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EDC wants a more buoyant capital market in a sector of stable growth.

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THE CLIENT

Electricidad de Caracas (EDC) announced a public share offering with the expectation of raising around US\$15 million. The issue will be equivalent to 80.8 million new shares, representing 2.5% of the company's total capital with a nominal value of VEB100.0. The funds received from the operation will improve the debt profile and increase new investments. The private utility is also aiming to expand its current base of 43,000 shareholders by 5,000.

The Venezuelan electricity sector is mainly public, with regulation of tariffs and a massive investment deficit.

The electric sector is composed of the phases of production, generation, transmission, distribution and commercialization. The prices of electric power in transmission, distribution and commercialization are regulated by the Ministry of Energy and Oil, with the exception of the services provided to large users which have a free tariff. Installed generating capacity is 20,249 MW of which 87% comes from state-owned utilities and the rest from private companies. Hydroelectricity provides 65% of generation and thermal energy 35%. In recent years the sector has been in crisis due to underinvestment

which has left the 4% year-on-year increase in demand unsatisfied. The investment needed to improve the service is estimated at US\$6 billion.

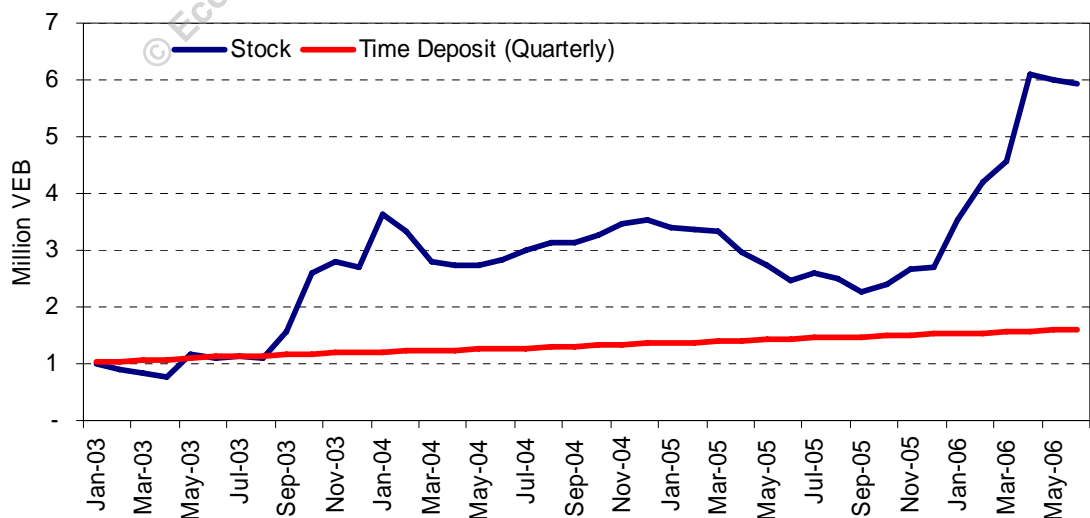
A FODA of the sector

The main strengths of the electricity sector include cheap fuel prices, economic generation mainly from hydroelectricity, and abundant natural gas. The main weaknesses stem from the largely public structure, with massive disinvestment, tariff regulation, and electricity theft. (Electricity losses are estimated at 29.3% of national production). Opportunities are growing demand, and the interconnection processes with other countries. The main threat is from the regulatory agencies and the lag in tariff adjustment, which leaves the profitability of the utilities dependant on the level of tariffs set by the Ministry.

In the last three years, the return on EDC shares has outperformed the interest rate.

At **Ecoanalítica** we think this issue could be a good opportunity to invest in the capital market. In the last two years EDC has had a highly profitable dividend policy for its investors, although past returns are no guarantee of future returns, it is interesting to look at the movement of the share in the last two years. If an investor had bought VEB1.0 million in EDC shares at the start of 2004 and reinvested all the dividends in the same shares, he would now have a portfolio of VEB CC with an average year-on-year return of ZZ, which is much higher than the interest rate of BB%.

