# Delaware Municipal Electric Corporation

## Electric Revenue Bonds

**New Issue Report**

### Ratings

**New Issues**

| | |
|---|---|
| $56,000,000 Series 2011 Electric Revenue Bonds | A– |

**Outstanding Debt**

| | |
|---|---|
| $34.3 Million Electric Revenue Bonds | A– |

### Rating Outlook

Stable

### Key Utility Statistics

**(Fiscal Year Ended Dec. 31, 2010)**

| | |
|---|---|
| System Type | Wholesale Electric |
| NERC Region | MAAC |
| Number of Customers | 9 |
| Annual Revenues ($ Mil.) | 120.12 |
| Top User (% of Revenues) | 3 |
| Fuel Dependency (%) | — |
| Primary Fuel Source | Gas |
| Peak Demand (MW) | 245 |
| Energy Growth (%) | 5 |
| Debt Service Coverage (x) | 2.67 |

### Related Research

U.S. Public Power Peer Study — June 2011, June 20, 2011


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## New Issue Details

**Sale Information:** $56,000,000 Electric Revenue Bonds Series 2011.

**Security:** Net revenues from take-or-pay power sales contracts with seven members.

**Purpose:** Finance the construction of Unit 2 at Beasley Power Station and refund Unit 1 outstanding bonds.

**Final Maturity:** Unit 2 bonds mature in 2041. Unit 1 bonds mature in 2026 (if not refunded).

## Key Rating Drivers

**Stable Performance:** Delaware Municipal Electric Corporation's (DEMEC or the agency) rating reflects stable performance supported by strong take-or-pay contracts with its seven members that include a 125% step-up provision.

**Member Credit Strength:** The rating also reflects the credit of the seven members, the largest of which are Newark (GO rated 'AA+'/Stable) and Milford, which make up 47.4% and 20.8% of Beasley Unit 1, respectively. The rating takes into consideration the strength of the remaining member systems, which are smaller towns located in different parts of the state.

**Mixed Demographics:** The local economies are moderately diverse, and income levels are not particularly strong compared to the state and the nation. The state of Delaware's (GO rated 'AAA'/Stable) economy is stable and includes strong financial, government, and education sectors.

**Stable Financials:** Financial metrics are stable but lean at the joint action agency level, as illustrated by coverage ratios close to 1.2x, after adjusting for purchased power. Cash balances are low at 11 days. Total liquidity improves slightly to 21 days after including the currently undrawn $3 million line of credit.

**Increasing Control over Power Costs:** The addition of the planned second unit at Beasley and the Fremont Energy Center (Fremont) power purchase agreement (PPA) should enable DEMEC to have more control over its power costs, especially during peak periods. The new unit can also act favorably as a hedge against the volatility seen in PJM's reliability pricing model.

**General Fund Transfers:** Credit concerns include the sizable transfers at the member level to the general fund of the host city (10%–20% of electric system revenue). Fitch notes that for some member systems transfers have exceeded operating income in the last two years.

## What Could Trigger a Rating Action

Deterioration in financial metrics at the member utility level or at the joint action agency level, particularly as a result of continued high general fund transfers could result in downward rating pressure.

**Rating History**

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| A– | Affirmed | Stable | 10/3/11 |
| A– | Affirmed | Stable | 8/11/11 |
| A– | Affirmed | Stable | 12/18/08 |
| A– | Assigned | Stable | 3/12/04 |

## Credit Profile

DEMEC is a joint action agency providing all-requirements wholesale energy to seven of its nine members in the state of Delaware. DEMEC owns a 45-megawatt (MW) peaking unit, but has historically obtained most of its power requirements through bilateral contracts and market purchases. Financial performance at the agency level has historically been stable. Bonds are limited obligations of DEMEC, payable solely from and secured by amounts payable by the participants under power sales contracts that provide for 1.1x debt service coverage. Seven of the nine members participate in the bond financing for the peaking unit.

