FITCH AFFIRMS 'A' RATING ON DELAWARE MUNI ELECTRIC CORP'S ELECTRIC REV BONDS; OUTLOOK STABLE

Fitch Ratings-New York-02 August 2019: Fitch Ratings has affirmed the 'A' rating on the following obligations of the Delaware Municipal Electric Corporation (DEMEC):

--Approximately $48.1 million electric system revenue bonds, series 2011.

The Rating Outlook is Stable.

Fitch had designated the rating as Under Criteria Observation (UCO) on April 9, 2019, following the publication of Fitch's revised rating criteria. The UCO designation has been removed and resolved.

ANALYTICAL CONCLUSION

Fitch's affirmation of the rating is supported by the credit quality of the largest participants in DEMEC's Warren F. Beasley Power Station project (Beasley Project, or the project) and the strong contractual framework, which includes the take-or-pay power sales contracts (PSCs) that secure the electric system bonds. The purchaser credit quality assessment broadly reflects the very strong financial and operating profiles of the largest participating utilities, including Newark and Milford, who benefit from independent rate setting authority, service area characteristics consistent with national and regional averages, and little or no system debt. However, the assessment and rating are currently constrained by the slightly weaker profile of the city of Middletown's electric system, the third largest purchaser. The operating profile of the Beasley Project is further assessed as strong based on the project's strategic location on the Delmarva Peninsula and its contribution to each utility's capacity requirements, but is less of a consideration in the final rating.

CREDIT PROFILE

DEMEC is a joint action agency serving nine municipally owned electric distribution utilities located in the state of Delaware (AAA/Stable). Seven of DEMEC's nine members receive power explicitly from the Beasley Project, which consists of two natural gas-fired simple-cycle combustion turbine generation units (Units 1 and 2), each with 45 MW capacity. While DEMEC provides all-requirements power supply to its members, including the seven Beasley project participants, payments necessary to meet project operating expenses and debt service on the series 2011 bonds are made separately pursuant to the PSCs.

Collectively, the DEMEC members serve approximately 131,000 people and about 69,000 end use meters. In 2018, non-coincident peak demand reached 305 MW.

Given the take-or-pay nature of the PSC, the strong purchaser credit quality is more of a consideration in the rating than the project's financial profile, leverage and coverage.

KEY RATING DRIVERS

Revenue Defensibility: 'a'; Strong Contractual Framework and Purchasers

Revenue defensibility is assessed as strong based on the contractual obligations underpinning the project, which are unconditional but only provide for a limited reallocation of costs. The assessment also reflects the project's purchaser credit quality (PCQ) assessment. The PCQ is determined through Fitch's evaluation of the credit quality of the largest purchasers accounting for over 80% of the contractual obligation.

Operating Risk: 'a'; Strategic Single-Asset Natural Gas Project

The Beasley Project's operating risk profile is assessed as strong based on the strategic importance of the single-asset project and total project costs that are manageable and consistent with similar peaking resources. Importantly, the take-or-pay contract structure requires payment on the project bonds whether the project is operating, or operable.

Financial Profile: 'a'; Strong Consolidated Financial Performance

The project's financial profile has been assessed as strong using DEMEC's consolidated financial metrics, which indicate relatively low leverage, and sufficient coverage and liquidity. However, given that the project's operating performance is largely balanced and passed through to the project participants, financial profile is less of a consideration in Fitch's determination of the final rating.

Asymmetric Additional Risk Considerations

No asymmetric risk considerations affect this rating.

RATING SENSITIVITIES

CHANGE IN PARTICIPANT CREDIT QUALITY: The rating is largely driven by the credit quality of the seven project participants. Any positive or negative movement in the credit quality of the project participants will continue to be factored in Fitch's review and could affect the rating on the project bonds.

SECURITY

The series 2011 bonds are secured by a first lien on net revenues, which are principally derived from PSC between DEMEC and the seven project participants related to the Beasley project. Other pledged net revenues include administrative charges derived from full requirements contracts with the same seven participants, but annual amounts are nominal.

Revenue Defensibility
The Beasley Project exhibits strong revenue source characteristics driven by terms of the PSCs that underpin the project's revenue stream, which are unconditional but only provide for a limited reallocation of costs. The seven project participants' obligation pursuant to the PSCs requires each to purchase the project capacity and energy based on their allocated share of the project. Payments are unconditional and imposed on a take-or-pay basis whether or not the project is operating, operable or capacity has been interrupted or suspended. While each participant may be reallocated the payment obligation of defaulting participants, such reallocation or "step-up" is limited to 25% of each participant's original allocated share of the project.

