

Credit Opinion: Espírito Santo Centrais Elétricas S.A.

Global Credit Research - 31 Mar 2010

Vitoria, Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
Senior Unsecured -Dom Curr	Baa3
Subordinate -Dom Curr	Ba1
NSR Senior Unsecured -Dom Curr	Aa1.br
NSR LT Issuer Rating -Dom Curr	Aa1.br
NSR Subordinate -Dom Curr	Aa2.br
Ult Parent: Energias de Portugal, S.A	
Outlook	Stable
Issuer Rating	A3
Senior Unsecured -Dom Curr	A3
Commercial Paper -Dom Curr	P-2
Parent: EDP - Energias do Brasil S.A	
Outlook	Stable
Issuer Rating -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa2.br

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Key Indicators

[1]Espírito Santo Centrais Elétricas S.A	2009	2008	2007	2006
ACTUALS				
(CFO Pre-W/C + Interest) / Interest Expense	6.2x	4.1x	4.4x	2.5x
(CFO Pre-W/C) / Debt	44.0%	38.2%	45.1%	20.2%
(CFO Pre-W/C - Dividends) / Debt	36.3%	11.8%	39.4%	13.6%
(CFO Pre-W/C - Dividends) / Capex	153.3%	41.9%	150.9%	58.2%
Debt / Book Capitalization	50.0%	53.1%	46.7%	49.4%
EBITA Margin %	19.7%	20.6%	19.3%	22.2%

[1] All ratios calculated in accordance with the Regulated Electric and Gas Utilities Rating Methodology using Moody's standard adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

Solid credit metrics

Strong ownership of its ultimate parent company, EDP - Energias de Portugal

Sound liquidity and resilient access to the local banking market

Relatively predictable and stable cash flow

Forecasted lower tariffs from the third periodic tariff review in 2010

Corporate Profile

Espirito Santo Centrais Eletricas S.A. (Escelsa), headquartered in Vitoria, Espirito Santo, is an electricity distribution utility fully controlled by EDP - Energias do Brasil S.A. (EDB), an integrated utility group controlled by EDP - Energias de Portugal (EDP, A3, stable). Escelsa serves around 1.2 million clients in the state of Espirito Santo. In 2009, the company reported net revenues of BRL 1,373 million (USD 684 million) on sales of 4.9 GWh, representing approximately 1.1% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

The Baa3 rating for Escelsa reflects the stable and predictable cash flows from the regulated distribution business, and the company's status as an essential service provider in a relatively important economic service area in the state of Espirito Santo, along with solid credit metrics for its rating category. The ratings also incorporate the overall investment grade credit profile of the group, EDP- Energias do Brasil, its resilient access to the local capital markets and the strong ownership by its parent company EDP. The ratings are constrained by the high dividend pay-out ratio, relatively sizeable capital expenditures within the group in Brazil and the evolving Brazilian regulatory environment.

DETAILED RATING CONSIDERATIONS

SOLID CREDIT METRICS

Escelsa has healthy profitability and solid cash generation driven by the relatively stable nature of its regulated business. In the past five years, cash drains mainly consisted of capital expenditures and distribution of dividends which have been in line with the company's internal cash generation. This is evidenced by steady financial leverage as measured by the Debt to EBITDA ratio, which has been 2.3x on average since 2005.

The economy of Espirito Santo was significantly impacted by the deterioration of Brazil's industrial production and decrease in foreign trade from the second half of 2008 through the first half of 2009; however, Escelsa's internal cash generation, as measured by the Funds from Operations (FFO), increased 37% to approximately BRL 280 million in 2009. This growth was a combined result of strong growth of residential volumes and favorable tariff increases. As a result, Escelsa's FFO to debt increased to 36.5% in 2009 from 26.6% in 2008.

In 2009, the 7.8% growth of residential demand more than offset the 9.5% decrease in demand from industrial consumers as the lower volumes at the free market had only a minor impact on revenues since most of the supply agreements are take-or-pay contracts that require a 180-day notice for cancellation. Management stated there was no significant cancellation of contracts as result of the economic crisis.

