

## RESEARCH

**Delaware Municipal Electric Corp.; Retail Electric**

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**Credit Profile**

Delaware Muni Elec Corp (AMBAC)

*Unenhanced Rating*

A-(SPUR)/Stable

Affirmed

Many issues are enhanced by bond insurance.

**Rationale**

The 'A-' Standard & Poor's underlying rating (SPUR) on Delaware Municipal Electric Corp.'s (DEMEC) series 2001 electric revenue bonds reflects:

- Strong take-or-pay contracts with creditworthy project participants,
- Healthy project debt service coverage,
- Good project economics,
- Steady electricity demand growth ranging from 2% to 4%, and
- Proactive management.

The rating also incorporates:

- Thin financial margins at the agency level, which is typical of joint-action agencies; and
- A moderate degree of customer concentration.

DEMEC is a joint-action agency with nine Delaware municipal members. The agency's first and only project was a 45-MW gas-fired peaking facility located in Smyrna, Delaware (the project), which has been in commercial operation since mid-2002. Only seven of DEMEC's members participate in the project under long-term, take-or-pay contracts that extend for the life of the debt through mid-2026. All of DEMEC's debt, currently about \$31 million, is related to the project.

Under the project's take-or-pay contracts, participants must pay their pro rata share of the cost of ownership of the project, including debt service on the bonds. The obligation to pay DEMEC is an operating obligation, and therefore ranks prior to any debt service that the retail utility may have. The rate covenant requires 1.1x aggregate debt service. Prudently, the DEMEC board elected to fund at the higher level of 1.1x maximum annual debt service (MADS), exclusive of net capacity and energy revenues of the project. Because the project provides positive revenues, the coverage is significantly more than the required 1.1x.

Contract step-up provisions provide an additional layer of protection to bondholders in the event of an individual participant default. As per contract provisions, if a participant defaults in its payment obligation to DEMEC, the remaining participants must pay their respective pro rata share of the defaulted amount up to 125% of their initially contracted allocation. Contracts run for the life of the bonds, which relieves DEMEC of re-contracting risk, provided that no participant defaults.

Overall, participant credit profiles are characterized by a lack of retail choice, low debt burdens, and

adequate cash flow protection and liquidity. Although investor-owned utilities operate in a competitive electric utility market, under Delaware law municipal electric utilities have complete discretion regarding when and if to implement retail choice. Participants are not highly leveraged. Including each participant's share of the project debt, debt per customer averages around \$1,200. Before accounting for transfers, participant fixed-charge coverage ratios, which include payments for purchased power, are typically adequate, ranging from 1.0x to 1.4x. Actual project debt service coverage, although targeted at 1.1x MADS in DEMEC's annual budget, has ranged from 1.95x (in 2003) to 2.5x (in 2005) due primarily to increasing positive revenues from operations of the peaking plant.

Liquidity at the participant level is also generally adequate. In addition to unrestricted cash and reserves reported on the balance sheets, in Delaware the unrestricted cash and reserves of all utilities in the Enterprise Group and general fund is available for combined short-term cash requirements. Cash not required for utility capital reserves and liquidity is transferred to each city's general fund, which limits the need to raise property taxes. Cash in all reserves can be used to meet unanticipated needs in any governmental operation.

At the agency level, fixed-charge coverage, including debt service and purchased power, is 1.0x, which is typical for joint-action agencies; liquidity is adequate. In addition to the debt service reserve and a \$10 million line of credit, unrestricted cash has typically amounted to about 30 days of cash operating expense. In 2004 and 2005, reported year-end cash was lower due to rising operating costs related to rising fuel costs. However, fuel costs are recovered through purchased power costs, which account for 80%-85% of load, billed to project participants monthly and are, in turn, collected from retail customers through a purchased-power adjustment clause in the retail tariffs. In addition, DEMEC can bill participants for interim unanticipated costs; these bills are typically paid within three days. This situation occurs rarely.

The project serves as a physical hedge against congestion and reduces participant exposure to power price volatility in the PJM locational marginal pricing (LMP) market. As such, it demonstrates good project economics. The 45-MW generator serves a load pocket on the transmission-constrained Delmarva peninsula and has replaced high-cost peak power purchases for participants. The project's operations and maintenance costs and reliability continue to meet expectations.

