



Moody's Investors Service

Credit Opinion: Empresa Nacional del Petróleo

Global Credit Research - 10 Jul 2009

Santiago, Chile

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	A3

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Opinion

Rating Drivers

- > Strong market position tempered by small scale and limited diversification
- > Structural shift in energy supply weakens margins
- > Downstream investments should provide modest near-term margin uplift
- > Increased leverage and debt levels weakens financial profile
- > High level of government support exhibited > Poor capital efficiency in upstream investments
- > Foreign exchange risk partially mitigated

Issuer Profile

Empresa Nacional del Petróleo (ENAP) is an integrated petroleum company 100% owned by the Chilean state. ENAP is primarily involved in refining and wholesale petroleum product distribution and exploration and production. The company owns three refineries in Chile, two of which are large-scale refineries, with a total crude distillation capacity of approximately 227,000 barrels per day and a weighted average Nelson Complexity rating of 6.2 (per the Oil & Gas Journal). As of March 31, 2009, the company estimates its total proved reserves at approximately 149 millions of barrels of oil equivalent, 49 million barrels of which were oil reserves (according to SPE standards). With total assets of approximately US\$6.6 billion, ENAP is the third-largest company in Chile. Chile's energy industry has been deregulated since 1978, but ENAP remains the only refiner in Chile.

Rating Rationale

Since ENAP is 100% owned by the Chilean state, ENAP's A3 foreign currency rating reflects the application of Moody's joint default rating methodology for government-related issuers (GRIs). The A3 rating combines: (i) ENAP's underlying baseline credit assessment, and (ii) the willingness and ability of the Government of Chile to provide credit support to ENAP in a distress situation.

We rank ENAP's underlying baseline credit assessment in the range of 11-13 (on scale of 1 to 21, where Aa assessments are published as a range from 2 to 4, single-A assessments map from 5 to 7, Baa assessments map from 8 to 10, Ba assessments map from 11-13, and so forth). The baseline credit assessment reflects ENAP's dominant market position within Chile, the high quality of its refined products, and relatively strong refinery reliability records. However, the baseline credit assessment also considers the company's relatively small size, particularly in the context of its exposure to volatile and cyclical commodity prices and dependence on crude oil imports, its weak profitability levels relative to its peers, poor capital productivity in its upstream segment, and a high financial leverage profile.

The government of Chile's ability to provide support to ENAP is measured by its A1 local currency rating and positive outlook, weakened only somewhat by the low dependence of the government and the company on credit factors that could eventually cause stress on both simultaneously. We consider the government's willingness to support the company as high, considering the strategic importance of ENAP to the Chilean economy, ENAP's 100% ownership by the state, and the government's involvement in the company's budget approval and other policy-related processes.

DETAILED RATING CONSIDERATIONS

STRONG MARKET POSITION TEMPERED BY SMALL SCALE AND LIMITED DIVERSIFICATION

ENAP not only has a dominant market position within Chile, supplying about 76% (via its own refinery production) of the country's petroleum product requirements, but its refinery reliability has consistently remained high and its refined product output is also of high quality, consisting of 59% diesel and gasoline. In addition, the company's transportation network and Chile's relatively stringent environmental requirements create high barriers to entry. ENAP has completed the bulk of its investments required to meet Chile's fuel quality standards.

However, with total refining (crude distillation) capacity of approximately 227,000 barrels per day, ENAP is smaller than several of its peers in terms of crude distillation capacity and the number of refineries (two) having crude distillation capacity in excess of 100,000 barrels per day. In addition, the company's degree of downstream integration is modest, reflecting a degree of retail exposure in Peru and Ecuador.

While ENAP's upstream operations help to diversify ENAP's earnings and cash flow and provide a degree of operational integration, the company's reserves and production remain relatively small and capital productivity has been weak. Total proved reserves have been in decline since 2001, with production levels also facing declines over the last several years, although Moody's notes that both oil and gas production increased modestly in 2008. As a result, ENAP's reliance on imports from third parties to meet its crude requirements has increased. In 2008, the company's upstream operations supplied only 1% of its crude requirements.

STRUCTURAL SHIFT IN ENERGY SUPPLY WEAKENS MARGINS

ENAP's earnings and cash flow remain subject to the volatility and cyclicity that are inherent to both refining margins and oil and natural gas prices. Historically, ENAP generated wider and more stable margins than many of its US Gulf Coast peers, mainly as a result of a favorable domestic pricing mechanism based on import parity (US Gulf Coast prices plus transportation costs, insurance, and custom duties), its proximity to Argentina's oil and gas producing regions, which historically supplied over 50% of the company's crude imports and all of the country's gas imports, and limited competition. However, over the last few years the company has experienced a weakening in its operating margins relative to its refining peers. ENAP's margins have faced pressure and become more volatile as a result of curtailed natural gas and crude oil imports from Argentina and the 2006 elimination of tariffs from product imports from the US and MERCUSOR countries.

