

Saint Lucia Electricity Services Limited

USD 15 million Debt Issue (Notional)	CariBBB (Regional Scale Foreign Currency) CariBBB (Regional Scale Local Currency)
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RATIONALE SUMMARY

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Caribbean Information and Credit Rating Services Limited (CariCRIS), the Caribbean regional credit rating agency, has reaffirmed the ratings of *CariBBB* (Foreign Currency Rating) and *CariBBB* (Local Currency Rating) on the regional rating scale to the notional debt issue of the size of USD 15 million of Saint Lucia Electricity Services Limited (LUCELEC). These ratings indicate that the level of creditworthiness of this obligation, adjudged in relation to other obligations in the Caribbean¹, is **adequate**.

The ratings on LUCELEC continue to reflect the company's monopoly position in Saint Lucia, healthy financial profile and favourable operating efficiency. The ratings on LUCELEC are constrained by the creditworthiness of its sovereign as its operation is solely in the Saint Lucian economy. The demand for LUCELEC's services is cyclical in nature, reflecting the economic cycle of the sovereign. Further tempering the ratings are its indirect exposure to fuel prices, the potential effects of damage to its property at its single location generating plant,

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¹ The term Caribbean as used here covers the following countries: Bahamas, Barbados, Belize, Costa Rica, Dominican Republic, Guyana, Haiti, Jamaica, Panama, Suriname, Trinidad and Tobago and the following countries in the OECS: Anguilla, Antigua & Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, Saint Lucia and St. Vincent & the Grenadines. Refer www.caricris.com for a more detailed explanation on CariCRIS ratings and rating definitions.

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self-insurance for its Transmission and Distribution infrastructure and the deteriorating accounts receivable aging profile.

DETAILED RATIONALE

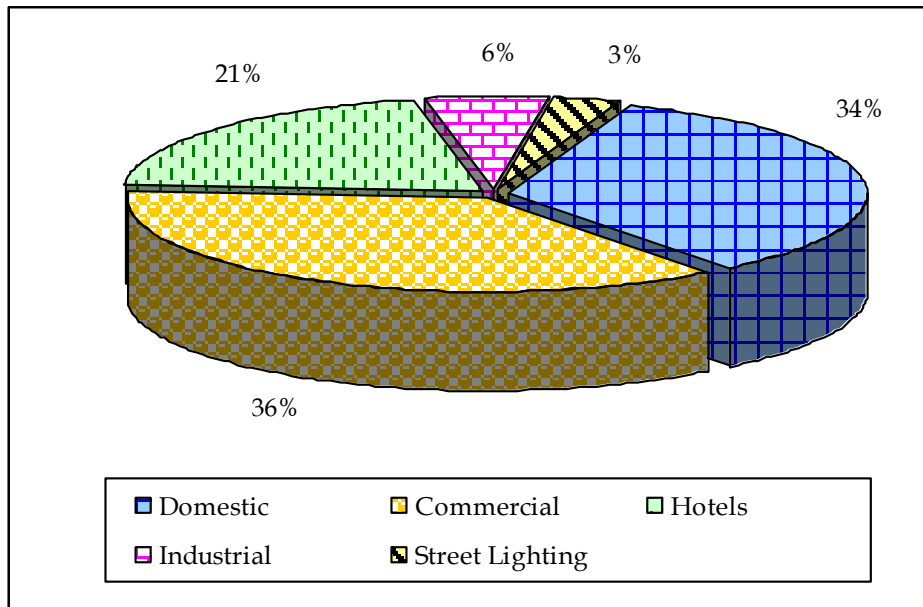
Dominant market position

The company has sufficient power plant capacity of 76 megawatt (MW) to meet the country's average demand for power of around 59MW. Through its power station at Cul de Sac, LUCELEC transmits power to seven substations located around the country via a 66 kilo volt (kV) transmission line. The voltage is then transformed to 11kV at the substations and distributed to its customers over 1,600 miles of primary and secondary distribution lines.

