

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: Espírito Santo Centrais Elétricas S.A.

Global Credit Research - 30 Jul 2014

Vitoria, Brazil

#### Ratings

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

ACTUALS	2013	2012	2011	2010	2009
(CFO Pre-W/C + Interest) / Interest Expense	6.5x	5.4x	3.8x	5.4x	4.2x
(CFO Pre-W/C) / Debt	31.3%	23.9%	26.9%	35.7%	26.2%
(CFO Pre-W/C - Dividends) / Debt	27.8%	13.2%	11.5%	23.5%	19.3%
Debt / Book Capitalization	60.8%	64.5%	56.4%	53.1%	52.6%

[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 thermal energy and involuntary exposure to the spot market

- Resilient access to the local capital and banking markets
- Relatively predictable and stable cash flow
- Lower tariffs from the Third tariff review in August 2013

### **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 1.4 million clients in the state of Espirito Santo. In 2013, Escelsa reported net revenues of BRL1,849 million (USD856 million), which does not include construction revenues of BRL178.3 million (USD 82.5 million), on sales of 10.548GWh, representing approximately 2.2% 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, and the adequate credit metrics for its rating category. The implicit support from its parent holding company EDP- Energias do Brasil (EDB, Ba1 stable) and its resilient access to the local capital markets further supports the ratings.

The ratings are constrained by the historically 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 thermal energy and involuntary exposure to the spot market also constrains the ratings as does the evolving Brazilian regulatory environment.

### **Recent Events**

In the first four months of 2014, Escelsa received BRL 387 million, of which BRL 356 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 involuntary 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 the first half of the 2014, Escelsa borrowed BRL 310 million, of which BRL 110 million from the federally-owned bank Banco do Brasil which consisted of a 17-month bullet payment loan. The other BRL 200 million relates to a 4-year loan provided by Citibank to be paid in three annual installments after a one-year grace period.

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 and involuntary exposure to the spot market 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 a final maturity in February 2015.

### **DETAILED RATING CONSIDERATIONS**

## 2013 STRONGER CREDIT METRICS THAN ANTICIPATED

Escelsa posted stronger credit metrics in 2013 in comparison with the previous two years, which exceeded both ours and management's expectations, particularly when we consider that the company's tariffs were reduced as a result of a 10.1% reduction in the so-called part B of the company's tariff structure, which resulted in a 3.87% reduction in the company's tariffs in August 2013 from the application of the operational procedures of the Third tariff review by the regulator ANEEL.

Escelsa's relatively weak performance in 2012 stemmed from the combination of much lower electricity consumption from industrial consumers in both the regulated and free markets and from the exacerbated increase in costs associated with the acquisition of more expensive thermal energy in the second half of 2012, given the mandated reduction of available hydro power due to drought conditions. Increases in the cost of acquiring energy hurt Escelsa's cash flow in 2012, which resulted in the creation of BRL 89 million in net regulatory assets which were not recovered 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 was to prevent the permanent transfer to the current electricity tariffs of the more expensive thermal power acquired during the previous year under what was viewed as rather unusual circumstances.

Escelsa received BRL 231.9 million in 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.

Escelsa's better financial performance in 2013 is evidenced by the CFO Pre-WC over debt ratio of 31.3% up from the previous two-year average of 25.4% while the RCF over debt ratio dramatically improved to 27.8% in 2013 from the average 12.4% ratio in the previous two years.

The improvement in credit metrics from 2012, largely reflects the fact that the company's cash from operations (CFO) was understated by around BRL 89 million in 2012 from the non recognition of net regulatory assets in the same amount in the company's tariffs. Conversely, Escelsa' CFO was slightly overstated by around BRL 5 million in 2013, which is the equivalent value of the reduction in the company's net regulatory assets, which decreased from BRL 105.4 million in December 2012 to BRL 100 million in December 2013.

## CFO TO DECREASE IN 2014 BUT IMPROVE THEREAFTER

Going forward, we forecast that CFO before changes in working capital will deteriorate in 2014 from the application of the regulator's periodic tariff review which reduced the company's tariffs by 3.87% in August 2013 as above described and our expectation that the increase in costs for the acquisition of more expensive energy due to the continuation of drought conditions will not be fully reflected in the company's tariffs and the likelihood that the company will not be fully reimbursed by the CDE fund or CCEE during the year. We conservatively estimate that net regulatory assets will increase in 2014 by BRL 40 million.

As a result, we project that the CFO before WC over Debt ratio will decrease to around 20% in 2014 and improve thereafter when Escelsa's net regulatory assets are expected to reduce by around BRL 50 million per year from 2015 through 2017. We expect that the reduction in CFO will be tempered by a reduction in the payment of dividends as indicated by management leading to a RCF to debt ratio slightly below 20% in 2014.

In line with our assumptions, we believe that Escelsa is bound to post CFO over debt ratios in the high twenties from 2015 through 2017, while the RCF to debt ratio is projected to be just slightly below the CFO over debt ratio from 2014 through 2015, and decrease to around the mid tens thereafter.

