obligation would be implemented. In our opinion, the low cost and high availability of the Beasley units would make it an attractive option for other power suppliers in the PJM market, which would mitigate reliance on the defaulting participant's diminished credit strength.

We believe the project exhibits very strong debt service coverage for a joint action agency, which enhances the credit quality of the revenue stream that the participants contribute and the participants' step-up commitments. The lack of retail choice, low debt burdens, and adequate liquidity characterize most participant profiles. Although Delaware's investor-owned utilities operate in a competitive electric utility market, municipal electric systems have complete discretion regarding retail choice.

The Beasley project's debt service coverage (DSC) has ranged from 2.18x in in 2012 to 3.45x in 2010, and was 3.20x in 2013. Management expects DSC to remain strong at about 3.0x, well above the required minimum of 1.1x.

In our opinion, the participants' credit metrics and business profiles place them in the medium investment grade category. Fixed charge coverage after transfers to the general fund averaged 1.1x in 2013, but ranged from 1.38x (New Castle) to 0.91x (Smyrna). Liquidity is what we consider good for three of the seven participants, ranging from 147 days cash to 314; adequate for a fourth at 45 days; and weak for the other three, ranging from 27 days to none. However, the utilities set their own rates and pass purchased power costs on to their retail customers monthly, which reduces the need for surplus cash. In addition, the amount of debt each participant carries is low, in our view. Including each participant's share of the project debt, debt per customer is about $1,000 for the five municipalities with smaller participations and about $2,000 for Newark and Milford.

The participants' service area economies are generally stable, have survived the recession relatively well and continue to add customers. In August 2014, unemployment for Newark, Middletown, Milford, and New Castle (81.5% of project revenue) averaged 6%, which is below the national average. Median household effective buying income (MHEBI) for each participant is around the national average, although Seaford's MHEBI is lower at 78%. Several of the participants have large customers, but they have been local employers for many years and provide stable revenue. Newark provides electricity to the University of Delaware, Milford serves Perdue Farms and U.S. Cold Storage, and Middletown serves Johnson Controls Inc. and Amazon.com Inc.

DEMEC borrowed $33 million from AMP's liquidity facility to provide a rate stabilization fund for the initial years of power supply from their 92 MW share of AMP's Fremont Energy Center. The Fremont capacity exceeded members' power needs from January 2012 through May 2014, but the utility is repaying the loan from power sales to members June 2014 through May 2017. DEMEC's board, which represents the members, chose to incur the initial cost increase to secure a beneficial long-term asset. As a result, its net position in 2012 and 2013 was negative. Management expects the utility net position to be positive by the end of 2015, and may be positive as soon as the end of 2014.

In our opinion, liquidity is adequate. DEMEC maintains a $3 million line of credit for working capital and a $25 million line of credit for letters of credit for posting collateral. Both lines are renewed annually in September. The highest level of collateral posting was in 2008, when gas prices plunged to $5 per thousand cubic feet from $12. The collateral posting was $27 million. There are currently no draws under the lines, but the utility does have $1.9 million posted with PJM. The agreement with each of DEMEC's counterparties contains a rating trigger: if the rating on the counterparty slips below 'BBB', the collateral threshold is eliminated.

Beyond collateral postings, the agency's liquidity requirements are minimal. Purchased power costs are billed to participants monthly and collected from retail customers through a purchased power adjustment clause. In addition, the utility can bill participants for interim unexpected costs, and they typically pay them within three days.

Outlook

The stable outlook reflects our assessment of the predictable cash flow under contracts that match the project debt's life, with the added protection from the step-up; the project's strong credit metrics and good economics; and the gradual approach of DEMEC's members in determining the most effective strategy for meeting the increasing electricity demand on the Delmarva Peninsula. We do not expect to raise or lower the rating in the two-year outlook horizon.

Related Criteria And Research

Related Criteria

USPF Criteria: Electric Utility Ratings, June 15, 2007

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