

Global Credit Research - 23 May 2011

Sao Paulo, Brazil

## Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
Subordinate -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa1.br
NSR Subordinate -Dom Curr	Aa2.br
<b>Ult Parent: Energias de Portugal, S.A</b>	
Outlook	Rating(s) Under Review
Issuer Rating	*Baa1
Bkd Sr Unsec MTN -Dom Curr	*(P)Baa1
Commercial Paper -Dom Curr	*P-2
<b>Parent: EDP - Energias do Brasil S.A</b>	
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]Bandeirante Energia S.A

ACTUALS	1Q2011	1Q2010	2010	2009	2008	2007
(CFO Pre-W/C + Interest) / Interest Expense	8.3x	7.9x	7.0x	9.0x	6.2x	7.7x
(CFO Pre-W/C) / Debt [2]	61.2%	66.2%	46.7%	52.7%	63.3%	82.3%
(CFO Pre-W/C - Dividends) / Debt [2]	61.2%	34.2%	22.1%	23.8%	13.1%	75.5%
Debt / Capitalization	46.8%	51.8%	52.7%	50.5%	47.5%	46.2%

[1] All ratios calculated in accordance with the Regulated Electric and Gas Utilities Rating Methodology using Moody's standard adjustments. [2] Annualized indicators for 1st Quarter 2011

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

## Opinion

### Rating Drivers

Solid credit metrics

Resilient access to the local banking market

Evolving regulatory framework for electric utilities operating in Brazil

Lower tariffs expected from the third tariff review in October 2011

Potential volatility in FFO from the adoption of IFRS

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

### **Corporate Profile**

Bandeirante Energia S.A., headquartered in São Paulo, Brazil, is an electricity distribution utility fully controlled by EDP - Energias do Brasil that serves around 1.5 million clients in the eastern portion of the industrialized state of São Paulo. In the last twelve months ended March 31, 2011, Bandeirante reported net revenues of BRL2.3 billion (USD1.3 billion) on sales of 14.3GWh, representing around 3.5% of the electricity consumed in Brazil's integrated system.

### **SUMMARY RATING RATIONALE**

The Baa3 rating for Bandeirante reflects the stable and predictable cash flows from its regulated distribution business, strong 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, the relatively sizeable capital expenditures anticipated within the group in Brazil 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.

On June 20, 2010, Moody's América Latina Ltda (Moody's) assigned a Ba1 local currency rating on the global scale and Aa2.br rating on the Brazilian national scale to the 6-year BRL 390 million amortizing unsecured subordinated debentures issued by Bandeirante Energia S.A. in the local market. At the same time, Moody's affirmed Bandeirante's Baa3 issuer rating on the global scale and Aa1.br issuer rating on the Brazilian national scale. The outlook is stable for all ratings.

### **DETAILED RATING CONSIDERATIONS**

#### **STRONG CREDIT METRICS**

Bandeirante has steadily posted strong profitability and cash flows over the past three years driven by the fairly stable nature of its regulated distribution business. In this period, cash drains mainly consisted of capital expenditures and the distribution of dividends which have been in line with the company's internal cash generation. This is evidenced by the steady financial leverage as measured by the three-year average debt over EBITDA ratio of just 1.5x and the three-year average retained cash flow (CFO Pre-WC - dividends) over debt ratio of 19.7% in the same period.

As expected, Bandeirante recorded a stronger operating performance in 2010 in comparison with 2009 because of an outstanding volume growth of 7.7% in the supply of electricity. This volume growth was mainly fueled by the growth consumption of the so-called free consumers, which increased the electricity consumption by 12% while the captive consumers volume sales grew by 5.3% in 2010.

One should bear in mind that the free consumers' electricity tariff largely consists of a fixed payment estimated at around 60% of the tariff in a regular year charged for the use of the distribution grid of the electricity utility while the remaining 40% represents the variable portion of the tariff and changes in accordance with the volume of electricity consumed in the period. As a result, changes in the consumption of the free consumers tend to have a more moderate impact on cash flow.

Despite this significant sales growth, Funds from operations (FFO) remained virtually unchanged at BRL 440 million slightly down from BRL 444 million in 2009 largely due to the changing of the accounting procedures to IFRS from the previous Brazilian GAAP. (Please see below our comments on IFRS potential volatility). Nevertheless, Bandeirante's financial position is very strong for its rating category particularly with respect to its cash flow coverage metrics.

While slightly weaker, the debt capitalization ratio has remained stable over the past five years, which stems from the company's historical high dividend pay-out ratio close to 95% over the past five years. As of March 31, 2011, Bandeirante showed a debt to capitalization ratio of 46.8%, below the previous two-year average of 51.6%.

#### **STRONG CREDIT METRICS THROUGH OCTOBER 2011 BUT SOME DETERIORATION THEREAFTER**

Moody's forecasts that Bandeirante will maintain adequate credit metrics for the rating category throughout our three-year projections. This reflects the company's low cost structure coupled with a forecasted annual volume growth of around 4% during this period. CFO is expected to continue to grow up to October 2011 and then decrease as tariffs are expected to decline from the application of the third tariff review.

In spite of potentially lower tariffs, we do not foresee a dramatic reduction in credit metrics because the company's cash flow should benefit from higher volume sales and a more moderate level of capital expenditures while dividend distributions remains in tandem with the potentially lower net profits.

Moody's projects that the RCF over debt ratio will average 19.8% over the next three years slightly down from the previous 23.0% two-year average. Interest coverage is expected to reduce significantly to 5.5x over the next three years from the 7.0x level achieved in 2010. This basically reflects our conservative projections of higher interest rates in the local markets and the fact that around 80% of the company's debt is indexed to the base rate, which right now is running around 12% per annum.

