MOODY'S INVESTORS SERVICE

Credit Opinion: Espírito Santo Centrais Elétricas S.A.

Global Credit Research - 12 Jun 2013

Vitoria, Brazil

Ratings

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

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Key Indicators

[1]**Espírito Santo Centrais Elétricas S.A.**

ACTUALS	**LTM 03M13**	**2012**	**2011**	**2010**	**2009**	**2008**
(CFO Pre-W/C + Interest) / Interest Expense	**6.0x**	**5.8x**	**3.8x**	**5.4x**	**4.2x**	**4.0x**
(CFO Pre-W/C) / Debt	**26.0%**	**27.0%**	**26.9%**	**35.7%**	**26.2%**	**36.0%**
(CFO Pre-W/C - Dividends) / Debt	**15.8%**	**16.0%**	**11.5%**	**23.5%**	**19.3%**	**9.6%**
Debt / Book Capitalization	**64.5%**	**63.4%**	**56.4%**	**53.1%**	**52.6%**	**53.1%**

[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

- Adequate credit metrics

-Weaker liquidity from the acquisition of more expensive thermal energy

- Resilient access to the local capital and banking markets

- Relatively predictable and stable cash flow

- Lower tariffs expected from the tariff review in August 2013

- The level of support of its parent company, EDP - Energias do Brasil

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) (Ba1, outlook negative). Escelsa serves around 1.3 million clients in the state of Espirito Santo. In the last twelve months ended March 31, 2013, the company reported net revenues of BRL 1.9 billion (USD942 million), which does not include construction revenues of BRL 137 million, on sales of 10,278GWh, representing approximately 2.28% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

Escelsa's Baa3 issuer rating reflects the relatively stable and predictable cash flows from the regulated distribution business, the adequate credit metrics for its rating category, and the overall investment grade credit profile of the group EDP- Energias do Brasil and its resilient access to the local capital markets.

The ratings are constrained by the high dividend pay-out ratio, relatively sizeable capital expenditures within the group, and the potential volatility in cash flow stemming from some customer concentration in commodity producers. The recent deterioration in its liquidity from higher costs associated with the acquisition of more expensive energy and the evolving Brazilian regulatory environment further constrain the ratings.

Recent Events

On June 5, 2013, Moody's America Latina Ltda (Moody's) affirmed the ratings of Energias do Brasil S.A. (EDB, Ba1; Aa2.br), Bandeirante Energia S.A (Bandeirante, Baa3; Aa1.br), Espirito Santo Centrais Eletricas S.A. (Escelsa, Baa3; Aa1.br) and Energest S.A. (Energest, Baa3; Aa1.br). The outlook for all ratings remained stable.

On March 7, 2013, the Federal Government published decree law # 7,945 with the following objectives:

1) Use of financial resources from the sector's regulatory charge CDE (Energy Development Account) to fund distribution companies for additional costs incurred with the acquisition of more expensive thermal power so as to avoid the permanent transfer of these costs to electricity tariffs.

2) Changes in the criterion to calculate PLD (spot prices) by including associated costs with the dispatch of energy out of the order of merit.

3) Costs associated with promoting energy safety are to be shared among all the electricity industry's players including generators, distributors, traders and free consumers.

On February 15, 2013, Escelsa borrowed BRL 68 million from Banco do Brasil with final maturity in February 2015.

On October 04, 2012, Escelsa borrowed from Banco do Brasil BRL 90 million with a two-year tenor to be amortized in a single payment. The cost was very attractive at 98.5% of CDI (Interbank Deposit Certificate).

On February 16, 2012, Moody's downgraded Energias de Portugal SA (EDP), its finance subsidiary EDP Finance BV (EDP Finance) and its Spanish subsidiary, Hidroelectrica del Cantabrico (HC Energia) to Ba1 from Baa3. Moody's has also downgraded the rating of EDP's and EDP Finance's EMTN programme to (P)Ba1 from (P)Baa3. Concurrently, Moody's downgraded the short-term ratings of EDP, EDP Finance and HC Energia to Not-Prime from Prime-3. The assigned outlook on all affected ratings is negative.

