MOODY'S
INVESTORS SERVICE

Credit Opinion: Espírito Santo Centrais Elétricas S.A.

Global Credit Research - 24 Apr 2012

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
NSR LT Issuer Rating -Dom Curr	Aa2.br

Contacts

Analyst	Phone
Jose Soares/Sao Paulo	55.11.3043.7300
Cristiane Spercel/Sao Paulo	
William L. Hess/New York City	1.212.553.1653

Key Indicators

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

ACTUALS	2011	2010	2009	2008	2007
(CFO Pre-W/C + Interest) / Interest Expense	**4.0x**	**5.4x**	**4.2x**	**4.0x**	**4.1x**
(CFO Pre-W/C) / Debt	**27.5%**	**35.2%**	**26.2%**	**36.0%**	**41.2%**
(CFO Pre-W/C - Dividends) / Debt	**12.1%**	**23.0%**	**19.3%**	**9.6%**	**35.5%**
Debt / Book Capitalization	**56.2%**	**53.1%**	**52.6%**	**53.1%**	**46.7%**

[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

- Sound liquidity and 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 2011, the company reported net revenues of BRL1.52 billion (USD910 million) on sales of 10.35 GWh, representing approximately 2.4% 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 solid 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, the potential volatility in cash flow stemming from some customer concentration in commodity producers and the evolving Brazilian regulatory environment. The recent rating downgrades and the negative outlook of its ultimate major shareholder EDP Portugal further constrains the ratings.

Recent Events

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.

On July 08, 2011 Moody's downgraded the senior unsecured ratings of EDP - Energias de Portugal SA, its finance subsidiary EDP Finance BV ("EDP Finance") and its Spanish subsidiary, Hidroelectrica del Cantabrico ("HC Energia") to Baa3 from Baa1. Moody's also downgraded the rating of EDP's and EDP Finance's Euro Medium Term Note programme to (P)Baa3 from (P)Baa1. The outlook assigned to the ratings was negative.

This rating action concluded the review initiated on 6 April 2011 and followed the earlier downgrade of the rating of the government of the Republic of Portugal ("RoP") to Ba2 with a negative outlook from Baa1, on review for downgrade.

DETAILED RATING CONSIDERATIONS

SOLID CREDIT METRICS

Escelsa has healthy profitability and solid cash generation driven by the relatively stable nature of its regulated distribution business. In the past three 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 three-year average RCF to debt ratio of 18.1% and interest coverage ratio of 4.4x in the same period.

In 2011, despite relatively satisfactory performance, Escelsa posted a weaker than expected profitability and cash generation as shown by two major credit metrics as measured by RCF to debt of 12.1% and interest coverage of 4.0x. This performance shortfall was largely attributed to the combination of two extraordinary events, consisting of the migration of industrial consumers to the free market and lower than expected volume consumption for most of the consumers categories. Volume sales in the regulated market grew by just 2.4% in 2011, below management expectations of around a 5% annual volume growth. The increase of manageable operating costs, mainly consisting of labor and third party costs, by BRL 44 million, also contributed to the lower operating profit in 2011.

In 2011, the lower than expected consumption of electricity and the migration of consumers to the free market forced the company to sell the excess contracted electricity in the spot market at much lower tariffs than previous years. In 2011, Escelsa sold 529 thousand MW/h at an average tariff of BRL 31.5 compared to 410.4 thousand MW/h of energy sold at an average tariff of BRL 103, which resulted in around BRL 30 million in net revenue losses.

The company might have incurred additional losses during 2011 from the energy oversupply in the Brazilian electricity market last year related to acquired energy which could not even be sold in the spot market in an amount, which is believed not to be material in the case of Escelsa but that also explains part of the reduction in the operating profit and cash flow. The company also incurred additional losses estimated at BRL 9 million from lower tariffs for the use of its distribution network from free consumers , which should be recovered in the next tariff period.

