FitchRatings

FITCH RATINGS AFFIRMS PEMEX AT 'BBB-'

Fitch Ratings-Chicago-07 December 2005: Fitch Ratings has affirmed the foreign currency rating of Petroleos Mexicanos (PEMEX) at 'BBB-' and the local currency rating at 'BBB'. In addition, Fitch has affirmed the national scale rating of 'AAA(mex)'. The Rating Outlook for all is Stable.

The ratings affirmation reflects the company's solid pretax financial and export-oriented operating profile, an attractive upstream cost structure, its fiscal importance to the sovereign, and its dominant domestic market position. The rating also reflects PEMEX's significant debt levels, sizable but declining proven hydrocarbon reserves, substantial tax burden, low net worth position, large capital investment requirements, and exposure to political interference risk. PEMEX's foreign currency rating remains linked with the credit profile of the United Mexican States (UMS), which has been upgraded by Fitch to 'BBB' on an international foreign currency basis. The differentiation of PEMEX's international ratings from those of the UMS stems from PEMEX's weakening stand-alone operating profile, related to a large yet still insufficient investment program to maintain its reserve base due to government imposed funding constraints, and significantly increased debt, which carries no explicit government guarantees. Without changes to the corporate governance structure of PEMEX or further energy sector reform, Fitch believes PEMEX may have difficulty achieving its long-term exploration, development, and production targets.

Over the past several years, there has been a shifting of debt from the sovereign to PEMEX as Pemex's substantial tax burden relative to revenues has forced the company to seek external funding for an aggressive capital investment budget. Under the current tax scheme, which will be changed for the coming years, PEMEX's tax payments amount to 60.8% of its revenues. This has siphoned off cash flow that could otherwise be used to support the company's investment program. As a result, the company has dramatically increased debt levels in recent years, even during the rising oil price environment, while equity has been declining. Total debt at Sept. 30, 2005 was MXP518 billion (US$48 billion), up more than 200% from MXP165 billion (US$17.4 billion) in December 1999. Given the increase in the effective tax rate on PEMEX as oil prices have risen, a relatively low portion of the oil price windfall has been reinvested in the oil sector through PEMEX.

In a positive move, the Mexican Congress recently approved a new fiscal regime for PEMEX that should somewhat help improve the company's financial condition, support increased investment, and modestly strengthen its competitive position. The new fiscal regime's variable duties are designed to provide PEMEX with realized savings regardless of the price of crude (ie, different values of crude are taxed at variable rates). PEMEX management estimates tax reduction savings of US$1 billion-$2 billion in the first year and an average of US$3 billion-$4 billion in annual savings over the first five years. These savings should allow the company to finance a portion of its large capital expenditure program with internally generated funds. The company is likely to continue utilizing third-party financing to increase debt levels given expected annual capital investment of approximately US$10 billion-US$13 billion. A substantial portion of these investments is to maintain production, while the reserve base should continue to decline.

While the change in PEMEX's fiscal regime is positive, there are still significant reforms that need to be made in the energy sector. The larger concerns are the need for changes in corporate governance, increased autonomy, and an ability to enter into joint ventures and partnerships. PEMEX suffers from numerous inefficiencies and very high administrative and operating costs reflecting a lack of transparency and accountability in the management process. PEMEX also remains subject to government approval of investment plans and strategies, as its budget is part of the federal budget, thus limiting the company's ability to affect its business development. In order to reduce the effect of these inefficiencies on PEMEX's operations and financial results, a movement toward best practices in corporate governance has been sought. Such changes were linked to the fiscal regime sent by President Fox back to the congress in September 2005, but these provisions have been eliminated from the most recent version due to political opposition. As mentioned previously, Fitch believes PEMEX may have difficulty achieving its long-term exploration, development, and production targets absent additional reform.

PEMEX's stand-alone financial measures, such as debt-to-EBITDA of 0.9 times (x) and EBITDA-to-interest of 10.3x through September 2005, are consistent with other investment-grade energy companies. However, the company's other operating statistics, particularly its hydrocarbon reserve measures, are moving in a negative direction and opposite to the other major integrated players. PEMEX's average reserve replacement rate over the last three years was only 22% of production. Offsetting this trend continues to be one of management's key long-term strategic objectives. Reserve replacement should increase in the coming years as the company undertakes certain development projects, specifically in the Ku-Maloob-Zaap fields. Still, reserve replacement remains low despite a significant increase in capital expenditures to approximately US$10 billion in 2003.

Recently, PEMEX has maintained an ambitious investment strategy, but has not been as successful in achieving its targets in light of underinvestment in crude and natural gas production due to capital constraints. Going forward, certain exploration and development opportunities (primarily deepwater) are likely to require participation by third parties in the form of technical expertise and/or capital, yet constitutional provisions prohibit third-party participation at this time.

PEMEX's upstream expenditures should be sufficient to maintain and slightly improve production over the near and medium term although continued declines in the company's reserve base could ultimately begin to affect production levels over the medium to long term. PEMEX has not been able to translate higher international oil prices into increased investment or debt reduction, two common elements found throughout the international energy sector, which highlights concerns regarding the achievement of prospective long-term operating targets. Energy sector reform or changes in PEMEX's corporate governance may allow PEMEX to more ably meet its long-term growth strategy, self-finance the majority of its projects, possibly a portion with partners, and support the company's ability to meet the energy needs of Mexico.

PEMEX is Mexico's state oil and natural gas company. It is the nation's largest company and ranks among the world's largest petroleum enterprises, with year-end 2004 proved oil and gas reserves of 17.6 billion barrels of crude oil equivalent (BOE), compared to 18.9 billion BOE in 2003, and mean annual production of 3.3 million BOE per day through September 2005.

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