

PETROBRAS ENERGIA PARTICIPACIONES SA

Form 20-F

June 30, 2005

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As filed with the Securities and Exchange Commission on June 30, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 20-F**

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**ANNUAL REPORT PURSUANT TO SECTION 13**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended: December 31, 2004

Commission file number 333-11130

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**PETROBRAS ENERGÍA PARTICIPACIONES S.A.**

(Exact name of Registrant as specified in its charter)

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N/A  
(Translation of Registrant's name into English)

REPUBLIC OF ARGENTINA  
(Jurisdiction of incorporation of organization)

Maipú 1, 22<sup>nd</sup> Floor

(C1084ABA) Buenos Aires

Argentina

(Address of principal executive offices)

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**Securities registered or to be registered pursuant to Section 12(b) of the Act:**

<u>Title of each Class</u>	<u>Name of Each Exchange On Which Registered</u>
American Depositary Shares, each representing 10 Class B shares	New York Stock Exchange

**Securities registered or to be registered pursuant to Section 12(g) of the Act: None**

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None**

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The number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2004 was:

Class B ordinary shares, par value P\$1.00 per share	2,132,043,387
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days:

Yes  No

Indicate by check mark which financial statement item the Registrant has elected to follow:

Item 17  Item 18



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**INTRODUCTION**

All references in this annual report to:

Petrobras Energía Participaciones, we, us, our, and similar terms refer to Petrobras Energía Participaciones S.A. and its subsidiaries, but excludes affiliates and companies under joint control. Prior to July 2003, our corporate name was Perez Companc S.A.

Petrobras Energía refers to Petrobras Energía S.A., a subsidiary of Petrobras Energía Participaciones together with its controlled subsidiaries, but excludes affiliates and companies under joint control. Prior to July 2003, the corporate name of Petrobras Energía was Pecom Energía S.A. See Item 4. Information About the Company Our History and Development.

Petrobras refers to Petróleo Brasileiro S.A. PETROBRAS.

Argentine pesos , pesos or P\$ refer to the currency of the Republic of Argentina.

US dollars or US\$ refer to the currency of the United States of America.

**FORWARD-LOOKING STATEMENTS**

Some of the information included in this annual report contains information that is forward looking, including statements regarding capital expenditures, competition and sales, oil and gas reserves and prospects and trends in the oil and gas, refining, petrochemicals and electricity industries.

Certain statements contained in this annual report are forward-looking statements and are not based on historical fact, such as statements containing the words believe, may, will, estimate, continue, anticipate, intend, expect and similar words. These forward-looking statements are subject to risks, uncertainties and assumptions, including those discussed in Item 3. Key Information Risk Factors and elsewhere in this annual report. Factors that could cause actual results to differ materially and adversely include, but are not limited to:

Changes in general economic, business, political or other conditions in Argentina or changes in general economic or business conditions in other Latin America countries;

The availability of financing at reasonable terms to Argentine companies, such as us;

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The failure of governmental authorities to approve proposed measures or transactions described in this annual report;

Changes in the price of hydrocarbons;

Changes to our capital expenditure plans;

Changes in laws or regulations affecting our operations;

Increased costs; and

Other factors discussed under "Risk Factors" in Item 3 of this annual report.

We believe that our estimates are reasonable, but you should not unduly rely on these estimates, which are based on our current expectations. We undertake no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict all of these factors. Further, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to be materially different from those contained in any forward-looking statements.

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**Item 1-2. NOT APPLICABLE**

**Item 3. KEY INFORMATION**

**SELECTED FINANCIAL DATA**

The financial information set forth below may not contain all of the financial information that you should consider when making an investment decision. This information should be read in conjunction with, and is qualified in its entirety by reference to, the Risk Factors included in this annual report. See Risk Factors. You should also carefully read our financial statements and Item 5. Operating and Financial Review and Prospects included in this annual report for additional financial information about us.

Our consolidated financial statements are prepared in accordance with regulations of the National Securities Commission (*Comisión Nacional de Valores*), which we refer to as the CNV, and, except for the matters described in note 3 to our consolidated financial statements, with generally accepted accounting principles in Argentina (as approved by the Professional Council of Economic Sciences of the City of Buenos Aires, or CPCECABA), which we refer to as Argentine GAAP. Argentine GAAP differs in certain significant respects from generally accepted accounting principles in the United States, which we refer to as U.S. GAAP. Note 22 to our financial statements provides a description of the principal differences between Argentine GAAP and U.S. GAAP as they relate to us, and note 23 provides a reconciliation to U.S. GAAP of net income, shareholders' equity and certain other selected financial data.

We are a holding company whose only asset as of December 31, 2004 is our 98.21% equity interest in Petrobras Energía. Our interest in Petrobras Energía is expected to decrease to 75.82% as a result of the merger of certain companies controlled by Petrobras into Petrobras Energía, which is further described in Item 4. Information About the Company Our History and Development The Petrobras Energía Merger. We were initially organized as a result of a spinoff of Petrobras Energía shares by Sudacia S.A., effective July 1, 1998. We acquired control of Petrobras Energía on January 25, 2000 as a result of the completion of an exchange offer of our Class B shares for 69.29% of Petrobras Energía's outstanding common stock. Prior to January 25, 2000, our only asset was a minority interest in Petrobras Energía.

Our selected financial data relating to the fiscal years ended December 31, 2004, 2003 and 2002 set forth below have been derived from our financial statements included in this annual report. Selected financial data for the fiscal years ended December 31, 2000 has not been restated to reflect the changes in Argentine GAAP, and accordingly is not comparable to the financial data for the fiscal years ended December 31, 2004, 2003, 2002 and 2001. Argentine law does not require that we restate these financial statements and any such restatement cannot be prepared without unreasonable effort or expense.

*Presentation of figures in constant Argentine pesos*

Due to the inflationary environment in Argentina in 2002, there was a 118.2% increase in the applicable wholesale price index used in the restatement of our financial statement from the period of January 1, through December 31, 2002, the CPCECABA approved on March 6, 2002 Resolution MD No. 3/02 applicable to financial statements for fiscal years or interim periods ending on or after March 31, 2002. Resolution MD No. 3/02 required the reinstatement of the adjustment-for-inflation method of accounting in financial statements.

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On July 16, 2002, the Argentine government issued Decree No. 1,269/02 instructing the CNV and other regulatory authorities to issue the necessary regulations for the delivery to such authorities of financial statements prepared in constant currency. On July 25, 2002, under Resolution No. 415/02, the CNV reinstated the requirement to submit financial statements in constant currency. As the inflation rate stabilized, on March 25, 2003, Decree No. 664/03 rescinded the requirement that financial statements be prepared in constant currency. On April 8, 2003, the CNV issued Resolution No. 441/03 discontinuing inflation accounting as of March 1, 2003. This method was not in accordance with professional accounting standards effective in the city of Buenos Aires. The CPCECABA, through Resolution No. 287/03 discontinued the application of the restatement method as from October 1, 2003.



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In accordance with the above, for comparative purposes, our financial statements for the fiscal years ended December 31, 2002 were restated in constant pesos as of February 28, 2003, based on changes in the Argentine wholesale price index or the wholesale price index published by the National Institute of Statistics and Census (*Instituto Nacional de Estadísticas y Censos*), which we refer to as the INDEC. This price index does not reflect any specific variation in the price of products and services sold by us, and, therefore, variations in gains (losses) for both periods include positive or negative price variations that may be higher or lower than the price variations for the products or services sold by us. The selected financial data for the fiscal years ended December 31, 2001 and 2000 has also been restated in constant pesos as of February 28, 2003.

### *Proportional consolidation of companies under which we exercise joint control*

In accordance with the procedure set forth in Technical Resolutions Nos. 4 and 19 of the Argentine Federation of Professional Councils in Economic Science, or FACPCE, we have consolidated line by line on a proportional basis our financial statements with the companies in which we exercise joint control (other than Compañía Inversora en Transmisión Eléctrica Citelec S.A., or Citelec) in our financial statements. See Item 5. Operating and Financial Review and Prospects Proportional Consolidation and Presentation of Discussion. In the consolidation of companies over which we exercise joint control, the amount of the investment in the companies under joint control and the interest in their income (loss) and cash flows are replaced by our proportional interest in the subsidiaries' assets, liabilities and income (loss) and cash flows. In addition, related party receivables, payables and transactions within the consolidated group and companies under joint control are eliminated on a pro rata basis pursuant to our ownership share in that company.

### *Presentation of information related to income (loss) per share*

Our net income per share under Argentine and U.S. GAAP was calculated as follows:

diluted net income per share was calculated by dividing net income by the average number of shares outstanding during each year (assuming all Class A shares are converted into Class B shares);

for 2004, 2003 and 2002, net income per share was calculated by dividing net income by the average number of shares outstanding during each year (as of October 2002, all outstanding Class A shares were converted into Class B shares);

for 2001 and 2000, basic net income per Class A share was calculated by dividing net income by the sum of (1) the average number of Class A shares outstanding during 2001 and 2000, respectively, and (2) the average number of Class B shares outstanding during 2001 and 2000, respectively, multiplied by 1.5; and

for 2001 and 2000, basic net income per Class B share was calculated by multiplying (a) the quotient attained by dividing net income by the sum of (1) the average number of Class A shares outstanding during 2001 and 2000, respectively, and (2) the average number of Class B shares outstanding during 2001 and 2000, respectively, multiplied by 1.5 (b) by 1.5.

Our basic net income per share for the fiscal years 2001 and 2000 was calculated in the manner described above because Class B shares were entitled to dividends equal to 150% of dividends that were paid with respect to Class A shares.

### *U.S. GAAP Reconciliation*

Neither the effects of inflation accounting nor the proportional consolidation of Distriec Inversora S.A., a company under joint control which we refer to as Distriec, under Argentine GAAP have been reversed in the reconciliation to U.S. GAAP.

The proportional consolidation of Compañía de Inversiones de Energía S.A., which we refer to as CIESA, another company under joint control, in 2003 and 2004 under Argentine GAAP has been reversed in the reconciliation to U.S. GAAP. This reversal was a result of (1) CIESA having negative shareholders equity for the years-ended 2003 and 2004 for purposes of U.S. GAAP, and (2) our not having assumed commitments to make capital contribution or to provide financial assistance to CIESA, which caused our interests in CIESA to be valued at zero.

**Table of Contents****Income Statement Data**

	Year Ended December 31,				
	2004	2003	2002 <sup>(1)</sup>	2001 <sup>(1)</sup>	2000 <sup>(1)(2)</sup>
	(in millions of pesos, except for per share amounts and share capital or as otherwise indicated)				
<b>Income Statement Data</b>					
<b>Argentine GAAP:</b>					
Net sales	6,974	5,494	5,106	5,170	3,185
Cost of sales	(4,210)	(3,386)	(3,284)	(3,347)	(2,161)
Gross profit	2,764	2,108	1,822	1,823	1,024
Administrative and selling expenses	(640)	(559)	(609)	(665)	(385)
Exploration expenses	(89)	(196)	(58)	(41)	(13)
Other operating (expense) income, net	(304)	(121)	(28)	23	22
Operating income	1,731	1,232	1,127	1,140	648
Equity in earnings of affiliates	76	163	(638)	119	189
Financial income (expense) and holding gains (losses)	(1,261)	(417)	(1,827)	(573)	(325)
Other (expense) income, net	(27)	(421)	(187)	(88)	132
Income (loss) before income tax and minority interest in subsidiaries	519	557	(1,525)	598	644
Income tax provision	198	(18)	(82)	(385)	(41)
Minority interest in subsidiaries	(39)	(158)	28	(112)	(15)
Net income (loss)	678	381	(1,579)	101	588
Basic net (loss) income per share:					
Class A <sup>(3)</sup>				0.035	0.215
Class B	0.319	0.179	(0.744)	0.053	0.322
Diluted net (loss) income per share	0.319	0.179	(0.744)	0.047	0.288
Number of shares outstanding (in millions):					
Class A <sup>(3)</sup>				628	628
Class B	2,132	2,132	2,132	1,504	1,504
<b>U.S. GAAP:</b>					
Net sales	6,562	5,078	5,182	4,630	3,343
Operating income	1,408	622	830	853	864
Income (loss) from continuing operations <sup>(4)</sup>	760	109	(1,868)	(2,254)	286
Income (loss) from discontinued operations		(39)	135	12	38
Cumulative effect of changes in accounting principles		30	179		
Net income (loss) <sup>(5)</sup>	760	100	(1,554)	(2,266)	324
Basic net (loss) income per share:					
Class A <sup>(3)</sup>				(0.786)	0.119
Class B	0.356	0.047	(0.729)	(1.179)	0.178
Diluted net (loss) income per share	0.356	0.047	(0.729)	(1.063)	0.157
Basic net (loss) income per share:					
Class A <sup>(3)</sup>					
Continuing operations				(0.782)	0.105
Discontinued operations				(0.004)	0.014
Class B					
Continuing operations	0.356	0.051	(0.876)	(1.172)	0.157

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Discontinued operations	(0.018)	0.063	(0.006)	0.021
Cumulative effect of changes in accounting principles	0.014	0.084		

- (1) Expressed in constant pesos as of February 28, 2003, except share capital.
- (2) Selected financial data for the fiscal year ended December 31, 2000 has not been restated to reflect changes in Argentine GAAP, which have been effective since January 2003, and accordingly are not comparable to the financial data for the fiscal years ended December 31, 2004, 2003, 2002 and 2001.
- (3) As of October 2002, there are no Class A shares outstanding.
- (4) After minority interest in subsidiaries and income tax (expense) benefit.
- (5) We have applied SFAS No. 142, Goodwill and Other Intangible Assets, effective as of January 1, 2002, and SFAS No. 143, Accounting for Asset Retirement Obligations, effective as of January 1, 2003. If the new standards had been effective and applied before January 1, 2001, net income (loss) for the years ended December 31, 2003, 2002 and 2001, would have been P\$70 million, P\$(1,723) million and P\$(2,265) million, respectively.

**Table of Contents****Balance Sheet Data**

	Year Ended December 31,				
	2004	2003	2002 <sup>(1)</sup>	2001 <sup>(1)</sup>	2000 <sup>(1)(2)</sup>
(in millions of pesos, except for per share amounts and share capital or as otherwise indicated)					
<b>Argentine GAAP:</b>					
<b>Consolidated Balance Sheet</b>					
<b>Assets</b>					
<b>Current assets</b>					
Cash	128	153	93	98	59
Investments	790	802	664	1,254	543
Trade receivables	1,210	886	784	1,108	908
Other receivables	629	861	734	397	470
Inventories	487	319	356	346	374
Other assets	1	3	178		
<b>Total current assets</b>	<b>3,245</b>	<b>3,024</b>	<b>2,809</b>	<b>3,203</b>	<b>2,354</b>
<b>Non-current assets</b>					
Trade receivables	39	36	21	21	7
Other receivables	648	131	220	370	162
Inventories	56	61	39	240	205
Investments	1,323	1,284	1,103	1,341	2,750
Property, plant and equipment	11,280	11,559	10,433	11,633	6,572
Other assets	19	43	24	63	11
<b>Total non-current assets</b>	<b>13,365</b>	<b>13,114</b>	<b>11,840</b>	<b>13,668</b>	<b>9,707</b>
<b>Total assets</b>	<b>16,610</b>	<b>16,138</b>	<b>14,649</b>	<b>16,871</b>	<b>12,061</b>
<b>Liabilities</b>					
<b>Current liabilities</b>					
Accounts payable	893	860	651	852	547
Short-term debt	1,652	3,204	1,543	3,501	1,625
Payroll and social security taxes	90	93	76	99	75
Taxes payable	163	172	133	145	138
Other current liabilities	686	423	372	563	97
<b>Total current liabilities</b>	<b>3,484</b>	<b>4,752</b>	<b>2,775</b>	<b>5,160</b>	<b>2,482</b>
<b>Non-current liabilities</b>					
Accounts payable	26	7	9	4	20
Long-term debt	6,248	5,098	6,130	4,114	3,100
Other liabilities	313	279	641	368	303
Reserves	71	277	86	61	55
<b>Total non-current liabilities</b>	<b>6,658</b>	<b>5,661</b>	<b>6,866</b>	<b>4,547</b>	<b>3,478</b>
<b>Total liabilities</b>	<b>10,142</b>	<b>10,413</b>	<b>9,641</b>	<b>9,707</b>	<b>5,960</b>

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<b>Transitory differences</b>					
Measurement of derivative financial instruments designated as effective hedge	(2)	(18)			
Foreign currency translation	(47)	(56)			
Total transitory differences	(49)	(74)			
<b>Minority interest in subsidiaries</b>	1,006	966	556	1,133	149
<b>Total Shareholders Equity</b>	5,511	4,833	4,452	6,031	5,953
Total liabilities and shareholders equity	16,610	16,138	14,649	16,871	12,062
<hr/>					
Capital Stock	2,132	2,132	2,132	2,132	2,132
<hr/>					
<b>Dividends<sup>(3)</sup></b>					
Per Class A share					0.0208
Per Class B share					0.0317
<b>U.S. GAAP:</b>					
Total assets	15,015	14,508	16,108	20,264	15,794
Shareholders equity	5,286	4,523	4,499	6,403	8,406

(1) Expressed in constant pesos as of February 28, 2003, except share capital.

(2) Selected financial data for the fiscal year ended December 31, 2000 has not been restated to reflect changes in Argentine GAAP, which have been effective since January 2003, and accordingly are not comparable to the financial data for the fiscal years ended December 31, 2004, 2003, 2002 and 2001.

(3) Dividends declared in 2000 as expressed in U.S. dollars would equal amounts in historical pesos since the exchange rate between the peso and the US dollar was fixed at a one to one ratio during those years in accordance with the Convertibility Law. See Exchange Rates.

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**EXCHANGE RATES**

Prior to December 1989, the Argentine foreign exchange market was subject to exchange controls. Between April 1, 1991, when Law No. 23,928 and Decree No. 529/91 (together referred to as the Convertibility Law) became effective, and January 5, 2002, pesos were freely convertible into US dollars at a fixed one-to-one exchange rate. Pursuant to the Convertibility Law, the Central Bank of Argentina, which we refer to as the Central Bank, had to (1) maintain a reserve in foreign currencies, gold and certain public bonds denominated in foreign currency equal to the amount of outstanding Argentine currency and (2) sell US dollars to any requesting person at a fixed US\$1.00 to P\$1.00 exchange rate. In addition, on January 12, 1995, the Central Bank issued Communication A 2298 which provided that all exchange transactions made with the Central Bank also had to be made at a fixed US\$1.00 to P\$1.00 exchange rate.

On January 6, 2002, the Argentine Congress passed the Public Emergency and Foreign Exchange System Reform Law No. 25,561, which superseded certain provisions of the Convertibility Law, including the fixed one-to-one exchange rate, and which we refer to as the Public Emergency Law. This law granted the federal executive branch the power to set the exchange rate between the peso and foreign currencies and to issue regulations related to the foreign exchange market. On January 6, 2002, the executive branch established a temporary dual exchange rate system. As of February 11, 2002, a single and free exchange market has been established for all exchange transactions. Within this new exchange regime and for the purpose of supporting the peso exchange rate, the Central Bank intervened several times in the exchange market by selling US dollars.

In light of a growing demand for US dollars during the six months ended June 30, 2002 and the shortage of US dollars available to satisfy this demand, the Argentine government adopted a series of measures to mitigate the demand for US dollars and increase its US dollar reserve base. As a result, (1) the export sector has had to exchange on a daily basis its non-Argentine currency into Argentine pesos through the Central Bank, (2) new restrictions on the transfer of funds abroad were implemented, (3) the purchase of foreign exchange was limited and (4) requirements relating to the purchase of foreign currency from banks and exchange agencies became more stringent. Under these guidelines, the demand from private parties for US dollars significantly declined and the Central Bank gradually started to accumulate US dollar reserves. Towards the end of 2002, the Argentine government implemented different measures aimed at stimulating the economy and abrogating certain restrictions in order to gradually normalize the foreign exchange market and the commercial and financial flow of foreign currency.

In 2003, the balance of trade yielded a strong surplus, which, together with the continuing default in partial foreign debt payments by the government declared at the end of 2001, caused an excess supply of foreign currency. As a result, the peso appreciated significantly against the US dollar during 2003. Only numerous currency purchases by the Central Bank, supported by the explicit intention of the Argentine government to maintain a high rate of exchange, prevented greater appreciation of the Argentine peso against the US dollar. In addition, on June 26, 2003, through Decree No. 285, the government fixed the minimum period that currencies may enter the country with speculative purposes at 180 days in order to avoid volatility in the exchange rate.

In 2004, the peso was relatively stable, again supported by the government's explicit position in favor of a high exchange rate. To such respect, the Central Bank's intervention in the exchange market steadily increased due to an ongoing excess supply of foreign currency, again determined both by a still wide but contracting trade balance surplus and the continuation of the partial default on the sovereign external debt, and, to a lesser extent, due to foreign capital inflows. The trade balance evidenced a new surplus, although not as sizable as the previous year due to the increase in imports. In an effort to maintain the rate of exchange at about P\$3 to US\$1 by the end of 2004 purchases by the Central Bank achieved record levels of approximately US\$100 million per day, totaling approximately US\$1,400 million during December 2004. During the course of 2005, purchases by the Central Bank have remained at similar levels, totaling US\$1,500 million during May 2005. In addition, on May 24, 2005, through Resolution No. 292/05, the government extended the minimum period for which currencies may enter the country with speculative purposes from 180 to 365 days, as an additional measure to mitigate the volatility of the exchange rate.

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On June 9, 2005, the federal executive branch issued Executive Order 616/05. As a result of this executive order any cash inflow to the domestic market derived from foreign loans to the Argentine private sector shall have a maturity for repayment of at least 365 days as from the date of inflow of cash. In addition, 30% of the amount shall be deposited with domestic financial institutions. This deposit must be (1) registered, (2) non-transferable, (3) non-interest bearing, (4) made in US dollars, (5) have a term of 365 days and (6) cannot be used as security or collateral



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in connection with other credit transactions. Export and import financing operations, as well as, primary public offerings of debt securities listed on self-regulated markets are exempt from the foregoing provisions. See Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Changes to Exchange Market Regulations.

The following table sets forth, for the periods indicated, the high, low, average and period end exchange rates for the purchase of US dollars, expressed in nominal pesos per US dollar. The Federal Reserve Bank of New York does not report a noon buying rate for pesos.

	Exchange Rate			
	High	Low	Average <sup>(1)</sup>	Period End
	(in pesos)			
<b>Year Ended December 31,</b>				
2000	1.00	1.00	1.00	1.00
2001	1.00	1.00	1.00	1.00
2002	3.90	1.60	3.14	3.38
2003	3.37	2.73	2.95	2.94
2004	2.99	2.94	2.97	2.98
<b>Most Recent Six Months:</b>				
December, 2004 <sup>(2)</sup>	2.99	2.94	2.97	2.98
January, 2005 <sup>(2)</sup>	2.97	2.92	2.95	2.92
February, 2005 <sup>(2)</sup>	2.94	2.89	2.92	2.94
March, 2005 <sup>(2)</sup>	2.96	2.91	2.93	2.92
April, 2005 <sup>(2)</sup>	2.92	2.88	2.90	2.91
May, 2005 <sup>(2)</sup>	2.91	2.88	2.89	2.88
June, 2005 <sup>(2)(3)</sup>	2.90	2.87	2.88	2.87

<sup>(1)</sup> Based on monthly average exchange rates.

<sup>(2)</sup> Source: Banco de la Nación Argentina.