DEMEC has signed a long-term PPA, in addition to the planned Unit 2 at Beasley, for 70 MW of power from Fremont, a combined-cycle gas plant, which is currently under construction and owned by American Municipal Power (AMP Partners). DEMEC expects Beasley and Fremont to supply a majority of its power needs from 2012 onward. DEMEC is now a member of AMP Partners, another joint action agency, as a result of the Fremont PPA.

## Governance and Management Strategy

DEMEC operates as a joint action agency representing its nine member systems. While the agency has nine members, only seven have all-requirements power supply contracts. The city of Dover and the city of Lewes are not included in all-requirements supply. The agency is headed by Mr. Patrick McCullar, President and CEO, who has been with the agency in this capacity for more than 14 years. Management at the agency level has historically been lean, and there has been a reliance on consultants to actively manage the portfolio.

DEMEC's wholesale rates to its members are not regulated by any state or federal regulatory authority. The board, with representatives from each member city, has sole authority to adjust wholesale rates to cover operating expenses. Relations between the agency and its members are strong and constructive. The agency has historically shown a willingness to adjust rates on a regular basis to maintain reliable and cost-effective power supply to its members.

## Power Supply and Asset Operations

DEMEC meets the load requirements of its members with a combination of owned generation and short- to medium-term power contracts. Unit 1 of the Beasley plant, which was financed with Series 2001 bonds, went into commercial operation in 2002. The unit is dispatched into the PJM transmission system and offsets high-cost peak power purchases associated with the transmission-constrained market conditions that characterize the Delmarva Peninsula.

Proceeds from the Series 2011 issuance will be used to finance the construction of Unit 2, which is expected to cost about $29 million. The two simple-cycle peaking units at Beasley are expected to be operated for about 10% of the hours in a year, but will provide an important hedge against peak power prices and PJM's volatile capacity market. DEMEC has already locked in about 60% of the cost for Unit 2, which will be of the same make and type as Unit 1.

DEMEC currently gets about 90% of its energy from short- and medium-term contracts (approximately two years) with various counterparties. DEMEC recently signed a 30-year PPA with AMP Partners for a 70 MW share in Fremont to gain more long-term certainty over its purchase power costs. Fremont is expected to be a long-term source of base load power and to account for a large share of DEMEC's supply from 2012 onward.

**Related Criteria**

U.S. Public Power Rating Criteria, March 28, 2011
Revenue-Supported Rating Criteria, June 20, 2011

DEMEC has adequate contracts in place in the interim, whereby it has locked in about 90% of its energy requirement. However, the agency is exposed to collateral posting risk in case there is an adverse movement in the mark to market position on the forward contracts. Although DEMEC has been granted some unsecured credit by its counterparties, the agency had posted about $550,000 in collateral by using the available $35 million letter of credit (LOC) facility as of July 2011.

## Power Supply Contracts

The agency has three power supply contracts with its members as shown in the table below.

### Power Supply Contracts

| Power Sales Contract (Beasley Power Station) | Full Requirements Contract | Partial Requirements Contract |
|---|---|---|
| Seven participating members in each unit | Seven participating members. DEMEC provides full requirement wholesale power and renewable energy. | DEMEC supplies renewable energy to Dover and Lewes. |
| Take-or-pay. | Take-or-pay. | Take-or-pay. |
| 25% step-up. | No step-up as contract revenues are not pledged to outstanding bonds. | No step-up as contract revenues are not pledged to outstanding bonds. |
| Contract obligation is O&M expense for members. | Contract obligation is O&M expense for members. | Contract obligation is O&M expense for members. |
| Participants have pledged to set rates to cover contract obligation. | Participants have pledged to set rates to cover contract obligation. | Participants have pledged to set rates to cover contract obligation. |
| Contract valid as long as bonds are outstanding. | One-year notice period, but forward purchase commitment survives termination. | One-year notice period, but forward purchase commitment survives termination. |

O&M – Operations and Maintenance.
Source: DEMEC.

The table below shows the participation level of DEMEC's members in each unit of the Beasley power station.