Over the next two to three years, DEMEC's management will decide what the most cost-effective investments will be to meet growing electricity demand, which in some areas of the Delmarva peninsula is as high as 4% annually. The decision will depend, in part, on which new transmission links are approved by PJM and the Federal Energy Regulatory Commission (FERC). DEMEC's management has been gradually increasing its electricity sourcing capabilities, establishing a risk management policy, expanding trading agreements, using The Alliance for Cooperative Energy Services Power Marketing (ACES) to manage short-term power purchases and sales, and recently signing three new agreements for the supply of electricity in 2007, 2008, and 2009--some of which take the risk for transmission line congestion. Management typically locks in supply for about 85% of supply and uses the peaking unit and short-term purchases from the PJM power grid to meet remaining requirements. In 2005, the president and CEO of DEMEC chaired the PJM Members' Committee and currently serves on the PJM Board's nominating and finance committees.

While all of these factors are considered, the project's rating is primarily based on the credit of the participants, as the power sales agreements, which include a 125% step-up arrangement, provide the assurance of debt service coverage. In cases where there are only a few members, the rating assigned is usually the weakest rating. In this case, the weaker members are viewed as having credit profiles that would warrant a rating of 'A-' or 'BBB+'. However, the city of Newark, which owns nearly 50% of the project, has a strong financial position and credit profile, which supports the rating. There would be a cause for concern if the city's credit profile were to weaken or if the Delaware market were not growing as rapidly as it is, which makes the peaking unit an attractive asset for an alternative owner.

## Outlook

The stable outlook reflects the predictable cash flow under contracts that match the life of the project debt, with the added protection of a step-up arrangement capped at 25% of current ownership; the strong economics of the project; and the gradual approach of DEMEC's management in determining the most cost-effective, limited-risk strategy for meeting the increasing electricity demand on the transmission-constrained Delmarva peninsula.

## The Agency

DEMEC is a joint-action agency of nine municipalities in the state of Delaware created in 1979 for the purpose of ownership and operation of electric utility facilities and the cooperative purchase of electric power. The agency's first and only project is a 45-MW peaking unit located in Smyrna, Del.

Seven of the agency's nine members are participants in the project: the towns of Clayton, Middletown, Milford, and Smyrna and the cities of Newark, New Castle, and Seaford—all in Delaware. Each participant has entered into take-or-pay purchased-power contracts, under which they must pay their pro rata share of the cost of ownership and operation of the project, including debt service on the bonds. If any participant defaults in its payment obligation under the above contracts, the remaining participants must pay their respective pro rata share of the defaulted amount up to 125% of their initially contracted allocation.

## Contracts Include 25% Step-Up

All agency debt (\$31 million) is related to the project. Since the contracts require take-or-pay payments and include step-up provisions that require nondefaulting members to make up any project deficiencies with additional payments up to 25% of a member's original allocation, the rating reflects the respective percent shares of the project held by each participant, the step-up percent limit, the credit rating of the individual participants, and the project's positive performance.

Specifically, the rating methodology requires that the credit quality of all participants be assessed and ranked in order of highest to lowest. Starting with the highest rating, the cumulative percent share of the participants plus their respective maximum step-up percents are tallied. A joint-action agency's rating will tend to approximate the rating level of the participant that increases the cumulative combined mandatory and step-up percent share to at least 100%—the level at which all project operational and debt service costs are covered.

The agency's business profile of '5' on a '10'-point scale, with '1' being the strongest and '10' the weakest, reflects an average utility business profile.

## The Project: A Reliable Peaking Unit

The project is a 45-MW General Electric LM6000 PC combustion turbine with dual-fuel capability. The unit was placed in service in mid-2002 and currently provides participants with approximately 25% of their peak power requirements. Access to the 45-MW unit enables participants to manage the high power costs and reliability issues endemic to the transmission constrained Delmarva peninsula. The unit's availability factor was 100% during the summers of 2003 through 2006. Maintenance-related outages are planned for the spring and fall of each year.

The project's primary fuel is natural gas, which is transported to Smyrna by Eastern Shore Natural Gas. The project uses low-sulfur oil as backup fuel in the event of gas supply interruptions. DEMEC purchases gas on a competitive basis. Chesapeake Utility Corp. manages the agency's gas supplies. Eastern Shore has two pipelines in the area, which are connected to two other interstate pipelines: Columbia Gas Pipeline and Texas Eastern Pipeline. The pipelines typically experience capacity shortages during the winter. Although the project operates primarily during the summer, DEMEC is exposed to potential gas supply interruptions in the winter. Partially mitigating the risk of a short-term gas supply shortage is the project's dual-fuel capability. The agency has the ability to store on-site enough oil to run the project for up to five average peaking days.