#### **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 Bandeirante's 2009 and 2010 financial statements does not interfere with Moody's comparative analysis of the utility's 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.

The outstanding volume sales growth in 2010 has not been fully reflected in the company's FFO (funds from operations) as result of the implementation of the IFRS accounting procedures, which does not recognize the existence of the regulatory assets and liabilities. Based on management's information, we infer that FFO was understated by BRL 18.2 million in 2010 and overstated by BRL 41.2 million in 2009. Apart from other considerations and assuming other variables constant, FFO should benefit from the recognition of the BRL18.2 million in the tariffs in 2011.

#### LOWER TARIFFS FROM THE TARIFF REVIEW IN OCTOBER 2011

In October 2011, the regulator ANEEL will apply the new methodology for tariff review to Bandeirante, 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%.

#### 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 further downgrade could potentially limit the ability of EDP Portugal to potentially step in to support its subsidiaries with a material undertaking in case of financial distress.

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, Bandeirante'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 any 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.

#### IMPROVEMENT IN THE BRAZILIAN REGULATORY ENVIRONMENT

An important factor constraining Bandeirante's rating 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. The current 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. In light of this relevant improvement, Moody's lifted the Brazilian regulatory framework to a higher category level in August 2008.

Despite the upgrade in the supportiveness of the local regulatory environment, 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. In our evaluation of these factors we also took into consideration potential future electricity shortages due to a tight reserve margin, limited independence of the regulator and minimal jurisprudence backing the new regulatory framework.

#### Liquidity

Bandeirante has an adequate liquidity profile supported by its resilient access to the capital and bank markets and cash availabilities of BRL 282 million as of March 31, 2011, which compares favorably with its short-term debt position of just BRL103 million.

In 2011, Moody's projects CFO of BRL 420 million, which is expected to comfortably meet most of the company's cash needs. The main cash outlays will consist of capital expenditures of BRL 236 million, the payment of short-term debt of BRL 219 million and BRL220 million of dividends. Moody's expects that these cash requirements will be funded with a combination of internal cash generation and additional debt issuance.

Moody's deems the liquidity standing of EDB on a consolidated basis as adequate as well. On December 31, 2010, EDB reported a sizeable consolidated cash position of BRL1,1 billion. This strong cash position along with estimated CFO of around BRL1.2 billion should support EDB's planned capital expenditures of around BRL1 billion and dividends of approximately BRL 370 million in 2011. Despite sizeable debt maturities in the short-term of approximately BRL772 million, the overall refinancing risk is considered manageable since this debt is concentrated in the operating subsidiaries, where cash flows are expected to comfortably meet cash needs. Currently, there is no debt outstanding at the parent holding company level.

Additionally, based upon management's provided information, EDB has around BRL 1 billion in pre-approved long-term loan commitments from

the BNDES (BRL 870 million), the EIB ( BRL 200 million) and the IDB (BRL14 million) to support its subsidiaries' capital expenditures in the near term including the company's 50% portion in the joint venture Porto do Pecem Geração de Energia S.A (Pecem I) thermoelectric plant.

### Corporate Governance

Bandeirante'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 Bandeirante's level of indebtedness will not change dramatically over the medium horizon despite the expectation that any additional cash generated by operations is bound to be distributed to its parent company EDB. Conversely, Moody's expects that Bandeirante will maintain its current strong credit metrics during this period with the fairly 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 subsidiaries' cash flow capacity and will efficiently handle its liquidity position so that retained cash flow remains above 20% of total debt on a consolidated 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 rating or the outlook could be upgraded as a result of greater clarity as to the successful completion of the Pecem project. Quantitatively, an upgrade could result from retained cash flow to total debt of above 25% and interest coverage above 4.5x on a sustainable basis along with Moody's expectation that EDP Portugal will not undertake any actions to materially alter the current capital structure of EDB.

### What Could Change the Rating - Down

A downgrade of Bandeirante could be triggered by a downgrade of EDB's ratings, which could occur if the consolidated RCF over debt ratio is below 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 Bandeirante and EDB.

### Other Considerations

The principal methodology used in rating Bandeirante was Moody's Regulated Electric and Gas Utilities Rating Methodology, published in August 2009 and available on [www.moody.com](http://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

### Bandeirante Energia S.A

Regulated Electric and Gas Utilities	Current 12/31/2010		Moody's 12 - 18 month Forward View	
Factor 1: Regulatory Framework (25%)	Measure	Score	[1]Measure	Score
a) Regulatory Framework (25%)		Ba		Ba
<b>Factor 2: Ability to Recover Costs and Earn Returns (25%)</b>		Ba		Ba
<b>Factor 3: Diversification (10%)</b>		Ba		Ba
a) Market Position (10%)		Ba		Ba
b) Generation and Fuel Diversity (0%)				
<b>Factor 4: Financial Strength, Liquidity &amp; Financial Metrics (40%) [2]</b>				
a) Liquidity (10%)		Baa		Baa
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	7.3x	Aa	5.3x - 5.7x	A
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	53.1%	Aaa	50.2% - 50.3%	Aaa
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)	20.4%	A	17.6% - 23.6%	A
e) Debt / Capitalization or Debt / RAV (7.5%)	50.5%	Baa	49.0% - 51.3%	Baa

(3yr Avg)				
<b>Rating:</b>				
a) Methodology Implied Issuer Rating		Baa2		Baa3
b) Actual Issuer Rating				Baa3

[1] 12 - 18 month Moody's forecast [2] 3-year historical average



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