Stock EDC VS Time Deposit



Source: BCV ,Reuters and ECOANALÍTICA

We recommend leverage for investing in the EDC issue

In *Ecoanalítica* we have commented over and over again that this is the time to borrow. The problem is finding assets to invest in which guarantee a return equal or higher than the interest rate. Since it is predictable that the macro-environment of the next two years will be very similar to the last two years, it seems that EDC could well repeat its good returns. As there does not seem to be any risk of higher interest rates, it is reasonable to suppose that the return on the shares will continue to be higher than the interest rate.

The high concentration of share ownership has reduced liquidity, which the offering should increase.

The majority shareholder AES was obliged to acquire 86.05% of the EDC share capital in 2000, so the share is very illiquid. With this offering, the company will obtain fresh money for investments and expand the liquidity of the share and the capital market in general. After the issue, 16.1% of shares will be in the hands of minority investors. At *Ecoanalítica* we think the utility is going to make more share offerings in the medium term, diluting its share ownership concentration and increasing the depth and liquidity of the market. To promote the interest of small investors in new issues, EDC has to guarantee a good return on this initial issue. This is an additional reason for recommending this investment opportunity to our clients.

Economic Tips

Inflation surprise. According to the Central Bank, June inflation reached 1.9%, a jump from June last year (0.6%) and the highest for 12 months. The growth of CPI in June was determined by the rise in the prices in the food and non-alcoholic beverages group, which had the highest rate for the second month in a row (4.7% in May and 5.5% in June). The Central Bank gives seasonal reasons.

Labor costs setback. Although the Central Bank didn't mention it, at *Ecoanalítica* we believe that behind the inflation surge in June are the effects of the changes in the labor regulations announced by President Chávez last April; especially the minimum wage, contractor companies, industrial safety, and other aspects. The June spurt also reflected the effects of the sales related to Father's Day and the Football World Cup.

Inexplicable. Controlled products gained 1.0% in June in comparison with 0.4% in May, explained by unauthorized increases in the prices of beef, eggs, and white

cheese. But how can controlled prices be subject to unauthorized increases? Uncontrolled products gained 2.7%, similar to the month before (2.8%).

Inflation still in target range. Inflation in the first half was 5.5%, and 11.8% in the last 12 months, down from the same period last year (15.9%). At **Ecoanalítica** we maintain our forecast that inflation will end this year around 10%.

Meager foreign investments. According to the Superintendency of Foreign Investments (SIEX), foreign direct investments totaled US\$9.8 million in May, concentrated almost entirely in manufacturing. This amount is extremely low for a medium-sized economy like Venezuelan with a GDP of over US\$140 billion. To put it another way, foreign investments in May represented only 13% of the average amount that CADIVI liquidates in one day, or 6% of one day of oil exports.

Tax reform. Seniat will present the VAT and Income Tax Reform bills to the National Assembly. For VAT, the changes include higher fines and longer closures of businesses after audits of formal duties. The regulations for the processes of sales of dollars through CADIVI will be tightened up, along with control of foreign exchange firms; however, SENIAT did not detail the scope of these changes.

Possible cut in rate. Another fundamental point is the possibility of a cut in the VAT rate from 14% to 13%. **Ecoanalítica** believes the administration will cut this rate given the approach of the presidential election and the fiscal surpluses generated by the oil boom.

The case of income tax. A chapter on the oil, gas and mining sectors will be included in the income tax bill. For the oil area, the 50% rate for joint ventures will stay and be extended to the strategic associations. For the tax return, the changes establish parameters for the expenses and losses that can be included to estimate tax payable, and a more exhaustive audit of PDVSA. Other changes include an increase in the income ceiling for natural persons from 1,000 to 1,500 tax units but official sources say that this aspect of the reform could be left for next year.

