MOODY'S INVESTORS SERVICE

**Credit Opinion: EDP - Energias do Brasil S.A.**

**Global Credit Research - 05 May 2011**

*Sao Paulo, Brazil*

## Ratings

| **Category** | **Moody's Rating** |
|---|---|
| Outlook | Stable |
| Issuer Rating -Dom Curr | Ba1 |
| NSR LT Issuer Rating -Dom Curr | Aa2.br |
| **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 |
| **Espirito Santo Centrais Eletricas - ESCELSA** | |
| 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 |
| **Bandeirante Energia S.A.** | |
| 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 |

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

## Contacts



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## Key Indicators

[1]**EDP - Energias do Brasil S.A.**

| **ACTUALS** | **2010** | **2009** | **2008** | **2007** |
|---|---|---|---|---|
| (CFO Pre-W/C + Interest) / Interest Expense | **5.0x** | **5.0x** | **3.9x** | **4.2x** |
| (CFO Pre-W/C) / Debt | **31.0%** | **33.1%** | **36.2%** | **40.0%** |
| (CFO Pre-W/C - Dividends) / Debt | **21.2%** | **25.1%** | **29.3%** | **34.1%** |
| Debt / Book Capitalization | **35.6%** | **35.9%** | **38.4%** | **38.9%** |

[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

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

Resilient access to the local capital and banking markets

Relatively sizeable capital expenditure program, including construction risks associated with the 720 MW Pecem thermo-power project

Evolving regulatory framework for electric utilities operating in Brazil

**Corporate Profile**

Headquartered in São Paulo, Brazil, EDP - Energias do Brasil S.A. (EDB) is a holding company controlled by EDP - Energias de Portugal (EDP, Baa1; on review for downgrade) with activities in generation, distribution and commercialization of electricity. In 2010, EDB`s power distribution business represented 53% of the consolidated EBITDA, the power generation business represented 46% and the commercialization of energy represented the remaining 1%. The two distribution subsidiaries, Bandeirante and Escelsa, distributed, together 23,749 GWh in 2010 (approximately 5.7% of the electricity consumed in the Brazilian electricity integrated system). The generation business, including Investco S.A. (Investco), totaled 1,741 MW of installed capacity at year-end 2010 which accounted for approximately 1.6% of the country's electricity installed capacity. EDB reported consolidated net revenues of BRL5,034 million (USD 2,862 million) and net profit of BRL582 million (USD 331 million) in 2010.

**Recent Developments**

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 February 2010, Bandeirante and Escelsa signed an addendum to their concession agreements to introduce a change of the calculation for non controllable costs (Parcel A) in order to neutralize the effects of regulatory charges over demand volatility. These changes, requested by the regulator, are in line with changes in the concession agreements of other Brazilian utilities.

In December 2009, EDB successfully concluded the secondary public offering of 15,500,000 common treasury shares, equivalent to 9.9% of its total capital stock for BRL 441.75 million.

**SUMMARY RATING RATIONALE**

EDB's rating reflects the group's overall investment grade credit metrics, resilient access to the local capital and banking markets, conservative management and the ownership of its parent company EDP. The ratings are constrained by the relatively high 50% dividend pay-out ratio, a fairly sizeable capital expenditure program and the inherent risks associated with the completion of the 720MW Pecem I thermoelectric power plant project. EDB's Ba1 issuer rating is one notch lower than the Baa3 Issuer Rating of its subsidiaries, Bandeirante and Escelsa, to reflect the structural subordination of its debt to the existing debt at the level of its operating subsidiaries.

**DETAILED RATING CONSIDERATIONS**

SOLID CREDIT METRICS

EDB has posted healthy profitability and stable cash generation on a consolidated basis in the past four years. This is evidenced by the CFO Pre WC over debt ratio which has steadily remained above the 30% level during this period. In 2010, this ratio slightly decreased to 31% from 33.1 % in 2009 partly reflecting the recognition of extraordinary items, which included the BRL 76 million gain from the sale of its participation in a telecommunication company (ESC 90) in 2009. In addition, the distribution companies were hurt by an estimated amount of BRL 34 million from signing a concession contract amendment with the regulator by which most of the distribution companies accepted changing the tariff formula for a presumed irregular gain in the past. The generation segment also reduced its revenues by an estimated amount of BRL 24 million in 2010 in comparison with 2009. This stems from the decision of ONS ( The Brazilian National Operator) to dispatch a lower amount of hydro energy in 2010.

This along with extraordinary gains in the previous year explains a slightly lower CFO Pre WC of BRL 1,155.3 million in 2010 down from the BRL 1,203.1 million achieved in 2009. Moody's was expecting a higher cash generation amount in 2010 supported by outstanding sales volume growth of 5.8% in the regulated market and 21.7% in the free market for the distribution segment. The negative IGP-M, the index used to adjust the parcel B of the tariff formula, further impaired operating margins in the second half of 2010.