### Participants' Share of Beasley Project

(%)

| Project Participants | Share of Beasley Unit 1 | Share of Beasley Unit 2 | Combined Share |
|---|---:|---:|---:|
| City of Newark ('AA+') | 47.00 | 35.10 | 41.50 |
| City of Milford | 21.00 | 19.50 | 20.00 |
| City of New Castle | 9.00 | 7.20 | 8.00 |
| Town of Smyrna | 8.00 | 9.70 | 8.50 |
| City of Seaford | 7.00 | 10.00 | 8.50 |
| Town of Middletown | 7.00 | 16.50 | 12.00 |
| Town of Clayton | 2.00 | 1.90 | 1.50 |

Note: Numbers may not add due to rounding.
Source: DEMEC.

The outstanding bonds are primarily secured by the revenue from the power sales contracts with the seven participating members in the Beasley power plant. Participants are obligated to pay for their share of Beasley's debt service regardless of whether the unit is operating due to the take-or-pay nature of the contracts. There is a 25% step-up provision as an added security features, should one or more participants default on their obligation.

Fitch notes that if DEMEC successfully refunds the Series 2001 bonds used to finance construction of Unit 1, then the combined share shown in the "Participants' Share of Beasley Project" table above will be applicable to each member. However, Fitch also notes, based on the “Power Supply Contracts” table above, that the 25% step-up provision in the Beasley contract is not sufficient to cover the obligation of Newark under either scenario.

## Renewables

Municipal utilities such as DEMEC are not exempt from the 25% renewable requirement, which includes a 3.5% solar carveout, under Delaware’s renewable portfolio standards. However, sales to industrial customers are exempt from the renewable requirement. The compliance deadline is June 1, 2013. The agency has recently signed a 20-year PPA for a 10-MW solar facility (Dover Sun Park) and a 25-year PPA for 69 MW of a wind farm (Laurel Hill Wind Farm). These two facilities taken together should enable DEMEC to meet the state renewable mandate. Fitch notes that although DEMEC provides full requirement service to only seven of its nine members, renewable energy is supplied to all nine members.

## Member Systems

The joint action agency consists of nine members. Two of the members, Dover (electric system revenues rated ‘A+’ with a Stable Outlook) and Lewes (GO rated ‘AA’/Stable), do not participate in the Beasley project and the full requirement contracts. Newark and Milford make up the largest percentage of participation of the other seven members. It is important to note that the participation levels in Unit 2 of the Beasley project are different from Unit 1, though Newark and Milford remain the two largest participants for the plant as a whole.

Although Newark and Milford do exhibit strong credit characteristics at the city level, their utility systems, especially Newark’s, have not maintained steady net income levels, and have traditionally been subject to general fund transfers of about 15%–20% of revenues. However, the debt associated with each system is low, and the debt service payments associated with the Beasley project are less than 3% of each system’s revenues.

The Delaware economy has traditionally been strong and is characterized by diverse employment sectors with high income levels. Fitch’s assessment does take into consideration

### Sales Information

| | 2010 | 2009 | 2008 | 2007 |
|---|---|---|---|---|
| Peak Demand (MW) | 245 | 231 | 243 | 249 |
| Total Electric Sales (MWh) | 1,157,100 | 1,100,170 | 1,122,410 | 1,121,657 |
| Sales Growth (%) | 5.2 | (2.0) | 0.1 | 6.5 |
| Members | 7 | 7 | 7 | 7 |

Source: DEMEC.

### Large Participants Demographic Info

| Project Participants | 2009 Median Household Income ($) | % of U.S. Median Income | Population |
|---|---|---|---|
| City of Newark (‘AA+’) | 53,537 | 106.60 | 31,000 |
| City of Milford | 32,525 | 64.80 | 9,559 |
| Town of Middletown | 41,663 | 83.00 | 18,871 |

Source: DEMEC.

that the economies of the member systems are somewhat limited compared to the state and median income levels. Most of the cities, barring Newark, are below the state and national averages.

The state of Delaware has a strong retail sector that benefits from an absence of sales tax. Population in DEMEC's service territory has exhibited strong growth of about 10% over the last decade. Electricity consumption, prior to the 2009 recession, consequently grew by a compounded annual growth rate (CAGR) of nearly 4% over the same period. However, DEMEC expects CAGR to be about 0.3% through 2013.