<sup>(3)</sup> Through June 21, 2005.

On June 21, 2005, the exchange rate for the purchase of US dollars published by Banco de la Nación Argentina was P\$2.87 per US dollar.

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**RISK FACTORS**

**Factors Relating to Argentina**

*Recent political and economic instability in Argentina has and may continue to adversely affect our financial condition and results of operations.*

We are an Argentine corporation (*sociedad anónima*). As of December 31, 2004, approximately 55% of our total assets, 61% of our net sales, 53% of our combined crude oil and gas production and 36% of our proved oil and gas reserves were located in Argentina. Fluctuations in the Argentine economy and government actions adopted by the Argentine government have had and will continue to have a significant effect on Argentine private sector entities, including us. Specifically, we have been affected and might be affected by inflation, interest rates, the value of the peso against foreign currencies, price controls, regulatory policies, business regulations, tax regulations and in general by the political, social and economic scenario in and affecting Argentina.

The Argentine economy has experienced significant volatility in recent decades, characterized by periods of low or negative growth and high and variable levels of inflation and currency devaluation. Following a seven-year period (1991-1997) of economic growth and monetary stability, starting in the fourth quarter of 1998, the Argentine economy entered into a severe recession, with gross domestic product declining by 3.4% in 1999, 0.8% in 2000 and 4.4% in 2001. Beginning in the second half of 2001, Argentina's recession significantly worsened. As the public sector's creditworthiness deteriorated, interest rates reached record highs, bringing the economy to a virtual standstill. The lack of confidence in the country's economic future and its inability to sustain the peso's parity with the US dollar led to massive withdrawals of deposits from banks and capital outflows and Argentina experienced significant social and political instability. As a response, the government adopted a series of measures, including monetary and exchange control measures.

In January 2002, the government enacted the most important of these measures, the Public Emergency Law, which granted broad economic, financial and monetary powers to the executive branch and ended the US dollar-peso parity established in 1991. In accordance with this law, the federal executive branch implemented a number of far-reaching initiatives, including, but not limited to the following:

The pesification of certain assets and liabilities denominated in foreign currency and held in the country;

An amendment to the charter of the Central Bank authorizing it to (1) issue money in excess of the foreign currency reserves, (2) grant short-term loans to the federal government and (3) provide financial assistance to financial institutions with liquidity or solvency problems;

The pesification and elimination of indexing clauses on utility rates, fixing those rates in pesos at a P\$1=US\$1 exchange rate; and

The implementation of taxes on hydrocarbon exports and certain oil by-products.

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As a result of these measures, commercial and financial activities were virtually paralyzed in 2002, further aggravating the economic recession, which included a 10.9% decline in GDP in 2002. In addition, there was a significant devaluation of the peso and increased inflation.

The crisis had significant and adverse consequences on our company, including (1) losses derived from the effects of peso devaluation on our and our affiliate's net borrowing position, which was primarily denominated in US dollars, (2) the impairment of the book value of certain gas areas and tax credits due to material changes in the prospects of our operations, (3) a decrease in US dollar cash flows due the imposition of export taxes, (4) limits on our ability to renew our short-term lines of credit and the current portion of our medium and long-term financings at maturity and (5) restrictions on our ability to pass through the effects of inflation to the prices of products sold by us in the domestic market. In 2002, we reported a net loss of P\$1,579 million compared to income of P\$101 million in 2001, which was a significant departure from the historical evolution of our results. In order to secure compliance

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with our financial commitments, we implemented a plan, which focused on refinancing a substantial portion of our debt and significantly reduced our investments plan. As a result, capital expenditures in 2002, net of divestments, totaled only P\$139 million, a relatively low amount compared to our historical average investment. The Argentine economy and social and political environments have experienced improvements since 2002 and the Argentine government has eased certain regulations and taken measures to effectively stimulate the economy. There are, however, important unresolved issues (such as the treatment and position of holdout bondholders that declined to participate in Argentina's voluntary debt exchange, the renegotiation of utility contracts, arrangements between the Argentine government and the International Monetary Fund, or IMF) that if not addressed satisfactorily could derail the recovery, which, in turn, could affect our business. See Item 4. Information About the Company Business Overview Our Principal Market.

Further, Argentine government actions concerning the economy in response to the crisis, including with respect to inflation, interest rates, price controls, foreign exchange controls and taxes, have had, and may continue to have, a material adverse effect on private sector entities, including us. We cannot provide any assurance that future economic, social and political developments in Argentina, over which we have no control, will not adversely affect our business, financial condition, or results of operations.

### ***The lack of financing alternatives may impact the execution of our strategic business plan.***

After the default on the Argentine sovereign debt, Argentine companies have had significantly fewer opportunities to access the international credit markets. Non-Argentine financial markets and institutions are reluctant to lend additional capital and grant loans to Argentine entities and companies.

The prospects for all Argentine companies, including us, of accessing financial markets in the near or medium-term continue to be challenging. If we are unable to have access to the international financial markets to refinance our indebtedness at reasonable cost, we may have to reduce our projected capital expenditures, which, in turn, may affect the implementation of our strategic business plan.

### ***Fluctuations in the value of the peso create greater uncertainty as to Argentina's economic future and may adversely affect our financial condition and result of operations.***

The peso has been subject to large devaluations in the past and may be subject to significant fluctuations in the future. Since the end of the US dollar-peso parity, the peso has fluctuated significantly. As a result, the Central Bank has taken several measures to stabilize the exchange rate and preserve its reserves. At December 31, 2002, the exchange rate was P\$3.38 per US dollar, at December 31, 2003, the exchange rate was P\$2.94 per US dollar and, at December 31, 2004, the exchange rate was P\$2.98 per US dollar. As of June 21, 2005, the peso/US dollar exchange rate was P\$2.87 per US dollar, as published by Banco de la Nación Argentina. See Exchange Rates. Devaluation of the peso could create additional inflationary pressures. On the other hand, appreciation of the peso against the US dollar may lead to a deterioration of the country's current account and the balance of payments.

The marked peso devaluation during 2002 adversely affected our results and financial position. Substantially all of our financial debt and a significant portion of our affiliates' debt were denominated in US dollars. Before the enactment of the Public Emergency Law, our cash flow, usually denominated in US dollars or dollar-adjusted, provided a natural hedge against exchange rate risks. The Argentine regulatory framework after the enactment of the Public Emergency Law (which included the pesification of utility rates, regulatory issues related to the renegotiation of pesified utility rates, new taxes on hydrocarbon exports and the implementation of regulations to prevent an increase in prices to final users in the domestic market), however, limited our ability to mitigate the impact of the peso devaluation.

Given the continuing uncertainty regarding Argentina's medium and long-term economic prospects, it is impossible to predict whether, and to what extent, the value of the peso may further depreciate or appreciate against the US Dollar and how those uncertainties will affect the demand of our products and services. Moreover, we cannot assure you that the Argentine government will not adopt new regulations or make regulatory changes that prevent or limit us from offsetting the risk derived from our exposure to the US dollar and, if so, what impact these changes will have on our financial condition and results of operation.

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***Inflation may escalate and undermine economic growth in Argentina and adversely affect our financial condition and results of operations.***

In the past, inflation has materially undermined the Argentine economy and the government's ability to stimulate economic growth. During 2002, the Argentine consumer price index increased by 41%, and the wholesale price index increased by 118.2%.

In 2003, inflation decelerated sharply, and the consumer and wholesale price indices for 2003 were 3.7% and 2.0%, respectively. The strong recovery of domestic demand caused an acceleration of retail inflation in 2004, with the consumer price index increasing by 6.1%. Wholesale inflation in 2004 also showed clear signs of acceleration driven by the pace of economic growth. The wholesale price index increased by 7.9% during 2004, with a significant rise in prices for manufactured products, energy and mineral products and, to a lesser extent, imported products. Increases in these items are in contrast with the slight rise in the price of the remaining primary products. The variability of inflation in Argentina makes it impossible to estimate with a reasonable degree of certainty how our activities and results of operations will be affected in the future.

In 2003 and 2004 there was a slowdown in the inflation indexes as compared to 2002. We, however, cannot assure you that this situation will remain the same. There is considerable concern that significant inflation will result if the Central Bank prints currency to finance public-sector spending, assist financial institutions in distress or attempt to limit the future appreciation of the peso. Sustained inflation in Argentina, without a corresponding increase in the price of our products in the local market, would have a negative effect on our results of operations and financial position.

***Argentina has imposed exchange controls in recent periods and exchange controls may impair our ability to service our foreign currency-denominated debt obligations and to pay dividends.***

After December 2001, Argentine authorities implemented a number of monetary and currency exchange control measures that included restrictions on the withdrawal of funds deposited with banks and on foreign transfers, including restrictions relating to the servicing of foreign debt. The Central Bank has since issued a number of regulations aimed at gradually normalizing the domestic exchange market and, as a result, most restrictions in connection with the repayment of foreign creditors and the payment of dividends to foreign shareholders have been lifted.

We cannot assure you as to how long these more flexible regulations will be in effect or whether they will become more restrictive again in the future. If the Argentine government decides further to tighten its transfer restrictions, we may be unable to make principal or interest payments when they become due and/or we may be unable to pay dividends.

***Limits on exports of hydrocarbons have and may continue to lower our anticipated US dollar-denominated cash receipts.***

In recent periods, Argentina has faced difficulties in satisfying its domestic energy needs. As a result, the government has enacted a series of measures limiting the export of hydrocarbons. On May 23, 2002, the Argentine government enacted Decree No. 867/02 declaring a state of emergency in the supply of hydrocarbons in Argentina until September 30, 2002 and empowering the Secretary of Energy to determine the volume of crude oil and liquefied petroleum gas produced in Argentina that should be sold in the local market.

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In March 2004, the Secretary of Energy issued Resolution No. 265/04, which authorizes the imposition of limits on natural gas exports. This resolution instructs the Undersecretary of Fuels to create a program for the rationing of gas exports and for the regulation of the use of transportation capacity. Temporary limits on certain natural gas exports have been imposed under the program to avoid a crisis in the local supply of natural gas. See Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework Gas for further details. As of the date of this annual report, these measures have not had a material adverse effect on our results or financial condition, but we cannot assure you that this will be the case in the future.

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In April of 2004, in order to facilitate the recovery of gas prices, the Secretary of Energy entered into an agreement with natural gas producers requiring them to sell a specified amount of gas in the local regulated market for prices determined in accordance with a schedule of gradual increases in gas prices that culminates with the expected complete deregulation of wellhead prices for natural gas by January of 2007.

In addition, pursuant to Resolution 1679/04, which was passed in December 2004, producers must obtain the approval of the Argentine government prior to exporting crude oil or diesel oil. In order to obtain this approval, exporters must demonstrate that they have either satisfied local demand requirements or have granted the domestic market the opportunity to acquire oil or diesel oil on terms similar to current domestic market prices and, in the case of diesel oil, they must also demonstrate, if applicable, that commercial terms offered to the domestic market are at least equal to those provided to their own gas station network. See Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework Gas Modifications to the Regulatory Framework.

We cannot assure you that the Argentine government will not impose additional export restrictions on hydrocarbons. If it were to do so, we would receive lower US dollar-denominated cash receipts, which might affect our results of operations and financial position.

***Export taxes on our products have negatively affected, and may continue to negatively affect, the profitability of our operations.***

The Argentine government has levied a series of tax increases on crude oil, its by-products and gas. On March 1, 2002, the Argentine government imposed a 20% tax on exports of crude oil and a 5% tax on exports of certain oil by-products, which are due to expire in five years. In May 2004, the tax on exports of crude oil and liquified petroleum gas increased to 25% and 20%, respectively, and a 20% tax was levied on exports of natural gas. Effective August 4, 2004, the Argentine government further increased taxes on exports of crude oil by an additional 3% to 20% more than the current rates, with a cap set at 45%. The determination of the additional rate depends on the price per barrel of crude oil, increasing gradually from 3% when crude oil price is US\$32.01 per barrel to 20% when the price is US\$45 or more per barrel. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Economic and Political Developments in Argentina Price Stabilization and Supply Hydrocarbons.

This tax regime has adversely affected the profitability of our upstream operations and has prevented us from fully benefiting from the significant increases in international oil prices.

We cannot assure you that the Argentine government will reduce the current export tax rates or will not increase them further. We do not know the government's future intentions in regard to export taxes. As a consequence, we cannot predict the impact that any changes may have on our results of operations.

***Price controls have affected, and may continue to affect, our results of operations and capital expenditures.***

For the purposes of reducing inflationary pressures generated by the sharp Argentine peso devaluation, the Argentine government issued a set of regulations aimed at controlling the increase in prices to end users. These regulations were particularly focused on the energy sector.



*Hydrocarbons*

In an effort to mitigate the impact of the significant increase of West Texas Intermediate Crude reference price, or WTI, on local prices and ensure price stability for crude oil, gasoline and diesel oil, since January 2003, at the request of the Argentine Federal Executive Branch, hydrocarbon producers and refineries entered into a series of temporary agreements, which contained price limits with respect to crude oil deliveries. The most recent agreement expired in June 2004. In August 2004, in light of the WTI having exceeded US\$42, the Argentine government established a cap on the domestic price of crude oil equal to the international market price net of the taxes imposed on exports. As from October 2004, hydrocarbon producers and refiners negotiate crude price based on the export

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parity reference price. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Economic and Political Developments in Argentina Price Stabilization and Supply Hydrocarbons. These measures had an impact and may continue to have an impact on our upstream operations profitability and have prevented and may continue to prevent us from capitalizing fully on the benefits derived from the significant increases in international oil prices. We cannot be certain whether further price control measures with respect to hydrocarbons will be taken in the future nor can we be certain of the impact such measures may have on our results.

### *Gas and electricity*

Pursuant to the Public Emergency Law, we were precluded from increasing the price of the gas and electricity sold in the domestic market. This limitation, within the context of the peso devaluation and subsequent inflation, resulted in a substantial change in the economic and financial balance of our energy and gas related businesses, significantly affecting our operating results and prospects. As a result, we postponed infrastructure, development and exploration investments, especially at the Neuquén basin in Argentina.

In April 2004, we along with the remaining gas producers entered into an agreement with the Argentine government, which provides for a schedule of gradual increases in gas prices in the domestic market that culminates in complete deregulation of the wellhead price of natural gas by January 2007.

In December 2004, the Secretary of Energy committed to approve successive seasonal electricity price increases to reach values covering at least total monomic costs by November 2006. In addition, as soon as the market returns to normal and once new generation capacity derived from the government maintained fund called FONINVEMEM becomes available to dispatch energy to the market, the Secretary of Energy has committed (1) to pay for energy at the marginal price obtained in the spot market and (2) to pay for power at the US dollar values that were in effect prior to the enactment of the Public Emergency Law. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Economic and Political Developments in Argentina Price Stabilization and Supply.

Through these combined measures, the Argentine government is expected to gradually restore the economic and financial balance in the natural gas and electricity sectors. Our results and capital expenditure plans, however, may be adversely affected if (1) the agreed schedule of increases in gas prices or commitments with respect to electricity prices fail to be implemented by the Argentine government, (2) the government continues issuing additional decrees or exerting political pressure to curb price increases or (3) the government applies its regulatory emergency authority or adopts other laws to control prices or supply.

### *Downstream margins*

Downstream margins have significantly declined since the enactment of the Public Emergency Law. As part of the effort to avoid inflationary escalation, the Argentine government exerted pressure to limit the increase in prices of gasoline and diesel oil at the retail level that would have resulted from (1) higher costs due to increases in WTI prices, (2) the peso devaluation and (3) domestic inflation. These measures affected the sector's profitability. Since the enactment of the Public Emergency Law, crude oil cost for Argentine operations have increased 67% while gasoline and diesel oil average sales prices have increased only by 21% and 46%, respectively.

Notwithstanding the absence of a formal price control policy, many initiatives taken by other downstream companies in an attempt to recover the profitability of the sector, have been thwarted by governmental pressure, including a communication campaign aimed at generating social

opposition to these initiatives.

The downstream business in Argentina has been and may continue to be subject to extensive governmental intervention that affect prices and profitability, and these interventions may have an adverse affect on the results of our operations.

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***The pesification of utility rates has affected and may continue to affect utility companies' financial position, results of operations and their ability to generate cash.***

The new macroeconomic scenario after enactment of the Public Emergency Law impacted the economic and financial balance of utility companies in Argentina. The combined effect of (1) the devaluation of the peso, (2) the pesification of rates on a one to one basis and (3) financial debts primarily denominated in foreign currency, adversely affected the utility companies' financial position, results of operations and ability to satisfy financial obligations.

In light of the adverse conditions faced by utility companies, during 2002, CIESA, Transportadora de Gas del Sur S.A., or TGS, and Compañía de Transporte de Energía Eléctrica en Alta Tensión Transener S.A., or Transener, defaulted on their debt. TGS has recently concluded a debt restructuring process with creditors. Transener proposed an exchange offer to its creditors, which in April 2005 was accepted by 98.8% of them. Pursuant to a restructuring agreement entered into on May 19, 2005, Transener has 45 business days to comply with the terms of the exchange offer, otherwise the restructuring agreement may be terminated at their creditors' option. As a result of Transener's restructuring, our indirect interest in Transener would be reduced from 32.5% to 26.326%. CIESA is currently negotiating with creditors to refinance its defaulted obligations. See Item 4. Information About the Company Electricity Electricity Transmission: Transener, Yacylec and Enecor Transener and Item 4. Information About the Company Hydrocarbon Marketing and Transportation Gas Transportation-TGS Our interests in TGS and Corporate Developments. Until a successful restructuring of this debt, there will remain substantial doubt about the ability of CIESA, Citelec and Transener to continue operating as a going concern.

The problems faced by our affiliated utilities have adversely impacted our net income and our ability to receive dividends from these companies. We did not receive dividends from them in 2002, 2003 or 2004. In addition, we could lose some or all of our ownership in CIESA, Citelec and Transener if any necessary debt restructuring is unsuccessful and creditors proceed against the assets of the defaulting affiliates. The outcome of any such proceedings is uncertain due to the procedural difficulties of Argentine bankruptcy courts and laws relating to the ownership of Argentine utilities companies.

***The Argentine government and our affiliated utility companies are in the process of renegotiating utility contracts, and the recovery of these affiliates depends on the successful completion of these negotiations.***

The Public Emergency Law granted the Argentine government broad authority to renegotiate utility contracts, which authority has been extended to December 2005. On October 1, 2003, the Argentine Congress passed a bill allowing the executive branch of the government to set public utility rates until the completion of the renegotiation process. See Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework Electricity UNIREN. UNIREN (the agency created to, among other things, provide assistance in the utility renegotiation process, execute comprehensive or partial agreements with utility companies and submit regulatory projects related to transitory rate adjustments) is currently in the process of renegotiating contracts with our affiliates Edesur S.A., or Edesur, TGS, Transener and Empresa de Transporte de Energía Eléctrica por Distribución Troncal de la Provincia de Buenos Aires S.A., or Transba. These discussions are in different stages, and some of our affiliates have rejected UNIREN's latest proposals. See Item 4. Hydrocarbon Marketing and Transportation Gas Transportation - TGS Regulated Energy Segment and Item 4. Information About and Company Electricity Electricity Transmission: Transener, Yacylec and Enecor Transener. We cannot guarantee that these discussions will ultimately result in a level of tariff increases sufficient to restore the economic and financial position of utility companies.

## **Factors Relating to Venezuela**

*Adverse economic, political and social conditions in Venezuela have and may in the future adversely affect our financial position and results of operations.*

Operations in Venezuela are an important component of our business. In 2004, Venezuela's oil and gas sales volumes accounted for 31.5% of our total volumes of barrels of oil equivalent, and as of December 31, 2004, a significant percentage of our total combined proved reserves were located in Venezuela.

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The government through Petr oleos de Venezuela, S.A., or PDVSA, strictly controls oil production in Venezuela. Accordingly, our operations are affected by the economic and political conditions of Venezuela. Additionally, as Venezuela is a member of the Organization of Petroleum Exporting Countries, or OPEC, we are subject to the production cut decisions that OPEC may adopt, as was the case in 2002.

Since the end of 2002 and throughout 2003, Venezuela faced one of its worst political and economic crisis in the last 40 years. On December 2, 2002, a nationwide strike was organized, which included PDVSA and involved the country's main production areas. This situation affected our operations of the three fields located in the east of the country (Oritupano-Leona, Mata and Acema), significantly reducing their production. Throughout the first quarter of 2003, oil production average volume dropped by 40.2% to approximately 30,400 barrels per day compared to the same quarter of 2002. After the conclusion of the nationwide strike, the situation gradually reversed. The year 2004 was marked by economic recovery, triggered by high prices of hydrocarbons in the international market and recovery of the national oil production. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Political and Economic Situation in Venezuela.

Given the importance of Venezuela to our business, we are unable to assure you that political, economic and social events in Venezuela will not adversely affect our results of operations and financial position.

*Changes in the regulatory and contractual framework applicable to our operating agreements have and may in the future adversely affect our financial position and results of operations.*

The Venezuelan government increased royalties in 2001 from 1-16.66% to 20-30% thereby affecting our results of operations. This increase in royalties resulted in lower revenues of P\$84 million, P\$57 million and P\$60 million for 2004, 2003 and 2002, respectively.

In April 2005, the Venezuelan Energy and Oil Ministry instructed PDVSA to review the thirty-two operating agreements signed by PDVSA with oil companies from 1992 through 1997, including agreements with our affiliates in connection with the areas of Oritupano Leona, La Concepci n, Acema and Mata. The Venezuelan government has instructed PDVSA to take measures within a six-month term to convert all currently effective operating agreements into mixed-ownership contracts in order to grant the Venezuelan government, through PDVSA, more than 50% ownership of each field. The government has further instructed PDVSA to limit the total accumulated payments to contractors during a calendar year to 66.67% of the value of oil and gas produced under the related agreement. On April 15, 2005, PDVSA notified our subsidiary Petrobras Energ a Venezuela, S.A. about this and advised that the Venezuelan Energy and Oil Ministry will, as soon as possible, contact our subsidiary to fix a date to begin the related discussions. Without opining on the proposed changes or the legitimacy of the operating agreements, we have expressed our willingness to engage in discussions with PDVSA and the Venezuelan government. See Item 4. Information About the Company Oil and Gas Exploration and Production Production Production Outside of Argentina Venezuela.

On June 23, 2005, we received notice from PDVSA that it would start paying in local currency the amounts due to us under the operating agreements that correspond to national services and materials, instead of US dollars as provided in the relevant agreements. Under the current agreements, all payments from PDVSA are due in dollars outside Venezuela. During an interim period and until PDVSA performs an audit that finally determines the portion of services under the operating agreements that correspond to national services, PDVSA would start paying 50% of the amounts due to us under the operating agreements in local currency, and the remaining 50% would continue to be payable in dollars.

Given the early stage and uncertainty of the overall process, we are unable to predict its outcome or the impact that it may have on our operations, financial results, liquidity or investment plans. Accordingly, we cannot assure you that the changes resulting from this process will not adversely affect our financial position or results of operations.

In addition, the Venezuelan tax authorities have recently publicly stated that they are looking into the taxes paid by private oil companies in recent years. The authorities have stated that private oil companies may have

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under-reported their taxable income in Venezuela. As of the date of this annual report, none of the oil companies operating in Venezuela, including us, have received a claim from the National Integrated Service of Tax Administración ( *Servicio Nacional Integrado de Administración Tributaria*), or SENIAT, in connection with this alleged investigation.