Under the Electricity Supply Act (ESA) of 1994, as amended, LUCELEC has an exclusive license to be the sole commercial supplier of electrical energy in Saint Lucia up to 2045. The company is an integrated player present in all three streams: generation, transmission and distribution. It is therefore of strategic importance to the government and nation. There is a provision in the Act to allow for captive generation by other corporations using the fumaroles at Soufriere and sale of excess power to LUCELEC. The proposed National Energy Policy (NEP) may further reduce some of the monopoly elements for LUCELEC on the generation side. LUCELEC, however, has a wide coverage and supplies power to 99% of the establishments in Saint Lucia.

The customer base has grown on average by 3.5% annually over the past five years, though unit sales declined by 1.2% year-on-year (YOY) to September 2011. The commercial and hotel sectors accounted for 57.4% of total sales in the 9-month period in 2011 as illustrated in Chart 1 below. The domestic sector represented 34% of total unit sales for the same period.

Chart 1
Unit Sales by Sector as at September 2011



Source: LUCELEC

There is increased pressure to change the regulatory framework governing the industry and end LUCELEC’s monopoly in times of rising tariffs². In CariCRIS’ opinion, competition appears unlikely over the medium term, given the small economies of scale. If competition does emerge, it will most likely be in generation. Construction of a competing transmission and distribution network will entail higher costs, which will be passed on to the customer, thus defeating the purpose of a new regulatory framework. Meanwhile, LUCELEC has implemented a Fuel Price Hedging Policy to reduce tariff volatilities caused by fuel purchases at market prices. In order to reduce its vulnerability to volatile fuel prices, diversify energy sources and contribute to the sustainability of the environment, LUCELEC has been exploring opportunities to obtain alternative energy sources³.

² There was an official announcement from the World Bank on the proposed establishment of a new regulatory body for the energy sector in the OECS, the development of which will commence in the near future.

³ Alternative Energy Sources:

Wind – Collaboration is continuing with the Government of Saint Lucia to ensure an adequate site following setbacks from LUCELEC’s own efforts.

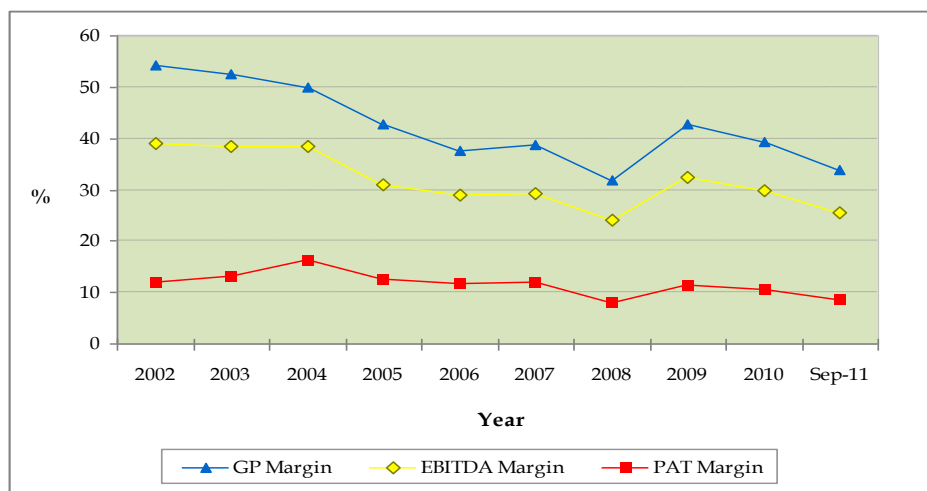
Solar – 6 photovoltaic systems have been tied to the national grid.

Geothermal – Government of Saint Lucia has signed a Memorandum of Understanding with Qualibou Energy for the development of a 12MW geothermal plant by 2012.

Healthy financial profile characterized by strong operating profit margins and favourable debt protection measures