Efficient Seniat. The tax authority reported receipts of VEB4.3 trillion in June, generating a total of VEB25.6 trillion for the first half, equivalent to 64.3% of the target set by the Ministry for all of 2006 (VEB 39.8 trillion) and 43.9% higher than the figure for the same period of the year before. These targets were obviously overestimated, so as to obtain extra funds outside the budget for spending in sectors defined by President Chávez in his regular Sunday TV program. Seniat receipts look set to total VEB55 trillion (US\$25.58 billion) this year.

A new fund. The administration submitted the Endogenous Development Fund (Fonendógeno) bill to the National Assembly. The new fund will feed the budgetary funds selected by the executive through the Ministry for Popular Economy. The bill repeals the so-called Special Sustainable Development Zones (Zedes) of 2001. The new fund aims to reduce the weight of the bureaucracy in the flow of resources. However the problem continues to be the absence of audit and control. The fund starts off with an initial VEB100 billion (US\$46.5 million).

The community banks get their share. BANDES plans to finance the community banks. The state development bank is planning to pay out up to VEB3.6 trillion, in addition to the VEB2.7 trillion that the executive has already transferred to the community councils. BANDES may offer financial assistance to the community banks through a loan mechanism with a subsidized interest rate, and one or two years of grace. The problem with these banks is that the supervision and inspection scheme, and how the public funds will be invested, has yet to be defined. Venezuelans will have to pay the bill for this enlargement of the state in the future.

More money for other banks and other countries. BANDES granted VEB0.5 trillion to FONCREI; VEB0.15 trillion to the Bank of the People, the Women's Bank and FONDEMI, and VEB1.0 trillion to Fondafa to finance rural producers. BANDES will also donate US\$500,000 to Somalia and Kenya. This economic aid follows on the donations of US\$800,000 to Mali and US\$2 million to Grenada at the start of the year.

Oil Tips

Basket up. In the last week, the oil price rose US\$2.15 to US\$61.9 per barrel. In June the price of the basket averaged US\$60.9 per barrel, bringing the average for this year to US\$57.1 per barrel.

More about PDVSA. According to the Ministry of Energy and Oil, the PDVSA contribution to the National Treasury (royalties and income tax) totaled US\$7.75 billion from January to May this year, while the social contribution totaled US\$4.19 billion in the period. No figures for investment in production and exploration were revealed.

An example for Venezuela. The Brazilian oil company PETROBRAS will invest US\$87.10 billion between 2007 and 2011 to achieve hydrocarbon production of 3.49 billion barrels in five years, according to its new strategic plan approved last week. On average, PETROBRAS will be investing US\$17.42 billion a year over the next five

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years. Of this total, 86% (US\$75.00 billion) will be invested in Brazil and the rest outside the country. Last year, PDVSA'S investments did not even reach US\$3.00 billion.

Rating down. Moody's agency downgraded the long-term external debt of the Orinoco Belt strategic associations (PETROZUATA, SINCOR, AMERIVEN and Cerro Negro) from Ba3 to B1, but maintained the stable prognosis. According to Moody's, "the reduction assigns higher financial risk to the projects as a result of the increase in royalties, the pending increase in the income tax rate (which will weaken coverage of the debt service), and uncertainty in view of new potential changes." In mid-May, Fitch downgraded its rating for the four projects from BB to B+ after PDVSA announced that it may restructure the debt to the associations. In the next few days, S&P is expected to follow suit.

Two more to go. According to SENIAT, only two oil companies - Harvest Vincler (USA) and Teikoku Oil (Japan) - have not liquidated all the taxes pending from 2001 to 2004. Both companies have 15 days to pay up. The amount involved was not given.

Sectoral Tips

Passed on first reading. The National Assembly passed the new Mines Law on first reading. The basic purpose of the legislation is to significantly raise the tax paid by the sector. According to the Ministry of Basic Industries and Mining, the contributions of the sector could rise from an average of 0.7% to 4.2% of GDP.

Deepening the new model. According to the government, there are currently 595 social production enterprises (EPS) and the figure is expected to reach 1,000 by the end of this year. The conceptual basis of the EPS is that their traditional owners assign part of their interest to the workers by transferring 60% to 70% of their shares to employees and plowing back the profits for the benefit of the community.