Restrictions in place since 2004 on Argentina's natural gas exports and insufficient refining capacity to meet demand have caused ENAP to substantially increase its imports of diesel from the US Gulf Coast and other regions. The company sells the imported diesel with no associated margin or in certain cases at a loss, as under Chile's import parity pricing formula some of ENAP's financing costs and additional storage costs are unable to be passed through to end-users. In addition, the natural gas shortages in Chile have resulted in ENAP using diesel and other fuels in lieu of natural gas to run its refineries, which has raised its refinery costs.

DOWNSTREAM INVESTMENTS SHOULD PROVIDE MODEST NEAR-TERM MARGIN UPLIFT

Management has been undertaking a number of steps in order to improve ENAP's profitability levels. These steps include investments to both increase ENAP's crude distillation and conversion capacity, improve Chile's natural gas supply, cost reduction efforts, and the revision of its hedging program.

The company successfully completed a US\$430 million coker at its Aconcagua refinery mid 2008, which improved the quality of its fuel slate, enabled it to process more Latin American crudes and increased its realized margins. As a result of the coker, ENAP has now fully replaced its imports of West African crude with cheaper crudes from Latin America. ENAP had been importing crude from West Africa as a result of the lack of crude imports from Argentina; however, this required large inventories with high carrying costs and an associated 6% import tariff that is not reflected in import parity pricing and thus could not be passed on to end-users. ENAP's imports of Latin American crudes do not face an import tariff and have lower inventory carry than imports from West Africa.

The company also holds a 20% equity stake in a liquefied natural gas (LNG) re-gasification plant, which received its first LNG shipment in July 2009 (with re-gasification and storage occurring onboard the shipping vessel until the facility is fully on stream in the second half of 2010).

ENAP's investments should enable the company to lower its diesel import needs and process even larger quantities of heavier, less expensive crude from Latin America. However, while Moody's notes that a weaker economy will likely keep diesel demand muted over the near-term, it remains to be seen to what degree ENAP's diesel import needs will be reduced over the medium to longer term through the additional refinery investments and the LNG facility. In addition, Moody's believes that ENAP's refinery operating costs will remain high relative to historical levels due to the expectation of high LNG prices relative to historical natural gas prices in the region. However, we note that the LNG facility should enable ENAP to benefit from a more stable source of energy for its refineries.

INCREASED LEVERAGE AND DEBT LEVELS WEAKENS FINANCIAL PROFILE

Weak profitability levels, in addition to high capital spending levels and substantial working capital needs, materially increased ENAP's financial leverage over the last few years. The company's EBITDA turned negative in 2008 as the company was impacted by squeezed fuel product margins, the holding of high cost inventories during a declining commodity price environment, and the company's inability to fully pass through the cost of importing diesel fuel to meet record diesel demand caused by unseasonably dry weather (which reduces hydroelectric output) and insufficient supplies of natural gas, which also resulted in increased low margin fuel oil production in the first half of the year. In addition, there was a reduction in diesel demand in the second half of 2009 when rainfalls increased, which meant a slower reduction in inventories.

Profitability in 2009 is expected to improve due to lower diesel demand, increased focus on cost controls and the benefit of the new coker. We note that ENAP's first quarter 2009 results came in stronger than expected. However, generating materially improved profitability levels will be difficult given our negative outlook for the refining and marketing sector and that margins in the second quarter of 2009 have weakened from first quarter levels.

While ENAP's long-term financial leverage target of debt/EBITDA of 2.5x is conservative, the company has limited opportunities to materially reduce its relatively high debt balances. Additionally, Moody's remains concerned that continued levels of high capital spending over the near to medium term could result in financial leverage remaining high. The company's current five-year plan,

which is subject to annual government review, calls for investments of over US\$1.5 billion over the next five years. However, we note that ENAP has already completed the lion's share of its required spending in order to meet Chile's stringent environmental regulations, providing the company with a degree of flexibility in its spending levels.

