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Credit Opinion: **Bandeirante Energia S.A.**

Global Credit Research - 30 Jul 2014

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
Ult Parent: Energias de Portugal, S.A.	
Outlook	Negative
Issuer Rating	Ba1
Senior Unsecured -Dom Curr	Ba1
Commercial Paper -Dom Curr	NP
Parent: EDP - Energias do Brasil S.A.	
Outlook	Stable
Issuer Rating -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa2.br

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Key Indicators

[1]Bandeirante Energia S.A.	2013	2012	2011	2010	2009
ACTUALS					
(CFO Pre-W/C + Interest) / Interest Expense	7.2x	4.1x	5.9x	6.0x	8.8x
(CFO Pre-W/C) / Debt	61.6%	23.5%	56.3%	45.4%	51.5%
(CFO Pre-W/C - Dividends) / Debt	56.4%	17.0%	23.2%	20.9%	22.6%
Debt / Book Capitalization	37.6%	51.6%	50.3%	52.7%	50.5%

[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

- Solid credit metrics

- Resilient access to the local banking market
- Lower tariffs from the third tariff review implemented in October 2012
- Weaker liquidity from the acquisition of more expensive thermal energy

Corporate Profile

Bandeirante Energia S.A., headquartered in Sao Paulo, Brazil, is an electricity distribution utility fully controlled by EDP Energias do Brasil (EDB) that serves around 1.7 million clients in the eastern portion of the industrialized state of Sao Paulo. In 2013, Bandeirante reported net revenues of BRL2,458 million (USD1,138million), which does not include construction revenues of BRL147.3million, on sales of 15,359 GWh, representing around 3.2% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

Bandeirante's Baa3/Aa1.br issuer ratings reflect its stable and predictable cash flow from its regulated distribution business, strong credit metrics for its rating category and its resilient access to the local banking and capital markets. The ratings are constrained by the high dividend pay-out ratio, the relatively sizeable capital expenditures and the evolving Brazilian regulatory environment. The recent deterioration in liquidity due to higher cost thermal energy costs further constrains the ratings.

Recent Events

In April 2014, Bandeirante borrowed BRL 300 million from a local bank Banco Safra with a five-year tenor and a three-year grace period for the payment of principal, which will be paid in five semiannual installments.

In the first quarter of 2014, Bandeirante distributed dividends of BRL 100 million.

In February 2014, Bandeirante borrowed from the federally-owned bank Banco do Brasil BRL 98 million with a bullet payment in July 2015.

In the first four months of 2014, Bandeirante received BRL 204 million from the Brazilian Electricity clearing House CCEE to compensate for the increased costs incurred acquiring dispatched thermal power energy.

In 2013, Bandeirante received BRL 355.6 million from the sector's regulatory charge CDE (Energy Development Account).

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 due to drought conditions 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.

DETAILED RATING CONSIDERATIONS

HISTORICALLY STRONG CREDIT METRICS

Bandeirante had historically posted strong profitability and cash flows for five consecutive years up until 2011 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 (2009-2011) of CFO-WC over Debt ratio of 50.8% and retained cash flow (CFO Pre-WC - dividends) over debt ratio of

22.2 %.

Bandeirante recorded a weaker operating performance in 2012 as result of the tariff freeze imposed by the regulator since October 2010 to partly offset the non-application of the third tariff review the company was scheduled to go through in October 2011 until October 2012 due to the delay by the regulator in publishing the methodology and operational procedures of the third tariff review. Consequently, lower operating margins resulted from the combination of the tariff freeze along with increased costs belonging to both categories part A and Part B of the tariff structure. The regulator applied the same tariff freeze procedure to all distribution companies initially scheduled to have their electricity tariffs reviewed in 2011 in accordance with the operational procedures of the third tariff review.

In 2012, Bandeirante posted a weaker operational and financial performance, which was in line with what we had previously anticipated, as evidenced by CFO-WC over Debt ratio of 23.5%. This weaker cash flow ratio was tempered by much lower dividend payment of BRL 54 million in 2012 down from the previous three-year average of BRL 242.7 million, which led to a lower but still strong RCF over debt ratio of 17.0% in 2012.