### **Factors Relating to the Company**

#### ***Decline in oil prices affect the profitability of our operations and capital expenditures.***

International oil prices, which are out of our control, can vary as a result of changes in supply and demand and may be influenced by factors such as economic conditions, weather conditions or actions taken by major oil exporting countries. Political developments, including war, embargos and political strife in oil producing regions can also affect oil supply, and thus affect international oil prices. Changes in oil prices typically result in changes in the price of oil products. International oil prices have fluctuated widely over the last ten years. During 2004 and 2003, the average WTI was US\$41.5 and US\$31 per barrel, respectively, compared to an average of US\$22.56 per barrel for the period 1994-2003.

Because a substantial amount of our revenues are derived from sales of oil and oil-related products, any declines in the price of oil may affect the profitability of our operations, our ability to generate cash, the value of our assets and the amount and timing of our projected capital expenditures. If oil prices decline significantly, we may have to dramatically cut capital expenditures, and this could adversely affect our ability to replace reserves and our production forecasts in the medium term.

Even during periods of high crude oil prices it may not be possible to pass through higher prices to end consumers, due to, among other factors, governmental regulations or changes in consumer demand. This may have an impact on our results of operations, particularly with respect to our downstream operations.

#### ***Our oil and gas proved reserve estimates are not 100% accurate and may be subject to revision.***

We estimate our proved developed crude oil and natural gas reserves by using geological and engineering data to demonstrate with reasonable certainty whether they are recoverable in future years from known reservoirs under existing economic and operating conditions. These estimates are audited by Gaffney, Cline & Associates, an international technical consulting firm for the oil and gas industry. Reserve estimates are based, in part, on subjective judgments and, therefore, are not 100% accurate and may be subject to revision. See Item 4. Information About the Company Oil and Gas Exploration and Production Reserves and Item 5. Operating and Financial Review and Prospects Critical Accounting Policies Estimation of Oil and Gas Reserves. Crude oil and natural gas reserves are reviewed annually to take into consideration many factors, including:

new production or drilling activities;

field reviews;



the addition of new reserves from discoveries, and extensions of existing fields;

changes in the international prices of oil and gas;

the application of improved recovery techniques; and

new economic conditions.

Proved reserve estimates could be materially different from the quantities of crude oil and natural gas that are ultimately recovered, and downward revisions of our estimates in the future could impact our results of operations and business plan, including our levels of capital expenditures.

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*We may not be able to replace our oil and gas reserves, which may have an adverse impact on our future results of operations and financial position.*

The rate of production from oil and gas properties generally declines, and the cost of production generally increases, as reserves are depleted. Our future oil and gas production is significantly dependent on the successful implementation of our development projects. Our development projects, in turn, are dependent on and affected by the interpretation of geological and engineering data, scheduling commitments, cost estimates, as well as, other factors. In addition to current development projects, our future oil and gas production depends on our ability to access new reserves, including through exploration and acquisitions funded by increases in capital expenditures. Failures in exploration and/or our inability to acquire suitable potential reserves could adversely impact our oil and gas production and reserve replacement, which, in turn, could have an adverse impact on our future results of operations and financial position. We have limited capital resources to implement an ambitious capital expenditure program. Moreover, we face strong competition in bidding for new production blocks, especially those blocks with the most attractive crude oil and natural gas reserves. This competition may result in our future failure to obtain desirable production blocks, undermining our ability to replace reserves.

Without successful development and exploration activities or reserve acquisitions, our proved reserves will decline as our oil and gas production will be forced to rely on our existing proved developed reserves. This was the case in 2002-2004 when our liquid hydrocarbon and natural gas proved reserves decreased by 10%. This was partly the result of the reduction in our capital expenditures during 2002 in response to the Argentine economic crisis, and the limited possibilities to negotiate gas price increases as a result of the Public Emergency Law. The reduction in our capital expenditures particularly affected our Argentine assets, which are mature assets, with low exploratory prospects, and are under production through secondary recovery methods. Therefore, we have experienced considerable natural declines with respect to our Argentine reserves. In Argentina, alone, our liquid hydrocarbon and natural gas proved reserves decreased approximately 30% during 2004-2002. During that period, Argentina's combined oil and gas production volume decreased by 13%. See Item 4. Information About the Company Oil and Gas Exploration and Production Reserves.

We cannot guarantee that our exploration, development and acquisition activities will result in significant additional reserves or that we will continue to be able to drill productive wells at acceptable costs. If we are not able to successfully find, develop or acquire additional reserves or drill cost-efficient productive wells, our reserves may continue to decline and, therefore, may adversely affect our future results of operations and financial position.

*Our activities may be adversely affected by events in other countries in which we do business.*

Our operations are concentrated in Latin America, a region that has experienced significant economic, social, political and regulatory volatility in recent periods. For example, recent political unrest in Bolivia has targeted foreign companies' participation in Bolivia's natural gas industry, which in May 2005 resulted in a significant increase in royalties and taxes and calls by some groups for nationalization of the energy industry. The Bolivian political, economic and social situation, generally, and the country's energy policy, in particular, remain extremely volatile and unpredictable. As we expand our operations in other countries throughout Latin America, we may be increasingly affected from time to time by economic, political and regulatory developments in such countries, such as forced divestiture of assets, restrictions on production, expropriation of property and cancellation or modification of contract rights, price controls, tax increases, currency exchange fluctuations and other risks arising out of the imposition of foreign investment or capital controls, and risks of loss in countries due to civil strife, acts of war, guerilla activities and insurrection.

The likelihood of these occurrences and their overall effect may vary greatly from country to country and are not predictable and, if they occur, they may have an adverse impact on our results of operations and financial position.

*Our operations run the risk of causing environmental damage, and any changes in environmental laws may increase our operational costs.*

The nature of some of our operations are subject to certain environmental risks that are inherent in the oil and gas industry and which may arise unexpectedly and result in material adverse effects on our results of operations

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and financial position. We recorded a P\$58 million loss in 2003 and a P\$51 million loss in 2004 for environmental remediation efforts. We may have to incur additional environmental related costs in the future, which may negatively impact our results of operations. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Environmental Matters.

In addition, we are subject to extensive environmental regulation both in Argentina and in the other countries in which we operate. Local, provincial and national authorities in Argentina are moving toward more stringent enforcement of applicable environmental laws, which may require us to incur higher compliance costs. We cannot predict what additional environmental legislation or regulations will be enacted in the future or the potential effects on our financial position and results of operations.

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### **Item 4. INFORMATION ABOUT THE COMPANY**

#### **OUR HISTORY AND DEVELOPMENT**

##### **Our History**

We are a holding company that operates exclusively through our subsidiary Petrobras Energía and its subsidiaries, which are engaged in oil and gas exploration and production, refining, petrochemicals, electricity generation, transmission and distribution and hydrocarbons marketing and transportation. We conduct operations in Argentina, Bolivia, Brazil, Ecuador, Mexico, Peru and Venezuela. We are a corporation organized and existing under the laws of the Republic of Argentina with a duration of 99 years from the date of our incorporation, September 25, 1998. Our legal name is Petrobras Energía Participaciones S.A. and we are known commercially as Petrobras Energía Participaciones. Our principal executive offices are located at Maipú 1, 22<sup>nd</sup> Floor, C1084ABA Buenos Aires, Argentina, Telephone: 54 11 4344-6000. Our process agent in the U.S. is CT Corporation System, located at 111 Eighth Avenue, New York, New York 10011.

Our original name was PC Holdings S.A. We were formed in 1998 for the sole purpose of owning shares of Petrobras Energía, and both we and Petrobras Energía were controlled at the time by members of the Perez Companac family. As of December 31, 1999, we owned 28.92% of Petrobras Energía's common stock.

We acquired control of Petrobras Energía on January 25, 2000 as a result of the consummation of an exchange offer pursuant to which we issued 1,504,197,988 Class B shares, with one vote per share, in exchange for 69.29% of Petrobras Energía's outstanding capital stock, thereby increasing our ownership interest in Petrobras Energía to 98.21%. Since January 26, 2000, our Class B shares have been listed on the Buenos Aires Stock Exchange and our American Depositary Shares, each representing ten Class B shares, have been listed on the New York Stock Exchange. In July 2000, we completed the change in our corporate name from PC Holdings S.A. to Perez Companac S.A.

On October 17, 2002, Petrobras Participaciones, S.L.U., or PPSL, a wholly owned subsidiary of Petrobras, acquired from the Perez Companac family and Fundación Perez Companac their entire ownership interest, or 58.6%, in our capital stock. Petrobras is the largest integrated oil, gas and energy company in Brazil. It is engaged in a broad range of oil and gas activities and is a mixed-capital company with a majority of its voting capital owned by the Brazilian federal government.

On April 4, 2003, at a regular and special shareholders' meeting, shareholders approved the change of our corporate name to Petrobras Energía Participaciones S.A. from Perez Companac S.A. On the same date, shareholders of Pecom Energía S.A., or Pecom, approved the change of its name to Petrobras Energía S.A.

Our interest in Petrobras Energía is expected to decrease to 75.82% from 98.21% as a result of the merger of certain companies controlled by Petrobras into Petrobras Energía. Pursuant to the merger, Petrobras indirectly will receive 230,194,137 newly issued Class B shares of Petrobras Energía, representing 22.8% of its capital stock. See Petrobras Energía Merger.

##### **History of Petrobras Energía**

Petrobras Energía was founded in 1946 as a shipping company by the Perez Companc family. In the mid-1950 s Petrobras Energía began its forestry operations when it acquired an important forestry area in northeastern Argentina. In 1960, Petrobras Energía began servicing oil wells and, over time, its maritime operations were gradually discontinued and replaced by oil-related activities. The development of Petrobras Energía s oil and gas business is marked by two significant events. The first occurred in the early 1990s when Petrobras Energía was awarded concessions to operate Puesto Hernandez, the second most important oilfield in Argentina, and the Faro Virgenes and Santa Cruz II areas in the Austral basin, Argentina s most important area of oil and gas production. As a result of this and other concessions, Petrobras Energía has become one of the largest oil and gas producers in Argentina.

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The second milestone in Petrobras Energía's oil and gas operations occurred in 1994 when Petrobras Energía was awarded an exploration and production service contract for the Oritupano Leona area in Venezuela. Since this milestone, Petrobras Energía has expanded its operations in Venezuela, as well as in Peru, Ecuador, Brazil and Bolivia as part of its strategy to become a leading integrated energy company in Latin America.

Petrobras Energía developed its other energy businesses primarily through the acquisition of interests in state-owned companies that were privatized by the Argentine government between 1990 and 1994. Petrobras Energía acquired interests in companies operating in refining and petrochemicals, hydrocarbon transportation and distribution and power generation, transmission and distribution. These companies have formed the core of Petrobras Energía's energy businesses.

In addition to the energy sector, Petrobras Energía has in the past conducted operations in other industries, including construction, telecommunications and mining. These businesses were sold by Petrobras Energía during the late 1990s as part of Petrobras Energía's strategy to focus its operations on the energy sector. As a result of these divestitures and the development of Petrobras Energía's energy businesses over the last decade, Petrobras Energía has become a vertically integrated energy company.

## **Petrobras Energía Merger**

On January 21, 2005, the special shareholders' meetings of Petrobras Energía, EG3 S.A., or EG3, Petrobras Argentina S.A., or PAR, and Petrolera Santa Fe SRL, or PSF, approved the merger of EG3, PAR and PSF into Petrobras Energía. Prior to the merger, Petrobras, through its subsidiary PPSL, held a 99.6% interest in EG3 and a 100% interest in each of PAR and PSF. Pursuant to the merger, PPSL is expected to receive 230,194,137 newly issued Class B shares of Petrobras Energía, representing 22.8% of Petrobras Energía's capital stock. As a result, our interest in Petrobras Energía is expected to decline to 75.8%. On March 3, 2005, the final merger agreement was signed providing that, once implemented, following receipt of necessary governmental approvals and registration with the public registry, the merger would be given retroactive effect to January 1, 2005. On June 28, 2005, the CNV approved the merger. The merger is in the process of being registered with the Argentine Public Registry of Commerce. After the merger, Petrobras Energía will be the surviving entity.

EG3 is mainly engaged in the refining and processing of oil and oil by-products and the distribution and marketing of liquid and gaseous fuels and lubricants through gas stations and fuel retail outlets. EG3 has a refinery located at Bahía Blanca, Buenos Aires, a strategic location for the delivery of crude oil coming from the Neuquén Basin or by sea from the south of Argentina or international markets. With a crude processing capacity of approximately 31,000 barrels per day, EG3 manufactures a wide variety of products: high-grade gasoline, regular gasoline, super 97 SP gasoline, raw materials for the production of solvents and petrochemical products including kerosene, diesel oil, fuel oil, asphalt base, propane, propylene and butanes. EG3 has a wide network of gas stations (approximately 621) throughout the country that operate under the Petrobras and EG3 brands.

PAR is mainly engaged in oil and gas production. PAR owns a concession for a production area at the Noroeste basin, with a production volume of approximately 7,000 barrels of oil equivalent per day and proved reserves of 17 million barrels of oil equivalent as of December 31, 2004.

PSF is engaged in oil and gas production. PSF has concessions for five oil fields, which were located in the Neuquén, San Jorge and Cuyana basins. These fields had an aggregate production volume of approximately 12,000 barrels of oil equivalent per day and proved reserves of 78 million barrels of oil equivalent as of December 31, 2004.

**Capital Expenditures and Divestitures**

For a description of our capital expenditures see Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources. For a description of our most significant divestitures see Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Divestment of Assets and Divestments of Non-Core Assets.



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**BUSINESS OVERVIEW**

**Our Strategy**

Our long-term strategy is to grow as an integrated energy company with a leading presence in Latin America, while focusing on profitability as well as social responsibility.

The main points of this strategy are:

Increasing oil and gas reserves and production to secure sustainable growth;

Growing downstream in Argentina, while balancing the crude production refining logistics commercialization chain and differentiating ourselves through the quality of our products and services;

Developing businesses in the gas and energy areas that will allow for the best overall use of our gas reserves;

Consolidating our leading position in our petrochemical markets, by maximizing the use of our raw materials; and

Using capital in a disciplined manner, with a view to optimizing our debt to capital ratio and maintaining our financial solvency.

In order to adhere to this strategy, we consider the following to be essential:

A commitment to protect the quality of our goods and services, the environment and the health and safety of our employees, contractors and neighboring communities;

Adoption of, and compliance with, corporate governance practices in line with international best practices;

Maintenance of a style of management that favors communication and teamwork, fostered by the value of the people that work in our organization; and

Developing new business opportunities, by maximizing potential synergies and capitalizing on complementary business opportunities with Petrobras.

We currently manage our activities, with the support of corporate staff, in five business segments: (1) Oil and Gas Exploration and Production, (2) Hydrocarbon Marketing and Transportation, (3) Refining, (4) Petrochemicals and (5) Electricity.

## **Our Principal Market**

We are an Argentine corporation and, as of December 31, 2004, 55% of our total assets, 61% of our net sales, 53% of our combined crude oil and gas production and 36% of our proved oil and gas reserves are located in Argentina. Fluctuations in the Argentine economy and actions adopted by the Argentine government have had and will continue to have a significant effect on Argentine private sector entities, including us. Specifically, we have been affected and might be affected by inflation, interest rates, the value of the peso against foreign currencies, price controls, regulatory policies, business regulations, tax regulations and in general by the political, social and economic environment in and affecting Argentina. See Item 3. Key Information Risk Factors Factors Related to Argentina.

The Argentine economy has experienced significant volatility in recent decades, characterized by periods of low or negative growth and high and variable levels of inflation and currency devaluation. In 1988, 1989 and 1990, the annual inflation rates were approximately 388%, 4,924% and 1,344%, respectively, based on the

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Argentine consumer price index and approximately 422%, 5,386% and 798%, respectively, based on the Argentine wholesale price index. As a result of inflationary pressures, the Argentine currency was devalued repeatedly during the 1960s, 1970s and 1980s, and macroeconomic instability led to broad fluctuations in the real exchange rate of the Argentine currency relative to the US dollar. To address these pressures, the Argentine government during this period implemented various plans and utilized a number of exchange rate systems and controls.

In April 1991, the Argentine government launched a plan aimed at controlling inflation and restructuring the economy, enacting the Convertibility Law. The Convertibility Law fixed the exchange rate at one peso per US dollar and required that the Central Bank maintain reserves in gold and foreign currency at least equivalent to the monetary base. Following the enactment of the Convertibility Law, inflation declined steadily and the economy experienced growth through most of the period from 1991 to 1997. In the fourth quarter of 1998, however, the Argentine economy entered into a recession that caused the gross domestic product to decrease by 3.4% in 1999, 0.8% in 2000 and 4.4% in 2001.

Beginning in the second half of 2001, Argentina's recession worsened significantly. As the public sector's creditworthiness deteriorated, interest rates reached record highs, bringing the economy to a virtual standstill. The lack of confidence in the country's economic future and its ability to sustain the peso's parity with the US dollar led to a massive withdrawal of deposits from banks and capital outflows. To prevent further capital outflows, on December 1, 2001, the Argentine government implemented a number of monetary and exchange control measures which were perceived as further paralyzing the economy for the benefit of the financial system, and caused a sharp rise in social discontent, ultimately triggering public protests, outbreaks of violence and the looting of stores throughout Argentina.

On December 20, 2001, after declaring a state of emergency and suspending civil liberties, President Fernando de la Rúa tendered his resignation to Congress. After a series of interim presidents, on January 1, 2002, Eduardo Duhalde was appointed by congress at a joint session to complete the remaining term of former President de la Rúa. The new president, among other measures, ratified the suspension of payment of a portion of Argentina's sovereign debt declared by Interim President Rodríguez Saá.

On January 6, 2002, the Argentine Congress enacted the Public Emergency Law, which introduced dramatic changes to Argentina's economic model and put an end to the US dollar-peso parity established since the enactment of the Convertibility Law in 1991, leading to a significant devaluation of the Argentine peso. The Public Emergency Law also empowered the federal executive branch of Argentina to implement, among other things, additional monetary, financial and exchange measures to overcome the economic crisis in the short term, such as determining the rate at which the peso was to be exchanged into foreign currencies.

The federal executive branch implemented a number of far-reaching initiatives, which included:

Pesification of certain assets and liabilities denominated in foreign currency and held in the country;

Rescheduling of bank deposits, with the subsequent ability for owners of such deposits to receive certain US dollar-denominated government bonds maturing in ten years or peso-denominated government bonds maturing in three or five years or bills with specific terms in lieu of payment of such deposits;

Amendment of the charter of the Central Bank authorizing it to issue money in excess of the foreign currency reserves, to grant short-term loans to the federal government and to provide financial assistance to financial institutions with liquidity or solvency problems;

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Issuance by the federal government of bonds to compensate banks for losses resulting from the different pesification rates applicable to deposits and US dollar obligations assumed in Argentina;

Pesification of all private agreements entered into as of January 6, 2002 at the P\$1=US\$1 exchange rate and subsequent adjustment thereof by the Benchmark Stabilization Coefficient, published by the Central Bank;

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Pesification and elimination of indexing clauses on utility rates, fixing those rates in pesos at the P\$1=US\$1 exchange rate; and

Implementation of taxes on hydrocarbon exports and certain oil by-products, among others.

In 2002, our financial results were negatively impacted by drastic political and economic changes that resulted from the severe crisis that broke out in Argentina late in 2001. Due to high level of institutional instability, which included social conflicts, the default on most of Argentina sovereign debt, the abandonment of convertibility, the freeze on and rescheduling of banking deposits, the pesification and the elimination of indexation on utility rates and, in general, active intervention by the government in the development of the economy, commercial and financial activities were virtually paralyzed in 2002, further aggravating the economic recession, which included a 10.9% decline in GDP. Within this context, the peso devalued 238%, the wholesale price index rose 118.2% and the consumer price index increased 41%. Towards the end of 2002, the Argentine government implemented different measures aimed at stimulating the economy and abrogating certain restrictions to gradually normalize the foreign exchange market and the commercial and financial flow of foreign currency.

On May 25, 2003, Mr. Kirchner took office as Argentina's president. Argentina had numerous rounds of negotiations with the IMF in 2002-2003 regarding Argentina's economic program and the medium-term refinancing of its debt with the IMF. In September 2003, Argentina and the IMF entered into a three-year standby credit agreement. This new agreement guaranteed the refinancing of all principal maturities of credit facilities granted by multilateral agencies. The agreement specified a series of quantitative and qualitative conditions to be met by the Argentine government during the 2003-2004 period.

In 2003, the Argentine economy began to recover with GDP growing 8.7%. This recovery, at first based almost exclusively on import substitution, broadened as the level of consumption and investment increased. The domestic demand for energy and gas grew in line with GDP growth. Oil production, however, declined 2%, despite crude oil processing having increased by 4%. Reflecting the economic recovery, Argentine stock exchange indices displayed great dynamism in 2003, and both labor indicators and salary purchasing power registered consistent improvements during this year. The balance of trade exhibited a strong surplus, favored by an increase in commodity prices, which, together with the continuity of the partial foreign debt payment default, caused an excess supply of foreign currency. The peso appreciated significantly against the US dollar during 2003, even as the Central Bank made numerous currency purchases to attempt to maintain a high rate of exchange. Inflation was below 4% during 2003.

During 2004, the Argentine economy continued to exhibit signs of stability. Real GDP growth was 9.0% for the year. Both inflation and the peso nominal exchange rate were stable during 2004, with an increase of 6.1% in the consumer price index and 7.9% in the wholesale price index, while the peso devaluated 1.3%. Furthermore, the employment situation improved, unemployment reaching a 12.1% rate during the fourth quarter of 2004, which was a decrease of 26% from the levels it had reached during the 2002-2003 period. Notwithstanding the improvement in the economy, oil production in Argentina continued to fall in 2004 (6.1%), while crude oil processing increased 1.5% during the year, with a decline in crude oil exports. Gas production increased 3% during the year. The domestic demand for gas increased approximately 8%, mainly driven by compressed natural gas and power plants, while exports reflected similar growth and gas imports from Bolivia resumed at approximately four million cubic meters per day. Energy generation increased 8.5%, which was in line with GDP growth.

Negotiations with the IMF stalled in 2004 and the IMF and Argentina ultimately deferred negotiation of certain undetermined aspects of the IMF program until after Argentina completed the restructuring of its defaulted debt with private creditors. During that period, Argentina met its payment obligations to the IMF.

In March 2005, the government's debt exchange offer received a significant level of acceptance (approximately 76%). The agreement with the IMF, however, is still on hold. In May 2005, the IMF agreed to roll over US\$2.5 billion in loans owed by Argentina over the next 12 months.

In 2005, it is expected that the Argentine economy will continue to grow as long as it manages to overcome the remaining effects of the default on its sovereign debt and investments are made to expand production capacity.

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Nonetheless, the long-term evolution of the Argentine economy remains highly uncertain. The country still faces significant challenges, including the solution of the problem with holdout creditors, who did not accept the exchange offer with respect to Argentina's public debt, and the renegotiation of utility contracts.

### **OIL AND GAS EXPLORATION AND PRODUCTION**

#### **Overview**

The core of our operations is the oil and gas exploration and production business segment. The business segment's strategy is to increase reserves and oil and gas production in Argentina and other parts of Latin America, in order to secure our sustainable growth. In line with this strategy, our business goals are:

Increasing oil and gas production by capitalizing on our experience and presence in nearly all Latin American oil producing countries;

Optimizing our investment portfolio by balancing high risk exploration projects with development projects; and

Being recognized as an efficient operator and excellent manager, with competitive lifting costs and a good environmental record.

