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Ratings

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Summary:

Delaware Municipal Electric Corp.; Retail Electric; Wholesale Electric

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Credit Profile		
US$34.965 mil elec rev rfdg bnds ser 2021 due 07/01/2041		
Long Term Rating	A/Stable	New
Delaware Municipal Electric Corp. rev bnds		
Long Term Rating	A/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'A' rating to Delaware Municipal Electric Corp. (DEMEC)'s $34.965 million electric revenue refunding bonds, series 2021 (Beasley Power Station Project.) At the same time, S&P Global Ratings affirmed its 'A' rating on DEMEC's Beasley Power Station Project revenue bonds outstanding. The outlook is stable.

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 a qualifying buyer. If there are no buyers, the 25% step-up obligation takes effect.

DEMEC had $59.9 million in long-term debt outstanding as of Dec. 31, 2020, net of current maturities.

Credit overview

The rating reflects our view of the following strengths:

- Financial metrics (coverage and liquidity) at the project level are 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 Interconnection LLC (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 continually declining wholesale rates, which have come down over 25% since 2010 as the utility has reduced its power supply costs, offset this somewhat.
- Many participants have large general fund transfers, which limits their ability to accrue cash reserves.

Our criteria for rating joint-action agencies with fewer than 25 participants and a limited 25% step-up dictate that we focus on the weakest credit profile among those participants, with the strongest credit totaling 80% of the project (covering the 25% step-up). Therefore, our assessment of the credit quality of the participant light departments is a key factor in our rating. In our assessment of the participants' credit quality, we believe that the weakest among these participants support a solid medium-investment grade rating. Therefore, the rating on these bonds primarily reflects this assessment.

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.

Environmental, social, and governance (ESG) factors

We believe DEMEC's governance and social factors (including health and safety issues related to COVID-19) do not present elevated risk and are in line with those of other rated utilities. In our opinion, DEMEC has strong governance factors, represented by good financial management and rate-setting practices, and maintenance of ample coverage and liquidity. DEMEC has not experienced meaningful operational or financial effects thus far from the COVID-19 pandemic, with very modest demand declines for the year. However, the utility faces moderate environmental risk, given significant owned and contractual participation in gas-fired generation assets against the backdrop of increasingly stringent renewable portfolio standards . S&P Global Ratings will continue to monitor this risk.

Stable Outlook

Upside scenario

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

Downside scenario

We could lower the rating over the next two years if credit quality worsens for one or more members, but only to the extent that our analysis concludes that the stronger members would not be able to shoulder the burden of the project debt of the weakened members without credit erosion.

Credit Opinion

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 Beasley 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%). Lewes, Delaware is now also a full-requirements member, but does not participate in the Beasley project. We do not consider Lewes' financial metrics in our analysis.

DEMEC historically buys power for its members from independent power producers, power marketers, and the PJM 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 megawatt (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. DCO Energy 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. Additionally, the sale of spinning reserves is 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 115 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 205 MW of capacity for members. Finally, the utility has long-term purchase power agreements for 69 MW of wind and 14.5 MW of solar resources. Management expects to bring online about 12 MW of community-based solar generation in various member systems over the next several years. We view this asset diversity positively. Management reported it did not suffer any material financial or operational impacts from the recent winter storm and fuel price volatility, given its diverse power supply and fuel hedging policy.

DEMEC's owned generation accounted for approximately 59% of the utility's 2020 energy needs. Of the remaining balance, 27% came from contracts with a term of three or more years, 13% from one-year contracts, and 1% from the spot market.

In our opinion, the key participants' credit metrics and business profiles place them in the medium investment grade category. The participants' service area economies are generally stable. DEMEC reports that overall demand is down approximately 3% relative to normal years due to the COVID-19 pandemic, and that there have been no issues with member nonpayment. The project's largest participant, Newark, did suffer load loss from its largest customer, the University of Delaware, but management reports loads have generally stabilized and that the financial impact has been manageable.

We believe the project exhibits very strong debt service coverage (DSC) for a joint-action agency, which further supports the current rating. 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 above 2.5x in each of the past three years, with fixed-charge coverage around 1.3x.

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 no draws on either facility. Both facilities renew annually in September. Collateral postings were $5.68 million and $4.15 million in 2018 and 2019, 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 just over 90 days' worth of operating expenses in 2020, 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. Additionally, the utility can bill participants for interim unexpected costs, and they typically pay them within three days.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020