Total revenue increased by 12.1% YOY to September 2011 (2010 +21.3%) reflecting higher fuel prices that are passed through to customers (at no mark-up) in accordance with the ESA. Total electricity sales decreased by 1.2% YOY to September 2011 mainly from hotels (7.4%) due to lower performance of this sector; domestic sector (2.2%) due to reduced demand as a result of higher tariffs. The commercial sector sales increased by 3.1% YOY to September 2011, due to higher use of cooling equipment resulting from high temperatures and increased activity. LUCELEC’s low cost structure has fostered healthy gross profit (GP), earnings before interest, tax, depreciation, amortization (EBITDA) and PAT margins of 34%, 25.6% and 8.5% respectively for the 9 months to September 2011. These profitability measures have remained very healthy in the last five years despite the challenges posed in the market. Moreover, these profit margins remain well above regional electricity company peers. Chart 2 below illustrates the ten-year trend in GP, EBITDA and PAT margins. Contributing to these healthy profitability measures are the good control over expenditure and reduced finance charges from net repayments on debt. LUCELEC’s return on capital employed (ROCE) and return on equity (ROE) are comfortable at around 15.3% and 14.6% respectively (annualized) for 2011. ROCE and ROE averaged 17.1% and 18.8% over the last five years.

Chart 2
Profitability Measures

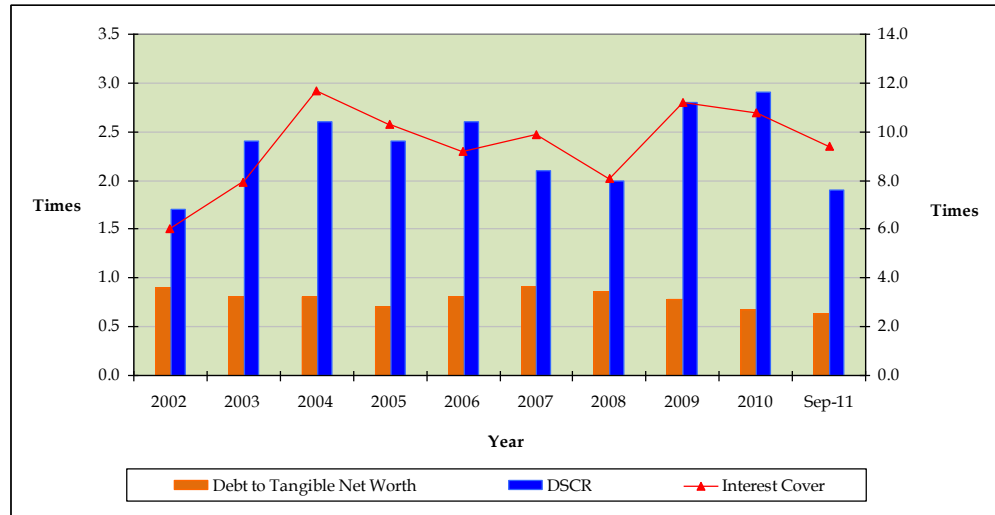


Source: LUCELEC Annual Reports

The company's tangible net worth (TNW) continues to strengthen reaching EC \$186.1 million as at September 2011. LUCELEC's sound financial discipline is reflected in relatively low debt to TNW falling to 0.6 times by September 2011 from 0.7 times as at December 2010. Improvement in net worth has been constrained by high dividend payout, which averaged 62% over the past five years.

Debt protection measures have remained favourable with general improvements in 2011. Interest cover and debt service coverage ratio (DSCR) continue to remain comfortable at 9.4 times and 1.9 times respectively by September 2011. Chart 3 below illustrates the debt to TNW and debt protection measures over the past ten years. Meanwhile, net cash accruals can comfortably satisfy all debt obligations maturing in 2012, and operating cash flows are healthy and sufficient to cover 39.5% of the total outstanding debt as at September 2011.

Chart 3
10-Year Debt to TNW and Debt Protection Measures



Source: LUCELEC Annual Reports

LUCELEC's liquidity position is adequate as reflected in its current ratio of 1.8 times as at September 2011. The comfortable liquidity position is supported by a healthy cash balance curtailed by a higher provision for dividend payout and excess reserve distributions.

