MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS A2 RATING TO DELAWARE MUNICIPAL ELECTRIC CORP'S NEW ISSUANCE; OUTLOOK IS STABLE

Global Credit Research - 04 Oct 2011

Electric Utilities
DE

Moody's Rating

ISSUE	**RATING**
Series 2011 Revenue Bonds	A2

Sale Amount	$56,000,000
Expected Sale Date	10/12/11
Rating Description	Revenue

Moody's Outlook Stable

Opinion

NEW YORK, Oct 4, 2011 -- Moody's Investors Service has assigned an A2 rating with a stable outlook to the new $56 million Series 2011 revenue bonds to be issued by Delaware Municipal Electric Corporation's (DEMEC).

DEMEC is well established as a joint action agency ("JPA") since 1978, providing services, serving as a wholesale electric utility and purchasing energy for its members.

RATING RATIONALE

The A2 rating reflects the strong historical financial performance, projected maintenance of strong debt service coverage ratios and management's strategy to meet peak demand growth while minimizing negative impacts of regional capacity market volatility. The rating also considers management's successful experience with similar construction and operations utilizing same well-proven technology, and the credit quality of the seven members whose "take-or-pay" contracts secure the bonds.

OUTLOOK

The stable outlook is based upon the expectation of successful completion of the new unit within time and allocated budget, DEMEC's ability to continue to prudently manage its load requirements while balancing a strategy of pursuing greater self-generation and ensuring a reliable and competitive power supply for its members, and maintaining stable financial operations.

What could change the rating - UP:

Improved credit quality of participant members, increase in liquidity, and sustained ability to provide reliable and competitively priced energy to its members.

What could change the rating - DOWN:

A deterioration in participant credit quality, inability to provide members with reliable and competitively priced energy, putting pressure on members to seek alternate power supplies, and inability to access member's cash on short notice, or contracted liquidity.

USE OF PROCEEDS:

The new issuance will (i) fund $29MM of capital costs for a new 45MW gas peaking unit (CT II) to meet the growing peaking requirements of the participants' municipal-owned utilities, including the payment of a bond anticipation note used to temporarily finance CT II, (ii) refund $25MM of outstanding Series 2001 ("A2/stable") revenue bonds originally issued to finance DEMEC's first 45MW peaking generator, (iii) refund $1MM of 2008-A bonds (not rated) associated with the acquisition and renovation of DEMEC's headquarters, (iv) fund capitalized interest and a debt service reserve account, and (v) pay bond issuance costs.

DEMEC originally financed the construction of Beasley, its first peaking unit, through the issuance of $36 million of the Series 2001 Bonds secured by take-or pay agreements terminating in 2026, with its seven all-requirement participants. The Series 2001 Bonds will be refunded, but the associated take or pay contracts will remain intact.

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 will also include a pledge of the administrative charges from DEMEC's full requirements' contracts for the benefit of the 2008A Series being refunded.

DEBT SERVICE RESERVE: The 2011 Series Bonds will have 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.

A 1.1x debt service coverage ratio covenant will continue to be in effect.

INTEREST RATE DERIVATIVES: None at this time.

KEY RATING FACTORS:

NEW PEAKER VIEWED AS COST EFFECTIVE STRATEGY IN HEDGING HIGH REGIONAL CAPACITY PRICES

DEMEC members serve customers located in the Delmarva Peninsula, a load pocket where regional electricity requirements significantly exceed capacity. Transmission constraints during peak periods have continued to result in volatile and high prices for peak power. Plans for the Mid-Atlantic Power Path transmission line which are still under review, could significantly alleviate transmission constraints in the Delmarva Peninsula, but a service date is not envisioned before 2019, according to a recent PJM decision. After undertaking economic and feasibility studies, management chose to construct a second peaking unit to meet its growing peaking demand and reduce capacity surcharges. Moody's views management's strategy to mitigate the impact of the region's energy market volatility as a positive step in the medium term.

