

Global Credit Research - 11 Dec 2015

Vitoria, Brazil

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Issuer Rating -Dom Curr	*Baa3
NSR LT Issuer Rating	*Aa1.br
Ult Parent: EDP - Energias de Portugal, S.A.	
Outlook	Stable
Issuer Rating	Baa3
Bkd Sr Unsec MTN -Dom Curr	(P)Baa3
Jr Subordinate -Dom Curr	Ba2
Commercial Paper -Dom Curr	P-3
Parent: EDP - Energias do Brasil S.A.	
Outlook	Negative
Corporate Family Rating -Dom Curr	Ba2
Senior Unsecured -Dom Curr	Ba2
NSR Corporate Family Rating	Aa3.br
NSR Senior Unsecured	Aa3.br

* Placed under review for possible downgrade on December 10, 2015

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Key Indicators

[1]Espírito Santo Centrais Elétricas S.A.

	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010
CFO pre-WC + Interest / Interest	3.2x	5.8x	5.2x	4.1x	5.6x
CFO pre-WC / Debt	26.0%	50.1%	38.4%	37.1%	37.3%
CFO pre-WC - Dividends / Debt	22.1%	44.8%	22.8%	18.4%	25.0%
Debt / Capitalization	49.8%	51.2%	55.6%	47.7%	56.0%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

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

Opinion

Rating Drivers

- Positive impact in cash flow of extraordinary and timely tariff increases
- Relatively high capital expenditures and uncertainties related to persisting drought conditions
- Expected increase in sales volumes, despite current negative economic environment
- Good access to the local capital and banking markets

Corporate Profile

Espírito Santo Centrais Eletricas SA (Escelsa), headquartered in Vitória, Espírito Santo, is an electricity distribution utility fully controlled by EDP - Energias do Brasil, S.A. (EDB), an integrated utility group that is in turn controlled by EDP - Energias de Portugal, S.A. (Baa3 stable). Escelsa serves around 1.4 million clients in the state of Espírito Santo. In 2014, Escelsa reported net revenues of BRL 2,273 million (USD 966 million), which does not include construction revenues of BRL155.9 million (USD 66.2 million), on sales of 10,992 GWh, representing approximately 2.2% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

Escelsa's Baa3 issuer rating has historically reflected the relatively stable and predictable cash flows from the regulated distribution business and adequate credit metrics for its rating category. Good access to the local capital markets and implicit support from its parent holding company EDB (Ba2, negative) further support the ratings.

The rationale for confirming Escelsa's ratings in June 2015 was because the deterioration in credit metrics and liquidity that had been expected will likely be less severe than previously estimated, particularly with the regulator recently granting extraordinary and timely tariff increases and the company securing long-term debt financing. The ratings are constrained by the historically high dividend pay-out ratio, relatively sizeable capital expenditures and the evolving Brazilian regulatory environment.

Recent Events

On December 10, 2015, Moody's placed Escelsa's ratings under review for downgrade following the placement of Brazil's issuer and bond ratings under review for downgrade on December 09, 2016.

In May 2015, Escelsa borrowed a 4-year BRL 100 million loan from Citibank with a 2-year grace period for the payment of principal, with amortization in years 3 and 4. In April 2015, Escelsa borrowed BRL 194 million long-term loan from BNDES, of which BRL 80.5 million were disbursed in February 2015 and BRL 113.5 million in April 2015.

On March 06, 2015, Moody's América Latina Ltda placed the Baa3/Aa1.br issuer ratings of Escelsa under review for possible downgrade and placed the Ba1/Aa2.br issuer ratings of Escelsa's parent company EDP Energias do Brasil (EDB) under review for possible downgrade.

On February 27, 2015, ANEEL (the Regulator) approved an extraordinary tariff adjustment for EDP Escelsa. The tariff repositioning was set at 33.27%, being 26.34% related to economic part and 6.93% related to financial components. The new tariff will be applied starting March 02, 2015.