In 2012, increases in the cost of acquiring thermal energy hurt Bandeirante's cash flow which resulted in BRL134.5 million in net regulatory assets, which were not recovered in the company's tariffs in 2012. The company is entitled to receive higher tariffs to recover any cost not covered by tariffs, which historically has been granted once a year to the distribution companies, which in the case of Bandeirante occurs every October.

Given the magnitude of the higher costs associated with the acquisition of the more expensive thermal energy, the federal government published a provisional measure in March of 2013 to be utilized to alleviate the liquidity pressure of virtually all Brazilian distribution companies due to these unrecovered costs but to also prevent the obvious negative impact these costs could have on inflation.

In 2013, Bandeirante recorded an outstanding financial performance, which exceeded not only ours but also management's expectation. This is evidenced by the significant improvement in the company's credit metrics as measured by the CFO-WC over Debt ratio of 61.6% in 2013 up from the previous three-year average ratio of 43.2% and 23.5% in 2012. Leverage as measured by the debt to capitalization ratio experienced a significant reduction to 37.6% from the previous three-year average ratio of 51.5% and 51.6% in 2012. The RCF to debt ratio dramatically improved to 56.4% in 2013 from the previous three-year average ratio of 20.4% and 17% in 2012.

The improvement in credit metrics in 2013 can be attributed to the combination of higher operating margins, lower payment of dividends and to a lesser extent to the capitalization of BRL 85 million in the first quarter of 2013 by EDB, and a reduction in the accounting amount of unfunded pension liabilities.

Bandeirante's higher operating margins stemmed from the reduction in net regulatory assets to BRL 98.6 million as of December 31, 2013 from BRL 135 million as of December 31, 2012 and negative BRL 6 million as of December 31, 2011. As a result, Bandeirante's EBITDA was overstated by around BRL 36 million in 2013 and understated by BRL 141 million in 2012 in comparison with the company's normalized EBITDA, calculated in accordance with the regulatory accounting procedures, which differ from the IFRS that does not recognize the existence of regulatory assets and liabilities.

The receipt of BRL355.6 million from CDE in 2013 and the 10.36% tariff adjustment granted by ANEEL in October 2013 were the main factors responsible for the reduction in the company's net regulatory assets. The receipt of resources from CDE 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.

In light of its tight liquidity position and the uncertainties regarding the receipt of additional resources from the CDE fund, Bandeirante has somewhat reduced the payment of dividends in the past two years. The company paid dividends of BRL54 million in 2012 and BRL 35 million in 2013, which represented dividend pay-out ratios of 66.6% and 18.3%, respectively.

The non-cash reduction in unfunded pension fund liabilities to just BRL7.5 million in 2013 from BRL161.3 million in 2012 also benefitted the company's credit metrics. This reduction derived from the application of a higher internal rate of return on the company's pension fund's assets and liabilities which resulted in a lower present value for the unfunded portion which Moody's considers debt-like.

In 2013, Bandeirante's total volume sales increased by 2.4% to 15,359 GW/h from 15,003 GW/h in 2012, considering all market segments, i.e., regulated, free and spot. The volume of the regulated market remained flat at 9,448 GW/h fueled by the significant growth of the commercial and residential consumer classes, which increased

electricity consumption by 3.8% in both consumer classes. This significant sales growth was hurt by the regulated industrial consumers, which reduced their electricity consumption by 7.5%.

The free market segment, which largely consists of large industrial consumers and represents around 38% of the company's total volume sales, increased its electricity consumption by 10.1% which basically reflected the migration of industrial consumers from the regulated to the free market.

2014 CREDIT METRICS TO DETERIORATE FROM 2013 AND IMPROVE THEREAFTER

We forecast that Bandeirante will present weaker credit metrics in 2014 as we expect that its net regulatory assets will expand as a result of the increase in the acquisition of thermal power, which will not be fully covered either by CDE or CCEE. Bandeirante's electricity tariffs will be adjusted in October 2014; however, the tariff adjustment is not known yet, as it will depend on, among other things, the amount of funding from CDE or CCEE to be received and the level of the company's existing regulatory assets prior to the tariff adjustment date. We conservatively estimate that net regulatory assets will increase by BRL140 million in 2014.

