Moody's Investors Service

Credit Opinion: Ecopetrol S.A.

Global Credit Research - 26 Aug 2010

Bogota, Colombia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa2
Senior Unsecured	Baa2

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Key Indicators

[1][2]**Ecopetrol S.A.**

	12/31/2009	12/31/2008	12/31/2007	12/31/2006
Average Daily Production (mboe/d)	432.8	366.2	327.1	314.1
Total Proved Reserves (billion boe)	1.51	1.12	1.19	1.23
Total Proved Reserve Life (years)	9.57	8.34	9.94	10.74
1-Year All Sources Reserve Replacement	350.82%	46.17%	63.14%	97.92%
1-Year All Sources F&D Cost	$6.87	$39.96	$17.05	$4.70
Return on Capital Employed (3-yr avg)	38.21%	38.40%	NA	NA
Leveraged Full-Cycle Ratio	2.60x	2.82x	NA	NA
Total Crude Distillation Capacity	335	335	335	335
Refineries with Capacity > 100 M bpd	1	1	1	1
Retained Cash Flow / Net Debt	2%	NA	NA	27091%
EBIT / Interest Expense	39.2x	264.5x	136.0x	82.5x
Debt / Total Proved Reserves	$2.24	$3.90	$3.71	$2.86
Debt / Total Capital	19.06%	34.76%	33.54%	21.71%

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, 2, and 3." In addition, Moody's adjusts for one-time items. [2] Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Recent Developments

In August 2010, Ecopetrol announced plans to acquire an approximate 51% stake in BP Exploration Company (Colombia) Limited together with Talisman Energy. Ecopetrol's share of the purchase price is about $892 million, plus $145 million for a return of equity on BP's stake in the Oleoducto Central S.A. (OCENSA) pipeline. The assets acquired are primarily oil and gas properties in the northeastern region of Colombia, including production and reserves from the Cusiana field, contracts in the offshore Atlantic, as well as downstream interests in OCENSA and gas plants at the Cusiana field.

Rating Drivers

- Leading upstream & downstream position in Colombia

- Mature asset profile

- Aggressive capital program with execution risk

- Rising leverage profile

- GRI and piercing methodology impacts

Issuer Profile

Founded in 1951 and based in Bogotá, Ecopetrol S.A. (Ecopetrol) is Colombia's largest corporation and is primarily involved in the exploration, production, refining, transportation, and commercialization of crude oil and gas in Columbia. Following an IPO in 2007, it is 89.9% owned by the government through shares held by the Ministry of Finance. The company was formerly known as Empresa Colombiana De Petroleos and changed its name to Ecopetrol S.A. in 2003.

SUMMARY RATING RATIONALE

Ecopetrol's Baa2 global local currency issuer rating (GLCR) reflects its fundamental credit profile and the application of joint default analysis for government-related issuers (GRI). Underlying the Baa2 GLCR is BCA of 10, equivalent to Baa3. The Baa2 foreign currency rating assigned to Ecopetrol's notes pierces Colombia's sovereign ceiling of Baa3 based on the company's status as a significant exporter, which would make it less likely to be caught up in a general debt payment moratorium in Colombia.

The BCA reflects Ecopetrol's status as the leading upstream oil and gas producer and refined products supplier to Colombian markets, with a significant export profile; its positioning as a mid-sized integrated oil company among its industry peers; and a rising level of upstream investment over the past few years, which is leading to increased oil and gas production. The company also has had a low (albeit rising) leverage profile following its change in status to a mixed company and initial public offering in 2007.

However, the BCA also factors in Ecopetrol's mature upstream asset profile, characterized until recently by a declining reserve trend and a short reserve life, and the staging and execution risk associated with its ambitious growth strategy, called the "Mega" plan. The plan entails significant execution risk, particularly in the upstream, where reserve additions and production success will have to be larger and more consistent than in the past to achieve plan goals. The baseline assessment also reflects the expectation that financial leverage will rise significantly in the next few years as capital spending is increased under the Mega plan.