HIGH LEVEL OF GOVERNMENT SUPPORT EXHIBITED

ENAP's rating to a large degree reflects strong implicit support from the Chilean government and the strategic importance of ENAP to Chile's energy security. Historically, this has been tempered somewhat by a relatively high tax and dividend burden and price stabilization mechanisms. As a state-owned entity, ENAP pays a 40% special tax on income and on dividends received from subsidiaries, in addition to the 17% income tax normally paid by private Chilean companies. In addition, the company has historically distributed a substantial portion (based on a return on equity threshold) of its annual net income to the government in the form of dividends. We recognize that the government has made some concessions with respect to the flexibility of the dividend payout and that due to ENAP's recent weak financial results, taxes have been modest. Additionally, the government provided a US\$250 million capital injection to ENAP in 2008, representing the first time the state made a direct capital infusion into the company. While we view these actions as indicative of high government support, they have had only had a modest impact on the standalone credit profile of ENAP.

POOR CAPITAL EFFICIENCY IN UPSTREAM INVESTMENTS

Management has been increasing both domestic and international upstream investment levels in order to improve ENAP's poor reserve replacement record. There is a particular focus on reducing ENAP's dependence on crude oil imports from third parties and finding and developing domestic natural gas reserves to help offset the lack of natural gas imports from Argentina. Areas of key investment are Chile (in the Magallanes region), Argentina, Ecuador, and Egypt. Moody's expects that substantial capital investments will be required before ENAP will be able to demonstrate a material improvement in its production and reserve growth profile. It also notes that investments in international exploration and production could subject the company to technical, operational, and political risks due to the company's somewhat limited experience in oil and gas projects outside of Chile and Argentina. Nevertheless, these risks are partially mitigated by management's practice to enter into projects with partners.

FOREIGN EXCHANGE RISK PARTIALLY MITIGATED

Because a substantial portion of ENAP's operating expenses (including crude import costs) and its debt is denominated in foreign currency, devaluations of the Chilean peso could adversely affect its performance and increase its financing costs. However, the weekly indexation of all of the company's revenues from refined products to US currency through the import parity pricing mechanism offsets virtually all of the negative effects of a devaluation on its financial position. In addition, the company also has currency hedging programs in place to help mitigate foreign exchange risk.

Liquidity Profile

In the first quarter of 2009 ENAP used proceeds from a US\$66 million upstream asset divestiture and a US\$340 million ten-year unsecured bond issued in the Chilean market to repay short term debt balances incurred during 2008 as a result of high working capital needs and operating losses. Even then, ENAP's short term debt balances was still almost US\$840 million at the end of March 31, 2009 (including both short term bank debt and forfaiting balances). However, the recent refinancing of approximately \$600 million of short term debt via US\$300 million of long term bank debt and US\$300 million of notes has significantly reduced refinancing risk over the next two years. In addition, liquidity in 2009 should further benefit from management's intention to maintain capital spending within cash flow and the more frequent (monthly) transfers from FEPCO to ENAP, which should benefit the company's working capital needs. Budgeted capital expenditures for 2009 is US\$400 million with approximately US\$78 million spent in the first quarter.

We believe ENAP's cash flows will remain subject to the volatility and cyclicity of commodity prices, which during periods of high prices can result in substantial working capital needs. Furthermore, we expect the company's capital spending program will remain high over the medium term with over \$1.5 billion expected to spent over the next five years, which could pressure its liquidity profile. Supporting the company's liquidity profile are the benefits associated with its ownership by the Chilean state.

ENAP does not have access to committed lines of revolving credit and currently its short-term loans are not subject to financial covenants. The company does not have any significant long-term debt maturities until 2012.

Rating Outlook

The stable rating outlook reflects our expectation that ENAP's financial performance over the near to medium term is likely to improve from 2008 levels as a result of its investment initiatives, the expectation of reduced diesel demand from recent record levels and reduced working capital needs.

What Could Change the Rating - Up

While a rating upgrade is unlikely over the near-term given the very weak 2008 operating results and the substantial capital expenditure program, a sustained improvement in ENAP's operating performance and financial leverage could result in positive rating momentum over the medium-term.

What Could Change the Rating - Down

The baseline credit assessment and the A3 rating could be pressured if ENAP is unable to improve its financial performance from 2008's very weak levels. The A3 rating could also be pressured by a deterioration in the government of Chile's willingness to provide credit support to ENAP in a distress situation.

Other Considerations

GRID IMPLIED RATING

ENAP maps to the Ba range under Moody's Global Independent Refining and Marketing rating methodology. We primarily analyze ENAP's baseline credit assessment within a peer group of independent refining and marketing companies, as this segment accounts for most of the company's capital employed. However, we also recognize that the company's upstream operations provide a degree of operational integration and diversification benefits to the consolidated entity. ENAP's final rating outcome of A3 also reflects the high level of implied government support.



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