These announcements followed Moody's earlier decision to downgrade the Republic of Portugal's sovereign rating to Ba3 with a negative outlook from Ba2 with a negative outlook, as announced on 13 February 2012.

DETAILED RATING CONSIDERATIONS

RECENT DETERIORATION IN CREDIT METRICS

Despite some deterioration in credit metrics over the past two years Escelsa has posted adequate credit metrics for its rating category during this period. Escelsa's weaker than expected profitability and cash generation over the past two years have mainly stemmed from the much lower electricity consumption from industrial consumers in both the regulated and free markets over the past two years and more recently from the exacerbated increase in costs associated with the acquisition of more expensive thermal energy in the second half of 2012 and first quarter of 2013, given the mandated reduction of available hydro power due to drought conditions.

In 2012, the consumption of industrial consumers in the regulated market presented modest volume growth of just 1,5% while the consumption of free consumers which consists primarily of larger industrial consumers reduced their electricity consumption by 1.1% last year which had a material impact on overall consumption considering that free consumers represented around 38% of the company's total distributed electricity. The poor performance of the industrial consumers was offset by the significant increase of other consumer's classes, particularly the residential class, which presented a volume increase of 5.1%; this resulted in a consolidated sales volume growth of 0.7% in 2012.

Escelsa posted a lower sales volume in the spot market of 290 thousand MW/h in 2012 down from 529 thousand MW/h in 2011. Selling energy in the spot market is not the core business of any distribution company as typically spot prices are much lower than those in the regulated market and in many instances result in losses. This was the case in 2011 when Escelsa was forced to sell the excess contracted electricity in the spot market at very low prices of around BRL 31 per MW/h. Conversely, Escelsa benefitted from higher spot prices in 2012 by selling energy at around BRL 193 per MW/h. As a result, the company posted an estimated gain of BRL 40 million in 2012.

Increases in the cost of acquiring energy hurt Escelsa's cash flow in 2012, which resulted in BRL 89 million in net regulatory assets which were not recovered in the company's tariffs in 2012. In August 2013, the regulator ANEEL will apply the new procedures of the third tariff review on the company's tariffs, which will be reduced accordingly. The reductions, however, will be partly tempered by the recognition of the higher energy costs not included in the company's tariffs in 2012.

On March 7, 2013, the federal government approved the use of existing financial resources from the sector's regulatory fund CDE (Energy Development Account) to alleviate the tighter liquidity position experienced by most of the Brazilian electric distribution utilities due to the higher thermal energy costs . Use of these funds is to prevent the permanent transfer of the more expensive thermal power acquired during this past 12 months under what is viewed as rather unusual circumstances to the current electricity tariffs.

Escelsa received BRL 94.9 million in the first quarter of 2013 from CDE. These payments not only reduced the amount of regulatory assets the company had been forced to recognize in 2012 but also contributed to a reduction in the pressure on their liquidity.

The deterioration in credit metrics is evidenced by lower cash flow metrics as measured by the retained cash flow over debt ratio of 13.8% over the past two years down from the 21.4% registered in the previous two-year period. Interest coverage remained strong at 4.8x during this period, in line with historical performance, as the lower cash flow was offset by lower interest rates during this period.

The debt to capitalization ratio has presented a similar deterioration over the past two years, which was further exacerbated by the recognition of additional BRL 171 million in unfunded pension fund liabilities in 2012 to comply with the new determination of the Brazilian security commission (CVM). This ratio was 63.4% in 2012 up from 56.4% in 2011.

As a result of the challenging period the company faced over the past two years, Escelsa posted lower net profitability during this period. In 2012, net profit was BRL 157 million up from BRL 104 mill in 2011, which compares with the previous two-year period net profit average of BRL 167 million.

As a matter of fact, the 2012 net profit is overstated by BRL 52 million net of income tax from the recognition of non-cash extraordinary revenues of BRL 79 million related to the recognition of the so-called "new replacement value", which is the additional amount Escelsa registered in its intangible assets to reflect the present value of its regulatory asset base. The company is eligible to receive this amount in case its concession is revoked. This is in accordance with the accounting procedures of IFRS.

