Ecopetrol

Colombia, Oil & Gas

Accounting		Climate Assumptions		Audit		Date of analysis: 23rd April 2021
Judgements	Consistency with other reporting	Visibility	Paris alignment	Visibility in CAMs	Consistency check	Year end: 31st December 2020 Report date: 8th April 2021 AGM: 26th March 2021
Significant concerns	Significant concerns	Some concerns	Significant concerns	Significant concerns	Significant concerns	CA 100+ company, so seen by investors as key to driving global net zero emissions

Summary view:

- In the narrative reporting of the Annual Report (20-F), as well as the Integrated Sustainable Management Report, Ecopetrol acknowledges the significant transition risks, as well as some physical risks, from climate change. However, the audited consolidated financial statements do not make any reference to what extent, if any, these risks impact accounting judgements.
- The company makes several high-level comments concerning commitment to tackling climate change and the stated strategy of diversifying into low carbon businesses, but this does not sit comfortably with their plans to expand oil production and the long-term oil price assumptions that they use.

Background

The Business

- Ecopetrol is the national oil company of Colombia. It is majority owned by the government of Colombia with 88.49% with the remaining 11.51% as free float. The company is listed on the Colombian Stock Exchange with ADRs trading on the New York Stock Exchange.
- Ecopetrol is the largest oil and gas company in Colombia and operates across upstream (exploration and production), oil and gas transportation and downstream (refining) segments.
- The company is significantly exposed to transition risk, as demand for oil and gas is expected to decline. Other transition risks include increases to carbon taxes, regulations on oil production and insurance costs. Ecopetrol is also exposed to physical risk from adverse climatic changes, such as extreme weather conditions, that could increase the difficulty or cost of production in certain locations.
- According to the sustainability report, scope 3 emissions in 2019 were between 101 and 118 million tons of CO2 equivalent, while scopes 1 & 2 were 11 million tons (split roughly equally between production and refining).

Approach to climate change

- There appears to be a disconnect between Ecopetrol's narrative reporting, which describes their climate risks in reasonable detail, and the audited financial statements that are silent on the financial implications of these risks.
- Ecopetrol's stated strategy is to decrease its carbon emissions while managing climate-related risks and opportunities. The company is investing to some degree in lower emission technologies and claims to be implementing an offset portfolio of natural climate solutions.
- More specifically, referencing in general terms the Sustainable Development Goals and the Paris Agreement, Ecopetrol has very recently announced plans to "achieve net zero carbon emissions by 2050 (scopes 1 & 2)". There is a target to reduce scopes 1 &2 carbon emissions by 25% by 2030 and reduce total emissions (scopes 1, 2 & 3) by 50% by 2050.
- With the stated aim of diversifying in to low-carbon businesses, Ecopetrol has announced the intention to purchase 51.4% of electricity transmission company ISA (a related party transaction since the Colombian government would be the selling entity). However, approximately three quarters of CAPEX is for upstream operations, where they aim to increase oil production.

Accounting: judgements and consistency with other reporting

Accounting judgements		Significant concerns

- With ADRs listed on the NYSE, Ecopetrol reports under IFRS as issued by the IASB.
- There is no reference in the notes to the financial statements that accounting judgements have been impacted by climate-related considerations despite the stated goals of the company and the climate risks identified in the narrative reporting. While Ecopetrol does disclose a set of oil price assumptions for impairment testing, there is no suggestion that these have been impacted at all by climate considerations – indeed, the assumptions show a *rising* oil price over the medium and long term.
- The narrative reporting refers to a revised assumption of a peak oil scenario globally in the late 2020s and in Colombia between the 2030s and the 2040s.
- Ecopetrol took an impairment charge of COP193 billion (US$52 million) on upstream assets in 2020 due to a "decrease in crude oil price forecast in the short and long term", but there is no mention of whether climate change was a factor in these lower price forecasts.

Consistency with other reporting		Significant concerns

- There is a disconnect between the relatively extensive consideration of climate-related risks and issues in the narrative reporting and the apparent lack of consideration of the financial implications of these in the financial statements or their notes.
- Ecopetrol produces a separate Integrated Sustainable Management Report, which is written in accordance with GRI standards. The content of this report repeats much of the discussion of climate issues in the narrative reporting of the annual report, but with additional information, especially concerning carbon emissions data.
- The narrative reporting in the annual report – but not the audited financials or their notes – refers specifically to the risk of stranded assets, defined as an asset that loses its capacity to create economic return before ending its life cycle due to the changes brought about by the low carbon energy transition. There is description of a methodology for assessing "stranded asset risk" with assets that score above a certain threshold being considered high risk. This assessment process has so far only been applied to their upstream assets but with no assets being identified as high risk. There are no quantitative disclosures beyond this.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Some concerns

- There is some limited disclosure of climate-related assumptions in Ecopetrol's financials, which refer to an oil price assumption of $46.36 for the first year, $57.00 for the medium term and $67.77 for the long term under Impairments of non-current assets. However, there is no suggestion anywhere that climate risk or the energy transition has been considered in any way in making these forecasts – indeed, the rising prices over the long-term suggest the opposite. ("Medium term" and "Long term" are not defined and no further explanation is given for how these numbers have been reached.)

Paris alignment		Significant concerns

- The narrative reporting, but apparently not the financials, describe a Sensitivity Analysis of Reserves, which revised future oil price expectations, but still uses assumptions that put oil prices well above those that would be considered aligned with the Paris Agreement: "The sensitivity analysis assumes a constant ICE Brent price of US$ 46 per barrel in 2021, between US$ 55 and US$ 58 per barrel in the period 2022-2025, and between US$61 and US$68 onwards." In fact, the result of this sensitivity analysis gives total oil and gas reserves 7% *higher* than the disclosed number in the financials using the US SEC methodology for reserve estimation.

Audit: visibility in CAMs and consistency check

Audit firm: Ernst & Young	Responsible partner: Daniel Alejandro Tortorella
Audit standards: PCAOB standards	

Visibility in Critical Audit Matters		Significant concerns

- There is no reference to climate change in the auditor's report.
- There are 3 CAMs identified: (i) Estimation of fair value amount of long-lived assets in the Cartagena refinery; (ii) Determination of depreciation, depletion and amortization and impairment of long-lived assets; and (iii) Recoverability of deferred tax assets.
- The first and, in particular, the second of these CAMs would be expected to be impacted by climate change assumptions since they both concern the fair value of long-lived assets, which will depend in large part on long-term oil price assumptions and expectations for the industry. Even the third CAM concerning deferred tax assets could be impacted by climate change expectations since the estimation of these deferred assets is based on the ability to realize future profits against which to off-set these deferred taxes.

Consistency check		Significant concerns

- PCAOB audit standards require the auditor to read other information that is presented together with financial statements and the auditor's report thereon. The auditor's report is silent on the outcome of the review, which implies that no material inconsistency was identified in the other information within the 10-K.
- However, the apparent absence of any consideration given to climate change in the audited financial statements does not appear consistent with the extensive discussion of climate risks in the narrative reporting.
- The Integrated Sustainable Management Report has a reference to Ernst & Young having audited "figures under the economic and financial statements", but this does not appear to extend to any assurance of the sustainability report in its entirety. The report has been "verified" by another firm, BSD Consulting.

The Climate Accounting Project is an independent investor-led project to reinforce the statements of the IASB and IAASB that material climate change issues are incorporated within their standards. This analysis seeks to understand the extent to which companies and auditors are delivering against this aspect of these standards and similar local standards.		**Key**
		Good practice
		Few concerns
		Some concerns
		Significant concerns

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