We expect that Bandeirante's cash flow will improve dramatically starting in 2015 boosted either by the receipt of resources from the CDE fund or the pass-through of some portion of the regulatory asset amounts to tariffs, which we project will be reduced by around BRL 100 million per year from 2015 through 2017. A forecasted 3% annual growth in sales volume will also contribute to higher operating margins during this period partly offsetting some forecasted reduction in tariffs in October 2015 as a result of the scheduled fourth tariff review.

We do not foresee a material reduction in tariffs from the application of the fourth tariff review based on the preliminary WACC of around 7.3% indicated by the regulator, down from the current 7.5%, which will be submitted to public hearings over the next several months. There are other factors that will also be considered in this tariff review, which are difficult to predict given the early stage of the current discussions. We conservatively estimate that the fourth tariff review would reduce the company's annual EBITDA by around BRL 50 million. The impact of the tariff reduction would represent around 2% of Bandeirante's projected net revenues and 10% of projected EBITDA in 2016.

Our projections indicate that CFO before changes in working capital will decrease to BRL 184 million in 2014 (23.2% of debt) but improve from 2015 through 2017 to an annual average of BRL 374 million (57.3% of total debt), which is in line with the company's performance in 2013.

As a result of the forecasted improvement in the company's cash from operations, we expect that Bandeirante will increase its dividend pay-out ratio which will reduce the RCF to debt ratio to an average of 17.4% from 2014 through 2017.

LOWER TARIFFS FROM THE TARIFF REVIEW IN OCTOBER 2012

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 October 2012, the regulator ANEEL applied the new methodology for its tariff review to Bandeirante. The application incorporated a lower WACC of 7.5% down from the 9.95% utilized in the second tariff review in the face of lower capital costs (equity and borrowings) experienced among the Brazilian electricity distribution companies. The new procedures of the third tariff review have been applied to the Brazilian distribution companies since 2011 and were completed in 2013.

In accordance with ANEEL's technical note #352/2012 on the application of the operational procedures of the third tariff review on Bandeirante' tariffs, the company's part B of the tariff structure was reduced by 22.2%, with an equivalent reduction in tariffs by 6.1%. As a result, the company's regulatory EBITDA was to be around BRL 310 million at the currency value as of October 01, 2012, with effects retroactive to October 2011.

The part B of the tariff formula mainly consists of the operating costs (Reference Company), depreciation and the remuneration amount. Bandeirante has consistently posted higher levels of EBITDA in comparison with that envisaged in the regulator's tariff methodology, which suggests that Bandeirante has adequately managed its operating costs. We foresee that the company's normalized EBITDA will most likely keep exceeding the parameters determined by the regulator.

LEVEL OF SUPPORT OF EDP PORTUGAL

The ratings assigned for the EDB group also factor in the ownership by its ultimate parent company, EDP Portugal

(Ba1; negative outlook). While EDP does not guarantee EDB's debt, the Portuguese parent expects that its subsidiaries will remain financially self sustainable, as stated in its published policies. We believe that the Brazilian operations of EDP continue to play an important role in the group's growth strategy. The rating downgrades and changing the outlook to negative 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, we believe that ownership by EDP does not support a one notch of uplift of the rating on the global scale. EDB's Ba1 issuer rating is largely based on EDB's overall investment grade characteristics on a consolidated basis supported by adequate credit metrics for the rating category, and the relatively stable cash flows emanating from the regulated distribution utilities and the long-term supply contracts underpinning the generation business along with continued conservative financial management.

In addition, we believe that the Brazilian subsidiaries, mainly the distribution companies, are to a large extent insulated from any potential credit deterioration of their ultimate parent company. These 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.

We further believe that EDP Portugal will continue to support the activities of EDB by preserving the current strong capital structure of its Brazilian subsidiary; however, we will continue to monitor the evolution of the creditworthiness of EDP Portugal and the potential impact that any further rating deterioration could have on the financial strength of EDB.