The major downside risks to our projections are a higher than expected increase in the company's regulatory assets not covered by tariffs or reimbursements from CDE and CCEE, higher payment of dividends than indicated by management and lower volume sales. Lower consumption by industrial consumers could arise 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 applied the new methodology for its tariff review to Escelsa. The application incorporated a lower WACC of 7.5% in the face of lower capital costs (equity and borrowings) among the Brazilian electricity distribution companies. The regulator ANEEL applied the new procedures of the Third tariff review to the Brazilian distribution companies from 2011 through 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 electricity tariffs reflected the terms and conditions of the Second periodic tariff review, which envisaged a higher WACC of 9.95%.

In accordance with ANEEL's technical note #320/2013 on the application of the operational procedures of the Third tariff review on Escelsa's tariffs, the company's part B of the tariff structure was reduced by 10.1%, with an equivalent reduction in tariffs of 3.87%. As a result, the company's regulatory EBITDA was around BRL 304 million at the currency value as of August 2013 30, 2013. The part B of the tariff formula mainly consists of the operating costs (reference company), depreciation and the remuneration amount.

## 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 last year.

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 concessionaires 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 involuntary exposure to the spot market due to hydrology reductions and because 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 through 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 April 2014, the federal government coordinated the use of the Brazilian electricity sector clearing house CEEE as a financial vehicle to raise additional financial resources in the local banking market and transfer them to the distribution companies. Accordingly, CCEE borrowed a three and a half-year BRL 11.2 billion loan from Brazilian local banks, consisting of large private banks and federally-owned financial institutions and immediately transferred the loan proceeds to the distribution companies so that they would be able to honor their financial obligations with the power generators.

The regulator ANEEL has recently indicated that CEEE would tap the local banking market within the following days for an additional BRL 6.5 billion loan to alleviate the continuing stressed liquidity position of the distribution companies. As previously mentioned, Escelsa benefitted from this financial transfer by receiving BRL 356 million in May 2014. Escelsa is eligible to receive additional funding from CCEE, which should occur within the following days but the amount is not clear yet.

Escelsa continues to demonstrate its good access to the local banking market by raising BRL 310 million in medium-term loans earlier this year which will work as a cushion to face any unexpected disbursement in the short term.

We believe that EDB's resilient access to the local banking and capital markets is an important mitigating factor for any 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 maintain their capital structure and liquidity positions so that they remain commensurate with their current 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 typical liquidity characteristics of other investment grade issuers in Brazil. EDB's weaker liquidity position has resulted primarily from the delays incurred during the start-up of operations of the PECHEM thermal power project which have been impacted by technical breakdowns, the relatively high payment of dividends at the level of the holding parent company, capital injections in major power projects and the forced purchase of higher priced energy to meet the obligations of its PPAs.

On June 27, 2014, the parent holding company EDB announced that it had received from CWE Brasil (unrated), controlled by China Three Gorges (A1 stable), BRL 420.6 million related to the sale of its 50% participation in two major power projects as described in our issuer comment published on December 12, 2013. These proceeds clearly improve EDB's current liquidity position.

## **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 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 forecasted deterioration in credit metrics in 2014, Escelsa will post stronger cash generation starting in 2015 as a result of our expectation of the pass-through of regulatory assets, which, however, will be tempered by lower tariffs from the Third tariff review that was implemented in August 2013.

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 and the non-recognition of regulatory assets in electricity tariffs.

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 Escelsa's retained cash flow remains above 12% of total debt on a consistent basis.

### What Could Change the Rating - Up

Given the expected deterioration in credit metrics and continued pressure of its liquidity position along with the impact of 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

We would consider a downgrade rating action if Escelsa's RCF over debt ratio becomes lower than 10% and interest coverage falls below 3.5x on a sustainable basis. A perceived deterioration of the company's liquidity position or a downgrade of EDB's ratings could also trigger a downgrade rating action. 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.

## Rating Factors

### Espírito Santo Centrais Elétricas S.A.

Regulated Electric and Gas Utilities	[1]Current31-Dec-2013		Moody's 12-24 Month Forward View	
	Measure	Score	Measure	Score
<b>Factor 1: Regulatory Framework (25%)</b>				
a) Judicial & Legislative Underpinnings (12.5%)		Ba		Ba
b) Consistency & Predictability of Regulation (12.5%)		Ba		Ba
<b>Factor 2: Ability to Recover Costs and Earn Returns (25%)</b>				
a) Timeliness of Recovery of Costs (12.5%)		Ba		Ba
b) Reasonableness of Allowed Rates & Returns (12.5%)		Ba		Ba
<b>Factor 3: Diversification (10%)</b>				
a) Market Position (10%)		Ba		Ba
b) Generation and Fuel Diversity (0%)				
<b>Factor 4: Financial Strength, Liquidity &amp; Financial Metrics (40%)</b>				
a) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	5.0x	A	4.0x - 4.9x	A
b) CFO pre-WC / Debt (15%) (3yr Avg)	25.4%	A	21.4% - 27.6%	A
c) CFO pre-WC - Dividends / Debt (10%) (3yr Avg)	16.4%	A	18.2% - 21.4%	A
d) Debt / Book Capitalization (7.5%) (3yr Avg)	61.6%	Ba	54.7% - 57.0%	Baa
<b>Rating:</b>				
a) Methodology Implied Rating		Baa3		Baa3
b) Actual Issuer Rating		Baa3		Baa3

[1] 3-year historical average

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