In 2014, Escelsa received BRL 627 million, of which BRL 596 million came from CCEE and BRL 31 million from CDE to compensate for higher costs incurred with the acquisition of energy either because of higher thermal power costs or higher energy costs as a result of the company's indirect exposure to the spot market. In 2013, Escelsa received BRL 239.1 million from CDE to compensate for higher costs for the same reasons as above described.

In August 2014, Escelsa issued BRL 176.8 million in debentures with a six-year tenor and a four-year grace period for the repayment of principal, which will be paid in five semiannual installments.

In May 2014, Escelsa borrowed from Citibank BRL 200.0 million with a four-year tenor and a one-year grace period for the repayment of principal, which will be paid in three annual installments.

In February 2014, Escelsa borrowed from the federally-owned bank Banco do Brasil BRL 110.6 million with a bullet payment in July 2015.

DETAILED RATING CONSIDERATIONS

ADEQUATE CREDIT METRICS FOR THE RATING CATEGORY

Escelsa posted stronger financial performance in the last twelve months ended March 31, 2015, as evidenced by CFO Pre-WC over debt ratio of 30.5% from the previous 26% at the end of 2014, while the RCF over debt ratio improved to 26.6% from 22.1%. Interest coverage ratio improved to 3.3x up from 3.2x for the same period.

As per the determination of the Brazilian securities exchange commission (CVM), all distribution utilities have started recognizing the existence of regulated assets and liabilities in their financial statements starting in December 2014. As a result, all Brazilian distribution utilities posted an extraordinary performance in the fourth quarter of 2014 because most of them reported a sizeable increase in the outstanding balance of regulated assets. Consequently, those existing regulated asset balances, in the amount of approximately BRL 250 million, were fully recognized in the last quarter boosting Escelsa's operating profit for the year.

We deem the change in this accounting procedure as very positive in that it will allow a better and more accurate interpretation of the cash flow performance of a given distribution utility. This new accounting approach is more in line with US GAAP's accounting practices which will permit a more reliable comparison between Brazilian and American electric utilities.

Improvement of metrics were offset by an increase in the company's debt from BRL721.2 million on December 31, 2013 to BRL 907.4 million on March 31, 2015, mainly due to the material increase in regulated assets, from BRL 100.0 million as of December 31, 2013 to BRL 250.0 million as of December 31, 2014. Unlike underfunded pension liabilities, Moody's does not consider the company's current BRL 344.2 million in existing unfunded post-retirement health benefits to be debt - like and has not adjusted the company's total debt upwards by this amount.

Moody's also expects that the regulator in the Fourth Tariff Review will change the methodology it uses to determine the level of energy losses it is willing to accept. Moody's expects the regulator to increase the level of energy losses embedded in the company's electricity tariffs to around 11% in September 2016, from the current 9.27% level which, in turn, is scheduled to decrease to 7.87% from September 2015 through August 2016. The higher level of energy losses allowed by the regulator starting September 2016 will benefit Escelsa's operating margin and cash flow; however, this benefit will be partially tempered by the reduction of electricity tariffs to pass on productivity gains to consumers, in line with the procedures of the Fourth Tariff Review. As a consequence, Moody's expects that Escelsa's cash flow as measured by FFO will weaken in 2015 in comparison with 2014 given the scheduled reduction in energy losses target.

CREDIT METRICS TO DETERIORATE FROM 2015 THROUGH 2017

Going forward, we forecast that CFO before changes in working capital will deteriorate in 2015 from 2014 because Escelsa will not be able to count on the extraordinary revenues of around BRL100 million as it did in 2014 for the recognition of regulated assets related to previous periods and also because we expect that in 2015 FFO will be affected by higher financial expenses as a result of much higher interest rates coupled with a higher level of debt.