In the National Assembly. Last week, parliamentarians gave the right to speak to the president of the CANTV Retirees and Pensioners Association, José Chácon, who charged that the judge who is hearing the case of the pensioners had acted against the former workers by not recognizing the payment of the minimum wage in force and leaving their pensions at VEB8,500. The deputies agreed to invite the judge to the Social Development Committee.

Land again. The National Land Institute (INTI) began the application of precautionary measures in over 53 farms in 14 states. According to the government, 334,500 idle hectares owned by the state will be recovered. The sensitive issue of land has become a factor in the pre-election period, although agricultural activity is a relatively small in terms of GDP of our economy.

Construction gets resources. According to the estimates of the Venezuelan Construction Chamber (CVC), the public investment program for the sector now totals VEB39 trillion (US\$18.14 billion). The funds are spread among budgetary contributions, regional funds, public credit operations, additional credits and the contribution from Pdvsa. In the first quarter of the year investment totaled VEB19.2 trillion. With this financial stimulus, construction activity will become one of the leading sectors in economic growth.

But the government fails to meet target. According to official figures 27,000 homes were built in the first five months of the year, compared with the government target of 150,000 units for this year. Sadly, in five months only 18% of the target has been achieved, a figure that cost the housing minister his job.

Printing industry on the move. Venezuela has over 1,000 printing establishments, 80% of which are small and medium-sized enterprises. This industry moves about US\$200 million a year, mainly in printing magazines, catalogs and POP material, not including the printing of packaging and exercise books.

Expensive and not competitive. The study by the International Comparison Program of Consumption Indicators, Prices and GDP coordinated by international organizations found that Chile, Brazil, Uruguay and Venezuela were the most expensive countries for living in 2005, and Argentina, Paraguay and Bolivia the cheapest. This trend will intensify this year.

Political Tips

No consensus between Súmate and the three candidates on the primaries. After several weeks of working to build consensus, last week the Súmate NGO unilaterally and unexpectedly told the country that it would not participate in the preparation of the primaries. At bottom the discussion is an attempt to impose conditions on the candidate who is elected from the primaries and the different opinions of the aspirants on the best date for holding them. At *Ecoanalítica*, we believe that the primaries are not the only

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method or the best one for choosing the opposition candidate. Although it is necessary to prepare a plan of government that unites the country, the leader elected in the primaries must have sufficient freedom to maximize votes in the presidential election. What is important is that the leading pre-candidates have confirmed their commitment to register a single candidate with the CNE.

Pre-candidates present. The CNE announced the unanimous acceptance of the proposal presented by the representatives of the main opposition candidates to take part with equal conditions and responsibilities in the audit of the voter roll, which the CNE has begun. According to the CNE it is not a "complementary or parallel" audit but the same one they have been carrying out.

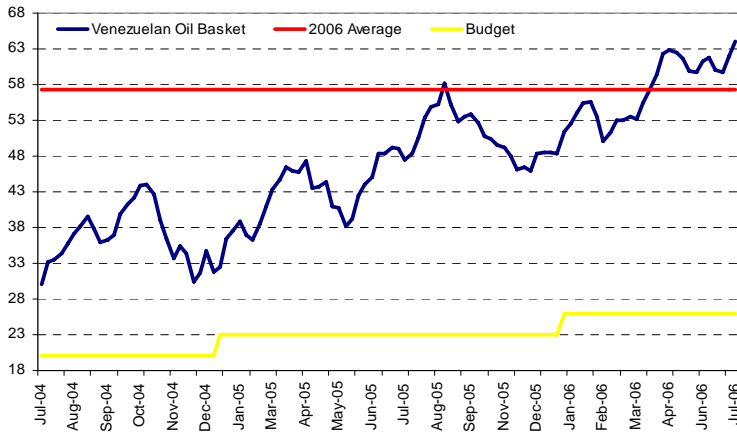
Another concession. The Electoral Council decided that the number of voting machines to be audited after the voting will not be less than 53%. The machines to be audited will be selected at random from all the voting centers in the country. This audit process would have a probability of error of a 1,000 trillionth. That is the probability of any fraud not being discovered is 1:1.000.000.000.000.000.