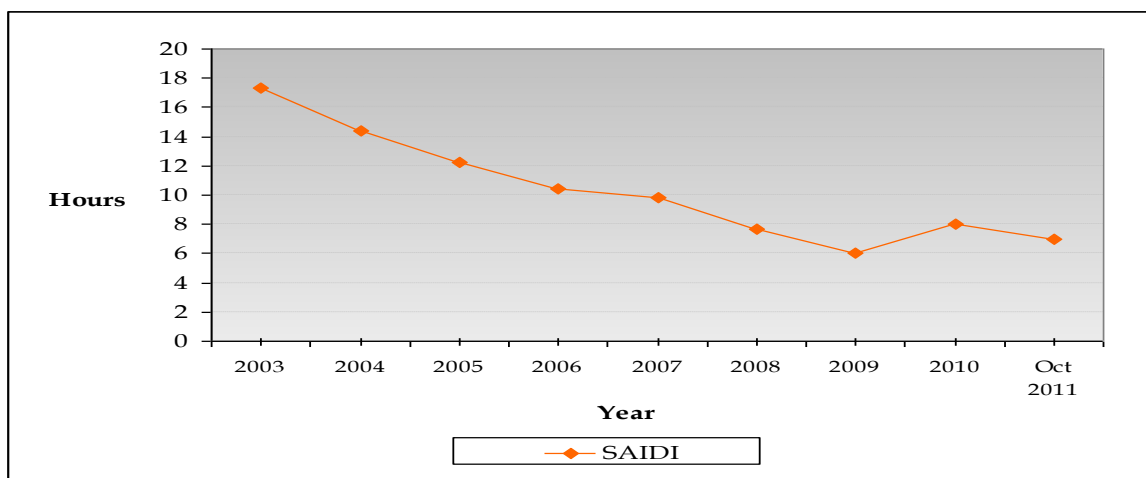
CariCRIS expects LUCELEC's profitability to remain good, albeit at a lower level than in

the recent past, due to the possible large increase in debt financing for the new generating capacity. LUCELEC is examining the possibility of obtaining additional equity in the near future. Though declining, GP, EBITDA and PAT margins are expected to remain above 35%, 25% and 5% respectively for the next two years. Debt protection measures are also expected to remain healthy as reflected in the interest cover and DSCR above 4 times in 2012. Even in CariCRIS' worst case scenario, debt protection measures still remain comfortable with the interest cover and DSCR above 2 times.

Favourable operating efficiency

Over the years, LUCELEC has improved its operating efficiencies through continuous investment in its transmission and distribution network to reduce losses. LUCELEC outperforms the equipment manufacturer's specifications on fuel efficiency due to timely maintenance of generation equipment and a strict overhaul program. The company's generating units are relatively new; more than half of them are less than five years old. LUCELEC's operating parameters performance is among the highest of its regional peers, though there has been some deterioration in total system losses in 2010 increasing to 9.5%, compared to 9.3% in 2009. However, the system average interruption duration index (SAIDI) has worsened over the year as reflected in Chart 4. This was as a result of two system shutdowns in 2011. LUCELEC is not expected to meet its target for 2011.

Chart 4
System Average Interruption Duration Index (SAIDI)



Source: LUCELEC Finance Department

The cost structure is sound with low breakeven levels. CariCRIS expects the breakeven levels to reduce further, if the wind power and solar power projects are successful, as it currently operates at an average of 57.7% capacity utilization.

The company derives locational advantages due to the close proximity of the power plant to its key oil supplier's terminal, Hess Oil Limited, resulting in negligible transportation costs. Locational benefits are also derived from the distribution since the generation plant is located in areas of high population concentration and commercial activity on the island.

LUCELEC invested considerable sums over the years to reduce system losses and improve reliability. Transformer upgrades were done to reduce technical losses resulting from a higher load. The company is in the process of replacing all old electromechanical meters with smart electronic meters⁴, which will contribute to lower non-technical losses on the system. Delays have been experienced over the past two years as a result of testing by the Saint Lucia Bureau of Standards for compliance of the new meters with the Metrology Act; this matter has since been resolved. The company has also set up 11kV underground cable network that is less vulnerable to hurricane, which will help reduce system losses, but represents less than 1% of total transmission and distribution lines. The full implementation of a Distribution Automation System will further improve the company's reliability making it possible to optimally reconfigure the distribution system based on its loading to reduce system losses and quicker restoration following service disruptions.

The company has adopted a short, medium and long term strategy for ensuring electricity demand is met beyond 2012. This will allow LUCELEC to be able to maintain the statutory reserve margin⁵ required under the ESA; demand peaked at 59.2MW in 2010 compared to an installed capacity of 76MW.