The participants' 2010 kilowatt hour sales and revenue mix is biased towards industrial consumption at 47.7% of sales and 43.4% of revenue. Residential consumption accounts for 31.8% of sales and 35.1% of revenue. Commercial customers make up the balance. Despite the bias towards industrial consumption, the diversity of the industrial customer base acts as a mitigant. The single largest customer for DEMEC is the University of Delaware, a stable entity, which accounts for about 13% of consumption and 10% of revenue.

Appendix A on page 8 shows selected recent financial information for some members.

## Rates

DEMEC has historically shown a willingness to adjust rates on a regular basis. Rates have been adjusted annually by an average of approximately 10% between 2002 and 2010. DEMEC's rate structure consists of a base wholesale rate and a purchased power charge that can be changed on a monthly basis, if required. Fitch notes that given the reliance on purchased power, a monthly power adjustment charge helps in recouping volatile power costs in a timely manner.

DEMEC's service territory is located exclusively in the state of Delaware, a fully deregulated retail choice state. However, DEMEC's members are exempt from retail competition. The agency's wholesale rates compare favorably with neighboring providers whose rates tend to be more volatile due to full retail competition.

DEMEC is expecting a reduction in costs of about 21% and 30%, in 2012 and 2013, respectively, compared with 2008 levels. Fitch notes that lower fuel costs and increased generation ownership are the primary drivers for this reduction.

## Financial Performance and Legal Provisions

DEMEC's financial metrics are stable but mixed when compared with other joint action agencies in the 'A' rating category. Debt service coverage at the agency level is adequate at 2.67x, but reduces to 1.15x after adjusting for purchased power.

DEMEC has taken steps to address its low cash levels by putting in place a line of credit totaling $3 million, and a $35 million LOC facility for collateral posting purposes. About $550,000 has been drawn against the LOC to post collateral with counterparties. DEMEC can require members to make payments to the agency within three days in the event of an unexpected cost increase. This provision is not used regularly, but has been used successfully in the past.

The outstanding bonds are secured by revenues from the power sales contracts for the Beasley project, and participants are required to make debt service payments equal to 1.1x of annual debt service. Project debt service coverage has historically been in excess of 2.0x due to increased energy sales and significantly higher capacity market revenues. Project participants have received annual rebates at the end of the year as a result of the surplus revenues, mainly driven by capacity prices.

While the agency does not prepare financial projections for the Beasley project, management has indicated that an annual budget that includes a 1.1x debt service is used to invoice project participants on a monthly basis during the financial year.

Fitch notes that given the historical reliance on purchased power, DEMEC has seen volatility in its revenues and expenses. Greater direct and indirect generation ownership through the Beasley project and Fremont PPA is expected to increase cost certainty and reduce volatility.

## Legal Provisions

DEMEC covenants to adjust wholesale rates to achieve 1.1x debt service after paying operating expenses.

The Series 2011 bonds have a debt service reserve requirement equal to the lesser of a) maximum annual debt service; b) 10% of the outstanding par amount; and c) 125% of the average annual debt service.