DEMEC's base and peak loads are projected to increase at 1.5% per year over the decade, exclusive of the partial requirements' members. The existing and new gas peaking facility will be primarily subject to gas price volatility, as well as oil prices due to their dual fuel capabilities, which could make the plants less economical to run amid a higher fuel cost environment. This has been offset in the past by increased capacity revenues.

DEMEC has power supply contracts with several counterparties at staggered maturities ranging from 1 to 30 years, and must also purchase from the spot market. Management has hired a services firm to help manage its power trading activity, while actively managing counterparties' credit quality for non speculative purposes. DEMEC contracts with counterparties rated Baa2 or better, or who post collateral according to limits mutually agreed upon. Moody's views the adoption of risk management policies as beneficial to the rating. Beasley, the existing gas peaker, accounts for 5% of energy requirements. The construction and installment of CT II, a nearly identical 45MW, GE LM6000PC gas fired combustion turbine and generator project with dual firing potential at the same site, at a cost of $644/ kW is considered as an economical alternative to the volatile peak power market prices in the region, while reducing ongoing capacity surcharges. Further, the installation of a synchronous condensing clutch will enable DEMEC to earn ancillary revenues from spinning reserve in PJM markets.

Approximately 60% of permits have been obtained, including local zoning permits, with the remaining air-quality permit anticipated to be received by December 2011, two months after commencement of the construction date. Operation date is scheduled for June 1, 2012 and 60% of equipment costs have been fixed at below budget costs. General construction risk exists. However Moody's does not view the construction risk or the ability to obtain the pending permit as significant pressure to the A2 rating given the well-known technology, the previous undertaking by DEMEC of a nearly identical plant within schedule with the same contractor having experience with similar size and larger projects, and the fact that the first unit has been operating since 2001 at below air quality maximum permitted levels.

INCREASING GENERATION SUPPLY AND MEETING RENEWABLE PORTFOLIO STANDARDS HAVE OVERALL POSITIVE IMPACT TO AVERAGE ENERGY PURCHASE COSTS

In efforts to increase its self-supply portfolio, as well as meet members' compliance with Delaware's state RPS requirements of 25% by 2025 (with a 3.5% solar carve-out), DEMEC has opted to participate in three generation projects which should all be in operation by the end of 2012, adding an additional 139MW to the supply portfolio. DEMEC's participation is in the form of long-term power purchase agreements, including a 70MW share as a take-or-pay participant to American Municipal Power's 544 MW natural gas fired Fremont Energy Center. Entry into these power purchase agreements will reduce DEMEC's average energy purchase price by 5 to 10%. As a result of these participations and the construction of CT II, DEMEC's share of owned generation should increase to 35% of total demand requirements by year-end 2012. Moody's views DEMEC's efforts to increase self generation and meet RPS requirements positively given the current 10% spot purchases, and 85% power purchase requirements at predominantly shorter term contracts (less than 2 years), in a volatile market.

SATISFACTORY BOND SECURITY FOR JOINT POWER AGENCY, SIMILAR TO SERIES 2001 BONDS, WITH SLIGHTLY WEAKER PARTICIPANT POOL

The bonds are secured by take-or-pay power purchase contracts from both the Beasley (Series 2001 Bonds) and CT II (Series 2011 Bonds) projects. The "take-or-pay" contracts between DEMEC and the same seven members participating in the two gas peaking facilities are authorized under Delaware statutes. 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. Since the issuance of the Series 2001 Bonds, the participant shares have shifted somewhat, with the city of Newark's share having declining from 47.4% to 35.1% in relation to the other members. Given the relative weighting of the City of Newark's stronger Aa rating on the participant pool, its share decline has also resulted in an overall pool rating decline to a weaker A level. Although Newark's share has declined from the previous 47% to a 41.5% blended participant share in both projects, a default event by Newark, still could not be fully covered by the remaining six members. This risk is offset by the stability and essentiality of Newark's electric utility and the strength of some of its largest base clients. A blended participant share will be in effect from the time the new bonds are issued until the full repayment allocable to the 2001 portion in 2026, at which time the Series 2011 participant share will apply. Moody's acknowledges the slightly weaker credit quality of the blended participant pool, but does not view the change as significant to warrant a shift in rating at this time.