## Participants: Solid Credit Profiles

DEMEC's ability to pay principal and interest on the project's bonds is largely a function of the ability of participants to make prompt and full power and transmission cost payments to DEMEC under the project's take-or-pay contracts. Each participant retains the following ownership interest in the project: Newark (47.4%), Milford (20.8%), New Castle (8.9%), Smyrna (7.5%), Seaford (7.1%), Middletown (6.8%), and Clayton (1.5%). Monthly power costs are calculated on the basis of these ownership interests.

The project is disproportionately affected by the electric system of Newark, which has the largest ownership interest at nearly 50%. Should Newark default on its contract payments to DEMEC, step-up

payments from the remaining six participants (capped at 25% above original payment) would be insufficient to cover 100% of project operational and debt service costs. Material exposure to Newark is tempered by the relative strength of the Newark system.

Newark's business profile is characterized by a moderately growing market with average wealth levels and competitive residential rates. The utility system's financial profile weakened in fiscal 2005, but a rate increase implemented in April 2006 is expected to result in fixed-charge coverage back up to a range of 1.2x to 1.3x.

Liquidity for the Newark system is also adequate, although cash at the end of fiscal 2005 was equal to only about 20 days of operating costs. However, when purchased power costs, which are passed through directly to customers, are excluded, cash coverage of operating costs increases to around 300 days. And, although Newark's 10 leading customers account for nearly 40% of total revenues, the largest customer (25% of revenues) is a stable university system under a 20-year contract (University of Delaware; AA+/Stable). Several of Newark's other large customers are also under long-term contracts and may not seek alternative suppliers since, under Delaware law, municipal systems have complete discretion regarding when and if to implement retail choice in their respective municipalities.

Overall, participant business profiles are characterized by above-average rates, high industrial and commercial concentrations, and disparate economic characteristics. However, leverage is low since the project-related debt is only \$31 million. Milford and Smyrna carry about \$1,700 per customer; Newark, New Castle and Middletown carry about \$1,000 per customer, and Seaford and Clayton carry less than \$1,000 per customer. Based on the most recent financial statements (ranging from June 2005 to June 2006), fixed-charge coverage after transfers, which includes each participant's share of project debt service and 50% of purchased power as a proxy for capacity payments, ranged from less than 1x at Newark and New Castle, to around 1x at Seaford and Middletown, 1.3x at Milford, and 1.4x at Smyrna.

Liquidity at the participant level is adequate, particularly since the available funds of the cities' and towns' Enterprise Group (all utilities) and general fund is combined. However, most of the participant cities and towns depend on fairly large transfers from the municipal utilities to the general fund.

The participants' take-or-pay contracts run for as long as the project's bonds are outstanding. The contracts require participants to set rates and charges for sufficiency only, somewhat weaker than what Standard & Poor's has seen in other projects of this nature, which are usually at 1.10x and sometimes as high as 1.25x coverage. The obligation to pay DEMEC is an operating obligation and, hence, ranks prior to any debt service that the retail utility may have, and the obligation is that of the respective electric department, board, or fund of each of the participants; there is no GO pledge to meet contractual obligations.

The take-or-pay contracts and the trust indenture together establish a number of funds and accounts important to the project's creditworthiness. All revenues flow into a revenue account and, from there, to a bond fund, which contains debt service reserve accounts for principal and interest; a rate stabilization account; and an operations and maintenance account. Lower in the flow of funds, and after the debt service reserve accounts, is a reserve and contingency fund. Although the indenture establishes these funds, there is no minimum funding requirement for funds other than the debt service reserve fund. The debt service reserve requirement is a project strength in that it requires the lesser of MADS, 125% of average annual debt service, or 10% of the original principal amount of the bonds, which is typical of municipal revenue bonds but not necessarily of project debt, which may only require a funding level equal to maximum annual interest. All accounts (except the bond rebate fund) are pledged to bondholders.

The reserve and contingency fund is only required to be funded if provided for in the annual budget. Only then is any revenue included in the 1.10x coverage covenant and, thus, billed to project participants.

The indenture permits additional bonds on parity with the project's bonds, which could dilute current bondholder protections.

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