The Brazilian local interest rate has dramatically increased in the past twelve months as measured by the benchmark Interbank Deposit Certificate (CDI), which currently is at 12.75 % per annum from the 10.8% average in 2014. Market expectation is that there is still room for additional increases in the base rate, reaching an average of 13.5% for 2015. In addition, given the current crisis that the Brazilian electricity sector is facing the spreads charged by bond holders and bankers have considerably expanded over the past year by at least 100 basis points. Moody's forecasts a gradual reduction in interest rates starting only in 2016 should the Brazilian Central Bank be able to reduce the inflation rate closer to the 4.5% annual target.

The increase in the company's debt level could come from either a time lag between incurred higher energy costs and tariff adjustments or lower internal cash generation without any adjustment in capital expenditures or distribution of dividends. We recognize that the implementation of more timely tariff adjustments since January along with ANEEL's recent extraordinary tariff increase will temper this impact; however, it is not clear what the full impact of the sizeable tariff increases will have on the company's cash flow given higher levels of energy losses and an increase in delinquency rates due to deteriorating economic conditions .

As a result, we project that Escelsa's CFO before WC over Debt ratio will decrease to around the mid-twenties

from 2015 through 2017 down from the previous 37.2% three-year average, while interest coverage should average 3.0x in the same period down from the previous 4.6x three-year average. In 2014, these ratios were at 26.0% and 3.2x, respectively. It is worth mentioning that the 2014 credit metrics are to a certain extent misleading as FFO was positively impacted by the recognition of extraordinary revenues of around BRL 250 million in regulated assets in the fourth quarter.

Our forecast is conservative in that we project that interest rates will remain high at least for the next eighteen months and that volume sales will remain relatively flat in 2015, with a substantial increase in 2016. FFO is expected to decrease in 2016 when the company's tariffs will be reduced from the application of the Fourth Tariff Review in August 2016. Even assuming that Escelsa receives more timely tariff adjustments going forward, we expect that under the forecasted above scenario debt levels will not be materially reduced, which further supports our thesis of deteriorated credit metrics during the next three years.

EVOLVING BRAZILIAN REGULATORY ENVIRONMENT

The Brazilian regulatory framework has been a constraining factor in the rating assessment of the Brazilian electric utilities given its history of being unpredictable having undergone substantial changes over the past several years. The electricity regulatory model implemented in 2004 has mitigated many of the uncertainties brought about by constant changes in the Brazilian regulatory framework over the past two decades. This model has provided a relatively more supportive and predictable environment for being, in many aspects, more transparent and technically-driven, thus increasing the predictability of returns on invested capital. Nonetheless, we believe that the significant improvements that the Brazilian regulatory framework had accomplished since the new model was implemented in 2004 have been offset, to a certain extent, by the manner in which the federal government managed the process of accelerating the renewal of the concessions expiring between 2015 and 2017 in 2013.

The publication of the federal government's provisional measure #579 in September 2012, which became law #12,783 in January 2013, has caused concern 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 concessionaries and investors.

Regardless of the legal aspects involving the implementation of this new legislation which has generated a series of lengthy legal suits and potential appeals in the Brazilian courts, the manner in which the government managed the whole process since the initial announcement and subsequent discussion and communication ended up creating uncertainties about the quality and the level of supportiveness of the Brazilian electricity regulatory environment. As a result, we foresee a lower assurance of timely recovery of costs and investments in Brazil since the publication of the federal law #12,783.

For Moody's, the regulatory framework (Factor 1) and the ability to recover costs and earn returns (Factor 2) are major drivers in the rating assessment of a given issuer pursuant to our updated methodology "Regulated Electric and Gas Utilities published in December 2013. 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 law #12,783.

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 a result of its indirect exposure to the spot market due to hydrology reductions and because it has been forced to acquire the more expensive thermal energy at very high prices. Extraordinary tariff increases in 2015 are expected to provide relief to Escelsa's liquidity position.

We deem the company's current liquidity position as inadequate in light of sizeable short term debt of BRL 330 million as of March 31, 2015 and planned capital expenditures that could reach as much as BRL170 million in 2015. Part of the company's cash needs could be covered by a relatively strong cash position of BRL 260 million at the end of the first quarter. Escelsa has historically had good access in the local banking and capital markets. Escelsa has indicated that it has BRL 194 million commitment in long-term financing from BNDES and BRL 100 million borrowed from Citibank with a four-year tenor and two-year grace period for the repayment of principal, which will be paid in two annual installments to cover the company's cash needs in 2015.