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 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

Like most Brazilian companies, Bandeirante 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 it has been forced to acquire the more expensive thermal energy at unusual very high prices due to the persistent drought conditions. Typically, Bandeirante, as any other distribution company, is eligible to be

reimbursed through the pass-through mechanism 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 the incurred increased energy costs to tariffs the federal government has stepped in by determining the transfer of resources from the CDE fund. In the first four months of 2014, Bandeirante received BRL 204 million from CCEE. As of March 31, 2014, Bandeirante was eligible to receive an additional BRL 131.4 million in net regulatory assets, which management believes will not be fully received in 2014.

Moody's understands that Bandeirante has successfully managed its liquidity position considering the rather unfavorable environment the Brazilian distribution companies have been facing since mid 2012. In addition to the receipt of the CDE and CCEE funding, its shareholder EDB capitalized Bandeirante by BRL 85 million in the first quarter of 2013 and somewhat reduced the payment of dividends to BRL 35 million in 2013, which was equivalent to a low 18% dividend pay-out ratio.

The borrowing of around BRL 398 million long-term debt in the first half of the year as above mentioned will strengthen its cash position to face any major unexpected cash disbursement in the short-to-medium term. It also evidences the fact that Bandeirante has good access to the local banking market.

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 Bandeirante but also all Brazilian distribution companies as it would have an immediate positive impact on cash flow.

We believe that EDB's resilient access to the local banking and capital markets is an important mitigating factor for potential additional pressure on liquidity. Nevertheless, we understand that it is very important that EDB and its subsidiaries, including Bandeirante, are able to secure long-term funding and balance capital expenditures and the distribution of dividends to improve their capital structure and liquidity standing so that they remain commensurate with the Baa3 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 from the delay in the start-up of operations of the PECEM thermal power project followed by technical breakdowns, 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 it received from CWE Brasil (unrated), controlled by China Three Gorges (A1 stable), BRL 420.6 million related to the sales of its 50% participation in two major power projects as described in our issuer comment published on December 12, 2013. This fact further improves EDB's liquidity position.

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 Sao Paulo stock exchange, the company has undertaken 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.

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, this committee is non-permanent and convened only when requested by shareholders.

Rating Outlook

The stable outlook derives from our expectation that Bandeirante will continue to prudently balance capital expenditures and the distribution of dividends in the light of expected lower cash generation from the application of the third tariff review and higher costs with the acquisition of energy which should not be fully compensated either from a tariff increase or the receipt of funds from CDE or CCEE in 2014.

The stable outlook also reflects our 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 10% of total debt on a consolidated basis.

What Could Change the Rating - Up

Given the recent deterioration in EDB' consolidated credit metrics and our expectation that Bandeirante is slated to resume the high payment of dividends in 2014 an upgrade rating action is unlikely in the short to medium term.

Quantitatively, an upgrade could result from retained cash flow to total debt of above 20% and interest coverage above 5.0x on a sustainable basis along with an 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 material deterioration of its credit metrics so that RCF over debt ratio is below 10% and interest coverage is below 3.5x on a sustainable basis. A downgrade of EDB's ratings could trigger a downgrade of Bandeirante, which could occur if the consolidated RCF over debt ratio is below 10% 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.

Rating Factors

Bandeirante Energia S.A.

Regulated Electric and Gas Utilities	[1]Current31-Dec-2013		Moody's 12 - 24 Month Forward View	
	Measure	Score	Measure	Score
Factor 1: Regulatory Framework (25%)				
a) Judicial & Legislative Underpinnings (12.5%)		Ba		Ba
b) Consistency & 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%) (3yr Avg)	5.8x	A	3.6x - 5.9x	A
b) CFO pre-WC / Debt (15%) (3yr Avg)	43.4%	Aaa	23.2% -59.1%	Aaa
c) CFO pre-WC - Dividends / Debt (10%) (3yr Avg)	24.1%	Aa	-1.2% - 34.3%	Baa
d) Debt / Book Capitalization (7.5%) (3yr Avg)	46.8%	A	35.2% - 44.0%	Aa
Rating:				
a) Methodology Implied Rating		Baa2		Baa2

b) Actual Issuer Rating		Baa3		Baa3
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[1] 3-year historical average

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.



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