We currently conduct oil and gas exploration and production operations in Argentina, Venezuela, Peru, Ecuador and Bolivia. In addition, we act as contractor and provide technical and operating support in Mexico.

As of December 31, 2004, our combined crude oil and natural gas proved reserves, including our shares of the reserves of our unconsolidated investees, were estimated at 732 million barrels of oil equivalent, approximately 51.2% of which were proved developed reserves and approximately 48.8% of which were proved undeveloped reserves. Crude oil accounted for approximately 75.5% of our combined proved reserves, while natural gas accounted for about 24.5%. As of December 31, 2004, 36% of our total combined proved reserves were located in Argentina and 64% were located abroad. Over the last few years, total reserves located abroad have become an increasing component of our assets portfolio, consistent with our strategy aimed at growing as an integrated energy company throughout Latin America. Pursuant to this strategy, between 2003 and 2004, total investments outside of Argentina accounted for approximately 60% of our total investments in the oil and gas exploration and production business segment.

For the year ended December 31, 2004, our combined crude oil and natural gas production, including our share of the production of our unconsolidated investees, averaged 163,600 barrels of oil equivalent per day, an increase of 3.1% compared to 158,600 barrels of oil equivalent per day in 2003. Crude oil production volume increased 4.5% to 119,800 barrels per day and gas volumes decreased 0.4% to 262.9 million cubic feet. Approximately 55.9% of our oil production and 24.6% of our gas production were outside of Argentina. Venezuelan production has become a main component of our production outside of Argentina, accounting for 31.5% of our total average production in barrels of oil equivalent.

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As of December 2004, we had total proved reserves equal to 12.2 years of production at 2004 oil and gas production levels.

Our integrated business vision places our Refining, Petrochemicals and Electricity businesses as primary links in our business value chain, through which the potential of our hydrocarbon reserves may be maximized. Integration with our Refining business segment enables us to process a large part of our crude oil production in Argentina. The Genelba Thermal Power Plant, which we refer to as Genelba, allows us to use approximately 2.9 million cubic meters of natural gas per day of our own reserves. In addition, we supply gas to our petrochemical operations in Argentina.

Significant investments made by us in the past have laid a foundation for the expansion and growth of our oil and gas exploration and production segment. The 2002 fiscal year, however, marked a change in our investment



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history. The magnitude and complexity of the crisis that broke out in Argentina late in 2001 and the limited opportunities to access the capital markets forced us to reformulate our growth strategy. Given this new environment, we developed a new strategy that prioritizes cash generation and the maintenance of adequate liquidity levels. This has resulted in more restrictive expense and investment policies. As a result, capital expenditures in 2002 totaled only P\$499 million (or P\$596 million on a cash flow basis), a relatively low amount compared to our historical average investment. See Item 5. Operating and Financial Review and Prospects Factors Affecting Our Consolidated Results of Operations Capital Investments. The reduced pace of investments influenced our growth objectives in the short-term, mainly affecting our future production volumes of oil and gas. In addition, reduced investments delayed the development of new operating areas and related production.

In 2003 and 2004, buoyed by the recovery of our operating cash flow and liquidity, capital expenditures amounted to P\$776 million and P\$954 million, respectively. The levels of expenditures in the last two years, we believe, are indicative of the new dynamics of our investment plan, and the expected recovery following the significant decline resulting from the Argentine crisis. In the years ahead, we plan to make significant investments in oil and gas exploration and production to achieve our production growth and reserve replacement targets, especially in Argentina, Venezuela and Ecuador. In accordance with this strategy and in order to grow from a financially solvent platform, investments will principally be made in our existing operations and in exploration, including new off-shore opportunities.

*Our Oil and Gas Exploration and Production Interests*

As is commonplace in the oil and gas exploration and production business, we generally participate in exploration and production activities in conjunction with joint venture partners. Contractual arrangements among participants in a joint venture are usually governed by an operating agreement, which provides that costs, entitlements to production and liabilities are to be shared according to each party's percentage interest in the joint venture. One party to the joint venture is usually appointed as operator and is responsible for conducting the operations under the overall supervision and control of an operating committee that consists of representatives of each party to the joint venture. While operating agreements generally provide for liabilities to be borne by the participants according to their respective percentage interest, licenses issued by the relevant governmental authority generally provide that participants in joint ventures are jointly and severally liable for their obligations to that governmental authority pursuant to the applicable license. In addition to their interest in field production, contractual operators are generally paid their production costs on a monthly basis by their partners in proportion to their participation in the relevant field.

As of December 31, 2004, we had interests in 23 oil fields, 17 of which are oil and gas producing fields and six of which are located in exploration areas, three in Argentina and three outside of Argentina. We are directly or indirectly the contractual operator of 22 of the 23 fields in which we have an interest.

As of December 31, 2004, our total gross and net productive wells were as follows:

	<u>Oil</u>	<u>Gas</u>	<u>Total</u>
Gross productive wells <sup>(1)</sup>	4,548	254	4,802
Net productive wells <sup>(2)</sup>	3,726	221	3,947

(1) Refers to number of wells completed.

(2) Refers to fractional ownership working interest in gross wells.

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As of December 31, 2004, our total producing and exploration acreage, both gross and net, is shown in the following table:

	Average			
	Producing <sup>(1)</sup>		Exploration <sup>(2)</sup>	
	Gross <sup>(3)</sup>	Net <sup>(4)</sup>	Gross <sup>(3)</sup>	Net <sup>(4)</sup>
	(in thousands of acres)			
Argentina	4,027	3,211	882	876
Peru	116	116		
Venezuela	585	379	363	181
Ecuador	775	691		
Bolivia	56	56		
<b>Total</b>	<b>5,559</b>	<b>4,453</b>	<b>1,245</b>	<b>1,057</b>

- (1) Includes all areas in which we produce commercial quantities of oil and gas or areas in the stage of development.  
 (2) Includes all areas in which we are allowed to perform exploration activities but where commercial quantities of oil and gas are not produced.  
 (3) Represents number of wells completed.  
 (4) Represents our fractional ownership working interest in the gross acreage.

The following table sets forth the number of total wells we drilled in Argentina and outside Argentina and the results thereof for the periods indicated. A well is considered productive for purposes of the following table if it justifies the installation of permanent equipment for the production of oil and gas. A well is deemed to be a dry well if it is determined to be incapable of commercial production. Gross wells drilled in the table below refers to the number of wells completed during each fiscal year, regardless of the spud date, and net wells drilled relates to the fractional ownership working interest in wells drilled. This table includes wells drilled by both our consolidated subsidiaries and unconsolidated investees.

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	Year ended December 31,					
	2004		2003		2002	
	Argentina	Outside Argentina	Argentina	Outside Argentina	Argentina	Outside Argentina
<b>Gross wells drilled:</b>						
Production:						
Productive wells:						
Oil	194	45	169	20	109	2
Gas	4		8	1	7	
Dry wells	2	1	8		4	
<b>Total</b>	<b>200</b>	<b>46</b>	<b>185</b>	<b>21</b>	<b>120</b>	<b>2</b>
Exploration:						
Discovery wells:						
Oil	2	1		2		
Gas						
Dry wells		1		1	1	2
<b>Total</b>	<b>2</b>	<b>2</b>		<b>3</b>	<b>1</b>	<b>2</b>
<b>Net wells drilled:</b>						
Production:						
Discovery wells:						
Oil	109.0	35.2	105.2	17.7	78.7	1.1
Gas	2.8		6.6	0.6	5.8	
Dry wells	1.7	0.9	6.2		2.8	
<b>Total</b>	<b>113.5</b>	<b>36.1</b>	<b>118.0</b>	<b>18.3</b>	<b>87.3</b>	<b>1.1</b>
Exploration:						
Discovery wells:						
Oil	1	2		1.4		
Gas						
Dry wells		0.7		1.0	1	1.1
<b>Total</b>	<b>1</b>	<b>2.7</b>		<b>2.4</b>	<b>1</b>	<b>1.1</b>

**Production***Argentine Production*

Argentina is currently the fourth largest oil producer in Latin America after Mexico, Venezuela and Brazil. In 2004, Argentina's daily production was approximately 695,000 barrels, accounting for approximately 7.5% of the region's total production. Production from Mexico, Venezuela and

Brazil accounts for about 37.5%, 24.3% and 16.4%, respectively, of total oil production in Latin America.

Oil production activities in Argentina are mainly developed in mature fields undergoing secondary recovery operations, which are capital-intensive projects. As a result of regulatory changes and the resulting influx of private capital in exploration and production, oil reserves in Argentina significantly grew in the 1990s, reaching 3.071 million barrels in 1999. Since that time period, a sustainable drop in reserves has been recorded, with a 13% reduction in 2003 compared to 1999. This drop was mainly due to price controls set by the government on oil and gas prices, including implementation of an export tax regime and a freeze on the price of gas, as well as, the lack of specific economic and tax incentives all of which have strongly discouraged investments in research for new reserves. In 2004, for the seventh year in a row, oil production in Argentina decreased, to 695,000 barrels per day, which represents a 6.1% reduction compared to 2003.

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Since the privatization of natural gas utilities in 1992, the natural gas industry in Argentina has grown significantly as a result of a number of factors, including: (1) an increase in gas availability, (2) increased and improved transportation and distribution, (3) environmental efficiency and (4) low prices as compared to international levels.

As a result of natural gas competitiveness, demand for gas significantly increased from 17,800 million cubic meters in 1990 to 43,466 million cubic meters in 2003, and natural gas became the preferred fuel for residential and industrial users as well as electricity generation companies. Compressed natural gas also became an important fuel source for vehicles during the last ten years because compressed natural gas is the least expensive and least polluting motor fuel. Argentina currently has the largest compressed natural gas-fueled vehicle fleet in the world.

In response to the increased demand for natural gas, significant investments in the natural gas chain were made following the privatization of the services of natural gas transportation and distribution which occurred in 1992 until 2001.

The Public Emergency Law, however, significantly changed the applicable regulatory framework. Measures such as the freezing of natural gas prices as well as the pesification and freezing of transportation and distribution tariffs have adversely affected the economic attractiveness of the gas business and have led to a significant reduction in exploration activities. This reduction juxtaposed with an increase in demand has significantly reduced Argentina's horizon of reserves, which decreased from approximately 25 years in the beginning of the 1990s to little more than a 12-year reserve by the end of 2004.

In 2004, natural gas volumes for the year reached 142.9 million cubic meters per day, a 3% increase compared to the same period of 2003 (139.5 million cubic meters per day). Demand for natural gas, however, outpaced this increase and grew by 8% during the same period, mainly boosted by the sale of compressed natural gas and consumption by power plants. In light of the foregoing imbalance between production and demand, the Argentine government intensified its intervention in the energy market through a series of measures, including: (1) increasing natural gas prices at well-heads; (2) increasing imports of natural gas from Bolivia; (3) reducing natural gas exports to Chile to between 2 and 5 million cubic meters a day; (4) creating the Program for the Rationalization of Energy, which attempts to stimulate savings of gas and electricity from domestic consumption in order to generate surpluses that can then be applied to industrial activities; (5) outlining the framework for the creation of trust funds in order to finance the expansion of gas pipelines; (6) creating the Gas Electronic Market, with the aim of improving the transparency and efficiency of daily operations through the free interaction of supply and demand of natural gas; and (7) creating the company Energía Argentina S.A., or ENARSA, a new state-owned energy company that attempts to, as one of its major goals, find new oil and gas reserves in unexplored areas in association with private companies.

In the fiscal year ended December 31, 2004, our oil and gas production accounted for 8% and 4% of total oil and gas production in Argentina, respectively. As of December 31, 2004, we had interests in ten Argentine oil and gas production fields, with production rights in approximately 3,211,000 net acres.

Our production is concentrated in two basins, the Neuquén and Austral basins. This positioning helps to optimize our operating efficiency and capitalize on the operating synergies of our own assets. The Neuquén basin is the most important basin in Argentina in terms of oil and gas production. We own approximately 578,000 net acres under production concessions. Our most important fields in the Neuquén basin are 25 de Mayo-Medanito S.E., Puesto Hernández and Río Neuquén. In the Austral basin, we own approximately 2,633,000 net acres under production concessions, with Santa Cruz I and Santa Cruz II being our most important fields in that basin.

Rights to develop oil and gas fields in Argentina are granted through concessions and exploration permits. Concessions are generally granted for periods of 25 years and are typically renewable for a maximum term of ten years, and permits are generally granted for initial periods of four

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years. The concessions for all areas in Argentina typically provide for the free availability of oil. All permanent fixture, materials and equipment are under the control of the concessionaire, although they revert to the Argentine government at the end of the concession. Royalties based on production are paid to the respective Argentine provinces where the production of crude oil occurs and the volumes of natural gas are located. Throughout the country, these royalties are fixed at 12% of the wellhead price for oil and gas.

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*Production outside of Argentina*

As a result of the substantial investments we have made in the rest of Latin America in recent years, as of December 31, 2004, 63.9% of our combined proved reserves were located outside of Argentina. In addition, approximately 56% of our oil production and 25% of our gas production came from outside Argentina in 2004. We have interest in eight oil and gas production fields outside of Argentina: Oritupano-Leona, Acema, La Concepción and Mata in Venezuela, Lote X in Peru, Block 18 and Block 31 in Ecuador and Colpa Caranda in Bolivia.

Venezuela

Venezuela is an important country in the international oil market. With proven reserves of approximately 78 billion barrels of crude oil in 2004, Venezuela possesses the largest proven reserves in the Western Hemisphere and has 6.8% of the total reserves on earth. Its commercial production is concentrated in the basins of Zulia and Barinas-Apure in the western part of the country and in the basins of the Estados Monagas and Anzoátegui in the eastern part of the country. Venezuela also has billions of barrels of heavy duty crude and bitumenes, the great majority of which is situated in the Faja Petrolífera of Orinoco. In 2004, Venezuela produced approximately 2.6 million barrels of crude oil a day, of which close to 407,000 barrels were consumed in the local market and the remainder was exported.

Production from Venezuela is an important part of our total production, accounting for 31.5% of the total average production in barrels of oil equivalent in 2004. In Venezuela, our rights are held under operating service contracts.

In 1994, during what is referred to as the second round bids, we were awarded the first service contract by PDVSA at the Oritupano-Leona field to provide production services for a 20-year period, which may be extended for an additional ten-year period. (We refer to the contracts awarded pursuant to the second round bids as the second round operating agreements.) Oritupano-Leona is an approximately 215,000 net acre block located in the Oriental basin that includes 272 producing wells.

The Oritupano Leona joint venture's sole customer for the sale of oil production is PDVSA. Per our operating service agreement, PDVSA is the sole owner of the facilities, assets and/or operating equipment used by the joint venture to conduct the activities provided for in this agreement. For the provision of production services, we receive (1) a variable fee based on production volumes plus (2) an additional fee for reimbursement of capital expenditures. The additional payments in item (2) that commence during the first ten-year period of the agreement are paid in quarterly installments for a term of ten years, and the additional payments that commence during the second ten-year period of the agreement are paid in quarterly installments for a term equivalent to the remainder of the twenty-year period. The contract has a cap on the amount, which we can collect, which is reset quarterly based on the market price of oil. As of December 2004, this cap was approximately US\$37.9 per barrel. The contract also establishes an incentive, which is not subject to the cap, for any production over 155 million barrels of oil, calculated using a rate per barrel that is based on variations of certain crude oil prices. During the first quarter of 2005, cumulative field production exceeded the 155 million barrel production level and, since then, any additional production has been subject to the incentive.

In 1997, during what is referred to as the third round bids, PDVSA awarded us three 20-year service contracts for the exploration and production of Acema, La Concepción and Mata blocks. (We refer to the contracts awarded pursuant to the third round bids as the third round operating agreements and the three blocks awarded to us during those bids, namely the Acema, La Concepción and Mata blocks, as the third-round blocks.) The bids were initially made through joint ventures. Currently, we have a 90% interest in the La Concepción block and an 86.23% interest in the Acema and Mata oil blocks. La Concepción is an approximately 55,000 net acre block located in the Maracaibo basin with 116 producing wells. Acema and Mata, located in the Oriental basin, are approximately 64,000 and 45,000 net acre blocks with 18 and 57 producing wells, respectively. According to the concession contracts, PDVSA will be the sole owner of the facilities, assets, and operating equipment. We receive a fee for each barrel delivered which has a fixed component related to contractual baseline production and a variable component related

to the incremental production that covers investments and production costs, plus a gross profit up to a maximum that is tied to a basket of international oil prices.



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Effective January 2002, the Venezuelan government adopted a new law whereby royalty payments increased from 16.67% to 30%. This law had a significant adverse impact on the operating results of our third round blocks. Under contractual terms, royalties are deducted from the sales price.

The government of Venezuela may set a limit on our oil production under the terms of the service agreements. Venezuela is a member of OPEC and has set forth a policy of strict compliance with the production quotas decided within OPEC. According to the Venezuelan Hydrocarbon Law, any decisions made by the federal administration in connection with agreements or international treaties involving hydrocarbons are applicable to any party that carries out the activities governed by the law. As a result of this, if there are production cuts approved by OPEC, these cuts affect private producers as well as PDVSA. See Regulation of Our Businesses Venezuelan Regulatory Framework Petroleum and Gas Additional Matters OPEC. Production cuts were only contemplated by the third round operating agreements, but not by the second round operating agreements, which apply to the Oritupano-Leona field. Although no production cuts have been ordered under the second round operating agreements to date, it is not completely clear whether the constitutional principle that prohibits retroactive application of the law will protect those agreements against future production cuts.

In April 2005, the Venezuelan Energy and Oil Ministry instructed PDVSA to review the thirty-two operating agreements signed by PDVSA with oil companies from 1992 through 1997, including agreements with our affiliates in connection with the areas of Oritupano Leona, La Concepción, Acema and Mata. According to the Venezuelan Energy and Oil Ministry, each of these operating agreements includes clauses that do not comply with the Venezuelan Hydrocarbon Law enacted in 2001.

The Venezuelan government has instructed PDVSA to take measures within a six-month term to convert all currently effective operating agreements into mixed-ownership contracts in order to grant the Venezuelan government, through PDVSA, more than 50% ownership of each field. The government has further instructed PDVSA to limit the total accumulated payments to contractors during a calendar year to 66.67% of the value of oil and gas produced under the related agreement. On April 15, 2005, PDVSA notified our subsidiary Petrobras Energía Venezuela, S.A. about this and advised that the Venezuelan Energy and Oil Ministry will, as soon as possible, contact our subsidiary to fix a date to begin the related discussions. Without opining on the proposed changes or the legitimacy of the operating agreements, we have expressed our willingness to engage in discussions with PDVSA and the Venezuelan government.

On June 23, 2005, we received notice from PDVSA that it would start paying in local currency the amounts due to us under the operating agreements that correspond to national services and materials, instead of US dollars as provided in the relevant agreements. Under the current agreements, all payments from PDVSA are due in dollars outside Venezuela. During an interim period and until PDVSA performs an audit that finally determines the portion of services under the operating agreements that correspond to national services, PDVSA would start paying 50% of the amounts due to us under the operating agreements in local currency, and the remaining 50% would continue to be payable in dollars. See Item 3. Key Information Risk Factors Factors Relating to Venezuela Changes in the regulatory and contractual framework applicable to our operating agreements have and may in the future adversely affect our financial position and results of operations.

In addition, the Venezuelan tax authorities have recently publicly stated that they are looking into the taxes paid by private oil companies in recent years. The authorities have stated that private oil companies may have under-reported their taxable income in Venezuela. As of the date of this annual report, none of the oil companies operating in Venezuela, including us, have received a claim from the SENIAT in connection with this alleged investigation.

Peru

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In 1996, we acquired 30-year oil and 40-year natural gas production rights in Lote X, an approximately 116,000-acre block in Peru's Talara basin, through a public bidding process. The purchase included all of the then existing assets on the site. As of December 31, 2004, Lote X had 2,388 productive wells. We have entered into a long-term sales contract under which Perupetro S.A., the Peruvian state-owned company, which we refer to as Perupetro, is obligated to purchase all of our production at market prices. The sales contract is set to expire in July 2006.

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In June 2003, the Peruvian government approved the National Law for the Promotion of Investment in the Exploitation of Resources and Marginal Reserves of Hydrocarbons (*Ley para la Promoción de la Inversión en la Explotación de Recursos y Reservas Marginales de Hidrocarburos a Nivel Nacional*), which authorizes Perupetro to reduce the level of royalty payments, which are equal to 24% of the sales price. In accordance with the new law, we entered into an agreement with the Peruvian government whereby we undertake to make investments of approximately US\$97 million in Lote X during the 2004-2011 period. Works covered by this agreement include the drilling of 51 wells, the workover of 526 wells, the reactivation of 177 temporarily abandoned wells and the implementation and expansion of a water injection project. The Peruvian government, in turn, reduced the percentage of royalties. Royalties paid for the production of crude oil are based on the price of a basket of crude oil prices, starting at a rate of 13% for prices up to US\$23.9 per barrel. The royalty rate applicable as of December 31, 2004 was 17.6%. Production of natural gas is subject to a fixed royalty rate of 24.5%.

Due to the decrease in royalties as a result of this agreement, our economic projections in connection with operations in Peru have improved. Peru production accounted for 8% of our total average production in barrels of oil equivalent in 2004.

### Ecuador

In Ecuador we operate Blocks 18 and 31, in which as of December 31, 2004, we hold a 70% and 100% interest, respectively. Ecuador production accounted for 4% of our total average production in barrels of oil equivalent in 2004.

### Block 18

In 2001, we acquired a 70% interest in Block 18, located in the Oriente basin of Ecuador. Block 18 is a field covering approximately 197,000 net acres and having a significant potential of 28° to 33° API light crude oil reserves. The concession for production activities in Block 18 is for an initial 20-year term, which commenced in October 2002. Once this term expires, Ecuadorian hydrocarbon laws provides for the possibility of an additional five-year extension period.

In October 2002, the Hydrocarbons National Directorate approved the development plan for the Pata field in Block 18, thereby initiating its production phase until October 2022. Exploratory activities were to continue for an additional three-year period and are scheduled to end in October 2005. With respect to this field, the government receives a production share ranging from 25.8%, if daily production is lower than 35,000 barrels per day, to 29%, if production exceeds 45,000 barrels per day. For the middle production range, the average share is about 26.1%.

In August 2002, Petroecuador, the Ecuadorian state owned company, subscribed to a joint exploitation agreement for the Palo Azul field in Block 18. In December 2002, the Palo Azul development plan was approved and the duration of the exploitation concession has been extended until December 2022. The general terms of the agreement include differential production sharing percentages according to a formula that takes into account the final selling price of Palo Azul's crude oil and the level of total proved reserves. Namely, if the crude from Palo Azul is sold at less than US\$15 per barrel, the government receives about 30% of the crude produced, while, if the price of the crude is US\$24 or higher, the government receives about 50% of production. The selling price of the Palo Azul crude is calculated considering as reference the WTI after taking into account the standard market discount for the Oriente crude.

As of December 31, 2004, the government's shares of the oil produced at the Pata and Palo Azul fields was 25.8% and 50%, respectively.

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As of the date of this annual report, Block 18 has eight productive wells, two of which are located at the Pata field and six of which are located at the Palo Azul field. In addition, the area has early production facilities, which can handle a daily gross production of approximately 20,000 barrels per day. In 2004, we started works to expand production facilities in order to increase capacity to approximately 30,000 barrels per day by mid 2005.