DETAILED RATING CONSIDERATIONS

LEADING UPSTREAM & DOWNSTREAM POSITION IN COLOMBIA

Ecopetrol is the leading oil and gas producer in Colombia, accounting for approximately 54% of the country's BOE reserves and 52% of its BOE production. With 1.51 billion BOEs of net proved reserves as of year-end 2009 (83% liquids) and production in second quarter 2010 averaging 593,900 BOE/day (gross before royalties), Ecopetrol is positioned among the mid-sized integrated oil companies or could even be viewed comparably to a larger sized independent exploration and production company, rather than a large state oil company. While its production profile and reserves are slated for growth and increasing scale over the next 5 years, it remains relatively small among the peer group of integrated and state oil companies. In addition to its own crude and natural gas production. Ecopetrol purchases and trades the royalty crude and gas that is paid in kind to the Agencia Nacional de Hidrocarburos (ANH), as well as a portion of the third-party production in Colombia.

In the downstream, Ecopetrol owns all 335,000 barrels per day (bpd) of the country's crude refining capacity, primarily via the 250,000 bpd inland refinery at Barrancabermeja, and a smaller 80,000 bpd plant at Cartagena. The company produced approximately 300,000 bpd of refined product in 2009 and is the largest wholesale marketer in the Colombia, but does not engage in retail product marketing. Results from the refining operations were very weak in 2009 and the first half of 2010, reflecting reduced demand and narrowed refining margins. In addition, because of an increasingly heavy crude slate and its refining configuration Ecopetrol imports ultra low-sulfur diesel and naphtha for blending to comply with environmental regulations. A new hydro-treatment plant at Barrancabermeja is expected to come online in August 2010, reducing the company's reliance on ultra low-sulfur diesel imports. However, the refining environment is likely to remain challenged.

With the acquisition of Propilco in 2008, Ecopetrol is also the largest petrochemical producer in Colombia, with capacity of 500,000 tons annually, mainly in polypropylene. It also owns and operates directly or in joint ventures more than 8,400 kilometers of crude oil and refined product pipelines, including 100% or majority stakes in four of the largest crude pipelines. These connect field production to the refineries and to wholesale product and export terminals.

MATURE ASSET PROFILE

Colombia is considered to have a medium level of oil and resource prospectivity relative to regional giants such as Mexico, Brazil and Venezuela. Ecopetrol's production is derived from five main geographic regions, with the Northeast and Central regions accounting for the largest portion. The Northeast is the source of the company's major light crude production including the Cravo Norte, Cusiana and Cupiagua fields, which have been a mainstay and are now in decline. The Northeast is also the source of virtually all current natural gas production. Other significant crude production comes from the Mid-Magdalena and Catatumbo/Orinoquia regions, the latter of which is in the eastern provinces along the border with Venezuela.

The maturity of the reserve base, coupled with an extended period of underinvestment up to 2007, has resulted in a lower reserve replacement record, modestly declining reserves, and rising full cycle costs for Ecopetrol. (The underinvestment is also a legacy of the political problems and guerrilla activity of the late 1990s, which led to a decline in sector investment.) Ecopetrol's three-year average reserve replacement in 2009 was 168%, reflecting upward revisions rather than new discoveries, while its three-year organic replacement (extensions and discoveries only) was lower at 46%. Ecopetrol is showing the initial benefits of its large capital investment program, with a one-year organic growth reserve replacement of 91% in 2009. This investment has helped reverse the decline in Ecopetrol's reserve life, from 8.3 years total proved and 4.8 years proved developed in 2008, to 9.6 years and 5.8 years, respectively, at year-end 2009. At the same time, the company's proved undeveloped reserves are up sharply from historical levels at 39% of total reserves in 2009, although down from 43% PUD in 2008.