The regulator's recent extraordinary tariff increase should alleviate the pressure on the company's liquidity position but there is no assurance that it will cover all its expected increased costs on a timely basis. The reduction in the company's regulated asset position will be crucial to determine the amount of financial resources the company will need to raise in the local capital market.

We view the current liquidity standing of the parent holding company EDB and some of its subsidiaries as also being inadequate when compared with the liquidity characteristics of other issuers in the same rating category in Brazil. EDB's weaker liquidity position has primarily resulted from the delay in the start-up of operations of the Energia Pecém (Pecém I) project along with the reoccurrence of some technical shutdowns since it started operating in December 2012, which has forced EDB to inject additional capital and extend inter-company loans to Pecém I in the past two years. Furthermore, EDB had an additional disbursement of BRL 300 million in May 2015 to acquire the remaining 50% of Pecém's equity, becoming the thermo power plant sole shareholder.

EDB's liquidity standing will be challenging in 2015 in light of the forecasted maturity of short-term debt of BRL596 million, the commitment to inject capital in some of its power projects that could reach as much as BRL 350 million, and forecasted payment of dividends of around BRL 180 million while at the same time we expect that EDB's subsidiaries will be forced to reduce their payment of dividends to the holding company in face of their lower expected cash flows in 2015.

In order to improve its liquidity standing, EDB will need to raise long term debt that could exceed BRL 1 billion which will also depend on how much EDB can raise from the divestiture of EDP Renováveis Brasil along with potential additional dividends through a capital split at the level of one of its subsidiaries as management has indicated it will possibly undertake.

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 Sao Paulo stock exchange, the company undertook several steps beyond what is legally required to adapt the US 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. The board relies on four support committees: Audit, Sustainability, Corporate Governance and Related Parties, and Compensation. The Audit, the Sustainability and the Corporate Governance and Related Parties 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 review for downgrade follows the placement of Brazil's Baa3 issuer and bond ratings under review for downgrade on December 9, 2015. The company's operational and financial performance is subject to the evolution of the macroeconomic and regulatory environment in Brazil as captured by the sovereign rating.

What Could Change the Rating - Up

In light of this rating action an upgrade is unlikely over the medium term.

What Could Change the Rating - Down

A downgrade of Brazil's sovereign rating would exert downward pressure on the assigned ratings. The rating could also be downgraded if the company's liquidity deteriorates further. Quantitatively, Moody's would consider a downgrade if the ratio of retained cash flow to debt were to decline and remain below 12% and interest coverage, below 3.0x, for an extended period.

Rating Factors

Espírito Santo Centrais Elétricas S.A.

Regulated Electric and Gas Utilities Industry	Current FY	[3]Moody's 12-18 Month
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Grid [1][2]	12/31/2014		Forward ViewAs of 6/3/2015	
	Measure	Score	Measure	Score
Factor 1 : Regulatory Framework (25%)				
a) Legislative and Judicial Underpinnings of the Regulatory Framework	Ba	Ba	Ba	Ba
b) Consistency and Predictability of Regulation	Ba	Ba	Ba	Ba
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Ba	Ba	Ba	Ba
b) Sufficiency of Rates and Returns	Ba	Ba	Ba	Ba
Factor 3 : Diversification (10%)				
a) Market Position	Ba	Ba	Ba	Ba
b) Generation and Fuel Diversity	N/A	N/A	N/A	N/A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.2x	Baa	3x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	26.0%	A	23.5%	A
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	22.1%	A	16.1%	A
d) Debt / Capitalization (3 Year Avg)	49.8%	A	52.1%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa3		Baa3
HoldCo Structural Subordination Notching	0	0	0	0
a) Indicated Rating from Grid		Baa3		
b) Actual Rating Assigned				Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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