MOODY'S
INVESTORS SERVICE

Credit Opinion: Companhia de Eletricidade do Estado da Bahia S.A.

Global Credit Research - 30 Jun 2014

Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured -Dom Curr	Baa2

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Key Indicators

[1]**Companhia de Eletricidade do Estado da Bahia S.A.**

ACTUALS	2013	2012	2011	2010	2009
(CFO Pre-W/C + Interest) / Interest Expense	5.0x	4.4x	6.4x	6.1x	5.2x
(CFO Pre-W/C) / Debt	24.2%	27.3%	48.4%	51.9%	68.1%
(CFO Pre-W/C - Dividends) / Debt	19.7%	18.5%	16.6%	3.7%	45.4%
Debt / Book Capitalization	59.6%	63.8%	53.6%	45.8%	39.5%

[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

- Stable and predictable cash flow supported by long-term concession

- Implicit support of strong shareholders

- Weaker credit metrics from the third tariff review in April 2013

- Adequate access to the banking and capital markets

- Liquidity pressure from higher thermal power costs

Corporate Profile

Coelba distributes electricity to 415 municipalities of the 417 in the state of Bahia through a 30-year concession agreement granted by ANEEL which expires in 2027. In 2013, Coelba distributed 17,666 GWh to regulated and free consumers, which is equivalent to around 3.7% of all the electricity consumed in the Brazilian integrated system. In the last twelve months ended on March 31, 2014, Coelba posted net revenues of BRL4,101 million (USD1,824million), which does not include construction revenues of BRL 718 million (USD319.3 million) and net profit of BRL351 million (USD156.1 million).

Coelba is controlled by Neoenergia, which has 89.8% of its voting capital and 87.8% of its total capital. Neoenergia is a holding company with interests in three electricity distribution companies with also a relevant participation in the generation business. Neonergia is controlled through a shareholding agreement by the Spanish group Iberdrola (39% of the voting capital), Previ (49% of the voting capital), which is the pension fund of Banco do Brasil's employees and the federal owned bank Banco do Brasil (12% of the voting capital).

Recent Developments

On April 10, 2013 the regulator ANEEL published technical note 107/2013 on COELBA `s third tariff review by which the company's electricity tariffs were reduced by 5.91%. The real tariff reduction to be perceived by consumers is estimated at 7.92% due to the withdrawal of certain financial components embedded in the previous tariff.

On March 6, 2013, COELBA had a favorable court decision over the dispute of fiscal incentives with the regulator. This was not the final decision as the regulator can appeal to a superior court but undoubtedly this decision shed some light on what we consider the most likely direction.

On January 24, 2013, COELBA's electricity tariffs were reduced by 20% as a result of lower generation and transmission tariffs and the elimination of certain regulatory charges. This stemmed from the federal government's initiative to reduce energy costs to final consumers through the publication of the provisional measure 579 in September 2012, which became law number 12,783 in January 2013.

In accordance with this new legislation, the federal government offered concessionaries the ability to accelerate the renewal of their concessionaries ahead of their expiration date between 2015 and 2017. At the same time the federal government eliminated certain regulatory charges and reduced the collected amount of others. The application of this extraordinary tariff adjustment had no impact on COELBA's operating profit, as the lower revenue amount has matched lower operating costs.

In December 2012, COELBA borrowed USD 200 million from Bank of America and USD 50 million from Bank of Tokyo. Both loans will mature in June 2018 and will be amortized in three semi-annual payments starting in June 2017. The borrowing costs were Libor plus 1.7% and Libor plus 0.8%, respectively. Management has stated that the company has entered into derivative transactions to hedge the currency risk by swapping its exposure from the American dollar to the CDI (Interbank Deposit Certificate).

In November 2011, the federal government extended the tenor of fiscal incentives from 2013 to 2020 to Coelba. These fiscal incentives consist of a reduction of 75% on the income tax rate; however, the related amount of these fiscal incentives cannot be distributed as dividends and must be reinvested in the region.

SUMMARY RATING RATIONALE

The Baa2 issuer rating reflects Coelba's inherently stable and predictable cash flow supported by a long-term concession to distribute electricity in the state of Bahia and its relatively adequate credit metrics for the rating category. The Baa2 issuer rating is one notch higher than the rating indicated by Moody's methodology grid to reflect the implicit support of its immediate shareholder Neoenergia (not rated) and its ultimate shareholders, which include the Spanish company Iberdrola S.A (Baa1 negative), Banco do Brasil (Baa2 stable), Senior Unsecured Debt Rating) and PREVI (not rated).

The rather aggressive distribution of dividends and relatively high capital expenditures constrain the rating as does the Brazilian evolving regulatory framework. Coelba's rather inadequate liquidity position derived from exacerbated working capital needs over the past 18 months further constrains the ratings.

