

### Summary:

## Delaware Municipal Electric Corp.; Wholesale Electric

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## Summary:

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Credit Profile		
US\$56.0 mil rev bndsser 2011 due 07/01/2041		
<i>Long Term Rating</i>	A/Stable	New
<b>Delaware Muni Elec Corp</b>		
<i>Unenhanced Rating</i>	A(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

## Rationale

Standard & Poor's Rating Services has assigned its 'A' rating to Delaware Municipal Electric Corp.'s (DEMEC ) series 2011 electric revenue bonds. At the same time, Standard & Poor's affirmed its 'A' rating on DEMEC's bonds outstanding, which will be refinanced with proceeds from the 2011 bonds. The outlook is stable. Debt outstanding, after the issuance of the 2011 bonds, will be \$56 million.

About \$30 million of the new debt will fund 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 will also refund the \$25 million remaining from the debt issued in 2001 to construct CT I; refund the remainder of \$982,120 issued in 2008 to acquire and renovate an administrative building and land in participant Smyrna's business park; and fund 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 the project's financial metrics to be consistent with previous years, with debt service coverage (DSC) at about 3.0x.
- Take-or-pay power sales contracts between 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.
- We expect participant financial metrics to continue in a range that supports the 'A' rating, as will DEMEC's financial risk profile, which is characterized by adequate liquidity and fixed charge coverage (FCC) of about 1.25x. FCC deducts purchased power capacity payments from expenses and includes it, along with debt service, as a fixed-cost obligation.

In our opinion, the only cause for concern would be the fact that nearly half of the project revenue comes from Newark, Del.'s electric system. A 25% increase in the rates of the other six participants would only cover about two-thirds of Newark's share of payments if it failed to pay. However, its credit metrics remained stable despite the recession.

DEMEC is a joint action agency formed in 1979 to supply electricity to seven Delaware municipalities, which have all-requirements contracts. Two other municipalities purchase a portion of their power supply from it, but account for less than 1% of annual revenue. The seven full-requirements members are Newark (entitled to 37.1% of the

Beasley Power Station combined output from CT I and CT II), Milford (18.2%), New Castle (7.2%), Smyrna (7.7%), Seaford (7.7%), Middletown (10.5%) and Clayton (1.5%). The two partial-requirements members are Lewes and Dover.

The agency 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. NRG Thermal LLC operates the unit under an operations and maintenance contract, which has kept costs low and availability high at 95%. The unit has helped reduce wholesale rates to the members by reducing peak power purchases from the PJM pool, which has allowed them to maintain relatively competitive retail rates. The unit also earned \$3.3 million in 2010 selling capacity and energy into the PJM market. CT II, which management expects will begin commercial operation June 1, 2012, can also provide spinning reserves for the PJM market, which will be especially valuable as the PJM system adds more intermittent resources such as wind and solar. The PJM revenue also lowers wholesale rates for the participants.

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 70 MW of output from the recently-acquired Fremont plant, a 544 MW natural gas combined cycle unit. That unit will dispatch power into PJM's western side. The Fremont and Beasley assets provide 160 MW of capacity, representing 65% of the seven participants' 2010 peak load of 245 MW, and 35% of all nine members' 450 MW peak demand. Management has achieved its goal of owning and self-supplying at least 50% of capacity needed for its full-requirements members.

In addition to the Beasley Plant, which provided about 5% of energy in 2010, the agency manages a balanced portfolio of purchased power from independent power producers and power marketers. It purchases about 10% from the PJM spot market, and the rest is purchased with one-, two- and longer-year contracts. DEMEC contracts with the Alliance for Cooperative Energy Services Power Marketing LLC (ACES) to manage contracts and credit exposure, evaluate counterparties, model member requirements, bid and dispatch the Beasley unit, and execute near- and medium-term transactions. Participants can terminate the power sales contract by giving the agency one year notice, which would allow it to scale back contracted power purchases. None of the participants have indicated their intent to do so.

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, but this would not cover a Newark default. 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.