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Block 31

Block 31 is located in a highly sensitive ecological area of the Amazon jungle in the central part of the eastern border of the upper Amazon basin and covers an area of approximately 494,000 net acres. Pursuant to the block's production sharing agreement between Petroecuador and us, Petroecuador is entitled to a crude oil production share ranging between 12.5% and 18.5% depending on the field's daily crude oil production and crude oil gravity.

We have conducted extensive exploratory work in the block, including the drilling of four exploratory wells in Apaika, Nenke, Obe and Minta. Each of these wells was successful and led to the discovery of the Apaika/Nenke, Obe, and Minta fields. In order to further develop the block, significant investments are required prior to the production phase.

In August 2004, the Minister of Energy of Ecuador approved an environmental impact study, completing all of the required steps for the approval of the development plan for the block. Following approval of the environmental study, a 20-year exploitation period began. During an initial three-year period, the plan contemplates investments of US\$75 million by us, and we are obliged to provide Petroecuador a guarantee of 20% of this amount. In December 2004, as part of these contemplated investments, we commenced construction of a pier on the Napo River.

We have already started the development of the Apaika Nenke Field in Block 31. Initial investments of approximately US\$50 million are necessary prior to the commencement of the production phase.

In January 2005, we entered into a crude oil transportation agreement with Occidental Exploration and Production Company, or Oxy. Under this agreement, we will be able to use a pipeline owned by Oxy to transport oil produced by Block 31 to the head of the OCP pipeline. The agreement becomes effective thirty days after the earlier of (1) the date that Block 31's first volumes of crude oil are ready for transportation or (2) January 1, 2007, and runs through July 2019. A ship or pay clause is included in the agreement for an amount of approximately US\$10 million, which is spread over 13 years and equals 25% of the production related to the Apaika Nenke field's proved reserves. To comply with the agreement, Oxy's facilities must be expanded, which will require an investment of approximately US\$14 million. This investment will be financed by us and will be reimbursed by reducing the transportation rate charged to us. This agreement remains subject to approval by the Ecuadorian government.

Ship or Pay Contract with Oleoducto de Crudos Pesados (OCP)

We entered into a ship or pay contract with OCP, whereby OCP has committed to provide us with a shipping capacity of 80,000 barrels per day for a 15-year term. OCP started commercial operations on November 10, 2003 and, as of that date, pursuant to our contractual obligations, we are required to pay OCP a transportation capacity fee regardless of whether we use the committed capacity. As of December 31, 2004, the fee was US\$2.2 per barrel. We have assigned approximately 8,000 barrels a day of the 80,000 barrels per day commitment to a third party from July 2004 until January 2012. These arrangements will defray some of our shipping costs. Nonetheless, we currently estimate based on (1) the forecasted pace of development of Block 31 and (2) the revised outlook of the potential of Block 31's reserves, that during the ship or pay contract's term, oil production will be lower than our remaining portion of committed transportation capacity. We refer to this potential amount of unfulfilled commitment as an oil production deficit. After taking into consideration the significant economic effects due to this oil production deficit, as of December 31, 2003, we recorded a P\$324 million impairment allowance in connection with our assets in Ecuador.



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### Agreement with Teikoku

In January 2005, we entered into an agreement with Teikoku Oil Co., Ltd., or Teikoku, whereby, following approval by the Ministry of Energy of Ecuador, we will transfer 40% of our rights and interest in Blocks 18 and 31. In addition, once production in Block 31 reaches an average of 10,000 barrels of oil per day for a period of 30 consecutive days, Teikoku has agreed to assume 40% of our rights and obligations resulting from the crude oil transportation agreement with OCP. (Allocation of the transportation capacity to Teikoku will enable us to reduce the oil production deficit.) Teikoku, in turn, will pay us US\$15 million. In addition, Teikoku has agreed to make investments in Block 31 in excess of its interest in the joint venture, causing accelerated development of the block. Once the agreement is approved by the Ministry of Energy of Ecuador, our interests in Blocks 18 would be reduced from our current level of 70% to 30% and our interest in Block 31 would be reduced from 100% to 60%, but we will continue acting as operator for both blocks. We expect that our partnership with Teikoku will accelerate the development of our Ecuadorian assets, making our operations in Ecuador a more relevant component in our business portfolio.

### Bolivia

Petrobras Energía has a 100% interest in the oil and gas fields of Colpa Caranda and has operated them since 1989. Colpa Caranda is an approximately 56,000 net acre block located in the Sub Andina Central basin that has 48 producing wells with approximately 7,200 barrels of oil equivalent of production per day. Approximately 86% of our proved developed reserves in Bolivia are gas. These fields, which originally exported gas to Argentina, currently have priority in the dispatch of gas to the Santa Cruz-São Paulo pipeline that transports gas to Brazil. Bolivia production accounted for approximately 4% of our total average production in barrels of oil equivalent in 2004.

In January 2005, we entered into a sales agreement with Petrobras Bolivia, whereby, we will transfer, subject to the approval of Yacimientos Petrolíferos Fiscales Bolivianos, or YPF, a 5% interest in Colpa Caranda to Petrobras.

### Mexico

In 2003, as part of the bidding launched by Petróleos Mexicanos, or PEMEX, for the operation of areas under multiple service contracts, contracts for the Cuervito and Fronterizo blocks were awarded to a joint venture composed of Petrobras, Teikoku and Diavaz. Under an operating agreement, we act as contractor and provide the joint venture with the technical and operating support required for the operation of these blocks.

**Table of Contents****Statistical Information Relating to Oil and Gas Production**

The following table sets forth our oil and gas fields production as of December 31, 2004. In addition, the table includes our percentage interest in the oil and gas production of each field, the number of producing wells and the expiration date of the concessions. Although some of these concessions may be extended at their expiration, the expiration dates set forth below do not include any extensions.

Production Areas	Location	Basin	2004 Production		Oil and Gas Wells	Interest	Expiration
			Oil <sup>(1)</sup>	Gas <sup>(2)</sup>			
<b>Argentina:</b>							
25 de Mayo Medanita S.E.	La Pampa and Río Negro	Neuquén	5,051	1,847	512	100.00%	2016
Jagüel de los Machos	Río Negro and La Pampa	Neuquén	1,025	2,589	75	100.00%	2015
Puesto Hernández	Mendoza and Neuquén	Neuquén	5,121		642	38.45%	2016
Bajada del Palo La Amarga Chica	Neuquén	Neuquén	82		4	80.00%	2015
Santa Cruz II	Santa Cruz	Austral	3,711	18,385	83	100.00%	2017
Río Neuquén	Neuquén and Río Negro	Neuquén	811	10,414	131	100.00%	2017
Entre Lomas	Neuquén and Río Negro	Neuquén	742	1,278	345	17.90%	2016
Veta Escondida and Rincón de Aranda U.T.E.	Neuquén	Neuquén				55.00%	2016
Aguada de la Arena	Neuquén	Neuquén	88	6,862	10	80.00%	2022
Santa Cruz I U.T.E.	Santa Cruz	Austral	2,686	31,194	94	71.00%	2016
<b>Total in Argentina</b>			<b>19,317</b>	<b>72,569</b>	<b>1,896</b>		
<b>Outside of Argentina:</b>							
Colpa Caranda	Bolivia		497	12,914	48	100.00%	2029
Oritupano Leona	Venezuela	Oriental Maturín	10,453		272	55.00%	2014
Acema	Venezuela	Oriental Maturín	887		18	86.23%	2017
La Concepción	Venezuela	Lago Maracaibo	4,749	7,589	116	90.00%	2017
Mata	Venezuela	Oriental Maturín	1,491		57	86.23%	2017
Lote X	Peru	Talara	4,145	3,140	2,388	100.00%	2024
Block 31	Ecuador	Oriente				100.00%	2024
Block 18	Ecuador	Oriente	2,290		8	70.00%	2022
<b>Total outside Argentina</b>			<b>24,512</b>	<b>23,643</b>	<b>2,907</b>		
<b>Total</b>			<b>43,829</b>	<b>96,212</b>	<b>4,803</b>		

(1) in thousands of barrels

(2) in billions of cubic feet





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The following table sets forth our average daily production of oil, including other liquid hydrocarbons, for the three fiscal years ended December 31, 2004, 2003 and 2002. This table includes our proportionate share of the production of both our consolidated subsidiaries and our unconsolidated investees.

	Year ended December 31,		
	2004	2003	2002
	(average barrels per day)		
Argentina	52,778	57,803	56,746
Outside of Argentina	66,973	56,827	58,917
<b>Total</b>	<b>119,751</b>	<b>114,630</b>	<b>115,663</b>

The following table sets forth our average daily gas production for the three fiscal years ended December 31, 2004, 2003 and 2002. This table includes our proportionate share of the production of both our consolidated subsidiaries and our unconsolidated investees.

	Year ended December 31,		
	2004	2003	2002
	(average millions of cubic feet per day)		
Argentina	198,217	202,272	252,559
Outside of Argentina	64,657	61,679	61,238
<b>Total</b>	<b>262,874</b>	<b>263,951</b>	<b>313,797</b>

The following table sets forth the average sales price per barrel of oil and per million cubic feet of gas for each geographic area for the three fiscal years ended December 31, 2004, 2003 and 2002, of our consolidated subsidiaries.

	Year ended December 31,		
	2004	2003	2002
<b>Argentina:</b>			
Oil (in pesos per barrel of oil equivalent)	88.11	69.80	65.88
Gas (in pesos per million cubic feet)	1.93	1.76	1.98
<b>Outside of Argentina:</b>			
Oil (in pesos per barrel of oil equivalent)	61.91	52.70	50.70
Gas (in pesos per million cubic feet)	3.79	4.37	4.52



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The following table sets forth our average lifting cost, royalties and depreciation cost of oil and gas fields in each geographic area for the three fiscal years ended December 31, 2004, 2003 and 2002. This table includes our proportionate share of the production of our consolidated subsidiaries.

	Year ended December 31,		
	2004	2003	2002
	(in pesos per barrel of oil equivalent)		
<b>Argentina:</b>			
Lifting Cost	7.74	6.45	5.77
Royalties	6.27	5.37	5.28
Depreciation	11.35	10.02	9.61
<b>Total</b>	<b>25.36</b>	<b>21.84</b>	<b>20.66</b>
<b>Outside of Argentina:</b>			
Lifting Cost	8.92	9.42	10.41
Royalties	5.08	5.52	5.45
Depreciation	11.67	12.78	15.41
<b>Total</b>	<b>25.67</b>	<b>27.72</b>	<b>31.27</b>

**Exploration**

We believe exploration is an important vehicle for our future growth and for reserve replacement. We have, therefore, developed a strategy designed to constantly search for new exploration opportunities that are aligned with our growth targets. In accordance with this view, we plan on increasing investments in exploration, including new off-shore opportunities.

We use state of the art technology to minimize geological risk and to build a sound prospect portfolio.

In exploring off-shore areas, we will apply the technology and know-how of Petrobras, a world leader in offshore exploration and a pioneer in deep and ultra deep water activities. Petrobras has previously been awarded (on two occasions) with the Offshore Technology Conference Distinguished Achievement Award for its deep-water technology, the most important award in the international off-shore oil industry.

The following table lists our oil and gas fields in exploration areas as of December 31, 2004, the location of the basin in each area, our ownership interest and the expiration date of the exploration permits for each field.

Location	Basin	Interest	Expiration
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<b>Argentina:</b>				
Glencross	Santa Cruz	Austral	96.68%	1999 <sup>(1)</sup>
Estancia El Chiripá	Santa Cruz	Austral	100.00%	2001 <sup>(1)</sup>
Santa Cruz I Oeste	Santa Cruz	Austral	50.00%	2006
<b>Outside of Argentina:</b>				
San Carlos	Venezuela	Guarico	50.00%	2005
Tinaco	Venezuela	Guarico	50.00%	2005
Block 57	Peru	Ucayali	35.50%	2010

<sup>(1)</sup> We have requested that the lot be declared operational and are awaiting a response from the relevant authorities.

*Exploration in Argentina*

As of December 31, 2004, we hold interest in approximately 882,000 gross acres (876,000 net acres) of exploration acreage in Argentina. We may continue to acquire acreage positions in the future as the Argentine government offers additional exploration permits through license bidding rounds. We compete with other oil and gas producers in Argentina for the acquisition of new properties.

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In 2004, two successful wells were drilled in El Campamento - El Martillo exploratory field, in the Santa Cruz I Oeste Block, which resulted in discoveries. The first well yielded 190 barrels of oil per day and approximately 60,000 cubic meters of gas during the production test. The second well yielded 314 barrels of oil per day at a depth of approximately 1,400 meters. Further, exploratory drilling is scheduled for 2005.

In 2004, we decided to perform offshore activities in the Argentine marine basin and were awarded the seismic survey and exploration of two blocks: CAA 01, located 220 km to the east of Mar del Plata, in Buenos Aires Province and CAA 08, located 420 km to the south of this city. Water depth in these blocks ranges between 400 and 3,000 meters. No exploration activities have been previously performed in these areas.

During 2002, we farmed out a 50% interest in Santa Cruz I-Oeste exploratory block. The buyer committed to make all the investments necessary to acquire and process 500 km<sup>2</sup> of 3-D seismic lines and to drill five wells. However, we remain responsible for conducting operations in this block. During 2004, two successful wells were drilled in accordance with this arrangement.

### *Exploration Outside of Argentina*

As of December 31, 2004, we hold interests in approximately 363,000 gross acres (181,000 net acres) outside of Argentina available for exploration. We hold interests in three exploration blocks outside of Argentina: San Carlos and Tinaco in Venezuela and Block 57 in Peru. We also continue our exploration activities in Blocks 18 and 31 in Ecuador, and are seeking new business opportunities in Peru, Bolivia, Ecuador and Venezuela.

#### Venezuela

We began exploration activities in the San Carlos region of western Venezuela under a contract entered into with PDVSA through its subsidiary, Corporación Venezolana de Petróleo S.A., in July 1996. The block is located in the areas of Cojedes and Portuguesa and extends across approximately 125,000 acres. The exploration activities in this block started late in 1996 and the work commitments for the first stage of the exploration process were fulfilled with the acquisition of 2-D seismic data and the drilling of two exploratory wells. Total expenditures required for initial exploration in the block were US\$32 million. Our exploration activities in this block yielded gas findings.

In June 2001, upon the opening of free gas exploration areas, we were awarded a license for the exploration and production of gas in the Tinaco area, a field adjacent to the San Carlos field, with an area of approximately 238,000 acres. This event was an important step in the future development of the San Carlos block permitting us to confirm related natural gas reserves.

In connection with the joint future gas production of both blocks, we negotiated the conversion of the San Carlos contract into a contract with similar conditions as those appearing in the Tinaco contract. If gas reserves are commercialized in the future, we will be required to pay 23.21% in royalties.

In October 2002, we entered into an association agreement with Teikoku, whereby we transferred 50% of our rights and obligations in and to gas production in San Carlos and Tinaco exploratory areas. This agreement is subject to approval by the Venezuelan Ministry of Energy and provides for an initial cash payment of US\$1 million and a subsequent payment of US\$2 million for the financing of certain exploratory

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investments in the Tinaco area. Furthermore, in the event both parties agree on a joint commercial development for the area, we will receive a supplementary payment of US\$3 million.

Ecuador

The concession contract for Block 31 permits us to perform additional exploratory works for a period of three years following commencement of the development stage. We, therefore, may perform exploratory activities

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until August 2007. We are currently performing new exploratory activities to determine the existence of other oil accumulations within Block 31, as well as, along the Apaika-Nenke trend. We plan to drill an appraisal well to test a step-out structure located immediately to the south of the Apaika block, which may have an impact on the field's development. In addition, a 3D seismic survey is planned for later this year to appraise the Obe field discovery and potential structures immediately to the north of this field.

### Peru

In May 2004, we entered into a contract with Repsol Exploración Perú S.A. to perform certain exploration activities jointly in Block 57, which is located in the Ucayali basin. Pursuant to this contract, we participate in Block 57 with a 35.15% interest. The work commitment for the initial exploration period consists of the reprocessing of existing 2D seismic data and geological studies.

## **Reserves**

We believe our estimates of remaining proved recoverable oil and gas reserve volumes to be reasonable. Proved oil and natural gas reserves are those estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from reservoirs under existing economic, operating and regulatory conditions, i.e. prices and cost at the date of estimation. These estimates have been prepared in accordance with Rule 4-10 of Regulation S-X under the U.S. Securities Act. Gaffney, Cline & Associates, Inc., an international technical and management advisory firm for the oil and gas industry, audited our oil and gas reserves as of December 31, 2004, 2003 and 2002.

As of December 31, 2004, liquid hydrocarbon and natural gas proved developed and undeveloped reserves, audited by Gaffney, Cline & Associates, Inc., amounted to 732 million barrels of oil equivalent (552.5 million barrels of oil and 1,077.0 billion cubic feet of natural gas), representing a 3.5% decline compared to the reserves certified as of December 31, 2003 (a decline of 2.9% for liquid hydrocarbons and 5.1% for natural gas).

Liquid hydrocarbons and natural gas accounted for 75% and 25%, respectively, of our total proved reserves as of December 31, 2004. Approximately 64% of our total proved reserves as of December 31, 2004 were located outside of Argentina as compared to 60% as of December 31, 2003. This increase is attributable to increased proved reserves in Ecuador. As of December 31, 2004, our proved developed reserves of crude oil equivalent represented 51.2% of our total proved reserves of crude oil equivalent.

During 2004, production totaled 59.9 million barrels of oil equivalent. Net additions of proved reserve totaled 34 million barrels of oil equivalent. Net additions during 2004 resulted from:

14.1 million barrels of oil equivalent added from improved recovery in production areas, particularly in Peru, where as a result of the increased profitability expectations resulting from the reduction of royalties brought about by new Law 28,109 For the Promotion of Investment in the Exploitation of Hydrocarbon, Resources and Marginal Reserves, we have added development projects;

44.6 million barrels of oil equivalent added from extensions and discoveries, principally as a result of the classification as proved reserves of discoveries and extensions of proved areas in Ecuador. In addition, reserves were added in the Argentine Austral basin and in Venezuela from extensions on producing fields; and



technical reviews based on the performance of the different fields and the projects implemented during 2004, resulting in reductions of previous estimates by 25 million barrels of oil equivalent mainly at fields in Argentina and Venezuela that are under secondary production.

As of December 2004, we had total oil and gas proved reserves equal to 12.2 years of production at 2004 oil and gas production levels.

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The table below sets forth, by geographic area, total proved reserves and proved developed reserves of crude oil, condensate and natural gas liquids and natural gas reserves at the indicated dates. This table includes our proportionate share of the proved reserves of our consolidated subsidiaries and unconsolidated investees. Our proportionate share of the proved reserves of our unconsolidated investees represented only 2.4% of our total proved reserves as of December 31, 2004.

	Crude oil, condensate and natural gas liquids			Natural gas			Combined  (in millions of barrels of oil equivalent)
	Argentina	Outside of	Total	Argentina	Outside of	Total	
		Argentina			Argentina		
	(in thousands of barrels)			(in millions of cubic feet)			
Total proved developed and undeveloped reserves as of December 31, 2002	213,342	380,536	593,878	943,788	369,456	1,313,244	812.7
Proved developed reserves as of December 31, 2002	146,319	177,876	324,195	554,104	209,854	763,958	451.5
Increase (decrease) originated in:							
Revisions of previous estimates	(19,026)	(3,278)	(22,304)	(131,964)	23,110	(108,854)	(40.4)
Improved recovery	10,082	15,392	25,474		7,261	7,261	26.7
Extensions and discoveries	3,258	18,303	21,561	61,370	7,571	68,941	33.0
Purchase of proved reserves in place							
Sale of proved reserves in place	(7,707)		(7,707)	(49,450)		(49,450)	(15.9)
Year's production	(21,097)	(20,743)	(41,840)	(73,825)	(22,517)	(96,342)	(57.9)
Total proved developed and undeveloped reserves as of December 31, 2003	178,852	390,210	569,062	749,919	384,881	1,134,800	758.2
Proved developed reserves as of December 31, 2003	122,085	169,925	292,010	455,465	207,144	662,609	402.4
Increase (decrease) originated in:							
Revisions of previous estimates	(21,351)	(5,753)	(27,104)	14,276	(1,749)	12,527	(25.0)
Improved recovery	2,553	9,555	12,108	12,181		12,181	14.1
Extensions and discoveries	5,309	36,966	42,275	7,165	6,498	13,663	44.6
Purchase of proved reserves in place							
Sale of proved reserves in place							
Year's production	(19,317)	(24,512)	(43,829)	(72,568)	(23,643)	(96,211)	(59.9)
Total proved developed and undeveloped reserves as of December 31, 2004	146,046	406,466	552,512	710,973	365,987	1,076,960	732.0
Proved developed reserves as of December 31, 2004	97,696	168,119	265,815	444,404	208,440	652,844	374.6

The following table sets forth the breakdown of our total proved reserves of liquid hydrocarbons and natural gas into proved developed and proved undeveloped reserves as of December 31, 2004, 2003 and 2002.

2004		2003		2002	
Millions of barrels of oil equivalent	% of total proved reserves	Millions of barrels of oil equivalent	% of total proved reserves	Millions of barrels of oil equivalent	% of total proved reserves

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Proved developed reserves	374.6	51.2%	402.4	53.1%	451.5	55.6%
Proved undeveloped reserves	357.4	48.8%	355.8	46.9%	361.2	44.4%
<b>Total Proved Reserves</b>	<b>732.0</b>	<b>100%</b>	<b>758.2</b>	<b>100%</b>	<b>812.7</b>	<b>100%</b>

Approximately 9% of our proved developed reserves as of December 31, 2004 are non-producing reserves.

Estimated reserves in Argentina, Peru and Bolivia are stated prior to the payment of any royalties, as they have the same attributes as taxes on production and, therefore, are treated as operating costs. In Ecuador, due to the type of contract in which the government has the right to a percentage of production and takes it in kind, reserves are stated after such percentage. In Venezuela, the government maintains full ownership of all hydrocarbons. Reserve volumes in Venezuela are computed by multiplying our percentage interest by the gross proved recoverable volumes for the contract area. In Venezuela, for the Acema, Mata and La Concepción areas, 30% royalties are paid,

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calculated based on the crude wellhead estimated price. Under contractual terms the third round blocks royalties are deducted from the sales price. Pursuant to operating agreements in force, we are exempt from production royalty payments in the Oritupano Leona field.

Had the economic method of calculating proved reserves (future expected cash flows of each field divided by the oil market prices at year end) been used, the reported amounts of crude oil, condensate and natural gas liquids proved reserves outside of Argentina would have decreased by approximately 27.1%, 23.4% and 28.8% as of December 31, 2004, 2003 and 2002, respectively. Gaffney, Cline & Associates Inc. did not audit the information in the preceding sentence.

There are many uncertainties in estimating quantities of proved reserves and in projecting future rates of production and the timing of development expenditures, including certain factors that are beyond our control. The reserve data set forth in this annual report solely represents estimates of our proved oil and gas reserves. Reserve engineering is a subjective process of estimating underground accumulations of crude oil and natural gas that cannot be precisely measured. The accuracy of a reserve estimate stems from available data, engineering and geological interpretation and judgment of reserves and reservoir engineering. As a result, different engineers often obtain different estimates. In addition, results of drilling, testing and production subsequent to the date of an estimate may justify revision of such estimate, so the reserve estimates at a specific time are often different from the quantities of oil and gas that are ultimately recovered. Furthermore, estimates of future net revenues from our proved reserves and the present value thereof are based upon assumptions about future production levels, prices and costs that may not prove to be correct over time. Forecasts of future prices, costs and production levels are subject to great uncertainty and may not prove to be correct over time. The meaningfulness of such estimates is highly dependent upon the accuracy of the assumptions upon which they are based. Accordingly, we cannot assure that any specified production levels will be reached or that any cash flow arising therefrom will be produced. The actual quantity of our reserves and future net cash flows therefrom may be materially different from the estimates set forth in this annual report. See Item 3. Key Information Risk Factors Factors Relating to the Company Our oil and gas reserves are not 100% accurate and may be subject to revision.