DETAILED RATING CONSIDERATIONS

ADEQUATE CREDIT METRICS FOR THE RATING CATEGORY

Coelba has posted strong performances in the past five years. This has largely stemmed from the inherently stable and relatively predictable nature of the Brazilian electricity distribution business, and the company's continuing volume growth along with a favorable tariff structure during this period.

Despite satisfactory performance, COELBA posted weaker cash flow as measured by CFO (Cash from operations before changes in working capital) of BRL897.7 million, which represented 24.2% over total debt in 2013. This compares with the previous three-year average CFO of BRL 1,119.2 million or 40.2% over total debt in this period.

The much lower 24.2% CFO Pre-WC over total debt ratio mainly stems from the combination of lower tariffs from the third tariff review in April 2013 wherein the company's tariffs decreased by 5.91% along with an increased level of debt since the end of 2011 to face increased capital expenditures and the higher payment of dividends. Total debt has increased from BRL 2,689 million as of December 31, 2011 to BRL 3,702 million as of December 31, 2013.

Capital expenditures averaged around BRL 1 billion from 2011 through 2013 while the payment of dividends was particularly high in 2011 and 2012 when Coelba distributed BRL 855 million and BRL 313 million, respectively. In 2013, the payment of dividends decreased significantly to BRL 169 million, which is in line with management's financial policy to reduce the payment of dividends to the legal minimum 25% of net profit over the medium-term horizon.

Coelba also benefits from fiscal incentives, which have further boosted its cash flow and profitability since 1997 when Brazilian electricity regulator ANEEL granted the company a concession to distribute electricity in Bahia for 30 years. Fiscal incentives are part of the federal government's strategy to foster investments in the northern and northeastern regions of the country, which have historically lagged behind the more developed regions of the country. Coelba currently benefits from a reduction of 75% in the payment of income tax which was scheduled to expire in 2013 but has been extended to 2020. These fiscal incentives have been an important cash flow source and in 2013 reached BRL 101.3 million.

Conversely, relatively sizeable capital expenditures along with historically high dividend pay-out ratios have impaired the company's free cash flow and credit metrics. This is evidenced by comparing the previous outstanding three-year average CFO-WC (Cash from operations before working capital) to Debt ratio of 40.2% with the materially lower retained cash flow (RCF) to Debt ratio of 25.6% in the same period. Consequently, free cash flow was negative at 14.8% of debt in the same period. It is worth noting that these two latter ratios were positively influenced by the much lower payment of dividends in 2013.

RELATIVELY STABLE CASH FLOW IN THE MEDIUM TERM BUT VOLATILE IN THE SHOR TERM

Going forward, we forecast CFO slightly improving over the next three years in comparison with 2013 although we can see some volatility in operating margins in the face of the potential build-up of regulatory assets as a result of the increased costs mainly from the acquisition of thermal power due to the drought conditions experienced in Brazil over the last 18 months.

As a regulated business we would expect that electric utilities would post relatively stable operating margins during a specific tariff cycle, which in the case of Coelba is 5 years after which the company's tariffs are reviewed again. Any improvement would typically come from the expansion of electricity consumption and reduction of operating costs. Nevertheless, as IFRS does not recognize the existence of regulatory assets, any material increase in the acquisition of energy by the electric utility, which is not funded by the federal government either from the electricity sector's fund CDE (Energy Development Account) or through funding provided by CCEE (Electricity Clearing house), will necessarily be recovered by an annual tariff increase granted by the regulator ANEEL.

Since we expect that part of the increased energy acquisition costs will be only recovered by a tariff increase in April 2015, Coelba is bounded to post lower EBITDA in 2014. Conversely, we expect that EBITDA will improve from 2015 through 2016 to reflect increased costs incurred in 2014, which were not contemplated in the company's revised tariff structure in April 2013. We did not consider in our projections any extraordinary tariff increase in 2014, which the company could require from the regulator in case of a material increase in costs that could jeopardize the company's financial and economic position. Our base case scenario is that the Brazilian electric utilities will recover increased energy acquisition costs through a combination of tariff increase and some kind of financial support from the federal government.

Coelba is expected to maintain relatively high capital expenditures and limit its dividend pay-out ratio to the legal minimum limit of 25% of the net profit. The high capital expenditures level is primarily tied to the concession contract commitment to expand the distribution network to meet expected growing consumption in both markets regulated and free while improving the quality of services to existing consumers. In addition, Coelba is committed to expand capacity to meet the "Light For All" program targets as determined by the federal government. Coelba projects annual capital expenditures of around BRL750 million in 2014, BRL1,090 million in 2015 and BRL1,018 million 2015.