Conversely, EDB's profitability has benefitted from the application of the IFRS accounting procedures in 2010 and 2009. This stems from the fact that the IFRS does not recognize the existence of regulatory assets and liabilities. In 2010, this gain was estimated at BRL 44 million down from an estimated gain of BRL 76 million in 2009. On the other hand, the 2010 net profit was impaired by the recognition of higher net financial expenses of BRL 95 million, which mostly derived from non-cash financial revenues and expenses.

FINANCIAL LEVERAGE TO INCREASE MODERATELY IN LIGHT OF CAPITAL EXPENDITURES

Moody's expects that EDB will continue to post healthy cash generation over the medium term horizon. This stems from the growing contribution of the generation businesses with their stable and higher operating margins, which are expected to grow from being 46% of the group's cash generation as measured by EBITDA to around 55% within the next two years. Nevertheless, we expect a moderate increase of debt in 2011 driven by fairly sizeable capital expenditures of around BRL 1 billion this year along with the continued distribution of significant dividends during this period.

Moody's preliminary projections indicate a moderate increase in leverage as measured by the CFO pre-W/C to debt ratio, which Moody's estimates will still remain strong for the rating category at around 30%, while the debt to capitalization ratio is expected to remain around 35% in 2011. When the new generation projects commence operations after 2012, Moody's expects that the forecasted increase in internal cash flow will allow these ratios to improve.

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 further possible downgrade could potentially limit the ability of EDP Portugal to eventually 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, EDB's Ba1 issuer rating is largely based on EDB's overall investment grade characteristics on a consolidated basis supported by the steady improvement in credit metrics achieved in the past three years and continued 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 evolvement of the creditworthiness of EDP Portugal and the potential impact that any further rating deterioration 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 subsidiaries from increasing their leverage over a certain agreed limit.

COMPLETION RISK OF PECEM PROJECT REMAINS A MAJOR CHALLENGE

The Pecem I thermoelectric power plant, which has been jointly constructed with the local group MPX Energia S.A (unrated by Moody's) represents a major challenge to EDB because of the technical risks associated with the completion of this sizeable project, which could cost as much as BRL 3.2 billion including approximately BRL 300 million of capitalized interest. In 2009, the long - term financing from the BNDES and IDB was approved which management has stated is expected to cover around 75% of total investment cost. The first cash disbursement occurred in October 2009 and was used to take out an existing bridge loan of around BRL 550 million (50% guaranteed by EDP) granted by a pool of local and international banks, which somewhat enhanced the group's debt maturity profile.

The thermoelectric power plant, which is scheduled to come on stream in January 2012, has already reached the 91.9% level of completion and is in line with the company's project plan. The successful implementation of the Pecém project is likely to reduce the overall business risk of EDB by virtually eliminating the completion and operational risks of the project, enhancing cash generation and improving the group's capital structure.

EVOLVING 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.

**Structural Considerations**

EDB's issuer rating is one notch lower than the operating subsidiaries' issuer ratings to reflect the structural subordination of any eventual debt at the holding company level to that of the operating companies where debt levels are expected to increase in the near term as a result of current investment plans. Lenders to operating subsidiaries generally have claims on cash flow that are superior to those of the holding company creditors, which can also restrict the financial flexibility of the holding company.

**Liquidity**

Moody's deems the liquidity standing of EDB on a consolidated basis as very adequate. 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 will support EDB's planned capital expenditures of around BRL 1 billion and dividends of approximately BRL 370 million in 2011 ( Despite sizeable debt maturities in the short-term of approximately BRL772 million, the refinancing risk is considered manageable. 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 pre-approved long-term loans 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**

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 adapt the US 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 reflects Moody's expectation that EDB will continue to prudently manage capital expenditures in tandem with its cash flow and funding capacity and efficiently handle its liquidity position so that RCF remains above 20% of total debt on a consistent basis.

**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 could be triggered by a fall in the RCF over debt ratio below 15% and interest coverage below 3.5x for a prolonged period. Deterioration in the level of supportiveness of the Brazilian regulatory environment for regulated utilities could also prompt a negative rating action.

## Rating Factors

**EDP - Energias do Brasil 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 |
| **Factor 2: Ability to Recover Costs and Earn Returns (25%)** | | Ba | | Ba |
| **Factor 3: Diversification (10%)** | | | | |
| a) Market Position (10%) | | Baa | | Baa |
| b) Generation and Fuel Diversity (0%) | | Baa | | Baa |
| **Factor 4: Financial Strength, Liquidity & Financial Metrics (40%)** [2] | | | | |
| a) Liquidity (10%) | | Baa | | Baa |
| b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg) | 4.6x | A | 4.3x - 5.1x | A |
| c) CFO pre-WC / Debt (7.5%) (3yr Avg) | 33.3% | Aa | 31.9% - 43.1% | Aa |
| d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg) | 25.0% | Aa | 22.3% - 31.0% | Aa |
| e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg) | 36.5% | A | 31.4% - 35.0% | Aa |
| **Rating:** | | | | |
| a) Methodology Implied Issuer Rating | | Baa2 | | Baa2 |
| b) Actual Issuer Rating [3] | | | | Ba1 |

[1] 12 - 18 month Moody's forecast [2] 3-year historical average [3] Reflects the structural subordination of holding company

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