We replace our reserves through the acquisition of new producing fields, new exploration of our existing fields, the exploration of new fields and by proving up reserves in existing fields. Proving up is the process by which additional reserves classified as probable and possible reserves in a producing field are accessed and reclassified as proved reserves. We prove up reserves with reservoir management techniques by implementing waterflood and enhanced oil recovery projects. Reservoir management techniques currently used include water injection and drilling of horizontal wells, including producing and injection wells. In addition, technologies such as 3-D seismic process, horizontal and step out wells, underbalance drilling and reservoir numerical stimulation are also used.

As further discussed under Our History and Development Petrobras Energía Merger, as a result of the merger agreement, which will have retroactive effect as from January 1, 2005, EG3, PAR and PSF are expected to be merged into Petrobras Energía. If the merger had been consummated as of December 31, 2004, our volume of proved reserves as of December 31, 2004 of crude oil, condensate and liquids from natural gas and natural gas in Argentina would have increased by 20.7% and 54.7%, respectively.

## **Transportation and Sales**

In Argentina, we transport our oil and gas production in several ways depending on the infrastructure availability and the cost efficiency of the transportation system in a given location. We use the Argentine oil pipeline system and oil tankers to transport oil to customers. Oil is customarily sold through FOB contracts, and therefore, producers are responsible for transporting oil produced from the field to a port for shipping, with all costs and risks associated with transportation borne by the producer. Gas, however, is sold at the delivery point of the gas pipeline system near the field and, therefore, the customer bears most of the transportation costs and risks associated therewith. Oil and gas transportation in Argentina operates in an open access non-discriminatory environment under which producers have equal and open access to the transportation pipelines. The privatization of the pipeline system led to capital investments in the systems. We maintain limited storage capacity

at each oil site and at the terminals from which oil is shipped. In the past, these capacities have been sufficient to store oil without reducing current production during temporary unavailability of the pipeline systems, due, for example, to maintenance requirements or temporary emergencies.

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With respect to production from Block 18 in Ecuador, oil is transported by a system that has a current transportation capacity of approximately 25,000 barrels per day. This capacity is expected to be increased to 40,000 barrels per day during 2006. Once the Palo Azul field has been completely developed, a 12-inch diameter and 35 km long oil pipeline is expected to be constructed from the oil treatment plant to Lago Agrio to transport production through the OCP or the Sistema de Oleoducto Transportation in accordance with the commercial circumstances prevailing at that time.

Future oil production from Block 31 will be transported through the OCP. With respect to future oil production from Blocks 18 and 31, we have entered into an agreement with OCP to ensure 80,000 barrels per day of oil transportation capacity (of which 8,000 has been assigned to a third party). See Hydrocarbon Marketing and Transportation Oleoducto de Crudo Pesados (OCP). We have also entered into a crude oil transport agreement with Oxy, pursuant to which, we will be able to use a pipeline owned by Oxy to transport oil produced by Block 31 to the head of the OCP. See Production Production Outside Argentina Ecuador Block 31.

Sales of crude oil and gas for the year ended December 31, 2004 were made mainly to PDVSA, Petroperú, EG3 and Glencore AG and sales to those entities represented about 12%, 7%, 6% and 3%, respectively, of total crude oil and gas sales, before deducting export duties, for that year. During 2004, oil and gas exports totaled approximately P\$237 million or 7% of total consolidated crude oil and gas sales (calculated before deducting export duties). In 2004, exports sales were made principally to Chile.

## **Competition**

Our oil and gas related businesses are subject to oil price fluctuations determined by international market conditions. In executing our strategy to expand our oil and gas operations both in and outside of Argentina, we face competition from oil and gas producers throughout the world.

## **HYDROCARBON MARKETING AND TRANSPORTATION**

The hydrocarbon marketing and transportation segment serves to link our energy businesses. In the hydrocarbon marketing business, we provide oil, gas and liquified petroleum gas brokerage services to producing companies who prefer outsourcing oil, gas and liquified petroleum gas sales. This business enables us to position ourselves as a major commercial service provider since it assists clients not only in sales but also in logistics, foreign trade and market knowledge. We are engaged in the hydrocarbon transportation business through our interests in TGS, Oleoductos del Valle S.A., or Oldelval, and OCP.

### *Gas Transportation TGS*

Our interests in TGS and Corporate Developments

We hold, directly or indirectly, a 35% interest in TGS. TGS is controlled by CIESA, which, together with other companies of the Petrobras Energía group and the Enron group, own 70% of TGS capital stock. The remaining 30% of TGS's capital stock is listed on the Buenos Aires Stock Exchange and New York Stock Exchange. CIESA, in turn, is owned on a 50/50 basis by subsidiaries of Enron Corporation, or Enron, and us. Both Enron and we have a right of first refusal on the transfer of CIESA's shares and preferential rights to any shares issued by CIESA. An

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ownership committee composed of an equal number of our representatives and those of Enron manages the activities of TGS and CIESA. We appoint the chairman of the board of directors of both TGS and CIESA and the chief executive officer of TGS.

Due to the abrupt changes subsequent to the enactment of the Public Emergency Law in Argentina, CIESA and TGS both defaulted on their debt. CIESA failed to repay corporate notes having a principal amount of US\$220 million and derivative instruments of approximately US\$2 million in value. CIESA's shareholders, including us, have not assumed any financial obligations to assist CIESA. Currently, CIESA is negotiating with its creditors to

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refinance the terms of its debt. No pledges have been made by CIESA's shareholders to provide financial aid. In April 2004, in order to provide the flexibility necessary to facilitate the restructuring of CIESA's indebtedness, CIESA's shareholders executed a Master Settlement Agreement, which provides for the following share transfers: During the first phase, (a) Enron will transfer 40% of the shares issued by CIESA to a newly created trust or an alternate entity and (b) we will transfer common class B shares issued by TGS (representing 7.35% of the capital stock of TGS) to Enron. If CIESA successfully renegotiates its indebtedness, during the second phase, Enron would transfer its remaining interest in CIESA to the abovementioned newly created trust or an alternate entity while CIESA would simultaneously transfer common class B shares issued by TGS (representing about 4.3% of the capital stock of TGS) to Enron. In no case, will we hold, directly or indirectly, more than 50% of the capital stock currently held in CIESA or a controlling interest in CIESA. In addition, Petrobras Energía and Enron agreed to release each other from all claims related to their investments in CIESA and TGS. The bankruptcy court handling the Enron bankruptcy approved the Master Settlement Agreement in May 2004. The proposed share transfers were submitted to the CNDC for approval, which has been confirmed. They have also been submitted to ENARGAS, which has conditioned its approval on the receipt of a favorable opinion from the Treasury Attorney General (*Procuración General del Tesoro*) and, as of the date of this annual report, we do not know whether this opinion has already been rendered.

TGS failed to comply with certain financial restrictions contemplated in its debt obligations. As a result, in February 2003, TGS started an overall restructuring process involving US\$1,027 million of its indebtedness, which accounted for almost all of its debt. In 2004, TGS successfully emerged from default through a restructuring proposal presented to creditors in October 2004. The restructuring proposal was accepted by close to 100% of its creditors. The creditors that accepted the proposal received (1) a cash payment equivalent to 11% of the outstanding principal amount, (2) new debt securities for the remaining 89% of the outstanding principal amount, structured into two tranches, A and B, with amortization terms of six and nine years, respectively, accruing interest rates ranging from 5.3% to 10%, and (3) a cash payment in respect of the accrued and outstanding interest on the previous debt, calculated at the interest rate stipulated by contract for each instrument up to December 31, 2003, and at an annual rate of 6.18% from January 1 to December 15, 2004. The interest payment described in item (3) above was considered full settlement of any claim for interest owed, including any punitive interest.

In late 1992, TGS entered into the Technical Assistance Agreement with Enron Pipeline Company Argentina S.A., which has a term of eight years from December 28, 1992 and is automatically renewable upon expiration for additional eight-year periods. In accordance with the Master Settlement Agreement, this agreement was assigned to us on July 15, 2004, following receipt of approval from ENARGAS in June 2004. Since then, we have been in charge of providing services related to the operation and maintenance of the gas transportation system and related facilities and equipment, to ensure that the performance of the system is in conformity with international standards and in compliance with certain environmental standards. For these services, TGS pays us an annual fee equal to the greater of (1) P\$3 million or (2) 7% of the amount obtained after subtracting P\$3 million from TGS' net income before financial income (expense) and income taxes. Before this assignment, we shared in these management fees through an agreement with Enron, in which we were reimbursed for any costs associated with any service provided by TGS on behalf of Enron and received a percentage of the operating income.

### Business

TGS began operations in late 1992 as a part of the privatization of the Argentine energy sector. Currently, TGS is the leading gas transportation company in Argentina, delivering about 61% of the gas consumed. TGS is also one of the leading natural gas liquids producers and traders, both in the domestic and international market, and an important provider of midstream services, including business and financial structuring, turnkey construction and the operation and maintenance of facilities (used for gas gathering, conditioning and transportation).



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The following chart shows statistical information relating to TGS's business segments for fiscal years ended December 31, 2004, 2003 and 2002.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Regulated Segment:</b>			
Average firm committed capacity <sup>(1)</sup>	63.6	61.7	61.4
Average daily deliveries <sup>(1)</sup>	61.5	52.6	49.4
Annual load factor <sup>(2)</sup>	97%	85%	80%
<b>Unregulated Segment:</b>			
Liquids total production <sup>(3)</sup>	969.0	929.1	908.5
Processing capacity at year end <sup>(1)</sup>	43.0	43.0	43.0

(1) In millions of cubic meters per day.

(2) Corresponds to the quotient of the average daily deliveries and the average firm contracted capacity.

(3) In thousands of tons.

*Regulated Energy Segment*

Within the regulated energy segment, TGS is the gas transportation licensee in the south of Argentina and is the largest transporter of natural gas in Argentina and all of Latin America. TGS has an exclusive license for the utilization of the southern gas transport system, which is due to expire in 2027 with an option to extend for ten additional years if certain conditions are fulfilled.

TGS transports gas through more than 7,400 km of pipelines with a capacity of approximately 65 million cubic meters per day, substantially all of which is committed under firm transportation contracts. Pursuant to these contracts, the capacity is reserved and paid for irrespective of the actual use by the customer. Almost all capacity of the gas transportation pipelines in Argentina is currently apportioned among gas distribution companies, large industrial customers and gas-fired power plants under firm long-term contracts. In 2004, TGS entered into a new firm transportation agreements covering approximately 3.6 million cubic meters per day. The total average life of its firm transportation contracts is approximately eight years. In addition, TGS provides interruptible transportation services under which gas transportation is dependent on the availability of capacity. TGS's pipeline system connects Argentina's southern and western gas reserves with the main consumption centers in those regions, including Greater Buenos Aires.

Transportation services begin with the receipt of gas owned by a shipper (e.g., distribution companies, producers, marketers or major users) at one or more reception points. It is then transported and delivered to delivery points along the system. The total service area includes approximately 4.8 million end users, approximately 3.3 million of which are in Greater Buenos Aires. Direct services to residential, commercial, industrial users and electrical power plants is mainly rendered by four gas distribution companies, which are connected to the TGS system: MetroGas S.A., Gas Natural Ban S.A., Camuzzi Gas Pampeana S.A, and Camuzzi Gas del Sur S.A. Certain significant industries and electrical power plants are also located within TGS's operational area, to whom TGS renders direct transportation services and represent approximately 19% of TGS's total capacity.

TGS has made significant investments in its business. As a result, approximately 821 km of gas pipelines were laid in addition to the existing pipelines, totaling 7,400 km of gas pipelines, compression power was increased from 339,000 horsepower in 1992 to 550,230 horsepower in 2004 and transportation capacity increased from 42.9 million cubic meters per day to 63.4 million cubic meters per day by the end of 2004.

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As a consequence of the enactment of the Public Emergency Law, which pesified and froze tariffs, revenues from the regulated segment significantly decreased. In 2004, the gas transportation segment accounted for 44% of TGS' s total revenues compared to 47% and 57% in 2003 and 2002, respectively, and to approximately 80% since the start of the service until 2001. TGS continues seeking new alternatives aimed at growing its business and mitigating the effects derived from this law. Along these lines, in 2003, TGS entered into an agreement with a gas producing consortium at the Austral basin, comprised of Total Austral S.A., Panamerican Sur S.R.L. and Wintershall Energía S.A., for the purpose of providing Argentine natural gas to Methanex a leading company in the production of methanol located in Chile. Pursuant to this agreement, TGS constructed a compressor plant of

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12,700 horsepower along the General San Martín pipeline and built a pipeline approximately 6 km long with 1 million cubic meters per day of initial capacity, which links TGS's main pipeline system to the Chilean border. This project was developed in 2004 and was completed in February 2005.

In July 2004, UNIREN made a proposal to TGS to adjust the contractual terms of its license, by effecting a 10% rate increase for 2005 and providing for a comprehensive rate review effective as of 2007. Because UNIREN's proposal did not reflect the outcome of previous meetings held with UNIREN, TGS requested to continue the negotiation process in order to come to a comprehensive agreement during 2005. On April 27, 2005, at a public hearing called by UNIREN to analyze the proposal made on July 2004, UNIREN repeated its 10% increase proposal and proposed to accelerate effectiveness of the comprehensive rate review process to 2006, and TGS has decided to continue negotiating in order to seek to improve these terms.

In June 2004, in accordance with Argentine regulatory requirements with respect to the creation of trust funds to finance system expansions, TGS submitted to the Energy Bureau an expansion project for the San Martín pipeline that involved a capacity increase of approximately 2.9 million cubic meters per day. The project requires the construction of approximately 500 km of pipelines and the construction of a compressor plant and revamping of certain compressor units to increase compression capacity to 30,000 horsepower by the third quarter of 2005. Works for the project have begun. On November 3, 2004, TGS, the Argentine government, Petrobras, Nación Fideicomisos S.A. and certain other parties executed an agreement for the construction and financing of the project. This agreement provides that Petrobras will lead and coordinate the financing of the project, which includes financing for exports from Brazilian suppliers, to be provided by Banco Nacional de Desenvolvimento Econômico e Social de Brasil, or BNDES, (or any other financial institution appointed by Petrobras) amounting to at least US\$142 million and will obtain the financing, and/or, otherwise, contribute the funds to the project, until such financing is disbursed. TGS will be in charge of managing the project and operating and maintaining the new facilities.

Petrobras Energía has agreed to act on account and behalf of Petrobras by providing up to US\$142 million of the funds to finance the project until the financing is made available by BNDES. In turn, a financial trust created for the project's financing will deliver debt securities in equivalent value to Petrobras Energía. Petrobras Energía has contributed US\$53 million to the trust on account and behalf of Petrobras. On May 25, 2005, BNDES made an initial disbursement of US\$14 million and, since then, the financing facility with BNDES became effective.

Petrobras Energía's US\$142 million contribution to this project is being funded by a loan from Petrobras Internacional Braspetro BV, a subsidiary of Petrobras.

## *Businesses*

In addition to the regulated segment of natural gas transportation, TGS is also one of the leading processors of natural gas and one of the largest marketers of natural gas liquids. Natural gas liquids production and commercialization involves the extraction of ethane, propane, butane, and natural gasoline from the gas flow that arrives to the General Cerri Complex, located near Bahía Blanca, in the Province of Buenos Aires, which is connected to TGS's main pipelines. TGS has two gas processing plants at the General Cerri Complex: (1) an ethane, propane, butane and natural gasoline turbo expander separating plant and (2) an absorption plant which extracts propane, butane and gasoline from the gas transported through the TGS pipeline system, with a gas processing capacity of 43 million cubic meters per day and a storage capacity of 60,450 tons. After extraction, TGS commercializes these products in the domestic and international market. TGS also stores and ships the products at facilities located in Puerto Galván. These activities are not regulated by ENARGAS.

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As a result of agreements entered into with natural gas producers in the Neuquén basin, TGS became the owner of a portion of the General Cerri Complex production. TGS was also able to increase the richness of the gas reaching the complex for processing purposes and, thus, minimized the impact of competitive developments.

Natural gas liquids revenues, as a part of total revenues of TGS, increased from a share of 48% in 2003 to 51% in 2004. Three factors contributed to the growing strength of natural gas liquids: (1) the material increases in the international prices of liquids derived from gas which gained momentum with the sharp increase of oil prices during 2004, (2) the increase in demand for gas at the General Cerri Complex that generated record liquid volumes and (3) the effects of the Public Emergency Law on the revenues from the regulated segment.

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Through the provision of midstream services, TGS provides integral solutions for natural gas treatment at the wellhead, including conditioning, gathering and gas compression services. These services also include those related to the construction, operation and maintenance of gas pipelines and treatment plants provided by TGS or its related companies, Gas Link S.A. and Transporte y Servicios de Gas en Uruguay S.A. TGS is developing a strategy geared towards becoming one of the main service providers in Argentina.

TGS has a 49% interest in Gas Link S.A., a company engaged in the construction, operation and maintenance of the gas pipeline connecting the TGS system and the Cruz del Sur gas pipeline, which links Argentina to Uruguay and is likely to be extended to Brazil. This pipeline is approximately 40 km long, has a current transportation capacity of 1 million cubic meters per day and started operations in October 2002.

### *Oldelval*

Oldelval, a company in which we have a 23.1% interest, holds the concession for the transportation of crude oil through 888 km-long oil pipelines with 1,706 km of installed piping between the Neuquén basin and Puerto Rosales (located in the Province of Buenos Aires). The concession has a 35-year period starting in 1993 with an option to renew for ten years. Oldelval's other shareholders are Repsol-YPF, Petrolera San Jorge, Pluspetrol, Pan American and Tecpetrol.

The Allen/Puerto Rosales section transportation capacity is approximately 265,000 barrels per day, with a 173,000 cubic meters of storage capacity. In 2004 and 2003, Oldelval transported approximately 66.5 million and 65 million of oil barrels, respectively, from the Neuquén basin to the Atlantic coast.

The applicable laws governing the transportation of hydrocarbons through oil pipelines, which are based on the free access notion, assign loading preference quotas to pipeline owners based on their shareholdings. Oil transportation rates are set by the Argentine Secretary of Energy.

### *Oleoducto de Crudos Pesados (OCP)*

The government of Ecuador awarded OCP with the construction and operation for a 20-year term of the 503 km long pipeline that runs from the northeastern region of Ecuador to the Balao distribution terminal on the Pacific Ocean coast. As of December 31, 2004, we held an 11.42% interest in OCP. OCP's other shareholders are Encana, Perenco, Occidental, Repsol-YPF and AGIP.

The oil pipeline has an approximately 450,000 barrels per day transportation capacity, of which at least 350,000 barrels per day have been committed under a ship or pay contract for transportation of their production. Since the oil pipeline runs across ecologically sensitive areas, the pipeline was constructed under stringent environmental protection and technical standards.

The construction of the oil pipeline was performed by Techint International Construction Corporation, or Tenco, and was completed in 2003. After testing the system at its maximum capacity and obtaining approval by the Ministry of Energy and Mines of Ecuador, the oil pipeline officially started operations on November 10, 2003. During 2004, the first year of operation, it transported over 75 million barrels of heavy crude oil, which were shipped on more than 138 vessels from its offshore facilities on the Ecuadorian coast.

In 2004, OCP's marine terminal obtained the certificate for compliance with the Code of Protection of Vessels and Port Facilities required by the International Marine Organization, becoming one of the first ports in Latin America to obtain this certification.

OCP's original budget amounted to US\$1,210 million, US\$900 million of which was funded by banking institutions, US\$250 million of which was funded by subordinated loans from shareholders and US\$60 million through capital contributions. We made contributions in the amount of US\$9 million and were granted a 15% shareholding interest. The total construction cost of the oil pipeline amounted to US\$1.4 billion, which was US\$190 million in excess of the original budget. The need for additional financing was satisfied through loans and capital contributions by shareholders in the amount of US\$150 million and US\$40 million, respectively. We did not make any such contributions and our equity interest was diluted from 15% to 8.96%.

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In May 2004, Tenco exercised an option to sell to us its shares and subordinated debt in OCP, comprising a 2.46% ownership interest for US\$14 million. Consequently, our interest in OCP increased to 11.42%.

In connection with production from Blocks 18 and 31 in Ecuador (Block 31 has no production yet as it is in the early stages of development), we, through Petrobras Energía Ecuador, entered into a ship or pay contract with OCP, whereby OCP has committed to transport 80,000 barrels per day for a 15-year term, as from November 2003. For a more detailed discussion see Oil and Gas Exploration and Production Production Production Outside of Argentina Ecuador Ship or Pay Contract with Oleoducto de Crudos Pesados (OCP).

In June 2004, Petrobras Energía Ecuador entered into a transportation agreement with Murphy/Canam Oil whereby we committed to transport, using our committed capacity in the OCP, 8,000 barrels per day until January 2012. Under this agreement, we transported approximately 1.6 million barrels of crude oil in 2004, thereby mitigating the impact of the economic commitment under the ship or pay agreement by US\$3.6 million.

## **Competition**

TGS's gas transportation business, which provides an essential service in Argentina, faces only limited direct competition. In view of the characteristics of the markets in which TGS operates, it would be very difficult for a new entrant in the transportation market to pose a significant competitive threat to TGS, at least in the short to medium term. In the longer term, the ability of new entrants to successfully penetrate TGS's market would depend upon a favorable regulatory environment, an increasing and unsatisfied demand for gas by end users, and sufficient investment in gas transportation to accommodate increased delivery capacity from the transportation systems.

On a day-to-day basis, TGS competes, to a limited extent, with Transportadora de Gas del Norte S.A. for interruptible transportation services and for new firm transportation services made available as a result of expansion projects from the Neuquén basin to the greater Buenos Aires area. Interruptible transportation services accounted for only 5.4% of TGS's regulated net revenues for 2004. The relative volumes of such services will depend principally upon the specific arrangements between buyers and sellers of gas in such areas, the perceived quality of services offered by the competing companies, and the applicable rate for each company.

With respect to natural gas liquids processing activities, TGS competes with MEGA S.A., which owns a gas processing plant at the Neuquén basin and has a processing capacity of approximately 36 million cubic meters per day. Our controlling company, Petrobras, has a 34% interest in MEGA S.A.

## **REFINING**

Our presence in the refining business is a further step towards the vertical integration of our operations. The refining business enables us to capitalize on our significant hydrocarbon reserves. Refining operations are a necessary link in the business value chain, which starts with crude oil exploration and ends with customer service.

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Our refining operations are located in Argentina and Bolivia. In Argentina, we operate our own refinery in San Lorenzo and have a 28.5% interest in Refinería del Norte S.A., or Refinor. In Bolivia, as of December 31, 2004, we had a 49% interest in Empresa Boliviana de Refinación, or EBR.

### *The Refining Business in Argentina*

During recent years, the Argentine liquid fuel market was adversely affected by the growth of compressed natural gas as substitute fuel. The high taxes imposed on gasoline and, to a lesser extent, on diesel consumption, affected the market, encouraging the use of compressed natural gas to the detriment of liquid fuels. The gasoline domestic market shrank approximately 48% in the 1995-2003 period. In 2004, this downward trend was interrupted, achieving an increase of 2%. Demand for diesel grew by approximately 4% and 9% in 2003 and 2004, respectively, partly as a result of growth in the agricultural sector. This recovery halted a prolonged downward trend in the market, which had resulted in a 14% drop from 1999-2002.



