Standard & Poor's Credit Rating

July 7, 2004

Rationale

The 'A-' rating for Delaware Municipal Electric Corp's Series 2001 electric revenue bonds reflects strong take or pay contracts with project participants, the creditworthiness of project participants, and good project economics. These strengths are partially offset by significant participant concentration, relatively weak legal provisions, and thin financial margins at the agency level.

DEMEC is a joint action agency of nine Delaware municipalities. The agency's first and only project was a 45MW gas-fired peaking facility in Smyrna, DE in full operation since mid-2002. Only seven of DEMEC's members participate in this project under long-term "take-or-pay" contracts. Virtually all of DEMEC's debt, currently about $34 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, hence, ranks prior to any debt service that the retail utility may have. 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 systems have complete discretion regarding when and if to implement retail choice. As such, DEMEC members are currently protected against competition. After accounting for DEMEC-related off-balance sheet obligations, participants are not highly leveraged. The top-three participants carry only about $1,500 in total debt per customer. Before accounting for transfers, participant fixed charge coverage ratios are typically adequate, ranging from 1.2x to 1.6x. Liquidity at the participant level is also generally adequate. The project's two largest participants typically carry cash in excess of 100 days of operating expenses.

The project serves as a physical hedge against congestion and reduces participant exposure to power price volatility. As such, it demonstrates good project economics. The 45MW unit serves a load pocket on the transmission constrained Delmarva Peninsula and has replaced high-cost peak power purchases for participants. The project's O&M costs and reliability continue to meet expectations.

The project's rating 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 system, which enjoys a moderately growing market with average wealth levels and competitive residential rates. The system also has adequate cash flow protection with an average fixed charge coverage before general fund transfers of 1.34x over the last three years.

The project's legal provisions are somewhat weak. Although provisions establish several reserve funds, there are no minimum funding requirements other than for the debt service reserve fund. DEMEC's board had anticipated funding the project's R&C fund in an amount equal to 10% of annual debt service, with the first 5% provided by bond proceeds. Currently, however the R&C fund remains virtually unfunded. Moreover, there are no immediate plans to fund the project's rate stabilization fund.

On a consolidated basis, DEMEC's financial margins are thin with only 1x coverage of fixed charges. Going forward, Standard & Poor's anticipates that on a consolidated basis DEMEC will manage to a 1x fixed charge coverage. DEMEC anticipates material capital expenditures ($20mm) in relation to another peaking unit at the Smyrna facility site in 2006. The project, which would be financed with additional debt, is still preliminary. However, unit permitting is expected by the end of 2005.

Liquidity

The agency maintains approximately 30 days cash on average. DEMEC's purchased power contracts as well as access to owned peaking generation help temper the agency's exposure to spot market power prices. This moderate exposure and the agency's rate-setting flexibility as well as that the rate-setting flexibility of its members allow DEMEC to maintain modest levels of available liquidity.   The agency's primary liquidity risk is the unplanned purchase of power during peak summer months. DEMEC purchases two-thirds of its power needs through a short-term contract with fixed-load shape. The contract expires in less than 2 years but may be extended for another 19 months. DEMEC is exposed to volatile spot market power prices only to the extent that its power needs exceed supply specified under the fixed-load contract and available by way of the project. Project debt is amortizing with debt service of approximately $2.5 million per year.

Outlook

The outlook on the project's rating is stable and reflects expectations that participant credit profiles will not materially change over the near term. In addition, the outlook assumes that participants of the project will not opt for retail choice in their respective municipalities. Lastly, the stable outlook assumes that any additional debt to fund separate projects will not dilute current bondholder protections.

FULL REPORT

Business Description

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 45MW peaking unit in Smyrna, DE.

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

Ratings Methodology

All agency debt ($34 million) is related to the Project. Since contracts involve take-or-pay payments and include step-up provisions that require non-defaulting members to make up any Project deficiencies with additional payments up to 25% of a member's original allocation, the rating reflects the respective percentage shares of the Project held by each participant, the step-up percentage limit, the credit rating of the individual participants, and lastly, the Project's 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, the cumulative percentage share of the participants plus their respective maximum step-up percentages 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 percentage share to at least 100%, the level at which all project operational and debt service costs are covered.

Business Profile

The agency's business profile is rated a '5' on Standard & Poor's 10-point scale, with '1' being the highest score. A '5' score reflects business profile characteristics of the average utility.