The Series 2011 bonds, carry a debt service reserve requirement equivalent to the lesser of maximum annual debt service, 10% of par or 125% of average annual debt service. The Series 2001 Indenture will be closed but the associated power sales contracts will remain intact and fold into the security for the Series 2011 bonds, which will carry its own separate contracts for the life of the bonds. The bonds will amortize over 30 years, to create a level debt service of approximately $3.8MM from 2013-2026, and about $3MM from 2027-2041, after the portion associated to the refunding of Series 2001 have been fully amortized by 2026. The payments under each take or pay contract are considered operating and maintenance ("O&M") expenses of each member.

The security package will also include a pledge of the administrative charges from DEMEC's full requirements' contracts for the benefit of the $972 thousand of outstanding Series 2008-A bonds being refunded. Separate revenue accounts will be held through a trust, associated to each refunding and the Series 2011 bonds. The portion of the Series 2008-A bonds being refunded will be fully repaid by November 2018. Given its de minimis annual payments of $73 thousand until maturity, and corresponding secured pledge of revenues of approximately $1 million per year, Moody's considers the inclusion of this debt and the associated revenue as having little to no impact to the new issue's A2 rating.

The bonds do not benefit from a maintenance reserve, which is offset by the typical low operating and maintenance costs associated with the peaker units which are anticipated to run 5-6% of the time during any given year, the long known performing history of the technology, and DEMEC's access to lines of credit and three-day cash calls to members.

A 1.1x debt service coverage ratio requirement will continue to be in effect, which is equivalent to covenant levels set by similarly Moody's rated JPAs.

COST COMPETITIVE WITHIN UNREGULATED MEMBERS' TERRITORY

DEMEC provides electricity and other services to nine local municipally owned utilities. Seven of its members, including the cities of Newark (G.O. rated Aa2), New Castle, Seaford, and the towns of Clayton, Middleton, Milford, and Smyrna participate in DEMEC's currently only generating asset, Beasley, located in Smyrna, DE, which began operations in 2002. These seven members continue to be full requirements members of the JPA. Two additional members, the city of Dover (Aa2) and the Town of Lewes also purchase power from DEMEC on a partial requirements' basis. If these were to become full requirements' participants, DEMEC's peak demand would almost double from its 249MW peak in 2010. Dover would represent the vast majority of the increase at 165MW and would become DEMEC's largest full requirements member, with the City of Lewes representing an additional 19 MW.

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. Average residential retail rates for members are comparable to the rates of regional investor-owned utility, Delmarva Power & Light. Average annual wholesale prices to members have increased by 7% since 2006 to $93/MW in 2010, after a period of more significant price increases in 2005-06 to cover rising costs.

DEMEC's participants' ten largest customers account for close to 90% of total sales. Industrial customers account for 43% of the revenues, with residential and commercial accounting for 35.1% and 21.6% respectively. The composition of DEMEC's revenue share is changing somewhat with the installation of a few new commercial and industrial energy intensive clients in the region expected to increase peak load by 15.5MW in 2012. Participant's total customer base has remained overall stable in the past few years, increasing at a three-year average rate of 1%. The territory serviced by DEMEC has experienced lower unemployment rates than the state average of 8.4% as of June 2011, with the exception of the county of New Castle at 8.8% where Newark, Middletown and New Castle are located. Strong participants' customers such as the University of Delaware in the city of Newark, a customer for more than 50 years, represents a significant share of total energy sales. Given the lack of open choice to retail customers in DEMEC's service territory, unless elected city counsels 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.