Historically, Coelba's distribution of dividends has been quite aggressive. Up to 2011 the dividend payout ratio averaged 74% although COELBA's dividend pay-out ratio was considerably lower in 2012 when the company distributed BRL313 million dividends, which was equivalent to 47.2% of its BRL 663 million net profit and just BRL 169 million in 2013 or 34% of its net profit of BRL 495 million. This is evidence that COELBA is trying to balance the payment of dividends to the expected lower levels of CFO from the implementation of the third tariff review in April 2013 and the fact that capital expenditures are to a large extent mandatory with little flexibility for any material reduction.

As previously stated, we project that Coelba's credit metrics will remain commensurate with the Baa3 rating category but more at the low end of this rating category (current Baa2 issuer rating is one notch higher due to the implied support of NEOENERGIA) over the medium term.

LOWER TARIFFS FROM THE THIRD TARIFF REVIEW IN APRIL 2013

The application of the third tariff review by the regulator had a negative impact on Coelba and the other distributors because of the stricter parameters used to accelerate the transfer of productivity gains to consumers, and the application of a lower Weighted Average Cost of Capital (WACC) in the face of lower capital costs (equity and borrowings). The WACC is a gauge of funding costs used to decide the final tariff increase granted to the companies.

In November 2011, Brazil's electricity regulator, ANEEL, approved the new rules for the application of the third tariff review, which signaled a significant reduction in tariffs for all Brazilian electricity distribution companies to be implemented from 2012 through 2014 with effects retroactive to 2011 for some distribution companies. In the case of Coelba, the third tariff review came into force in April 2013 and should remain valid for the following five years.

As a result of the application of the third tariff review, Coelba's regulatory EBITDA was reduced by around 30% on an annualized basis as indicated by the reduction of 16.4% in the so-called parcel B of the tariff formula, which ultimately determines the effective reduction in operating profit. The 30% reduction in COELBA's regulatory EBITDA was relatively in line with the EBITDA reduction of other Brazilian distribution companies, which we estimate to have ranged between 25% and 30%.

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. ANEEL determined a weighted average cost of capital of 7.50 percent which was applied in the third tariff review cycle for distribution companies, down from the 9.95 percent level utilized in the prior review cycle.

JUDICIAL DISCUSSION ON FISCAL INCENTIVES

It should be noted that for the Third Tariff Review ANEEL initially indicated that it would incorporate the existing fiscal incentive benefits into the calculation of the WACC for all distribution companies operating in Brazil's northern and northeastern regions. This approach would have ultimately transferred the fiscal incentive benefits directly to the electricity consumers. COELBA has argued against this decision on the grounds that the fiscal incentive benefits have typically been aimed at the distribution companies to foster new investments in the affected regions pursuant to the fiscal incentives legislation. In addition, the portion related to the tax exemption cannot be distributed as dividends. To that end, on March 6, 2013, COELBA had a favorable court decision over the dispute of fiscal incentives with the regulator; however, this was not the final decision as the regulator has appealed to a superior court. Nevertheless, in our opinion this decision sheds some light on what we consider the most likely direction that the courts will be taking. Given this preliminary decision in the Brazilian court COELBA's tariffs still reflect the intended fiscal incentive benefits.

The outcome and timing of this judicial dispute is difficult to predict at the current stage of negotiations but we believe that COELBA has a reasonably good chance of prevailing given the fiscal incentives legislation. However, should the regulator's decision prevail, COELBA's future cash from operations would be impacted by an estimated annual amount of over BRL110 million after April 2013 tariff reduction.

SUPPORT OF STRONG SHAREHOLDERS

Neoenergia is an integrated electricity holding company, the second largest privately owned electricity producer in Brazil and one of the largest Brazilian distribution groups, with around a 7% market share.

In 2013, Neoenergia distributed 35,708.GWh to 9.9 million clients, had a total capacity of 1,625MW and operated 450km of transmission lines, employing around 26,620 people (5,160 directly and 21,460 subcontracted).

Neoenergia is currently owned by the Spanish group Iberdrola (39%, Baa1/negative outlook), PREVI (49.01%, non-rated) and BB Investimentos (12%, non-rated), the investment banking arm of Banco do Brasil.

Founded in 1997, Neoenergia started its operations in Brazil in the same year its subsidiary Coelba was granted its 30 year distribution concession. In 2013, Neoenergia posted Net Debt/EBITDA ratio of 2.4.x, EBITDA margin of 20.2% and debt /book capitalization ratio of 44.6%.

We understand that Coelba would count on the support of its major shareholder if needed because of the strategic role the company holds within NEOENERGIA's business strategy in Brazil. An example of this support came in 2009 when Coelba postponed the payment of dividends in the face of tight liquidity conditions in the local capital markets. Although unrated, Neoenergia, in our opinion, has a solid credit position thus implicitly reinforcing Coelba's credit profile.