CFO TO INCREASE THROUGH AUGUST 2013

Going forward, we forecast that CFO before changes in working capital will improve through August 2013 and decrease thereafter from the application of the regulator's periodic tariff review, which will consider a lower WACC and new operational procedures that are expected to transfer productivity gains to consumers. As a result, we project that the CFO before WC over Debt ratio will be above 20% during this period while interest coverage is expected to be slightly below 4.0x.

We expect that the periodic tariff review to be applied in August 2013 will significantly reduce the company's cash flow as measured by CFO before working capital, which could be partially tempered by potential reduction of operating costs, lower capital expenditures and a reduction in the payment of dividends as indicated by management.

Given the sizeable BRL 118.7 million amount in regulatory assets recognized as of March 31, 2013, which the company is entitled to receive mostly in 2013, as indicated by the federal government through the transfer of funds of the CDE, CFO could be stronger than the previous year by outweighing the expected reduction in tariffs from the third tariff review this coming August. Our base scenario is more conservative in that we considered that only 65% of this amount will be received in 2013.

The major downside risks to our projections are lower volume sales than forecasted. This could arise from lower consumption by industrial consumers given the company's concentration in large mining and metal industrial consumers and a spike in the local interest rates, which would affect the bulk of Escelsa's debt. In a stressed scenario, the deterioration in credit metrics would be relatively limited as we expect that management would recalibrate capital expenditures and the payment of dividends to the expected lower level of cash generation.

LOWER TARIFFS FROM THE TARIFF REVIEW IN AUGUST 2013

According to the Brazilian electricity regulatory model, all Brazilian electricity distribution companies are subject to periodic tariff reviews every four to five years in order to transfer any productivity gains to consumers.

In August 2013, the regulator ANEEL will apply a new methodology for its tariff review to Escelsa, which will transfer productivity gains to consumers. The application will incorporate a lower WACC in the face of lower capital costs (equity and borrowings) among the Brazilian electricity distribution companies. The new procedures of the third tariff review have been applied to the Brazilian distribution companies since 2011 and is expected to be completed in 2013.

Escelsa is the only Brazilian electricity distribution company, which is subject to periodic tariff reviews every three years because it was the first distribution company to be privatized back in 1996. As a result, the company's current electricity tariffs still reflect the terms and conditions of the second periodic tariff review, which envisages a higher WACC of 9.95%. We expect the reduction in EBITDA to stay within the 23-27% range, which translates into a tariff reduction of around 5%.

In accordance with ANEEL's technical note #151/2013 on the application of the operational procedures of the third tariff review on Escelsa' tariffs was submitted to public hearing on April 30, 2013. The company's part B of the tariff structure would be reduced by around 12.3%, with an equivalent reduction in tariffs by 4.72%. As a result, the company's preliminary regulatory EBITDA would be around BRL 297 million at the currency value as of April 30, 2013.The part B of the tariff formula mainly consists of the operating costs (reference company), depreciation and the remuneration amount.

HIGHER VOLATILITY IN FFO FROM THE IMPLEMENTATION OF IFRS

The implementation of the International Financial Reporting Standards (IFRS) comprising the 2009, 2010, 2011 and 2012 financial statements of Brazilian public companies, i.e. companies with shares traded at the Brazilian stock market or that issued public debentures has caused some difficulties in the interpretation of their financial statements.

Unlike the previous Brazilian GAAP accounting method, the International Financial Reporting Standards (IFRS) does not recognize the concept of regulatory assets and liabilities. As a result, Moody's expects higher volatility in cash flow parameters as measured by funds from operations (FFO) under IFRS since any change in the so-called regulatory assets and liabilities will be recognized either as an expense or revenue item in the profit-and-loss statement.

The change of the accounting principles from the Brazilian GAAP to the IFRS for ESCELSA''s 2009, 2010, 2011 and 2012 financial statements does not interfere with our comparative analysis of the utility's cash flow statements for these years against previous years. This stems from the fact that the main cash flow parameter used in Moody's methodologies for electric utilities, cash from operations pre- working capital needs (CFO Pre-WC), already excludes any variations in regulatory assets and liabilities.