Cabinet reshuffle. President Chávez fired Housing Minister Luis Figueroa and replaced him with Infrastructure Minister Ramón Carrizales. The reason for the change is the failure to meet the home building targets and the problems of solving the needs of the homeless. The new Infrastructure minister will be José David Cabello who is currently president of the Maiquetía Airport Institute and Conviasa, as well as vice minister of Infrastructure Service. Cabello, who is the brother of the governor of Miranda state, will be the seventh Infrastructure minister of the Chávez administration.

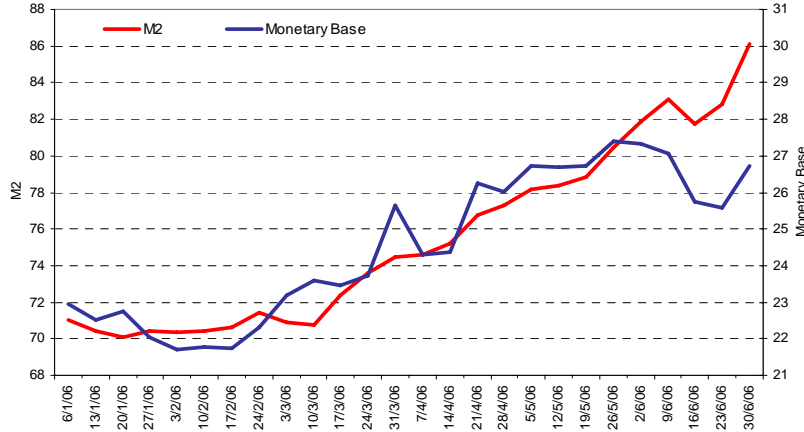
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ECONOMIC OVERVIEW

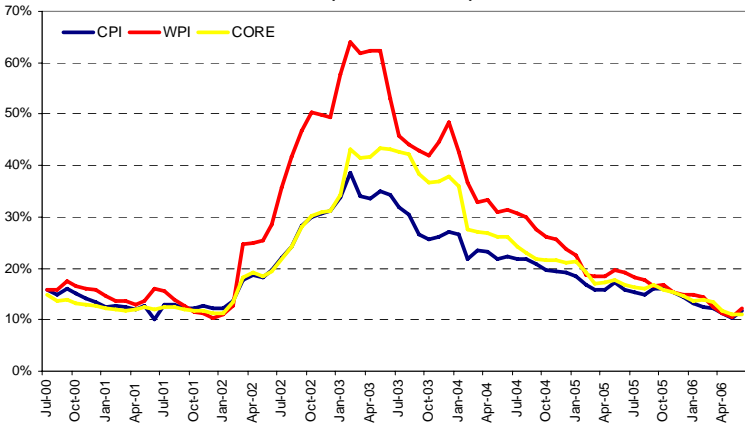
Oil Price
(Venezuelan Basket US\$/pb)



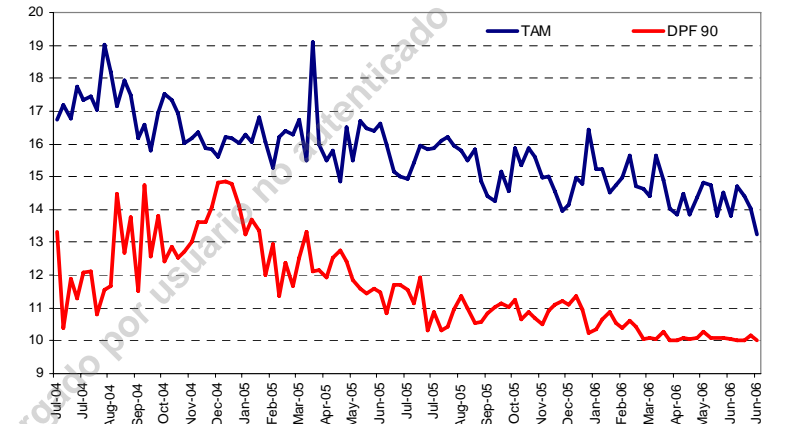
Monetary Base & M2
(VEB Billions)