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The Argentine government has imposed taxes on exports of crude oil, certain oil by-products and gas, in an effort to maximize volumes refined domestically, to shelter the domestic economy from foreign fluctuations and to stabilize domestic levels of industrial activity, employment and prices. During 2004, the Argentine government repeatedly increased export taxes in line with the increase of international crude oil prices. We have been able to minimize the impact of these increases through the integration of our upstream and downstream activities and the synergies derived from our relationship with Petrobras, as described below. During 2004 and 2003, sales volumes of crude oil among our business segments increased 7.2% and 21.6%, respectively, to approximately 34,000 barrels per day and approximately 31,700 barrels per day, while exports of crude oil in the 2002/2004 period declined approximately 75%.

### *Business synergy with Petrobras*

Our Refining segment, being a part of the Petrobras group, offers the most immediate prospects of further developing and exploiting business opportunities. During 2003 and 2004, the sale of diesel oil to and the purchase of gasoline from EG3, the change of flags of former Pecom gas stations and the development of high value added products such as Podium, were all examples of the benefits we have enjoyed from this relationship. The complementary nature of our business with EG3, a company previously controlled by Petrobras that merged into Petrobras Energía in 2005, provided us with the opportunity to further the vertical integration of our operations. Since the volume of diesel oil produced by us at our refinery in San Lorenzo exceeds the demand of our gas station network, during 2004 and 2003, we sold 466,000 and 248,000 cubic meters, respectively, of refined products to EG3, and as a consequence of these sales, there was an increase in crude oil volumes processed at our refinery in San Lorenzo.

### *Refining Division*

We operate a refinery in San Lorenzo, Province of Santa Fé, strategically located along the central product distribution system. The refinery capacity is approximately 37,700 barrels of oil per day, enabling us to process a large part of our crude oil production in Argentina. The refinery has three atmospheric distillation units, two vacuum distillation units, a heavy diesel oil thermal cracking unit and an aircraft fuel production unit, which produce the following products: premium and regular gasoline, jet fuel, diesel oil, fuel oil, kerosene, solvents, aromatics and asphalts.

The refinery has two fuel storage and dispatch plants located in the Provinces of Santa Fe and Buenos Aires, respectively. At our Dock Sud facilities, in the Province of Buenos Aires, crude oil is received, stored and dispatched. The Dock Sud facility has a total storage capacity of approximately 377,000 barrels. Crude oil is received from the oil pipeline connecting Bahía Blanca with Dock Sud and is dispatched to tankers transporting the oil to the San Lorenzo refinery. In addition, the San Lorenzo refinery, located on the right bank of the Paraná River, with access from the so-called hydroway forming part of the Océano-Santa Fé trunk navigation route, has three docks for 250 meter-long vessels having 70,000 ton displacement.

As of December 31, 2004, we had a commercial network of 122 retail outlets, including 86 gas stations (eight directly operated by us), 20 diesel centers, including six mobile diesel centers and ten agro-service centers, located in the Provinces of Santa Fé, Buenos Aires, Entre Ríos, Corrientes, Santiago del Estero, Tucumán, San Juan, San Luis, Catamarca, Chaco, Formosa, Salta, Mendoza and Córdoba. We continued the development of new Petrobras-branded gas stations and rebranding of gas stations from Pecom to Petrobras, aimed at capitalizing on the positive attributes associated with the Petrobras brand. As of December 31, 2004, 48 retail outlets were using the Petrobras brand, 39 of which changed names in 2004. Petrobras has built an excellent image for its brands, products and services in Argentina, currently competing with the image of the leading companies in the country.

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As part of our marketing strategy, in order to increase market share and profitability, we offer higher value-added products and services. In mid 2004, we launched Podium, a gasoline with the highest octane rating in the Argentine market. Created jointly by Petrobras and our technicians, Podium is produced at the San Lorenzo refinery in Santa Fe and is distributed on an exclusive basis by Petrobras retail network throughout Argentina.

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Podium is not only the first Argentine premium gasoline of its kind to offer a 100 octane rating but also contains multifunctional additives to help keep the engine clean. Podium meets the highest quality and environmental safety standards, having been awarded quality certifications by the Petrobras Research Center (CENPES) in Brazil and the South West Research Institute in Houston, United States. Podium was well received by the Argentine market and, by the end of the year, Podium's sales surpassed the premium gasoline it replaced, Magnum, by 54%.

Through our extensive gas station network, we also market Lubrax lubricants. These lubricants, which are manufactured by Petrobras, enjoy 9.2% of the domestic market share and have experienced the highest growth rate in Argentina among lubricants in 2004. Petrobras' technical, commercial and advertising efforts for the development of the Lubrax brand give considerable support to our sales growth in this business.

In addition, as part of our marketing strategy, we began offering in 2004 the Tarjeta Flota card, which is a brand loyalty program aimed at increasing sales volumes and establishing a more stable and lasting relationship with customers.

The following table shows production and sales figures for the Refining business segment for the fiscal years ended December 31, 2004, 2003 and 2002:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Production</b> (thousands of tons):			
Virgin naphtha	398	417	325
Diesel oil	647	613	499
Other products	622	619	507
<b>Sales:</b>			
Aromatics (thousands of tons)	39	56	67
Benzene (thousands of tons)	54	50	44
Gasoline (thousands of m3)	207	119	123
Diesel oil (thousands of m3)	913	883	622
Other medium distillates (thousands of m3)	5	11	13
Asphalts (thousands of tons)	115	86	43
Reformer plant products (thousands of tons)	74	79	65
Other heavy products (thousands of tons)	445	418	374
Paraffins (thousands of tons)	138	151	138
<b>Sales</b> (in millions of pesos):			
Argentina	1,275	956	636
Outside of Argentina	470	346	372
<b>Total</b>	<b>1,745</b>	<b>1,302</b>	<b>1,008</b>

During 2004, our refinery processed an average of 33,100 barrels per day. Crude oil volumes processed accounted for about 88% of the refining capacity. The integration of our operations with EG3 has allowed us to significantly increase the crude oil volumes processed and to further link our upstream and downstream businesses in Argentina. In 2003 and 2002, crude oil volumes processed amounted to on average 32,600 barrels per day and 27,100 barrels per day, respectively. As of December 31, 2004, we estimate that we had a market share of approximately 3.4% in the gasoline market, 3.5% in the diesel oil market, 25.3% in the asphalt market and 13.1% in the fuel oil market.

*Refinor*

We have a 28.5% interest in Refinor. Refinor's other two shareholders are Repsol-YPF (50%) and Pluspetrol Exploración y Producción S.A. (21.5%).

Refinor owns the only refinery in the northern region of Argentina, which is located in Campo Duran, Province of Salta. Refinor's refining capacity is 26,103 barrels of oil per day and its natural gas processing capacity

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is 19.5 million cubic meters per day. Refinor receives crude oil and natural gas from the oil and gas fields located at the northwestern region of Argentina and Bolivia. It has an atmospheric distillation unit, a vacuum distillation unit, a catalytic reformer plant, two turboexpander plants and a compressor plant. Refinor produces gasoline, diesel oil, fuel oil, virgin naphtha, propane, butane, natural gasoline and liquified petroleum gas. It is the leading liquified petroleum gas producer based on production volumes in the northern region of Argentina and the third largest producer in the country.

As of December 31, 2004, Refinor had a commercial network comprising 73 gas stations (14 owned by Refinor) located in the Provinces of Salta, Tucumán, Jujuy, Córdoba, Santiago del Estero, Catamarca and Chaco and had started developing a commercial network in Bolivia, where it has 12 gas stations under its brand. For logistics and distribution purposes, Refinor operates a 1,112 km poliduct that extends from the compression station in Campo Durán (Salta) to Montecristo (Córdoba). Along the pipeline, layout product recompression stations are located at Urundel (Salta), Lavallén (Jujuy), Cobos and Piedras (Salta) and Quilino (Córdoba). The pipeline supplies the following dispatch plants:

General Güemes (Salta), with a 1,800 cubic meter storage capacity (liquefied gas);

Banda del Río Salí (Tucumán), with a 57,508 cubic meter storage capacity (fuels); and

Leales (Tucumán), with a 5,054 cubic meter storage capacity (liquefied gas).

In addition, the poliduct discharges a large volume of products, such as petrochemical naphtha and liquefied gas, at the Terminal Station located at Montecristo (Córdoba), and these products are then dispatched in the area or sent to San Lorenzo, Province of Santa Fé.

The following table sets forth Refinor's sales and production for the fiscal years ended December 31, 2004, 2003 and 2002:

	Year ended December 31,		
	2004	2003	2002
<b>Production:</b>			
Gasoline (thousands of m3)	101	122	121
Virgin naphtha (thousands of m3)	387	420	473
Diesel oil (thousands of m3)	354	330	335
Natural gasoline (thousands of m3)	132	129	134
Propane/butane (thousands of tons)	363	313	287
Other products (thousands of m3)	158	138	100
<b>Sales:</b>			
Gasoline (thousands of m3)	109	121	122
Virgin naphtha (thousands of m3)	529	550	611
Diesel oil (thousands of m3)	406	378	374
Propane/butane (thousands of tons)	354	297	274
Other products (thousands of m3)	81	97	103
<b>Sales (in millions of pesos):</b>			
Argentina	582	490	428
Outside of Argentina	534	373	412
Total	1,116	863	840

In 2004, Refinor's sales through its service centers had a share in the gasoline and diesel oil markets in the northwest of Argentina of 25% and 18.2%, respectively. In addition, Refinor reached a 55% share in the diesel oil import market in Bolivia.

*Empresa Boliviana de Refinación (EBR)*

We have a 49% interest in EBR. Petrobras is our strategic partner, with a 51% interest.

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EBR owns two Bolivian refineries located in Cochabamba and Santa Cruz de la Sierra, with an estimated maximum production capacity of 47,500 barrels of oil per day, accounting for 95% of Bolivia's total refining capacity. In 2004, an average of 37,460 barrels per day were processed.

EBR wholly owns Petrobras Bolivia Distribución a company having a commercial network of 92 gas stations, 11 of which were added during the last fiscal year. In 2004, Petrobras Bolivia Distribución continued implementing the Integrated Gas Stations concept in Bolivia by offering supplemental products.

## **Competition**

We compete in Argentina principally with Repsol-YPF S.A., Shell CAPSA and Esso S.A., which hold approximately 49.7%, 16.3% and 14.1% of the domestic market share. Together with EG3, which, upon registration with the Argentine Public Registry of Commerce, is expected to merge into Petrobras Energía, we would have had a combined market share of 14.7% as of December 31, 2004.

## **PETROCHEMICALS**

The Petrochemicals business is a key component in our strategy of vertically integrating our operations. Our goal in the petrochemical business is to consolidate our regional leadership by:

Maximizing the use of our own petrochemical raw materials;

Taking advantage of current conditions in the styrenics market by increasing the supply; and

Consolidating the fertilizer business which uses and, therefore, adds value to our natural gas business.

Our petrochemical operations are performed in Argentina and Brazil, through the production of a wide array of products, such as styrene, polystyrene, synthetic rubber, fertilizers and polypropylene, both for the domestic and export markets.

Through Innova, our wholly owned subsidiary in Brazil, we have the region's largest installed capacity to produce styrene and polystyrene, and can provide services to clients in both Brazil and Argentina. We also have a 40% interest in Petroquímica Cuyo S.A, which we refer to as Cuyo, a producer and marketer of polypropylene

## **Argentine Operations**

*Argentine styrenics division*

In Argentina, we are the only producer of styrene monomer, polystyrene and elastomers and the only integrated producer of products from oil and natural gas to plastics. As part of our efforts to integrate our operations, we use a large amount of styrene for the production of polystyrene and synthetic rubber.

The styrenics division has a plant at Puerto General San Martín, Province of Santa Fé, with a production capacity of 110,000 tons of styrene per year and 57,000 tons of synthetic rubber per year, and a plant at Zárate, Province of Buenos Aires, with a production capacity of 66,000 tons of polystyrene per year and 14,000 tons of bioriented polystyrene, or Bops, per year. This state-of-the-art plant of Bops in Zárate is the only one of its type in Latin America.

In March 2004, we acquired from Imperial Chemical Industries an ethylene plant located in San Lorenzo. The plant has a production capacity of 20,000 tons per year, and became operational in October 2004. It is located along the Paraná river coast, adjacent to the San Lorenzo refinery, which provides the oil feedstock necessary for its operation, and the Puerto General San Martín petrochemical complex, which uses ethylene as raw material for the production of ethylbenzene and ultimately styrene. The acquisition of this ethylene plant has expanded our business value chain and our product offering, resulting in an increase in our share of the plastic raw material market. In addition, it allowed us to increase production capacity at the Puerto General San Martín ethylbenzene plant from



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116,000 tons to 180,000 tons per year. With this additional ethylbenzene production, we expect to be able to make full use of the installed production capacity of our Innova plants, thereby broadening our regional leadership in this market.

During 2004, production volumes from the Puerto General San Martín complex totaled 110,500 tons of styrene, a 4% increase from the previous year. Volumes from the Zarate plant, in turn, increased 8% compared to 2003, with a production of 62,000 tons of polystyrene. In 2004, Petrobras Energía achieved a new production record of 12,000 tons of Bops (11% higher than the previous year). Rubber production, in turn, totaled 58,400 tons (4% higher than volumes recorded in 2003), setting a historical record that was caused in part by increased domestic demand.

As of December 31, 2004, our estimated share in the Argentine market was:

Styrene - 100%; and

Styrene butadiene rubber, or SBR, combined with the market for nitrile butadiene rubber, or NBR - 95%.

In addition, we are market leaders in Argentina for polystyrene.

Exports are a significant part of our business. In 2004, we exported 30%, 57% and 42% of our total sales volumes of styrene, rubber and polystyrene, respectively. Exports were primarily to Mercosur member countries and Chile. As of November 2004, we started exporting ethylbenzene, produced from the ethylene from our new plant in San Lorenzo, to Innova in Brazil. In addition, we exported 9,600 tons of bioriented polystyrene, primarily to Europe and the United States.

### *Fertilizers division*

We are pioneers in the production and distribution of fertilizers in Argentina. We supply approximately one-third of the Argentine fertilizer market with a wide array of specific solutions and are the only liquid fertilizer producer in Latin America.

The fertilizers division has a plant located at Campana, Province of Buenos Aires, with a production capacity of 200,000 tons per year of urea. We are the only producer of liquid fertilizer (a composition of urea and ammonium nitrate) in Latin America. In 2004, we increased the installed production capacity of liquid fertilizer to 677,000 tons per year from 475,000 tons per year. In October 2004, we finished the construction of a thiosulfate fertilizer plant, with a production capacity of 140,000 tons per year. Construction of the plant required investments of approximately US\$15 million. The plant, which has state of the art equipment, was designed in accordance with environmental standards and in line with Petrobras' stringent standards of Quality, Safety, Environment and Occupational Health.

Liquid storage capacity totaled 40,000 tons, which, together with an automatic and computerized loading facility, has allowed us to manage the growth in the production of liquids.

We have 700 customers throughout Argentina. Of these, 130 are distributors with their own storage facility centers, complementing our warehouses and assistance centers in Buenos Aires, Santa F , Mendoza and Tucum n provinces.

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The following table sets forth production and sales by major product for both the styrenics and fertilizers divisions for the fiscal years ended December 31, 2004, 2003 and 2002:

	Year ended December 31,		
	2004	2003	2002
<b>Production</b> (thousands of tons):			
Styrene <sup>(1)</sup>	111	106	98
Synthetic rubber <sup>(2)</sup>	58	56	51
Urea	188	193	190
UAN	248	184	145
Polystyrene	62	57	61
Bops	12	11	6
<b>Sales</b> (in millions of pesos):			
Styrene <sup>(1)</sup>	202	124	100
Synthetic rubber <sup>(2)</sup>	195	161	138
Fertilizers	477	304	259
Polystyrene and Bops <sup>(3)</sup>	257	180	170
Other products and services	12	23	26
<b>Total</b>	<b>1,143</b>	<b>792</b>	<b>693</b>
<b>Export Sales</b> (in millions of pesos)	<b>270</b>	<b>260</b>	<b>223</b>

(1) Including styrene monomer and by-products.

(2) Including SBR, NBR and butadiene.

(3) Net of P\$5 million, P\$25 million and P\$9 million in intercompany eliminations for 2004, 2003 and 2002, respectively.

*Peroquímica Cuyo (Cuyo)*

Cuyo is primarily involved in the production and marketing of polypropylene. Admire Trading Company and we are Cuyo's main shareholders, with a 50.5% and a 40% interest, respectively. Cuyo's industrial plant, located at Luján de Cuyo, Province of Mendoza, has a production capacity of approximately 100,000 tons per year. The quality and specialization of its products have enabled Cuyo to enter international markets and export to several countries, especially to Mercosur member countries and Chile.

Approximately 87% of the propylene feedstock required for Cuyo's operations is supplied by Repsol-YPF from its Luján de Cuyo refinery under a long-term contract set to expire in 2014.

Cuyo is a licensee of the Novolen Technology Holding company, a member of the ABB Lumus Group, engaged in the production and marketing of polypropylene. In addition, Cuyo maintains transfer, assistance and technology upgrade agreements, allowing it to be a leading company in product applications and to serve the market with world-class processes and products.

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The following table sets forth Cuyos production and sales for the fiscal years ended December 31, 2004, 2003 and 2002.

	Year ended December 31,		
	2004	2003	2002
Production (thousands of tons)	89	87	84
Sales (in millions of pesos)	293	225	200

### Brazilian Operations

Our petrochemical operations in Brazil are conducted through Innova, our wholly owned subsidiary. Innova has the first integrated complex in Latin America for the production of ethylbenzene, styrene and polystyrene in one site. It is located at Triunfo Petrochemical Pole, Rio Grande do Sul, in the south of Brazil. The styrene plant has a production capacity of 250,000 tons per year and the polystyrene plant has a production capacity of 120,000 tons per year. Copesul, a Brazilian company, supplies the benzene and ethylene feedstock necessary for the production of styrene pursuant to a long-term contract.

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The polystyrene plant uses approximately 113,000 tons of styrene monomer as feedstock to produce two grades of polystyrene (Crystal and High Impact). The remaining styrene is sold mainly in the Brazilian market for the production of synthetic rubber, expanded polystyrene, polyester and acrylic resins.

In 2004, Innova plants produced a company record of 208,000 tons of ethylbenzene and 202,000 tons of styrene under ordinary operating conditions. Increased styrene production (from 179,000 tons in 2003) enabled us to partially satisfy the supply deficit in the regional market and to increase polystyrene production, with volumes reaching a company record of 105,000 tons per year. In November 2004, Innova started to import ethylbenzene from our Puerto General San Martín complex, which will enable Innova to use its estyrene plant at full capacity.

As of December 31, 2004, Innova was Brazil's largest styrene producer and merchant (not including styrene used in the production of polystyrene) and one of Brazil's largest polystyrene producers and merchants, with an estimated 47% and 30% market share, respectively.

As a key component of its business, Innova implements a customer-oriented strategy directed at developing new products and solutions jointly with customers. One of these customers, Sony, authorized the use of polystyrene compounds manufactured by Innova in its electronic products. Innova is currently performing final tests of high resistance products together with customers from the household appliances and packaging industries.

We, through Innova's operations in Brazil, enjoy a tax benefit, pursuant to an incentive program granted by the Rio Grande do Sul State, Brazil, for companies located in that state. The benefit consists of a 60% reduction of the interstate goods transport tax, or ICMS, until December 31, 2007. As of the fiscal year ended December 31, 2004, Innova started to pay ICMS and thereby began to accrue the related tax benefit. During 2004, we recognized a P\$27 million gain from this benefit.

The following table sets forth Innova's production and sales of styrene and polystyrene for the fiscal years ended December 31, 2004, 2003 and 2002.

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Production</b> (in thousands of tons):			
Styrene	202	175	179
Polystyrene	105	86	96
<b>Sales</b> (in millions of pesos):			
Styrene	339	216	234
Polystyrene	394	255	298
Other	40	31	29
	<u>773</u>	<u>502</u>	<u>561</u>
<b>Total sales</b>	<u>773</u>	<u>502</u>	<u>561</u>

**Competition**

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The petrochemical markets in which we compete are highly cyclical, and our results in these businesses are heavily influenced by world market conditions. We are the only producer of styrene monomer, polystyrene and elastomers in Argentina, but compete with other foreign producers, especially those in Brazil. In the fertilizers market, we compete with Profertil S.A., a local urea and ammonia producer with a production capacity of one million tons per year and other players who import and mix fertilizers such as Cargill, Nidera and Yara. Profertil is owned by Repsol-YPF and Agrium S.A. In the polypropylene business, Petroken S.A is Cuyo s main competitor with a production capacity of 180,000 tons per year.

In Brazil, we mainly compete with Dow Chemical and BASF, which have a polystyrene production capacity of 190,000 tons per year each and a styrene production capacity of 160,000 and 120,000 tons a year, respectively. In addition, Videolar, a Brazilian producer of polystyrene, operates a 120,000-ton capacity plant in Manaus.

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### ELECTRICITY

In the electricity business, we are involved in all three industry segments: generation, transmission and distribution. Thus, we are positioned as a major player in the Argentine electricity market.

We believe that electricity generation allows us to accelerate the monetization of our significant gas reserves. Electricity transmission and distribution provides us with new growth opportunities, adding value through the sale of power and energy services to end users, as well as, through the development of cutting edge technology.

We conduct electricity generation activities through Genelba in the Province of Buenos Aires and the Pichi Picún Leufú Hydroelectric Complex, or HPPL, in the Comahue region, on the Limay River, Province of Neuquén. In addition, we have a 9.19% interest in Hidroneuquén S.A., a company controlling 59% of Hidroeléctrica Piedra del Aguila S.A., a hydroelectric complex located on the Limay River, in the Comahue region at the dividing line between the Provinces of Neuquén and Río Negro. We are engaged in the transmission business through our interests in Transener (through Citelec), Enecor S.A. and Yacylec S.A, and in the electricity distribution business through our interest in Edesur (through Distrilec).

The changes resulting from the enactment of the Public Emergency Law in Argentina adversely impacted the financial equation of the electricity business. In particular, the devaluation of the peso and the subsequent inflation, within a context of fixed revenues from utilities companies as a consequence of the pesification of rates, affected the financial position and results of operations of the electricity utility companies and extremely hindered their ability to comply with their financial obligations.

#### *The Argentine Electricity Market*

In Argentina, in the early 1990s, within the state-reform general framework, the Argentine government carried out a deep restructuring of the electricity sector transforming it into a more decentralized model with greater private sector participation. Up to then, the electricity system was characterized by the inability to meet the requirements of short- and long-term demand and a low service quality standard, all within a framework of a limited financing capacity on the part of the state to make necessary investments. Over the last ten years, electricity demand in Argentina has strongly increased at an average rate of 4.8%, exceeding the growth in gross domestic product for the same period. In 2004, electricity demand grew approximately 6.7% to 82,967 GWH from 77,738 GWH in 2003. Total electricity generation including exports increased 8.5%. As of December 2004, installed generation capacity reached 22,500 MW, representing a growth of approximately 70% from the time of the privatization of electricity services.