Under the IFRS accounting procedures the increased supply costs will be expensed in the same period the cash is disbursed, generating a reduction in FFO. In the following period, FFO should expand in light of the expected increase in tariffs to compensate for the increased costs.

EVOLVING BRAZILIAN REGULATORY ENVIRONMENT

A major important factor constraining the ratings 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. This model provides a more supportive environment for acceptable rates of return since the current rules for electric utilities have been transparent and technically driven, thus increasing the predictability of return on invested capital.

Nonetheless, 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. Potential future electricity shortages due to a relatively tight reserve margin, limited independence of the regulator and minimal jurisprudence backing the new regulatory framework were also taken into consideration in our evaluation of this factor.

The publication of the federal government's provisional measure #579 last year has caused uneasiness within the electricity industry because the government's proposal to renew the generation and transmission concessions expiring between 2015 and 2017 was materially more costly versus the expectations of most market participants, including both concessionaries and investors.

Regardless of the legal aspects involving the implementation of this provisional measure which could potentially generate lengthy series of judgments and appeals in the Brazilian courts, the manner in which the government handled the whole process since the initial disclosure and subsequent discussion and communication was very poorly handled in our opinion since it has created uncertainties about the quality and the level of supportiveness of the Brazilian electricity regulatory environment.

For Moody's, the stability and the predictability of the regulatory framework (Factor 1) and the ability to recover costs on a timely manner (Factor 2) are major drivers in the rating assessment of a given issuer pursuant to our methodology "Regulated Electric and Gas Utilities". We believe that the significant improvements that the Brazilian regulatory framework had accomplished since the new model was implemented in 2004 have been tempered to a certain extent by the manner in which the federal government addressed the renewal of concessions expiring between 2015 and 2017.

The current low Ba rating assigned to these two factors largely reflects the increased levels of uncertainty relative to the continued development of the Brazilian regulatory framework and the timeliness of recovering costs and earning an adequate return recognizing that there have been inconsistencies in the way the framework has been applied as evidenced by some of the operational procedures contained in the federal government's provisional measure #579.

LEVEL OF SUPPORT OF EDP PORTUGAL

The ratings assigned for the EDB group also factor in the ownership by its parent company, EDP Portugal (Ba1; negative outlook). While EDP does not guarantee EDB's debt, the Portuguese parent expects that its subsidiaries will remain financially self sustainable, as stated in its published policies. We believe that the Brazilian operations of EDP play an important role in the group's growth strategy. The rating downgrades and changing the outlook to negative could potentially limit the ability of EDP Portugal to eventually step in to support its subsidiaries with a material undertaking in case of financial distress.

In this context, we believe that ownership by EDP does not support a one notch of uplift of the rating on the global scale. EDB's Ba1 issuer rating is largely based on EDB's overall investment grade characteristics on a consolidated basis supported by adequate credit metrics for the rating category, and the relatively stable cash flows emanating from the regulated distribution utilities and the long-term supply contracts underpinning the generation business along with continued conservative financial management.

In addition we believe that the Brazilian subsidiaries, mainly the distribution companies, are to a large extent insulated from any potential credit deterioration of their ultimate parent company. This results from regulatory oversight and existing financial covenants embedded in most of the debt contracts, which prevent those subsidiaries from increasing their leverage over a certain agreed limit.

We further believe that EDP Portugal will continue to support the activities of EDB by preserving the current strong capital structure of its Brazilian subsidiary; however, we will continue to monitor the evolvement of the creditworthiness of EDP Portugal and the potential impact that any further rating deterioration could have on the financial strength of EDB.

On the other hand, Escelsa's Baa3 issuer rating is largely based on EDB's overall investment grade characteristics on a consolidated basis supported by adequate credit metrics, in spite of some recent deterioration, and a conservative financial management.