CURRENT 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 concessionaries and investors.

Regardless of the legal aspects involving the implementation of this new legislation which can potentially generate a series of lengthy legal suits and 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 Profile

As is the case with most other Brazilian companies, Coelba does not have a committed banking facility to support any unexpected cash disbursements. In spite of this, we would deem Coelba's liquidity position as adequate if it were not for the exacerbated increase in working capital needs over the past 18 months as a result of the acquisition of the more expensive thermal power and to a lesser extent its involuntary exposure to the spot market, which forced the company to acquire energy at much higher prices.

It is difficult to accurately predict the company's working capital needs for the second half of 2014 given the uncertainties regarding the federal government's policy towards providing additional support either through injecting new capital in the Brazilian electricity's regulatory fund CDE (Energy Development Account) or provide financial funding from CCEE (energy clearing house), which would borrow money from the financial market and transfer the funding to the distribution companies so that the latter could pay off their debt with thermal power suppliers.

The financial support from the federal government as it occurred in the recent past would be the best alternative for the liquidity position not only for Coelba but also all Brazilian distribution companies as it would have an immediate positive impact on cash flow.

Coelba is entitled to receive an annual tariff increase every April as envisaged in the concession contract. The company received a 14.9% tariff increase in April 2014, which included the recognition of certain regulatory assets to resume its financial and economic equilibrium. However, if the Brazilian electricity national system operator (ONS) continues to dispatch thermal power at the current pace due to the drought conditions, Coelba will most likely incur additional costs, which would be either covered by the federal government's financial support as explained above or an extraordinary tariff increase, which we view as unlikely.

In the worst case scenario, Coelba would be forced to borrow money in the local capital or banking markets to face this additional working capital need, which we deem feasible in light of the company's proven resilient access to both local and international capital and banking markets, a relatively conservative financial policy, and the strong reputation of the NEOENERGIA group for its ample access to the capital and banking markets given its size, local prominence and perceived credit quality.

Corporate Governance

We deem the level of COELBA's corporate governance practices as adequate. Despite having less than 1% of its shares traded in the Brazilian stock market, the level of transparency and disclosure of information is in many respects in line with that provided by most of the largest Brazilian public companies.

Rating Outlook

The stable outlook reflects our expectation that, despite some forecasted deterioration in credit metrics in comparison with the historical three- year average, Coelba will continue to post credit metrics in line with the Baa3 rating category. It also reflects our expectation that the company will be able to continue to count on the support of its immediate and ultimate shareholders while maintaining its historical good access to the local banking and capital markets.

What Could Change the Rating - Up

Given the fact that some deterioration in credit metrics is expected in light of the lower tariffs implemented from the Third tariff review in April 2013, an upgrade over the medium term is highly unlikely.

What Could Change the Rating - Down

We would consider a downgrade rating action if CFO Pre WC - dividends over debt falls below 15% and interest coverage stays below 4.0x for a extended period. Deterioration of the financial condition of Neoenergia or a perception of lower support from its immediate and ultimate shareholders could also prompt a downgrade rating action. Deterioration in the company's liquidity, which could come from management's inability to timely access the local banking and capital markets to finance a potential increase in working capital needs, could also trigger a downgrade rating action.

Rating Factors

Companhia de Eletricidade do Estado da Bahia S.A.

Regulated Electric and Gas Utilities Methodology [1]	[2]**Current 31-Dec-2013**			**Moody's 12 - 18 month Forward View**	
Factor 1: Regulatory Framework (25%)	**Measure**	**Score**		**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework (12.5%)		Ba			Ba
b) Consistency and Predictability of Regulation (12.5%)		Ba			Ba

Factor 2: Ability to Recover Costs and Earn Returns (25%)					
a) Timeliness of Recovery of Costs (12.5%)		Ba			Ba
b) Reasonableness of Allowed Rates & Returns (12.5%)		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%)					
a) CFO pre-WC + Interest / Interest (7.5%)	5.2x	A		3.8x - 4.1x	A
b) CFO pre-WC / Debt (15%)	31.9%	Aa		19.9% - 21.5%	A
c) CFO pre-WC - Dividends / Debt (10%)	18.4%	A		17.6% - 19.8%	A
d) Debt / Capitalization or Debt / RAV (7.5%)	59.2%	Ba		57.2% - 58.4%	Baa
Rating:					
a) Methodology Implied Issuer Rating		Baa2			Baa3
b) Actual Issuer Rating		**Baa2**			**Baa2**

[1] Regulated Electric and Gas Utilities Methodology, as of December 2013 [2] 3-year historical average