In August 2008, the regulator granted 7.48% tariff increase on the annual review, of which 3.52% was to compensate for Escelsa's higher operating and investments costs (Parcel B), as a result of a 15.12% increase in the general price index (IGP-M). The net effect on parcel B was a 10% increase (15.12% IGPM less 5.13% X Factor) which had a positive effect on operating margins, particularly during the first half of 2009. Additionally, the company was granted 1.04% increase for its parcel B on the annual review in August 2009.

Going forward, Moody's forecasts some reduction in internal cash generation driven by the scheduled third periodic tariff review in August 2010, when we expect some reduction in tariffs that will reflect productivity gains to be transferred to consumers and the application of a lower WACC in the face of lower borrowing costs. Nevertheless, CFO-Pre W/C to Debt is expected to remain above 30% for the next three years, which is strong for the Baa3 rating category.

OWNERSHIP OF EDP PORTUGAL

The ratings assigned for the EDB group reflect the strong ownership of its parent company, EDP Portugal (A3; stable). While EDP does not guarantee EDB's debt, the parent expects that its subsidiaries will remain financially self sustainable, as stated in its published policies. Moody's believes that the Brazilian operations of EDP play an important role in the group's growth strategy which continues to support the one notch of uplift of the rating on the global scale. EDP is Portugal's dominant electricity generator and distributor with significant interests in the pan-berian conventional generation market. In 2009, EDP reported consolidated EBITDA of EUR 3,363 million (USD 2,418 million), of which approximately 16% was generated at its Brazilian subsidiary. The track record of EDP supporting its Brazilian subsidiaries was evidenced, for example, by the debt conversion of BRL 650 million into equity at the local subsidiary level in 2006. Moody's believes EDP will continue to support its Brazilian subsidiaries.

IMPROVEMENT IN THE BRAZILIAN REGULATORY ENVIRONMENT

An important factor constraining Escelsa's rating has been the Brazilian regulatory framework, which has a history of being unpredictable but has undergone substantial change over the past several years. The electricity regulatory model implemented in 2004 has mitigated the uncertainties brought about by constant changes in the Brazilian regulatory framework over the past two decades. The current model provides a more supportive environment for acceptable rates of return since the current rules for electric utilities are transparent and technically driven, thus increasing predictability of return on invested capital. In light of this relevant improvement, Moody's lifted the Brazilian regulatory framework to a higher category level in August 2008.

Despite the upgrade in the supportiveness of the local regulatory environment, we still believe there is a lower assurance of timely recovery of costs and investments in Brazil since the new framework has not yet experienced a prolonged period of high inflation, exchange rate devaluation or electricity rationing. In our evaluation of these factors we also took into consideration potential future electricity shortages due to a tight reserve margin, limited independence of the regulator and minimal jurisprudence backing the new regulatory framework.

Liquidity

Escelsa has an adequate liquidity profile supported by its resilient access to the capital and bank markets and cash availabilities of BRL 108 million as of December 31, 2009. In 2009, Cash Flow from Operations (CFO) of BRL233 million covered about 56% of its cash outlays including BRL170 million debt amortizations, BRL184 million capital expenditures and BRL60 million dividends to EDB. The shortfall was funded with proceeds from the BNDES under a long term revolving credit facility (CALC). In 2010, we expect the main cash outlays will consist of capital expenditures of BRL 140 million, the re-payment of BRL 124 million of short-term debt and BRL112 million of dividends. Moody's expects that these cash requirements will be funded with a combination of internal cash generation and debt issuance. The company counts on long-term funding from BNDES and European Investment Bank (EIB), of which around BRL 100 million will be disbursed in 2010.