Ecopetrol's upstream cost structure has also risen, primarily due to higher finding and development (F&D) costs, and climbing unit production costs. In 2009, average all-sources F&D costs benefited from sizable positive revisions, but with 1-year costs of $26.88 from E&D only, this appears to be in line with the industry, as do full cycle costs in the area of $35/BOE. Unit production costs have increased in 2009 and 2010 as a result of higher well maintenance, increased workover activity and greater reliance on contracted services, and the impact of the Peso appreciation on local costs. However, Ecopetrol's leveraged full cycle ratio was a competitive 2.6x for 2009. Additionally, we expect unit interest expense to rise in tandem with financial leverage as Ecopetrol completes its Mega plan. (Our cost structure analysis is based on a gas/oil conversion ratio of 6:1, with production reported net of royalties, whereas most of the company's reported information is based on gross production before royalties.)

AGGRESSIVE CAPITAL PROGRAM WITH EXECUTION RISK

In recent years, Ecopetrol's capital spending has ramped up significantly, from under $1 billion in 2005 to nearly $4 billion in 2009, plus another $2.3 billion in acquisitions. In the context of the Mega plan, total spending is expected to be at high levels through 2020, for a total of $80 billion. The company is projecting spending at $6.925 billion in 2010, not including acquisitions, most notably the $892 million acquisition of a 51% stake in BP's divested Colombian assets in August 2010. About 65% of the 2010 capital spending plan is slated for upstream exploration and production.

The updated Mega plan sets an ambitious capital investment program estimated at $44.3 billion for 2011-2015 (an average of about $8.86 billion p.a., vs. $6.3 billion actual spending in 2009), and an additional $35.9 billion from 2016 to 2020. Projected spending from 2011 to 2015 includes $34 billion in the upstream to increase production to 1 million BOE/day (up from current 593,900 BOE/day gross) by 2015. In the downstream, the two refineries are smaller scale with relatively low conversion capabilities. Planned investment of $5.2 billion is slated to upgrade the Barrancabermeja refinery and double throughput capacity at Cartagena from a current 80,000 bpd to 165,000 bpd by 2015, and will increase conversion to handle a heavier indigenous crude slate (from 20% currently to 60%) and produce clean fuels.

Ecopetrol originally had planned to upgrade the small Cartagena refinery via a joint-venture with Glencore, but ultimately bought back Glencore's 51% stake in the refinery when it withdrew early in 2009. Other significant aspects of the updated 2010-2020 plan include $5 billion for new and upgraded pipelines to handle rising amounts of heavy crude and additional marketing and storage infrastructure.

RISING LEVERAGE PROFILE

Our view of Ecopetrol incorporates rising financial leverage over the next two to three years as spending for the Mega plan exceeds internal cash flow. In 2010, we believe Ecopetrol should be able to fund its organic capital spending from internal cash flow from operations, based on better-than-budgeted oil prices. However, the company estimates that it will need to raise between $20 to $23 billion of debt over the next decade to help fund the 2011-2020 plan, assuming it generates $44 billion to $50 billion of cash flow and raises $30 billion of equity. Although the company is ramping up exploration and showing a rising production trend, debt increases will precede realization of the significant upstream and downstream growth targets

Ecopetrol is entering into its strategic expansion with a strong balance sheet, including low debt of approximately $3 billion and $3.5 billion of cash, cash equivalents and short-term investments at June 30, 2010. A portion of that cash has since been used to fund the $892 million acquisition of BP's Colombian assets. Ecopetrol's low debt position is a legacy of its status as a state company as well as the government's intention to strongly capitalize it post-IPO to support acquisitions and fund future growth. Ecopetrol retained the total $2.8 billion of proceeds realized at the time of the IPO, and will also realize the proceeds from future flotations up to the 20% level.

If oil prices were to fall, leading to significant negative free cash flow, we believe Ecopetrol's total debt could increase by another $500 million to $1 billion in 2010. The company has indicated it would consider funding in 2010 and 2011 via local Peso bonds or drawings under a $1 billion credit facility with the U.S. Export Import Bank. Debt increases could also depend on the timing and proceeds realized from a potential equity issuance, which would improve the company's financial leverage and flexibility as it proceeds with the updated Mega plan.

