S&P Global Ratings

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Delaware Municipal Electric Corp.; Retail Electric

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Long Term Rating	A/Stable	Affirmed
Delaware Municipal Electric Corp. elec rev rfdg bnds		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Credit Highlights

- S&P Global Ratings affirmed its 'A' long-term rating and underlying rating (SPUR) on Delaware Municipal Electric Corp.'s (DEMEC's) Beasley Power Station Project revenue bonds outstanding.
- The outlook is stable.

Security

The bonds are secured by members' 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 $49.1 million in long-term debt outstanding as of Dec. 31, 2021, net of current maturities.

Credit overview

The rating primarily reflects the financial profile of both DEMEC and the weakest members within a subset of members that are capable of fully covering debt service after a step-up. In our view, Newark and Smyrna's credit characteristics limit upward rating movement. Moreover, Newark exhibits weak fixed-charge coverage (FCC), and Smyrna exhibits thin liquidity.

The underlying rating further reflects our view of the following strengths:

- Financial metrics (coverage and liquidity) at the project level are good for a joint-action agency, which supports the current rating.
- 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. Further, management indicated DEMEC is approximately 90% hedged in a given month, providing additional price certainty.

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.
- Many participants have large general fund transfers, which limits their ability to accrue cash reserves.

Environmental, social, and governance

In our view, the agency's environmental risks are moderately negative, given significant owned and contractual participation in gas-fired generation assets against the backdrop of increasingly stringent renewable portfolio standards.

The utility's governance factors are credit neutral, highlighted by good financial management and rate-setting practices, and maintenance of ample coverage and liquidity.

Similarly, we believe DEMEC's social factors are credit neutral. While members generally exhibit retail electric rates higher than state averages, generally adequate income metrics mitigate this social pressure.

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.

Downside scenario

We could lower the rating over the next two years if financial metrics (including liquidity or FCC) worsens for one or more of the weakest members and if project level metrics do not support the current rating.

Upside scenario

We could raise the rating over the next two years if credit quality improves for the weakest participating members without concurrent deterioration of stronger members' metrics.

Credit Opinion

DEMEC provides electric service to eight members in Delaware: 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. 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 71 MW of wind and 28 MW of solar resources. Management reports DEMEC is generally about 90% hedged in terms of energy and price certainty in a given month, which mitigates the effects of recent elevated fuel and energy prices.

DEMEC's owned generation accounted for approximately 53% of the utility's 2021 energy needs, with the balance coming from contractual supply.

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.

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, along with 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 2.3x in each of the past three years. FCC has declined from around 1.4x to around 1.2x over the past three years, which we still believe supports the current rating.

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. Cash on hand equaled just over 71 days' worth of operating expenses in 2021, down slightly from 91 days' in 2020 but still 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 payment is typically made within three days.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022