S&P Global Ratings

Research

Summary:

Delaware Municipal Electric Corp.; Wholesale Electric

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Credit Profile		
Delaware Municipal Electric Corp. rev bnds		
Long Term Rating	A/Stable	Affirmed

Rationale

S&P Global Ratings has affirmed its 'A' rating on Delaware Municipal Electric Corp.'s (DEMEC) series 2011 electric revenue bonds. The outlook is stable.

Debt outstanding amounts to $48 million.

About $30 million of the 2011 bonds funded 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 also refunded the $25 million remaining from the debt issued in 2001 to construct CT I; refunded the remainder of $982,120 issued in 2008 to acquire and renovate an administrative building and land in participant Smyrna's business park; and funded a $3.9 million debt reserve and a $1.2 million capitalized interest fund, equal to eight months of interest expense.

The rating reflects our view of the following strengths:

- Financial metrics (coverage and liquidity) at the project level is very strong for a joint action agency, which offsets somewhat mixed financials at the participant level.
- The project participants' service territories generally have above-average demographics (including above-average wealth levels and below average unemployment) and they generally have limited direct debt, and limited capital needs.
- Take-or-pay power sales contracts with 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.
- Owned generation units provide a hedge against peak power costs in the PJM market.

We believe the following risks mitigate these strengths:

- Some project participants have customer bases that lack meaningful customer diversity, potentially limiting rate-setting flexibility.
- Project participants' rates are generally above the state average, which further limits rate flexibility. DEMEC's gradually declining wholesale rates, which have come down over 18% since 2010 as the utility has reduced its power supply costs, offsets this somewhat.
- Many participants have large general fund transfers, which limits their ability to accrue cash reserves.

DEMEC is a joint action agency formed in 1979 to supply electricity to seven Delaware municipalities, which have all-requirements contracts. The seven full-requirements members are Newark (entitled to 41.25% of Beasly combined output from CT I and CT II), Milford (16.1%), New Castle (8.05%), Smyrna (8.6%), Seaford (8.6%), Middletown (11.65%), and Clayton (1.7%). Del. Lewes, Del., is now also a full requirements member, and Dover, Del., is a partial requirements customer, but neither participates in the Beasley project. We do not consider either city's financial metrics in our analysis.

DEMEC 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. A second unit, CT II began operating in mid-2012. NRG Thermal LLC operates both units. The units have helped reduce wholesale rates to the members by reducing peak power purchases from the PJM pool. The units also earn revenue selling capacity and energy into the PJM market, which helps lower wholesale rates for the participants. In addition, the sale of spinning reserves are especially valuable as the PJM system adds more intermittent resources such as wind and solar.

DEMEC is also a member of American Municipal Power Inc., a joint-action agency based in Ohio, and has signed a 30-year contract to take 92 MW of power from the Fremont plant, a 675 MW natural gas combined-cycle unit. That unit dispatches power into PJM's western side. The Fremont and Beasley assets provide 182 MW of capacity, representing 65% of the seven participants' 2017 peak load of 278.5 MW. Management has achieved its goal of owning and self-supplying at least 50% of capacity needed for its full-requirements members. Finally, the utility has long-term purchase power agreements for 69 MW of wind and 13 MW of solar resources. Management expects to bring online around 12 MW of community-based solar generation in various member systems over the next several years.

DEMEC's owned generation accounted for approximately 48% of the utility's 2017 energy needs. Of the remaining 52%, 13% came from contracts with a term of three or more years, 18% from two-year contracts, 20% from one-year contracts, and 2% from the spot market.

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 or transfer payments that the utilities might have to make. 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. The step-up would not cover the Newark utility's share, which accounts for almost half of project revenue. If there were a default, that member's share would be offered to other participants or sold to an outside buyer. If there are no buyers, the 25% step-up obligation takes effect.

We believe the project exhibits very strong debt service coverage (DSC) for a joint action agency, which enhances the credit quality of the revenue stream that the participants contribute and the participants' step-up commitments. The lack of retail choice, low debt burdens, and generally good coverage of fixed costs characterize most participant profiles. Although Delaware's investor-owned utilities operate in a competitive electric utility market, municipal electric systems have complete discretion regarding retail choice.

The Beasley project's DSC has been strong--above 4.0x in each of the past three years. In our opinion, the participants' credit metrics and business profiles place them in the medium investment grade category. Fixed charge coverage after transfers to the general fund ranged from 1.02x (Clayton) to 2.70x (New Castle). Liquidity is what we consider good for three of the seven participants, ranging from 126 days' cash on hand to 215; adequate for a fourth, at 57 days; and weak for the other three, ranging from none to 36 days. However, the utilities set their own rates and pass purchased power costs on to their retail customers monthly, which reduces the need for surplus cash. In addition, the amount of debt each participant carries is low, in our view.

The participants' service area economies are generally stable. In 2017, unemployment for the project participants averaged 4.6%, slightly above the national average of 4.4%. Median household effective buying income (MHEBI) for each participant is above the national average, aside from Seaford, whose MHEBI was 68% of the national average. Several of the participants have large customers, but they have been local employers for many years and provide stable revenue. Newark provides electricity to the University of Delaware, Milford serves Perdue Farms and U.S. Cold Storage, and Middletown serves Johnson Controls Inc.

In our opinion, liquidity is good. DEMEC maintains a $10 million line of credit for working capital and a $20 million letter of credit for posting collateral. There are currently no draws on either facility. Both facilities renew annually in September. The highest level of collateral posting was in 2008, when gas prices plunged to $5.00 per thousand cubic feet from $12. The collateral posting was $27 million, while postings were just $4.2 million and $3.9 million in 2017 and 2016, respectively. The agreement with each of DEMEC's counterparties contains a rating trigger: if the rating on the counterparty slips below 'BBB', the collateral threshold terminates. Cash on hand equaled nearly 70 days' worth of operating expenses in 2017, up from just 16 days in 2014.

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, the utility can bill participants for interim unexpected costs, and they typically pay them within three days.

Outlook

The stable outlook reflects our assessment of the stable nature of the project's operations and our expectation of no material variations in the medium term in either DEMEC's or the participants' financial metrics. The outlook also reflects the predictable cash flow under contracts that match the project debt's life, with the added protection from the step-up as well as the project's strong credit metrics.

Upside scenario

We could raise the rating over the next two years to the extent that credit quality improves for one or more members, but only to the extent that our analysis concludes that those members would be able to shoulder the burden of the lower-rated members' project debt without credit erosion.

Downside scenario

We could lower the rating over the next two years to the extent that credit quality worsens for one or more members or if DEMEC experiences material declines in fixed charge coverage or cash levels.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.