Each of the participants and DEMEC, have covenanted to maintain rates sufficient to repay their obligations under the respective agreements through the maturity of the bonds. DEMEC has covenanted to collect charges related to the project that are sufficient, together with other available funds, to meet all requirements and provide 1.1x DSC. Additionally, DEMEC's wholesale rates contain a purchase power charge that can be changed monthly to pass through costs as necessary.

Rate flexibility is considered strong as Delaware municipal electric utilities maintain full local control of rate setting that is not subject to external party approval.

Purchaser Credit Quality the Focus of Project Rating

Fitch's assessment of purchaser credit quality focuses on the credit quality of the largest Beasley Project participants, who collectively account for 82% of the project's contractual obligations, an amount sufficient to meet the project's obligations after factoring the PSC's 25% step-up provision. The assessment broadly reflects the credit quality of the two largest participants, which are Newark and Milford. While the credit quality of Newark and Milford each effectively cap the PCQ, as each purchaser's share (41% and 20%, respectively) exceeds the amount covered by the step-up provision, neither currently constrains the PCQ. The 'a' assessment is constrained by the slightly weaker profile of Middletown, the third largest purchaser.

Newark is the project's largest off-taker with combined entitlement shares at over 40% of the project. The utility routinely generates very strong operating margins in excess of 20%, most of which it transfers to the city's general fund. The transfer amount has remained at or close to $10 million over the prior five fiscal years, or just under 20% of revenue. Newark's continued practice of making transfers much larger than its peers remains of some concern to Fitch; however, the strong operating performance provides positive cash flow and adequate liquidity after covering its full obligations, including purchase power costs and the general fund transfer. The utility's days of cash on hand recovered to 95 days in fiscal 2017, which is notable given the utility's limited role as a distribution only system and its ability to automatically recover the vast majority of its operating expenses from a power cost adjustment that can be made on a monthly basis if needed.

Milford is the second largest Beasley member and produced strong margins in fiscal 2018, deleveraging the system further to a low 4.3x. DCOH increased to over 200. Other participants generally exhibit healthy cash flow, minimal to no debt and cash reserves consistent with the project rating either at the system level or government-wide. Weaker liquidity in the electric fund of project participants Middletown and Smyrna results from policies to make sizable general fund transfers. In both of these cases DCOH in the city's governmental funds relieves Fitch's liquidity concerns. Additionally, Middletown's customer base is concentrated in two large commercial customers making up roughly a third of sales.

All of the Beasley project participants receive the balance of energy needs above the project participation from DEMEC's full requirements project. DEMEC's energy portfolio is diverse and includes market purchases, existing assets and other staggered-term power contracts. Participants rely on DEMEC to provide, among other benefits, power that meets the state's renewables standards.

Operating Risk
Project Cost Burden Less of a Concern

The project is a single-asset natural gas plant strategically located on the geographically isolated and transmission constrained Delmarva Peninsula. The peaking plant is used only minimally (the capacity factor ticked up slightly to 3.6% in fiscal 2018), but provides important cost protection to the participants during periods of peak energy demand. The project's cost burden is not deemed to be burdensome from a resource performance or cost perspective. The participants' capacity entitlement to the 90 MW Beasley Project averages about 30% of member peak demand. The actual cost of energy produced by the project is very high, as expected from a peaking resource, and less indicative of the operating cost burden or operating risk.

Fitch's assessment of the project's operating cost flexibility as a single-asset project is weaker, but does not constrain the operating risk assessment.

The project's capital needs appear manageable as evidenced by the relatively young Fitch-calculated age of plant at nine years. DEMEC expects to overhaul the older turbine in unit 1 (commissioned in 2001) in roughly five years, while the overhaul of unit 2's newer turbine (commissioned in 2011) is another 10-15 years out.

Financial Profile
The project's financial profile has been assessed at 'a' using the DEMEC's consolidated financial metrics in the context of the project's revenue defensibility and operating risk assessments. Consolidated leverage was 6.8x and COFO 1.15x in fiscal 2018. Only limited project financial data is available, but due to the unconditional PSC between DEMEC and Beasley Project purchasing members, the project's financial profile is less of a consideration in Fitch's determination of the rating.

Fitch notes that the Beasley project's debt service coverage is required to equal no less than 1.1x, per the bond indenture. Increased project energy sales and significantly higher capacity market revenues based on favorable fuel prices and transmission environment have provided for considerably stronger debt service coverage ratios averaging above 4.0x over the past five years.

The debt profile of the Beasley Project bonds is neutral to the rating. The bonds are fixed rate and amortize through 2041. Beasley debt (only the series 2011 bonds remain outstanding) totaled just under $50 million at year-end fiscal 2018. The series 2011 bonds have a cash funded debt service reserve fund equal to maximum annual debt service.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)

https://www.fitchratings.com/site/re/10064680
U.S. Public Power Rating Criteria (pub. 03 Apr 2019)
https://www.fitchratings.com/site/re/10066654