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 in the mid twenties during this period while interest coverage is expected to be around 4.0x. In addition, we expect that annual volume sales growth will average 4% over the next three years and that local interest rates will average 10%.

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 the reduction in the payment of dividends as indicated by management.

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

In August 2013, the regulator ANEEL will apply a new methodology for 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. At the end of 2010, ANEEL signaled a significant reduction of tariffs for all Brazilian electricity distribution companies when it placed for public hearing the new procedures for the third electricity tariff review, to be implemented from 2011 through 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.

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 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 25-30% range, which translates into a tariff reduction of 5% to 7%.

HIGHER VOLATILITY IN FFO FROM THE IMPLEMENTATION OF IFRS

Unlike the Brazilian GAAP accounting method the IFRS does not recognize the concept of regulatory assets and liabilities. As a result, going forward Moody's expects higher volatility in cash flow parameters as measured by funds from operations (FFO). Any change in the so-called regulatory assets and liabilities will be recognized either as an expense or income in the profit and loss statement.

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

IMPROVEMENT IN THE 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 are 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.

LEVEL OF SUPPORT OF EDP PORTUGAL

The ratings assigned for the EDB group also factor in the ownership of its parent company, EDP Portugal (Ba1; negative outlook). 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. The recent rating downgrades and change of the outlook to negative limits the ability of EDP Portugal to eventually step in to support its subsidiaries in case of financial distress of the latter.

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 a steady improvement in credit metrics in the past three years and a conservative financial management.

Moody's believes that EDP Portugal will continue to support the activities of EDB by preserving the current strong capital structure of its Brazilian subsidiary. However, Moody's will continue to monitor the evolvement of the creditworthiness of EDP Portugal and the potential impact this could have on the financial strength of EDB.

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

Liquidity

Like most Brazilian companies, Escelsa does not have any committed banking facility to accommodate any unexpected cash disbursements. However, Moody's believes that Escelsa has an adequate liquidity profile supported by its resilient access to the local capital and banking markets. In addition, the company's cash availability of BRL108 million substantially covers short-term debt of BRL164 million as of December 31, 2011.

In 2012, we project that Escelsa will post CFO of BRL 244 million, which is expected to meet the main cash outlays composed of estimated capital expenditures of BRL 140 million and the payment of dividends of BRL 78 million. As part of the capital expenditures will be funded by BNDES long-term funding, Escelsa is expected to maintain its cash position in line with the previous year at around BRL100 million.

We deem the liquidity standing of EDB on a consolidated basis as very good. At December 31, 2011, EDB reported a sizeable consolidated cash position of around BRL896 million, which comfortably covered short-term debt of BRL580million that was concentrated in the operating subsidiaries, where cash flows are expected to comfortably meet ongoing cash needs. There is no debt outstanding at the parent holding company level.

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 Moody's expectation that despite growing cash generation over the next four quarters, Escelsa's level of indebtedness will not change dramatically during this period because any additional cash generated by operations is bound to be distributed to its parent company EDB. Conversely, we expect 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 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 remains around 20% of total debt on a consistent basis. We also expect that EDP Portugal will continue to support its subsidiaries by preserving their liquidity position and low leverage.

What Could Change the Rating - Up

Given the expected deterioration in credit metrics after August 2013, we do not foresee any rating upgrade in the short- to- medium term. We would consider an upgrade rating action if credit metrics improve so that retained cash flow to total debt is above 25% and interest coverage is higher than 4.5x on a sustainable basis.

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 12/31/2011**			**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		Ba			Ba

Returns (25%)				
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%)		Baa		Baa
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	4.5x	A	3.7x - 4.2x	Baa
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	29.7%	A	24.8% - 27.3%	A
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)	18.1%	A	15.3% - 18.5%	Baa
e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg)	53.9%	Baa	53.0% - 53.6%	Baa
Rating:				
a) Methodology Implied Issuer Rating		Baa3		Baa3
b) Actual Issuer Rating				Baa3

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