A high dividend payout will also remain in contention with the company's need for funds to reinvest in growth. Under the Code of Commerce in Colombia there is a statutory payout (subject to the buildup of statutory reserves and certain exclusions for non-recurring charges) that will maintain the dividend at an elevated level. In addition, the public float is a highly dispersed base of retail holders that will expect generous dividends. Ecopetrol's dividends are declared based on the prior year's earnings, resulting in a payout ratio of 70% in 2009. We calculate its dividend payout as an average 98% over the past three years, based on a standard definition of dividends paid in the current year to current year earnings.

IMPACT OF GRI AND PIERCING METHODOLOGY

Ecopetrol's Baa2 global local currency issuer rating reflects ratings uplift based on Moody's joint default rating methodology for GRIs. Joint default analysis starts with a baseline credit assessment (BCA) of the company. It then factors in a level of expected government support in the event of financial stress and a measure of correlation among the various financial and economic factors that could affect both the support provider and the entity. In Ecopetrol's case, we assume a high level of government support, given the company's financial contribution to the government, its strategic importance to the country's energy supply, and reputation risk. We also attribute a moderate level of correlation of default risk between the two entities, resulting in an uplifted local currency rating of Baa2.

The Baa2 foreign currency bond rating pierces Colombia's sovereign ceiling of Baa3. Using the company's Baa2 GLCR, the methodology assigns a 50% probability to a general debt moratorium in Colombia, but a lower 25% probability that Ecopetrol would be caught up in a payment moratorium, based on its status as a significant exporter of crude oil and refined products. Ecopetrol exported about 55% of its own crude production and 21% of its refined product volumes in 2009, mainly in the form of crude oil and fuel oil to the U.S., the Caribbean basin, and Asian markets.

Liquidity

Depending on the level of oil prices and cash flow for the remainder of 2010l, Ecopetrol probably will not have to borrow, assuming cash on hand and cash flow from operations will cover its capital spending program. The company's cash position was sizable at June 30, 2009, with about $3.5 billion in cash equivalents and investments, some $892 million of which is expected to be used to fund its recent acquisitions. However, to finance significant capital expenditures in 2011 and beyond, it has been putting in place financings to accommodate expected deficits. In 2009, its first market issuance was $1.5 billion of ten year notes internationally via a 144-A issuance that was subsequently registered. The company has a Pesos 2.2 Trillion ($1 billion) syndicated 7-year bank loan arranged with a group of 11 Colombian banks which can be used to fund capital spending. The loan has a pledge of stock in certain assets, including the Cartagena refinery, the Ocensa Pipeline, and Propilco. Additionally, the company recently obtained a $1 billion credit facility from the US Export-Import Bank, which is undrawn but could be used if oil prices weaken and cash flow is insufficient to cover capital spending. The company will need to continue to develop new bank sources and long-term debt issuances to meet substantial funding needs.

Rating Outlook

The outlook for the Baa2 foreign currency rating and the Baa2 GLCR is stable. As noted, while the BCA does incorporate expectations of higher capital spending and debt increases, Ecopetrol's ability to stage and manage its future capital spending, dividends, and financial leverage will be key to maintaining its BCA and the stable outlook for its Baa2 GLCR.

What Could Change the Rating - Up

Ecopetrol is not likely to be upgraded in the near to medium term given the execution risk regarding such a large transformative capital spending plan and the company's position as a relatively smaller integrated oil company. In the longer-term, realization of the strategic plan, while maintaining moderate financial leverage, could lead to an upgrade.

What Could Change the Rating - Down

The BCA and ratings could come under pressure should leverage increase materially or if capital investments escalate or significantly underperform. The Baa2 ratings could also be pressured by deterioration in the government of Colombia's willingness to provide credit support to Ecopetrol in a distress situation.