STABLE FINANCIAL PERFORMANCE, BUT LOW LIQUIDITY LEVEL

Debt service coverage over the past few years on a bond ordinance basis has been significantly higher than the covenanted 1.1x coverage, primarily due to higher than anticipated capacity revenues since PJM moved to a new capacity pricing model in 2007. In FY 2010, debt service coverage was 3.2x, and 3.0x on average over the past five years. Debt service coverage by Moody's-calculated net revenues, including partial requirements' members, has increased to 3.3x in FY2010 from 0.97x in FY2005. Growing capacity revenues have helped balance the increased power purchase costs; wholesale prices to members increased 23% between 2005 and 2009 to cover rising costs. Debt service coverage on a bond ordinance basis is projected to remain at around 3x levels over the medium term, including capacity revenues based on recent forward capacity auction rates, and ancillary revenues. Based on Moody's more conservative assumptions, excluding ancillary revenues, and including capacity revenues derived from participants only, coverage ratios should be around 1.6x in the medium term. Although lower coverage ratios are typically offset by higher liquidity levels at similarly rated entities, management's projections appear reasonable and warrant maintenance of the A2 rating. Moody's notes that historical capacity revenues have surpassed management's expectations, and options to alleviate transmission constraints in the medium term remain limited.

DEMEC's liquidity position has historically been marginal, 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. Net working capital averaged 6% of operations and maintenance over the last four years, and days cash on hand was 11 as of FY 2010. This 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 contacts, as well as access to a $35MM letter of credit facility with PNC Bank, N.A. expiring in March 2012 (A2 Issuer Rating, P-1 short-term rating). The three-day cash call was implemented in early 2009 to raise $7 million from members to meet a collateral posting requirement for one of its power purchase agreements. Its members have maintained on average $14 million in cash balances over the past three years, representing 3.6x coverage of the approximate $3.8 million proforma annual debt service. The 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. DEMEC regularly reviews the sufficiency of these letters to cover its mark to market exposures to power providers. Additional liquidity is provided by a $3MM line of credit with PNC Bank, N.A. , containing similar MAC clause, recently extended to September 30, 2012, for general operations. Moody's views DEMEC's low liquidity as a weakness to the A2 credit rating, only partially mitigated by the ability for call on its members for cash on short-notice.

DEMEC's debt ratio of 81% as of FY 2010 is below-average for the sector, and it is expected to remain at this level proforma for the debt issuance, and construction completion. Further, additional parity debt is permitted under the indenture to finance acquisition and construction of generation facilities, including parity swap payments (termination payments would be subordinate), although DEMEC does not have any new capital projects planned through 2015. In anticipation of the project's construction, DEMEC entered into a $15MM loan agreement with PNC Bank N.A. maturing in May 2012, which will be repaid using proceeds from the 2011 Series, without penalty. DEMEC also has an additional $7MM of parity debt, not rated by Moody's, issued on behalf of the city of New Castle for the construction of a substation. DEMEC can also issue subordinated debt, provided it is in compliance with covenants under the indenture. Moody's believes that current debt level and debt service requirements proforma for the new issuance remain in line with the A2 credit rating.

TAKE OR PAY CONTRACTS REPRESENT A MINOR PART OF PARTICIPANT RESOURCES

Similar to the debt financing of Beasley, payments on the Series 2011 issuance, will represent a minor portion of member's resources. The debt service payments tied to the combined take-or-pay contracts, should 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. The associated stability and minor percentage of members' resources affected provide comfort in member's ability to meet contract requirements' in the event that either Beasley or CT II would become inoperable for a period of time.

KEY INDICATORS

Debt Ratio, FY 2010: 81.3% (Moody's Municipal JPA Median: 120.4%)

Operating Ratio, FY 2010 (5 YR AVG): 94.4%

Debt Service Coverage by Moody's Calculated Net Revenues, FY 2010: 3.36x

Debt Service Coverage by Bond Ordinance, FY 2010: 3.2x

Days Cash on Hand, FY 2010: 11 days (Moody's Municipal JPA Median: 157 days)

RATED DEBT

Electric Revenue Bonds Series 2011, $56 million

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The principal methodology used in this rating was U.S. Municipal Joint Power Agencies published in September 2006. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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