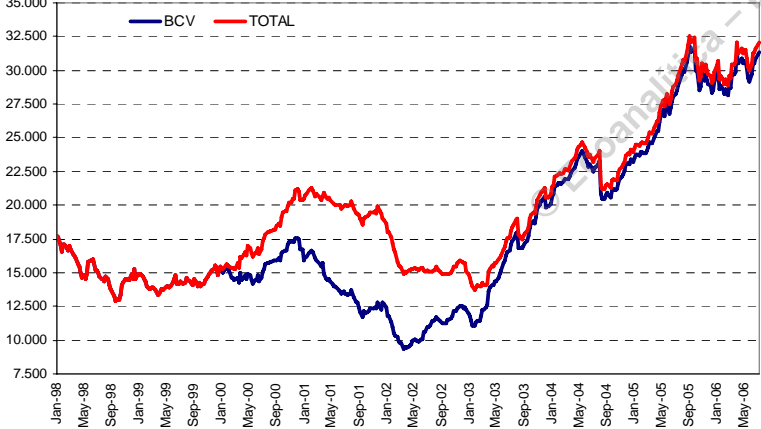
Inflation
(Last 12 Months)



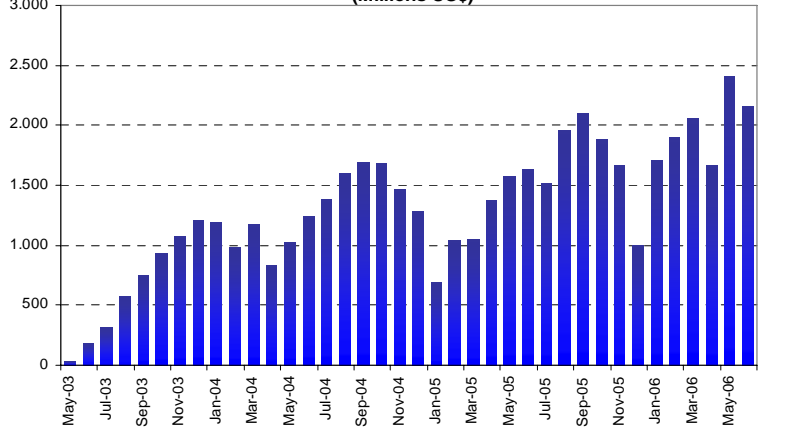
Interest Rate
(Six Principal Banks)



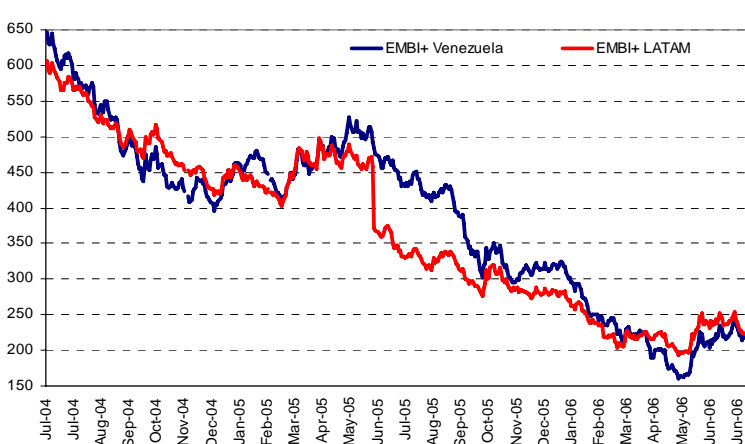
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