Overall, we believe a lack of retail choice, low debt burdens, and adequate liquidity characterize participant profiles. Although investor-owned utilities operate in a competitive electric utility market, under Delaware law, municipal electric systems have complete discretion regarding retail choice. In our opinion, participants are not highly leveraged. Including each participant's share of the project debt, debt per customer will average about \$1,000 for the five municipalities with smaller participations and about \$2,000 for Newark and Milford. The fixed charge coverage

ratio is fairly strong, in our view, averaging 1.5x for the seven full-requirements participants. This ratio compares net cash funds from operations to debt service, if any, and capacity payments included in purchased power payments, which we estimate to be about 50% of the total cost. However, most municipalities transfer the utilities' surplus funds from operations back to the general fund, which limits the need to raise property taxes. The ratio after the annual transfer is usually about 1x.

Countering that weakness is that most participants maintain a fairly healthy amount of cash to cover unexpected requirements. Since purchased power costs are automatically passed along to retail customers in the monthly bill, we exclude them from our comparison of unrestricted cash to operating costs. At fiscal year-end 2010, the number of days' operating costs covered by unrestricted cash ranged from 180-600 for five of the participants, but was low for Newark (24) and Smyrna (eight). Newark, which had about 250 days cash in fiscal 2008, used cash to stabilize and lower rates to its customers. DEMEC's management has stated its intent to create a rate-stabilization fund, which would provide more cash available to help offset a sudden rise in operating or power costs without having to raise rates abruptly. The agency does have the right to raise rates immediately if a sudden need for cash occurred, and members are required to pay within three days. A rate-stabilization fund would eliminate the need for sudden rate increases.

We believe the participants' service area economies are generally stable, have survived the recession relatively well and continue to add customers. Unemployment in the Philadelphia-Wilmington employment region is 8.9%, which is below the national average of 9.6%. Newark, New Castle, and Middletown (63% of project participation) are in this region. From fiscal year-end 2008 to fiscal year-end 2010, retail customers increased 4.5%, to 37,755 from 36,118. The compound average growth rate of kilowatt-hour (kWh) sales was 2.4% from 2006-2010, with a 2% decrease in 2009 due to the recession. DEMEC bases its forecast on very low growth of about 0.3% per year, but this does not include the estimated requirements of several new industrial customers. The largest customers do not pose a credit risk, although they do account for a high share of a few participants' revenue. For Newark, 35.2% of revenue comes from the University of Delaware. Industrial customers include Rohm & Haas Co., which produces specialty chemicals, is owned by Dow Chemical Co., and accounts for 7.4% of revenue; and Power Systems Composites LLC, an electronic components distributor that accounts for 1.6%. For Milford, the largest customers account for about 37% of revenue, and they include Perdue Farms Inc., which raise and process chickens (15.2%); United States Cold Storage Inc., which provides refrigeration for the East Coast and overseas shipment (7.3%); Sea Watch International Ltd., a harvester and processor of clam products (3.8%); a super Wal-Mart store (3.3%); and L.D. Caulk, a manufacturer and wholesale distributor of dental supplies (2.7%).

At the agency level, management expects DSC to remain at about the 3.0x level of the past few years, as wholesale rates will increase to accommodate the increased debt service. As noted above, capacity and energy sold into the PJM market and the lower-cost power from the Fremont plant in Ohio will partially offset rate increases. The FCC ratio, which takes into account both debt service and purchased power capacity payments, has been about 1.25x, and management expects the ratio to continue near there. The capacity payments, however, are the transmission congestion costs paid to PJM. Owning additional generating capacity will likely help lower congestion costs, as will additional transmission lines that are under construction.

In our opinion, liquidity is adequate. DEMEC maintains a \$3 million line of credit that is renewed annually in September, and a \$35 million letter of credit facility that matures in March 2012 for collateral postings. 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. Currently, the agency has posted a total of \$5.5 million in letters of credit for

collateral postings. The agreement with each of DEMEC's counterparties contains a rating trigger: if a rating on a 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, it 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 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.

## Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

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