⁴ *The smart electronic meters will enable LUCELEC to read, connect and disconnect meters remotely, and collect customer consumption and other technical information on a real time basis.*

⁵ *The Electricity Supply Act has stipulated that LUCELEC should be able to meet the peak demand of the country even with its two largest generators down.*

These rating strengths are tempered by:

Economic performance of the Saint Lucian economy

The demand for LUCELEC's services is directly linked to the performance of the Saint Lucian economy. The economy is primarily tourism driven, similar to most other Caribbean economies. Demand is therefore largely impacted by factors beyond LUCELEC's control, such as the current world recession on the source markets and exposure to natural disasters, for example, hurricanes. With the global recession impacting the major source markets, the Government of Saint Lucia (GoSL) embarked on increased marketing efforts and airlifts, while hoteliers discounted prices to shore up occupancy levels over the last two years. Despite these efforts, stay over arrivals declined by 6% up to the end of August 2011. Further challenges will come from the dampening effects of new taxes in the source markets, high intra Caribbean travel costs and the continued economic and financial crisis in North America and Europe. The commercial sector (including hotels) whose performance is directly linked to tourism activity in the country contributes around 57.4% to total sales units. The hotels segment represented 20.9% of total unit sales for the 9 months to September 2011. The cyclicity in the hotels segment is mitigated to some extent by the diversity in the tourist profile. Variability in growth rates is therefore a cause for concern for LUCELEC in planning capacity expansions.

Tempering the link to economic activity in Saint Lucia is the base level of demand that exists for LUCELEC's product as electricity is an essential commodity with negligible substitutes. Domestic consumers provide a relatively stable demand for electricity, consuming roughly one third of the electricity supply.

Indirect exposure to fuel prices

LUCELEC is not financially impacted by increases in fuel prices as protection is offered through the ESA which allows the company to pass on fuel prices to consumers as a pass-through charge. However, since electricity cost accounts for as much as 10% of the costs for small hotels, these establishments initiate efforts to conserve energy in periods of increasing tariffs, thus keeping off-take low. Furthermore, given this pass-through mechanism, the government has instituted a tariff mechanism which requires the

company to share 50% of its returns, above a stipulated maximum earned, with the productive sectors (hotel and industrial customers) and consumers needing special protection. This has effectively reduced the company's total returns. A minimum return of 10% is guaranteed to LUCELEC, calculated in the range between 2% to 7% above the cost of the most recent long-term bonds issued by the GoSL on the Regional Government Securities Market, with no cap.

The company has been successful in reducing the price volatility to customers under the pass-through mechanism by engaging in fuel price hedging over the last two years. LUCELEC implemented a formal hedge policy in 2011 for a cap of 75% of monthly fuel consumption. The company has completed its hedge placements with counterparties for 2011 and has Board approval to undertake hedges up to the end of the second quarter of 2012.

CariCRIS believes that in a scenario of increasing fuel prices and in an effort to honour its social responsibility, the government may introduce measures that can adversely impact the company. As such, LUCELEC will continue to face the challenge of balancing its social responsibility as a provider of an essential service with a commercial orientation. To this end, LUCELEC has been evaluating various alternative energy sources as a means to further reduce its vulnerability to fuel prices.

Single location and underinsurance

The company generates power at a single plant at Cul de Sac, Castries, and is highly exposed to operational risk, particularly as the region is prone to hurricanes. LUCELEC is seeking to mitigate this risk with proposed capacity expansion at another location which is expected to commence production by 2015. Till then, LUCELEC will remain exposed to the risk of major generation outages occurring at its single location. In November 2011, LUCELEC purchased two high speed units of 1.2 MW each stationed at Union and has contracted to install a new 10MW generating unit in 2012 at the existing Cul de Sac generating site.

Management has adopted a policy of self-insurance for all its transmission and distribution related assets owing to the non-availability of adequate cover and the prohibitive costs of obtaining it. Self-insurance increases the risks retained within the company. LUCELEC's declared value of its Transmission and Distribution assets was

estimated at EC \$139.3 million as at September 2011, with a self-insured value of EC \$22.8 million comprising a commercial line of credit and cash held in short term investments. Although risk assessments are conducted periodically to ascertain the most likely potential damage from a natural disaster, CariCRIS believes that LUCELEC is significantly underinsured, a risk that assumes criticality in this hurricane-prone region.

