

Global Credit Research - 05 May 2011

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	Rating(s) Under Review
Issuer Rating	*Baa1
Bkd Sr Unsec MTN -Dom Curr	*(P)Baa1
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

* Placed under review for possible downgrade on April 6, 2011

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Key Indicators

[1]Espírito Santo Centrais Elétricas S.A

ACTUALS	2010	2009	2008	2007
(CFO Pre-W/C + Interest) / Interest Expense	5.0x	4.7x	4.0x	4.1x
(CFO Pre-W/C) / Debt	31.18%	30.4%	36.0%	41.2%
(CFO Pre-W/C - Dividends) / Debt	18.97%	23.5%	9.6%	35.5%
Debt / Book Capitalization	53.07%	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 third tariff review in August 2013

Potential volatility in FFO from the adoption of IFRS

The level of support of its ultimate parent company, EDP - Energias de Portugal

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) (Baa1, under review for downgrade). Escelsa serves around 1.2 million clients in the state of Espirito Santo. In 2010, the company reported net revenues of BRL1.5 billion (USD 855 million) on sales of 5,221 GWh, representing approximately 1.2% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

The Baa3 rating for Escelsa reflects the relatively stable and predictable cash flows from the regulated distribution business, the solid credit metrics for its rating category, 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 downgrade and the placement of the rating outlook under review for further downgrade of its ultimate major shareholder EDP Portugal further constrains the ratings.

Recent Events

On April 6, 2011 Moody's placed the Baa1/P-2 senior unsecured ratings of Energias de Portugal SA (EDP) under review for possible downgrade.

On March 17, 2011 Moody's downgraded the senior unsecured ratings of Energias de Portugal SA (EDP) to Baa1 from A3 (on review for downgrade). The outlook was changed to stable.

In August 2010, the regulator applied the Fifth tariff review for Escelsa. The tariff review methodology has not changed from the last tariff review in 2007. The new methodology the regulator ANEEL placed for public hearing at the end of 2009, that is expected to be approved by the end of this year, will only be applied to Escelsa's tariffs in August 2013.

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 averaged 2.3x since 2005.

In 2010, Escelsa posted a satisfactory performance fueled by a significant 17.7% growth in volume sales. The recovery of the economy of the Espirito Santo State and, more specifically, the industrial segment generated an outstanding growth in the consumption of electricity in the state.

Free consumers, largely composed of industrial customers, increased their electricity consumption by 38.5% in 2010 compared with an increase in volume sales of 6.8% of the captive consumers. In addition, operating profit benefitted from the reduction of energy losses to 14% in 2010 from 15.5% in 2009 and the more strict control of the so-called controlled operating expenses which remained virtually flat in the past two years. The impact of the volume growth of free consumers is relatively limited in operating margins as typically around two thirds of the tariff charged from free consumers for the use of the distribution grid is fixed.

As expected, the adoption of the IFRS caused some variation in FFO because of the non-recognition of regulatory assets and liabilities. According to management information, FFO was inflated by around BRL 62 million in 2010 and BRL 35 million in 2009. Assuming other variables constant, FFO will most likely decrease in 2011 as these gains will be reduced from tariffs.

Conversely, operating profit has been hurt by the negative variation of IGP-M, which is the inflation index used to adjust the so-called parcel B of the tariff formula. From September 2008 to August 2009 this index was negative at 0.64%. In addition, according to management information, operating profit was reduced by approximately BRL 20 million in 2010 in comparison with 2009 because of the non-recognition of regulatory charges derived from higher volume sales which were above the amount recognized in the electricity tariffs. In 2010, like most of the Brazilian distribution companies, Escelsa signed an amendment contractual clause with the regulator by which it agreed to transfer to consumers the gains caused by the additional collection of regulatory charges.

Going forward, Moody's forecasts that CFO before changes in working capital will remain relatively stable through August 2013 and decrease thereafter from the application of the third tariff review, which is expected to consider new operational procedures. Moody's projects that the CFO before WC over Debt ratio will remain above 30% during this period while interest coverage will hover around 4.0x in the same period. Moody's projects that the annual volume sales growth will average 4% over the next three years and that local interest rates will average 11%.

The major downside risks of Moody's projections are lower volume sales than forecasted. This could arise from lower consumption of the 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 a potentially lower level of cash generation.

LOWER TARIFFS FROM THE TARIFF REVIEW IN AUGUST 2013

In August 2013, the regulator ANEEL will apply the new methodology for tariff review to Escelsa, which will transfer productivity gains to consumers. The application will also apply a lower WACC in the face of lower capital costs (equity and borrowings) among the Brazilian electricity distribution companies. At the end of last year, 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.

Based on public information available at ANEEL's website, a very preliminary estimate indicates that the average reduction in EBITDA for the Brazilian electricity distribution companies could reach as much as 30% if the tariff review parameters the regulator has suggested are strictly followed. Moody's expects that electricity tariffs will eventually be reduced but by a lower percentage amount than the regulator initially suggested. Moody's expects the reduction in EBITDA to stay within the 20-25% 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 utilities' 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 captures 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 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 (Baa1; on review for downgrade). 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 downgrade and placement of the outlook under review for possible downgrade limits the ability of EDP Portugal to eventually step in to support its subsidiaries in case of financial distress of the latter.

In this context, Moody's believes that ownership by EDP no longer supports a one notch of uplift of the rating on the global scale. 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 two 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 evolution 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 ring fenced against 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 of the Brazilian companies, Escelsa does not have any committed banking facility to accommodate any unexpected cash disbursement. 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 BRL 156 million substantially covers short-term debt of BRL 171 million as of December 31, 2010.

In 2011, Moody's projects that Escelsa will post CFO of BRL 312 million, which is expected to meet the main cash outlays composed of estimated capital expenditures of BRL 166 million and payment of dividends of BRL 130 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 BRL 150 million.

Moody's deems the liquidity standing of EDB on a consolidated basis as very good. On December 31, 2010, EDB reported a sizeable consolidated cash position of BRL1.1billion. Despite relatively sizeable debt maturities in the short-term of BRL607 million, the refinancing risk is 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.

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 - term 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 around 20% of total debt on a consistent basis. Moody's expects that EDP Portugal will continue to support its subsidiaries by preserving their liquidity position and low leverage.

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.

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 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

Espírito Santo Centrais Elétricas S.A

Regulated Electric and Gas Utilities	Current 12/31/2010		Moody's 12 - 18 month Forward View	
	Measure	Score	[1]Measure	Score
Factor 1: Regulatory Framework (25%)				
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%)		Baa		Baa
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	4.7x	A	3.8x - 4.7x	Baa
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	32.4%	Aa	30.9% - 40.3%	Aa
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)	17.6%	A	16.5% - 26%	A
e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg)	52.9%	Baa	48.5% - 52.1%	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

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