## Financial Summary — Delaware Municipal Electric Corporation

| ($000, Fiscal Years Ended Dec. 31) | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| **Cash Flow (x)** | | | | |
| Debt Service Coverage | 2.09 | 2.24 | 3.32 | 2.67 |
| Adjusted Debt Service Coverage with General Fund Transfer | 2.09 | 2.24 | 3.32 | 2.67 |
| Coverage of Full Obligations | 1.10 | 1.11 | 1.25 | 1.15 |
| | | | | |
| **Liquidity** | | | | |
| Days Cash On Hand | 16 | 9 | 8 | 11 |
| Days Liquidity On Hand | 16 | 9 | 18 | 21 |
| | | | | |
| **Leverage** | | | | |
| Debt/Funds Available for Debt Service (x) | 5.8 | 6.7 | 3.9 | 4.1 |
| Equity/Capitalization (%) | 14.6 | 11.0 | 14.7 | 18.4 |
| Equity/Adjusted Capitalization (%) | 2.3 | 1.9 | 2.8 | 2.6 |
| Net Debt/Net Utility Plant (x) | 0.82 | 1.11 | 1.02 | 0.84 |
| | | | | |
| **Other (%)** | | | | |
| Operating Margin | 4.3 | 4.2 | 7.5 | 6.4 |
| General Fund Transfer/Total Revenue | 0 | 0 | 0 | 0 |
| Capex/Depreciation | 3.5 | 154.1 | 318.5 | 449.6 |
| | | | | |
| **Income Statement** | | | | |
| Total Operating Revenues | 100,013 | 113,960 | 110,653 | 120,099 |
| Total Operating Expenses | 95,753 | 109,219 | 102,361 | 112,427 |
| Operating Income | 4,260 | 4,741 | 8,292 | 7,672 |
| Adjustment to Operating Income for Debt Service Coverage | 941 | 814 | 811 | 744 |
| Funds Available for Debt Service | 5,201 | 5,555 | 9,103 | 8,416 |
| Total Annual Debt Service | 2,487 | 2,478 | 2,746 | 3,153 |
| | | | | |
| **Balance Sheet** | | | | |
| Unrestricted Funds | 4,138 | 2,548 | 2,108 | 3,481 |
| Restricted Funds | 3,314 | 3,347 | 3,189 | 3,167 |
| Total Debt | 30,318 | 37,216 | 35,878 | 34,306 |
| Equity and/or Retained Earnings | 5,199 | 4,597 | 6,197 | 7,740 |

Source: DEMEC audited financial statements.

## Appendix A

### Selected Financial Data for Large Participants — Delaware Municipal Electric Corporation

| | Newark | | | Milford | | | New Castle | | | Smyrna | | | Middletown | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | December | | | June | | | March | | | December | | | June | | |
| ($000s) | 2008 | 2009 | 2010 | 2008 | 2009 | 2010 | 2008 | 2009 | 2010 | 2008 | 2009 | 2010 | 2008 | 2009 | 2010 |
| Operating Revenue | 53,356 | 50,852 | 57,758 | 26,849 | 28,219 | 26,995 | 9,973 | 10,275 | 9,733 | 13,125 | 13,213 | 13,833 | 17,538 | 19,789 | 20,381 |
| Operating Expenses | 43,329 | 42,301 | 45,258 | 21,964 | 24,627 | 23,247 | 8,688 | 9,322 | 9,406 | 11,169 | 11,254 | 12,452 | 13,640 | 16,059 | 15,536 |
| Operating Income | 10,027 | 8,551 | 12,500 | 4,885 | 3,592 | 3,748 | 1,285 | 953 | 327 | 1,956 | 1,959 | 1,381 | 3,898 | 3,730 | 4,845 |
| Depreciation (in Operating Expenditure) | 701 | 751 | 783 | 334 | 331 | 298 | 447 | 302 | 281 | 484 | 553 | 575 | 320 | 313 | 302 |
| General Fund Transfer In/(Out) | (10,911) | (11,437) | (12,097) | (3,279) | (2,500) | (2,762) | (481) | (522) | (572) | (2,347) | (2,171) | (1,046) | (5,073) | (3,834) | (4,010) |
| Annual Debt Service | — | — | — | 297 | 298 | 298 | — | — | — | 352 | 360 | 361 | 81 | 153 | 730 |
| Debt Service Coverage | — | — | — | 6.53 | 4.78 | 4.31 | — | — | — | 0.26 | 0.95 | 2.52 | (10.56) | 1.37 | 1.56 |
| Unrestricted Cash | 3,319 | 470 | 833 | 9,713 | 6,415 | 4,872 | 2,548 | 3,119 | 3,222 | 279 | 116 | 144 | — | — | — |
| Days Cash on Hand | 28 | 4 | 7 | 164 | 96 | 77 | 113 | 126 | 129 | 10 | 4 | 4 | 0 | 0 | 0 |

Note: Newark's electric system has no long-term debt outstanding. Newark electric system's 2010 financials are un-audited. New Castle's electric system has no long-term debt outstanding. New Castle's unrestricted cash is for the combined electric and water system.
Source: DEMEC.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.