Liquidity

Like most of the Brazilian companies, Escelsa does not have any committed banking facility to accommodate any unexpected cash disbursements. The company has been facing a tight liquidity position since the last quarter of 2012 as it has been forced to acquire the more expensive thermal energy at unusual very high prices. Typically, Escelsa, as any other distribution company, is eligible to be reimbursed trough the pass-through to tariffs of any increased cost of part A of the tariff structure, which consists of the so-called non-controllable costs.

In light of the severe liquidity stress faced by virtually all Brazilian distribution companies during this period and to avoid the permanent transfer of increased energy costs to tariffs the federal government has stepped in by determining the transfer of recourses from the CDE fund. In the first quarter of 2013, Escelsa received BRL 94.9 million from this fund. Escelsa is eligible to receive an additional BRL 118.7 million, which management believes will be mostly received in 2013.

We believe that EDB `s resilient access to the local banking and capital markets is an important mitigating factor for potential additional pressure on liquidity. Nevertheless, we understand that it is very important that EDB and its subsidiaries, including Escelsa, are able to secure long-term funding and balance capital expenditures and the distribution of dividends to improve its capital structure and liquidity standing so that they remain commensurate with the Baa3 rating category.

We view the current liquidity standing of the holding parent company EDB and some of its subsidiaries as being inadequate when compared with the liquidity characteristics of other investment grade issuers in Brazil. EDB's weaker liquidity position has resulted from the delay in the start-up of operations of the PECEM project and the forced purchase of higher priced energy to meet the obligations of its PPAs and the poorer financial performance of its distribution subsidiaries Bandeirante and Escelsa.

In order to support the weaker cash generation of its subsidiaries and added capital injections in PECEM, EDB has tapped the local market over the past ten months by raising BRL 950 million during this period. Going forward, EDB will need to be more effective in handling its overall liquidity position given the scheduled maturity of BRL 450 million in February 2014, the maintenance of historically dividend pay-out ratio along with sizeable capital expenditures over the next couple of years.

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 adopt the U.S. Sarbanes-Oxley act as part of its commitment of practicing superior standards of corporate governance.

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 our expectation that despite recent deterioration in credit metrics, Escelsa will post stronger cash generation in 2013 as a result of the pass-through of regulatory assets, which, however, will be tempered by lower tariffs from the third tariff review that will be implemented in August.

We expect that Escelsa's level of indebtedness will not change dramatically during this period and that management will balance the payment of dividends and capital expenditures to the lower cash generation level expected from the third tariff review, which should be more evident in 2014 because the BRL 118.7 million of regulatory assets Escelsa is entitled to receive mostly in 2013 is a non-recurrent event. In addition, the regulatory assets portion to be included in the upcoming tariff review in August will be withdrawn in August 2014.

The stable outlook also reflects our 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 is above 12% of total debt on a consistent basis.

What Could Change the Rating - Up

Given the recent deterioration in credit metrics and liquidity position along with expected lower tariffs from the application of the third tariff review in August 2013, we do not foresee any rating upgrade in the short- to- medium term.

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 less than 10% 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.moodys.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

Espírito Santo Centrais Elétricas S.A.

Regulated Electric and Gas Utilities	**Current 12/31/2012**		**Moody's 12 - 18 month Forward View**	
Factor 1: Regulatory Framework (25%)	**Measure**	**Score**	[1]**Measure**	**Score**
a) Regulatory Framework (25%)		Ba		Ba
Factor 2: Ability to Recover Costs and Earn Returns (25%)		Ba		Ba
Factor 3: Diversification (10%)				
a) Market Position (10%)		Ba		Ba
b) Generation and Fuel Diversity (0%)		-		-
Factor 4: Financial Strength, Liquidity & Financial Metrics (40%) [2]				
a) Liquidity (10%)		Ba		Ba
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	4.9x	A	3.5x - 4.0x	Baa
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	29.7%	A	20.7% - 22.7%	Baa
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)	17.0%	Baa	11.1% - 19.6%	Baa
e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg)	57.6%	Ba	61.4% - 62.0%	Ba
Rating:				

a) Methodology Implied Issuer Rating		Baa3		Ba1
b) Actual Issuer Rating				Baa3

[1] 12 - 18 month Moody's forecast [2] 3-year historical average