The Project

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 45MW 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 summer 2003. Maintenance-related outages are planned for both the spring and fall of 2004.

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 back-up in the event of gas supply interruptions. DEMEC purchases gas on a competitive basis. Chesapeake Utility Corporation manages the agency's gas supplies. ESNG 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 5 average peaking days.

Participants

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%), Middleton (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 system.

Newark's business profile is characterized by a moderately growing market with average wealth levels and competitive residential rates. The system also enjoys adequate cash flow protection with an average fixed charge coverage before general fund transfers of 1.34x over the last three years. Liquidity for the system is also adequate at 116 days cash on average for the same period. These strengths are partially offset by above-average commercial and industrial rates, material industrial/commercial exposure (70% of revenues), and significant customer concentration. Newark's top-ten customers account for nearly 40% of total revenues. However, Newark's largest customer (25% of revenues) is a stable university system under 20-year contract (University of Delaware/ AA+ Stable). Moreover, several of Newark's large customers are under long-term contract including Rohm and Haas Electronic Materials (5% of revenues) and the Lear Corporation (1% of revenues).

Overall, participant business profiles are characterized by above-average rates, high industrial and commercial concentrations, and disparate economic characteristics. Industrial and commercial rates for the two largest participants are between 30% and 50% above state averages. Most participants also serve a significant number of industrial

and commercial customers with attractive load factors. Industrial and commercial customers account for nearly 70% of revenues for each of the project's three largest participants. Should retail choice ever be implemented in the participant service areas, high rates combined with numerous industrial/commercial customers could deteriorate the credit strength of participant systems both quickly and materially. Standard & Poor's recognizes, however, that under Delaware law, municipal systems have complete discretion regarding when and if to implement retail choice in their respective municipalities.

Even after accounting for DEMEC-related off-balance sheet obligations, participants are not particularly leveraged. The top-three participants carry only about $1,500 in total debt per customer. Liquidity at the participant level is also generally adequate except for Middleton, which has had less than 1 days cash on average over the last three years. Transfers to city general funds are large for many participants, ranging from a low of 0.64 cents/KWh in New Castle to 3.15 cents/KWh in Smyrna. The cities' dependence on large transfers from participant municipal systems results in thin financial margins for the project's participants. Fixed charge ratio after transfers have hovered around 1x in the last three years for all project participants, adding to system financial risk.

Regulation

Delaware is currently implementing a competitive electric utility market for investor-owned utilities only. As such, only customers of Conectiv Power Delivery and Delaware Electric Cooperative have retail customer choice. Publicly-owned utilities, like municipal utilities and cooperatives, are currently not required to deregulate and have the option to determine if and when they wish to implement electric supply choice for their customers. None of DEMEC's Project participants is currently contemplating implementing choice in their respective service territories.

Finances

Standard & Poor's characterizes DEMEC's consolidated financial profile as slightly weak given its thin financial margins, limited liquidity, and unfunded R&C and rate stabilization funds. These risks are partially offset by modest levels of debt, currently at $667 per KW of capacity.

Consolidated financial margins are thin at roughly 1x fixed charges. Going forward, Standard & Poor's anticipates that DEMEC will manage to a 1x fixed charge coverage. DEMEC has historically maintained about one month of operating expenses in cash. DEMEC liquidity requirements are moderate given the corporation's pass-through of purchased power costs to participants.

DEMEC had previously anticipated funding its R&C and rate stabilization funds. To date, neither fund is materially funded, leaving bondholders will little cushion at the agency level.

The agency's debt is almost entirely related to the project and although currently low is expected to rise moderately in 2006. DEMEC anticipates adding additional peaking

generation at the Smyrna facility site in the near future. Capital expenditures for this project are projected at about $20 million for which the agency will need to issue additional debt.

Legal Provisions

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. Furthermore, the obligation is that of the respective light 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 creditworthiness of the project. 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 (R&C 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 is requires the lesser of maximum annual debt service, 125% of average annual debt service, or 10% of the original principal amount of the bonds. This requirement is higher than in other projects, which may only require a funding level equal to maximum annual interest. All accounts (except the bond rebate fund) are pledged to bondholders.

The R&C 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.

DEMEC's board had anticipated funding the R&C fund to an amount equal to 10% of annual debt service, with the first 5% to be provided by bond proceeds. Currently, however the R&C fund is virtually unfunded. There are no immediate plans to fund the rate stabilization fund either.

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