Deteriorating accounts receivable aging profile

The company has not been able to improve its management of working capital evidenced by a significant increase of 49.6% in accounts receivable as at September 2011. The long outstanding receivables from government and government utilities, which accounted for 35.8% of the total debtors, rose by 58.4% and 30.2% respectively YOY to September 2011. Over the last year, the debtor profile worsened, now comprising both less than 30-day balances (48.7% of total debtors) and over 90-day balances (34% of total debtors) as at September 2011. The profile comprised over 90-day balances of 27.3% of total debtors as at December 2010. Central government, government utilities and the general public continue to be the main contributors to the over 90-day balance representing 23.6%, 37.9% and 35.5% respectively as at September 2011. The debt borne by the government utilities is currently being addressed at the board level.

Rating Sensitivity Factors

- Changes to the creditworthiness of the GoSL
- Amendments to the ESA
- Significant reduction in demand
- Major debt funded capital projects

BUSINESS DESCRIPTION

Saint Lucia Electricity Services Ltd (LUCELEC) was established on November 9, 1964, as a private limited liability company with the purpose of power generation, distribution and dealing in electricity and electromotive force and energy. On August 22, 1994 the company moved towards public ownership. At present, the top five shareholders⁶ are Emera Inc (20%), First Citizen Bank Limited (20%), National Insurance Corporation (16.79%), Castries City Council (16.36%) and Government of Saint Lucia (12.44%).

LUCELEC has an exclusive license to generate, distribute and sell electricity in Saint Lucia up to the year 2045. The company presently operates one power station at Cul de Sac and seven substations, linked by a 66kV transmission network. The power station, which was commissioned in 1990, now houses nine generating units, with a total installed capacity of 76MW.

⁶ *The shareholding disclosed are of the voting shares*

SUMMARY FINANCIALS

Table 1
Summary Annual Financial Performance

	2010*	2009	2008	2007	2006
	<i>EC\$ Millions</i>				
Operating Revenue	276.3	238.7	303.2	242.5	227.6
Equity Share Capital	80.2	80.2	80.2	80.2	80.2
Net Worth	162.2	154.5	149.0	142.2	134.1
	<i>%</i>				
EBITDA Margin	29.8	32.5	24.1	29.3	28.9
PAT Margin	10.6	11.6	7.9	12.0	11.8
ROCE	17.5	16.6	15.9	17.7	17.7
	<i>Times</i>				
Interest Cover	10.8	11.2	8.1	9.9	9.2
Operating Cash Flow/Debt Servicing Burden	2.9	2.8	2.0	2.1	2.6
Net Cash Accruals/Total Debt	0.4	0.3	0.3	0.3	0.3
Total Debt/Net Worth	0.7	0.8	0.9	0.9	0.8
Current Ratio	1.4	1.3	1.3	1.1	0.9

Source: LUCELEC Annual Reports

* The financial year runs from January 1 to December 31

Table 2
Summary 9-Month Financial Performance

	9 mths to Sept 2011	9 mths to Sept 2010	9 mths to Sept 2009	9 mths to Sept 2008
	<i>EC \$ Millions</i>			
Operating Revenue	236	210	173	240
PAT	20	23	24	20
Net Cash Accruals	46	49	47	42
Net Worth	186	177	169	164
Total Debt	117	115	117	119
	<i>%</i>			
EBITDA margin	25.6	30.8	36.2	23.9
PAT margin	8.5	10.9	13.6	8.3
ROCE	11.5	13.5	13.8	12.5
	<i>Times</i>			
Interest Cover	9.4	10.1	9.1	8.6
Operating Cash Flow / Debt Servicing Burden	1.9	2.7	2.6	2.4
Net Cash Accruals/Total Debt	0.4	0.4	0.4	0.4
Total Debt/Net Worth	0.6	0.6	0.7	0.7
Current Ratio	1.8	2.1	1.8	1.8

Source: LUCELEC Quarterly Financial Report

Note: Mr. Marius St. Rose is member of the Board of Emera Barbados Holding Company and the CariCRIS Rating Committee. Emera Incorporated owns 20% of LUCELEC. Mr. St. Rose did not participate in the above rating decision.

December 2011