Moody's deems the liquidity standing of EDB on a consolidated basis as very adequate. On December 31,2009, EDB reported a sizeable consolidated cash position of BRL1.1 billion boosted by a successful equity offer during the fourth quarter, when the company was able to raise BRL 441 million through the sale of treasury shares. This strong cash position along with estimated CFO of around BRL1,0 billion will support EDB's planned capital expenditures of BRL 800 million and dividends of BRL 392 million in 2010 (dividends payable as of 12/31/2009). Despite sizeable debt maturities in the short-term of approximately BRL 855 million, the refinancing risk is considered manageable. This debt is concentrated in the operating subsidiaries, where cash flows are expected to comfortably meet cash needs. There is no debt outstanding at the parent holding company level. Additionally, EDB has nearly BRL 1.4 billion pre-approved long-term loans from the BNDES, the EIB and the IDB to support its subsidiaries' capital expenditures in the near term.

Corporate Governance

Escelsa's rating considers that EDB has corporate governance practices that are above the average of Latin American issuers. EDB is a publicly listed company with shares traded on the Novo Mercado of Bovespa. While its shares are only traded on the São Paulo stock exchange, the company undertook several steps beyond what is legally required to adapt the U.S. Sarbanes-Oxley act as part of its commitment of practicing superior standards of corporate governance, but also due to the fact that the shares of its controlling shareholder, EDP, are traded on the New York Stock Exchange.

EDB's Board of Directors is made up of eight members, of which four are considered independent (two appointed by minority shareholders). The board relies on three support committees: Audit, Sustainability and Corporate Governance, and Compensation. The Audit and the Sustainability Committees are permanent in nature and are comprised of three members where at least one is independent. There is also a Fiscal Council composed of three members and three alternates elected for a maximum term of one year; however, it is non-permanent and convened only when requested by shareholders.

Rating Outlook

The stable outlook derives from Moody's expectation that Escelsa's level of indebtedness will not change dramatically over the medium horizon because any additional cash generated by operations is bound to be distributed to its parent company EDB. Conversely, Moody's expects that Escelsa will maintain its current strong credit metrics during this period with the relatively stable and predictable cash flow derived from its electricity distribution business. The stable outlook also reflects Moody's expectation that EDB on a consolidated basis will continue to prudently manage capital expenditures in tandem with its cash flow capacity and efficiently handle its liquidity position so that retained cash flow remains above 20% of total debt on a consistent basis.

What Could Change the Rating - Up

The reduction of the completion risk of EDB's capital expenditures coupled with the accomplishment of strong credit metrics so that retained cash flow to total debt is above 25% and interest coverage is higher than 4.5x on a sustainable basis could prompt an upgrade rating action. Moody's expects that EDP Portugal will continue to support its subsidiaries.

What Could Change the Rating - Down

A downgrade of Escelsa could be triggered by a downgrade of EDB's ratings, which could occur if the consolidated RCF over debt ratio is below 15% and interest coverage is below 3.5x on a sustainable basis. Deterioration in the level of supportiveness of the Brazilian regulatory environment for regulated utilities could also prompt a negative rating action for Escelsa and EDB.

Other Considerations

The principal methodology used in rating Escelsa was Moody's Regulated Electric and Gas Utilities Rating Methodology, published in August 2009 and available on www.moody.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Rating Factors

Espirito Santo Centrais Elétricas S.A

Regulated Electric and Gas Utilities	Aaa	Aa	A	Baa	Ba	B
Factor 1: Regulatory Framework (25%)					X	
Factor 2: Ability to Recover Costs and Earn Returns (25%)					X	
Factor 3: Diversification (10%)					X	
a) Market Position (10%)					X	
b) Generation and Fuel Diversity (0%)						
Factor 4: Financial Strength, Liquidity & Financial Metrics (40%) [1]						
a) Liquidity (10%)				X		
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)			X			
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	X					
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)		X				
e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg)				X		
Rating:						
a) Methodology Implied Issuer Rating				Baa3		
b) Actual Issuer Rating				Baa3		

[1] Based on historical data

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