Other Considerations

Corporate Governance: Ecopetrol's mixed company status gives it flexibility in a number of areas not typical of state-owned companies, which will enable it to compete more effectively with the private sector. The company has autonomy in setting its own budgets and is authorized to incur debt. It is exempt from public contracting requirements and can negotiate compensation, benefits and union contracts on a private basis. It will also benefit, like other oil and gas companies, from more flexible hydrocarbon contract structures promulgated by the ANH.

The nine-member board also has a more independent cast. It includes three government appointments from the ministries of Finance, Mining and Energy, and the National Planning Department. The six independent members have no direct tie to the government or to Ecopetrol and include representatives of minority interest holders, the producing provinces, and designated experts in law, tax accounting, and the petroleum industry. The audit committee is composed of four independents, including a financial professional. The major shareholder is bound under a unilateral statement to guarantee the rights of minority interest holders, including profit and dividend entitlements. Governance was further enhanced to be in compliance with Sarbanes-Oxley requirements when Ecopetrol listed its ADRs on the NYSE in late 2008.

Political Risk Factors: Under the former President Uribe, Colombia witnessed a widespread decline in guerilla activity since the early 2000 period, largely the result of intensive military and security oversight in the large cities and countryside, including stepped-up protection of energy infrastructure such as the pipelines, as well as social programs instituted to gain the support of local populations. The elimination of the key top commanders of the guerilla movement has also been an important stabilizing factor. The newly elected president, Juan Manual Sanos, is a former defense minister and Uribe supporter, and is continuing with a hard line approach to guerrilla insurgency.

However, guerilla activity continues in some rural areas including the eastern provinces along the border of Venezuela. To the extent guerilla activity remains a problem, the oil industry could be a likely target. Many of the remote or frontier areas targeted for future exploration and development are in these regions. A continuing risk is also associated with gaining access to new areas for future exploration and development, which will require soliciting the support and participation of indigenous peoples.

Comment on Grid Implied Rating: Using the Global Integrated Oil Rating Methodology, the implied rating of Baa1 is two notches above our BCA of 10 (Baa3). The methodology outcome benefits from solid scale positioning and high historical financial metrics. The future methodology outcome could decline as the company moves forward with its debt financing and the roll out of the Mega plan.

Rating Factors

Ecopetrol S.A.

Integrated Oil & Gas	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Reserves & Production Characteristics (25%) [1][2]							
a) Average Daily Production (Mboe/d)				X			
b) Proved Reserves (Million boe)				X			
c) Total Proved Reserve Life (Yrs)			X				
Factor 2: Re-Investment Risk (10%) [1][2]							
a) 3-Year All-Sources Reserve Replacement	X						
b) 3-Year All-Sources F&D Cost ($/boe)		X					
Factor 3: Operating & Capital Efficiency (10%) [1][2]							
a) Return on Capital Employed (ROCE) (3 Year Avg)	X						
b) Leveraged Full-Cycle Ratio	X						
Factor 4: Downstream Rating Factors (15%) [1][2]							
a) Total Crude Distillation Capacity ('000 bpd)					X		
b) # of Refineries with Capacity > 100 M bpd						X	
c) Segment ROCE (3 Year Avg)				X			
Factor 5: Financial Metrics (40%) [1][2]							
a) Retained Cash Flow / Net Debt (3 Year Avg)	X						
b) EBIT / Interest Expense (3 Year Avg)			X				
c) Gross Debt / Total Proved Reserves			X				
d) Gross Debt / Total Capital	X						
Rating:							

Indicated Rating from Grid Factors 1-5			A2				
Notching for Government Fiscal Dependence			-2				
a) Indicated Rating from Grid			Baa1				
b) Actual Rating Assigned			Baa3 (10)				

Government-Related Issuer	Factor
a) Baseline Credit Assessment	10
b) Government Local Currency Rating	Baa3
c) Default Dependence	Moderate
d) Support	High
e) Final Rating Outcome	Baa2

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3". In addition, Moody's adjusts for one time items. [2] As of 6/30/2010(L); Source: Moody's Financial Metrics