Within this context, there has been growth in the installed capacity of non-nuclear thermal power plants and hydroelectric plants. As of December 31, 2004, thermal and hydroelectric power accounted for 54.1% and 35.9%, respectively, of total supply. In the case of non-nuclear thermal units, the new plants have substantially increased their operating efficiency by incorporating cutting-edge technology, such as combined cycles, which decreased the average unavailability of thermal units from 50% to approximately 20%. Serving as an integrating link, the system's transportation capacity increased by 20% between 1994 and 2004. These improvements in the installed capacity enabled plants to meet the growth in demand in Argentina.

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As a consequence of the Public Emergency Law, the Argentine government implemented the pesification of US dollar-denominated prices in the wholesale electricity market and set a price cap for the energy sold in the spot market. This regulatory change caused a deviation from the marginal cost system, which had been implemented in 1992. As a result of the distorted effects on the profitability of the electricity sector caused by the regulatory changes immediately following the enactment of the Public Emergency Law in Argentina, infrastructure investments in the electricity sector declined significantly. In addition, there was a halt in the growth in electricity generation and transport, breaking the growth trend that existed up until 2001. This decline coupled with a growing demand led to an energy crisis.

During 2004, the government took successive measures to restabilize the electricity business. Seasonal tariff adjustments were reinstated for the February-April and August-October 2004 periods, recognizing the greater



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costs resulting from the recovery of natural gas prices. In order to increase the available supply of electric power generation in Argentina and in addition adjust the Stabilization Fund deficit, the Secretary of Energy created a fund called FONINVEMEM. The Secretary of Energy invited wholesale electricity market's creditors to participate in investments in electric power generation, in order to expand thermal generation capacity that is expected to be available towards the end of 2007. We participate with 65% our credit balances recorded in the 2004-2006 period resulting from the spread between the sale price of the energy and the variable cost. Our estimated total contribution for the entire period is expected to equal US\$35 million and account for approximately 8% of the fund's capital. The final amount will depend on water conditions, the dispatch of our generation units determined by Compañía Administradora del Mercado Eléctrico S.A., or CAMMESA, and the resulting prices of energy. See Regulation of Our Businesses Argentine Regulatory Framework Electricity.

In December 2004, the Secretary of Energy committed to approve successive seasonal electricity price increases to reach values covering at least total monomic costs by November 2006. In addition, as soon as the market returns to normal and once new generation capacity derived from FONINVEMEM becomes available to dispatch energy to the market, the Secretary of Energy has committed (1) to pay for energy at the marginal price obtained in the spot market and (2) to pay for power at the values that were in effect prior to the enactment of the Public Emergency Law.

## **Electricity Generation**

### *Genelba and HPPL*

Our Genelba Thermal Power Plant is a 660MW combined cycle gas-fired generating unit located at the central node in the Argentine electricity network, at Marcos Paz, about 50 km from the city of Buenos Aires. As part of our strategy to increase vertical integration, Genelba allows us to use approximately 2.9 million cubic meters per day of our own gas reserves.

Genelba, which commenced commercial operations in February 1999, has two gas-fired turbines that receive gas through an 8 km duct connected to the transportation system operated by TGS. The electricity produced at Genelba is distributed via the national grid through a connection to the Ezeiza transformer station (owned by Transener) and is located only 1 km away from Genelba.

The allocation of electricity dispatch to the wholesale electricity market, whether the electricity is produced for firm contracts or for the spot market, is subject to market rules based on the lowest variable cost of electricity generation. See Regulation of Our Businesses Argentine Regulatory Framework Electricity. Since Genelba uses combined cycle technology for a natural gas-fired power plant, our short-run variable cost is expected to be lower than the cost of other thermoelectric power plants, granting significant competitive advantages for Genelba. Therefore, CAMMESA is expected to dispatch Genelba's generating capacity before that of most other thermoelectric plants, and Genelba is estimated to operate at an approximately 89% capacity on a month-to-month basis.

The development and implementation of the Primary Frequency Response system, or PFR System, operation mode along with the full combined cycle represents a milestone in Genelba operation. Plant engineers designed the associated system, and Genelba was the first of its type worldwide to provide this service to the interconnected system. In 2003, the U.S. Patent Office granted us patent rights on this system, and currently steps are being taken to obtain patents in Europe and Argentina.

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In May 2004, Genelba was authorized by CAMMESA to start commercial operations of the PFR System under joint control modality. As a result of this project, the power plant obtains significant economic benefits.

In 2004, the power plant entered into an agreement with Termorio S.A, an independent producer of electricity in Brazil, whereby the power plant will provide management and technical assistance services in connection with the operation and maintenance of the Termorio combined cycle power plant.

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During 2004, Genelba reached historical monthly and daily generation records having generated 480 Gwh of electricity in July and 16,445 Mwh on July 16, 2004.

We were awarded a 30-year concession beginning in August 1999 for hydroelectric power generation at HPPL. Our total investment in the construction of the complex was P\$291 million. The complex has three generating units with an installed capacity of 285MW. Units 1 and 2 began commercial operations during the third quarter of 1999, and Unit 3 started commercial operations in December 1999.

Pursuant to our concession contract and applicable law, since August 2003, we have paid 1% in hydroelectric royalties, which will be increased by 1% annually until reaching a 12% maximum tax rate, on the amount resulting from applying to the energy sold the tariff corresponding to block sales. In addition, we pay the Argentine government a monthly fee for the use of the water source amounting to 0.5% of the amount used in the calculation of these hydroelectric royalties.

In order to secure completion of the works within the term of the concession and to ensure certain minimum profitability levels needed to make the investment viable, the Secretary of Energy granted us P\$25 million from a government fund. For purposes of determining whether this amount should be reimbursed, a price support system was created. The price support system guarantees our project by providing a minimum return on investment. Given HPPL's energy sales prices for the period ended December 2004 and taking into consideration the guarantees provided by the price support system, we recognized P\$20 million in income from this fund as of December 31, 2004 and P\$15 million as of December 31, 2003.

Genelba and HPPL, together, account for approximately 6.7% of the power used by, and approximately 6.4% of the power generated for, the Argentine electricity system. The joint operation of the generating units minimizes income volatility, capitalizing on the natural barriers existing among the different energy resources used for power generation.

The following chart details energy generation and sales figures for Genelba and HPPL for the fiscal years ended December 31, 2004, 2003 and 2002.

	<b>For the year ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Generation (Gwh)</b>	5,689	5,400	5,278
<b>Sales (Gwh):</b>			
Contracted sales	1,437	1,588	1,569
Spot market	4,719	4,450	4,402
Total sales	6,156	6,038	5,971
<b>Sales (in millions of pesos)</b>	280	235	196

*Piedra del Aguila*

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We, through our 9.19% interest in Hidroneuquén S.A., have an indirect 5.4% interest in Hidroeléctrica Piedra del Aguila S.A., or HPDA.

The Piedra del Aguila hydroelectric complex has 1,400 MW of installed capacity and four vertical axis turbosets. During 2004, HPDA sold 5,758 GWh in the wholesale electricity market, 5,523 GWh of which were supplied by its own generation (close to its historical average) and 235 GWh were purchased in the spot market.

On June 30, 2002, Piedra del Aguila announced the suspension of principal and interest payments on its financial debt. During 2004, pursuant to an exchange offer, HPDA restructured its senior debt. Approximately US\$102 million of its subordinated debt owed to Total Finance S.A. is still in the process of being restructured.

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### **Electricity Transmission: Transener, Yacylec and Enecor**

#### *Transener*

We currently own an indirect participation of 32.5% in Transener. Transener is the leading power transmission company in Argentina. We are committed to divesting our aggregate equity interest in Transener as required in connection with the Argentine Antitrust Commission's resolution approving the purchase of our majority stock by Petrobras. This divestiture would be subject to supervision by the Argentine regulatory entity for electricity, Ente Nacional Regulador de la Electricidad, or ENRE, and must be approved by the Argentine Secretary of Energy. No time limits had been set to effect this divestiture. On May 26, 2005, we received a notice addressed to Petrobras, with a copy of Resolution 757 of the Argentine Secretary of Energy attached thereto. Under this resolution, March 31, 2006 is fixed as the deadline for Petrobras to divest our equity interest in Transener. The resolution also requires that a divestment plan be submitted within 15 days after receipt of notice. On June 17, 2005, the Secretary of Energy suspended Resolution 757.

Transener is controlled by Citelec, who owns 65% of the capital of Transener. Citelec, in turn, is owned on a 50/50 basis by Dolphin Fund Management, or Dolphin, and Petrobras Energía. On July 28, 2004, the Argentine Antitrust Commission authorized Petrobras Energía to exercise a right of first refusal on 17,406 shares of Citelec's common stock, representing 0.007% of Citelec's capital stock, thereby giving Petrobras Energía a 50% equity interest in Citelec. Petrobras Energía exercised this option within the framework of the purchase by Dolphin of the entire equity interest that National Grid Finance B.V. had in Citelec.

Under a 95-year concession, which is due to expire in 2088, Transener operates approximately 7,500 km of extra high and high voltage power lines (most of them 500 Kv lines) and 32 transformer stations. This network is the core of the power transmission system in Argentina.

Transener was awarded an exclusive license for the rest of the term of the original concession to construct, maintain and operate the fourth line of the Comahue-Buenos Aires electricity transmission system, which began operations late in 1999 and consists of 1,292 km of 500 Kv electricity lines.

In July 1997, Transener was awarded the exclusive 95-year concession to operate Transba, which expires in 2091. Transba operates approximately 5,991 km of electricity transmission lines (most of them 132 KV lines) and 81 transformer stations.

Transener operates approximately 90% of the Argentine extra high voltage power transmission system. Transener and Transba jointly operate approximately 75% of the Argentine high-voltage power transmission system.

We have agreed with Dolphin Fund Management to jointly manage Transener and Transba and to share equally in the management fees received under a management agreement with Transener. In addition, shareholders have a right of first refusal in any transfer of Transener's shares. Under the concession agreement with the government, certain shares of Transener are pledged as guarantee for the execution of obligations under such agreement.

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Transener generates additional income related from the supervision of the construction and operation of certain assets connected with the networks and other power transmission services provided to third parties. In this respect, efforts are being made by Transener to expand its activities abroad, supported by its quality engineering and experienced technical personnel.

In order to meet the commitments arising from two contracts with foreign joint ventures in Brazil, Transener organized Transener Internacional Limitada, with offices in Brasilia. During 2004, Transener Internacional Limitada performed operation and maintenance activities in Brazil, reaching a high operating efficiency level. In Brazil, Transener executed a five-year-term agreement with the ETIM Consortium (Expansión Itumbiara-Marimbondo Ltda.) to operate and maintain the 500 Kv Itumbiara-Marimbondo high voltage line and two transformer stations located in the Goiás and Minas Gerais states.

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In addition, in Paraguay, Transener completed the first works relating to the 500 Kv line in the transmission system, which was financed by the International Development Bank and awarded to the company on the basis of a public international bidding. The project encompasses 15 km of lines, a 500 Kv yard and a 200 Kv extension of the transformer station. On August 3, 2004, first works were provisionally accepted, with no significant works pending completion.

The following chart details the evolution of Transener's failure rate for the fiscal years ended December 31, 2004, 2003 and 2002. The failure rate represents the service quality provided by the company to users. The maximum admissible failure rate under the concession contract is 2.50 failures per year per every 100 km.

	For the year ended December 31,		
	2004	2003	2002
Transener failure rate	0.49	0.51	0.57

Maintenance of this low failure rate resulted from operating improvements, acquisition of special equipment and agreements with public safety agencies.

The provisions of the Public Emergency Law have severely affected the economic and financial balance of Transener's business. In April 2002, as a result of the changes caused by the Public Emergency Law, Transener publicly announced the suspension of principal and interest payments on all its financial debt. On February 22, 2005, Transener proposed an exchange offer to its creditors, which in April 2005 was accepted by 98.8% of them. Pursuant to a restructuring agreement entered into on May 19, 2005, Transener has 45 business days to comply with the terms of the exchange offer, otherwise the restructuring agreement may be terminated at creditors' option. This exchange offer restructured Transener's indebtedness, which as of March 31, 2005 amounted to P\$1,353 million in principal. In the offer, Transener will issue to its creditors an aggregate of: (1) US\$80 million in par notes due 2016, with interest accruing at an increasing rate from 3% to 7% per annum, (2) US\$199.8 million in discount notes due 2015 with interest accruing at an increasing rate from 9% to 10% per annum and (3) 84,475,000 shares (or cash in lieu of shares). (As a result of the issuance of the shares described in (3) above, Citelec's interest in Transener will be reduced from 65% to 52.652% and our indirect interest will be reduced from 32.5% to 26.326%.) In addition, Transener will redeem indebtedness with a nominal value of US\$110 million, by paying US\$550 in cash for every US\$1,000 of outstanding debt. The issuance of the new debt and the new shares has been approved by the CNV.

In addition to the renegotiation process described above, on February 2, 2005, Transener and Transba entered into letters of understanding with UNIREN, which contain principal terms (including a new tariff scheme) and conditions for a comprehensive renegotiation of both companies' concession contracts. These renegotiated agreements are expected to become effective before May 2006. In the meantime, temporary tariff increases of 31% to Transener and 25% to Transba are pending congressional approval and ratification and, if approved, will be in force with retroactive effect as of June 1, 2005.

*Yacylec*

Yacylec S.A., which we refer to as Yacylec, is an independent transmission company formed by a consortium of construction and engineering companies of Argentina and Europe, including Empresa Nacional de Electricidad S.A. of Spain, or ENDESA, Impregilo International Infrastructures N.V. of The Netherlands and Dumez S.A. of France, which currently hold 22.2%, 18.67% and 1.78% of Yacylec, respectively.

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We have a 22.22% direct interest in this consortium. The consortium operates and maintains the 500 Kv and 280 km-long electric power transmission line from the Yacyretá hydroelectric complex to the Argentine national grid under a 95-year concession that expires in 2091. Under the concession agreement, ENRE's approval is necessary to transfer or sell shares representing up to 49% of the capital stock of Yacylec. The transfer of a higher percentage requires a public tender.

Under the shareholders' agreement, shareholders have a right of first refusal in any transfer of shares.



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### *Enecor*

Enecor is an independent electricity transmission company. We own 69.99% of Enecor and Impregilo International Infrastructures N.V. of The Netherlands owns the remaining interest in the company. Enecor has a 95-year concession, expiring in 2088, to construct, operate and maintain approximately 22 km of electricity lines and a 500 Kv/132 Kv transformer station in the Province of Corrientes. Enecor has entered into a maintenance agreement with Transener until 2008. Under the concession contract, certain shares of Enecor are pledged in favor of the Province of Corrientes.

As collateral for the amounts owed by the Dirección Provincial de Energía de Corrientes, or DPEC, to Enecor, the Province of Corrientes has assigned to Enecor (1) all royalty credits it has against the Comisión Técnica Mixta de Salto Grande for the sales of electricity generated by the Salto Grande Hydroelectric Power Complex and (2) the funds that belong to the province under the Fondo de Desarrollo Eléctrico del Interior, or FEDEI. Enecor has been collecting from these guarantees because the DPEC has failed to pay tariffs to Enecor since September 1999. However, as a result of lower hydropower generation and the issuance of Resolution 406/03 of the Secretary of Energy, which affected all generators by establishing a priority for canceling existing debts subject to the Stabilization Fund having sufficient funds (coming from either the adjustment of the seasonal price or the federal government), Enecor's ability to collect fees has been affected and, therefore, Enecor has been accumulating receivables from DPEC since November 2003. Enecor is taking appropriate administrative and legal actions with respect to these matters, but it is not certain that these actions will result in a favorable outcome to Enecor.

### **Electricity Distribution: Edesur**

In 1992, Edesur was awarded an exclusive license by the Argentine government to distribute electricity in the southern area of the federal capital and 12 districts of the Province of Buenos Aires, serving a residential population of approximately 6 million inhabitants and a client portfolio of approximately 2.1 million. The license will expire in 2087 and is extendable for an additional 10-year period. Edesur was created as part of the privatization of the Buenos Aires electricity distribution network. We own 48.5% of Distrilec which, in turn, owns 56.35% of Edesur.

We and the Enersis/Chilectra group, owned by ENDESA, are the only shareholders of Distrilec and, pursuant to a shareholders' agreement, we each have the right to elect an equal number of directors.

The unanimous approval of the board of directors is necessary for the grant of any lien on Edesur's shares or any merger, reorganization, dissolution or spin-off of Distrilec. Shareholders also have a right of first refusal on any transfer of shares and preferential rights on any new issue of shares.

In compliance with the terms and conditions of the privatization, Edesur entered into an operating agreement with Chilectra S.A. for the provision of technical advisory services. This agreement is effective through August 2007, and we are reimbursed for costs incurred by us in connection with the management agreement.

Under the terms of the agreement, Chilectra was entitled to receive management fees of US\$1 million plus 10% of operating income per year. In November 2004, Edesur and Chilectra renegotiated the terms of the agreement and, as of 2005, Chilectra will receive an annual fee with a fixed component equal to US\$600,000, plus a variable component, based on the kind of service rendered.

Under the concession contract, Edesur is subject to a fixed cap on what it may charge each customer for the distribution of electricity to that customer. However, Edesur may pass through to the customer the cost of the electricity purchased, limited only by the pre-adjusted seasonal wholesale electricity market price. Customers are divided into tariff categories based on the type of consumption required. Under the current regulations, large users may purchase energy and power directly from the wholesale electricity market. Edesur charges these large users a wheeling fee for the provision of distribution services. Residential consumers purchase power only from distributors. These customers are generally daylight and weather sensitive and their consumption of electricity is different in summer and winter. Peak demand occurs in July, when there is the least amount of sunlight, and in January, which is usually the hottest summer month in Argentina.

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The enactment of the Public Emergency Law significantly affected Edesur's economic and financial balance and its ability to comply with its contractual commitments. For this reason, Edesur's efforts were focused on refinancing financial liabilities, reducing risks and optimizing working capital. Based on these guidelines, Edesur managed to refinance all of its financial debt, achieving a better maturity profile and lower average costs.

In addition, Edesur has regained access to the local financial market, becoming one of the first Argentine companies to place, after the crisis, an issuance in the domestic market of peso-denominated notes with favorable terms and rates. The proceeds of this issuance were used to repay financial debt with financial institutions, achieving a reduction to its exposure to devaluation.

On June 16, 2004, Edesur entered into a memorandum of understanding with UNIREN in connection with the renegotiation of Edesur's concession contract. The memorandum of understanding establishes terms and conditions which will be the basis for the comprehensive agreement for renegotiation of the concession contract between the federal executive branch and Edesur. The memorandum of understanding provides for the implementation of a transitional tariff scheme as from November 1, 2005, that increases the utility's average tariff by up to 15% and requires prior regulatory approval for the payment of dividends during that transitional period. In addition, the memorandum provides for a comprehensive tariff revision process to take place between June 16, 2004 and September 30, 2006 in order to establish a new tariff scheme with a 5-year term that would commence on November 1, 2006.

The chart below sets forth Edesur's annual power sales for each type of customer for the fiscal years ended December 31, 2004, 2003 and 2002.

	Annual sales in Gwh		
	2004	2003	2002
<b>Type of customer:</b>			
Residential	4,796	4,304	4,597
General	2,798	2,785	2,439
Large users	5,729	5,569	5,123
<b>Total</b>	<b>13,323</b>	<b>12,658</b>	<b>12,159</b>

Since its privatization, Edesur has made investments of approximately P\$3,000 million, of which P\$150 million were invested in 2004. As a result of these investments, Edesur was able to provide for more than a 35% increase in demand reaching its highest levels of output while maintaining a high quality of service.

In addition, investments enabled Edesur to reduce total energy loss through the system. This loss had accounted for 26% of total electricity received in 1992 but currently accounts only for 11.75%. Since 2004, an underground loss control campaign has been implemented where new technologies, such as radio detectors and georadars, are used to identify irregularities in underground networks that are likely to have unidentifiable connections.

By the end of 2004, Edesur's clients numbered 2,138,753, accounting for a 1.02% net increase compared to 2003. This indicator maintains the upward trend resumed in 2003 after two years of decline. Edesur has added more than 200,000 customers since its privatization. Some of these

customers were added as a result of new electricity lines and others, who had been receiving electricity outside the system, are now fully connected and accurately billed. Edesur has also substantially reduced overdue payments from customers and is implementing more efficient billing and collection practices.

### **Competition**

We compete with other generators in the wholesale electricity market, both in the spot market and for contracts (mainly short-term contracts). The price received by us for energy generation is determined by the wholesale electricity market rules and by rules and regulations enacted following the Argentine crisis and the adoption of the Public Emergency Law. See Regulation of Our Businesses Argentine Regulatory Framework Electricity.

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### **DIVESTMENTS OF NON-CORE ASSETS**

The sale of 58.6% of our capital stock to Petrobras represented a major milestone in the development of our strategy to focus on our core businesses.

The agreements executed in connection with the transfer of our control granted Petrobras an option whereby, if within 30 days after closing of the stock purchase transaction we did not consummate the sale of assets related to the farming, forestry and mining businesses, Petrobras had the right to compel our former controlling shareholders (the Perez Companc Family and Fundación Perez Companc) to acquire such assets for US\$190 million.

In line with the provisions of the agreements mentioned above, during 2002 we sold the asset portfolio associated with our mining, farming and forestry businesses.

In addition, in April 2002, pursuant to an asset swap, we transferred our 50% interest in Pecom Agra S.A., a company involved in the agricultural business. We, in turn, received (1) a 0.75% interest in the Puesto Hernandez oil field, (2) a 7.5% interest in Citelec and (3) a 9.19% interest in Hidroneuquen S.A.

These divestitures helped to enhance our asset portfolio and moved us forward with our strategy to focus on energy operations and to become an integrated energy company.

### **INSURANCE**

We carry insurance covering all operating risk damages, with assets valued at current market replacement cost. The coverage limit for each and every loss in our oil and gas exploration and production businesses is the total value at risk for each location:

US\$420 million for each and every loss in our Argentine styrenics petrochemical business;

US\$350 million for each and every loss in our Brazilian styrenics petrochemical business;

US\$190 million for each and every loss in our fertilizers business;

US\$130 million for each and every loss in our San Lorenzo refining business;

US\$181 million for each and every loss in our Bahía Blanca's refining business;

US\$180 million with respect to our thermoelectric generation businesses; and

US\$228 million for each and every loss in the hydroelectric generation power plant.

The rest of the assets have been insured in full value for each and every loss.

In addition, we carry insurance of up to:

US\$100 million for ocean marine and non-ocean marine third-party liability;

US\$7.5 million for well control costs in Argentine fields;

US\$40 million for wells in Bolivia;

US\$40 million for wells in Ecuador;

US\$25 million for fields in Venezuela; and

US\$10.5 million for cargo transportation by sea or river.

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We also carry insurance for workmen's compensation and automobile liabilities.

Our coverage includes the following different types of deductibles:

US\$10,000,000 for combined claims for property damage and business interruption for all our businesses, except for the oil and gas exploration and production businesses;

US\$10,000,000 for claims for each property of our oil and gas exploration and production businesses;

US\$5,000,000 for in well control costs;

US\$5,000,000 in non-ocean marine third-party liability; and

US\$5,000,000 in ocean-marine third-party liability.

Our insurance decisions are based on our requirements and available commercial and market opportunities.

## **PATENTS AND TRADEMARKS**

Minor portions of our commercial activities are conducted under licenses granted by third parties, including Petrobras. Royalties related to sales associated with such commercial activities are paid under the relevant licenses. We use the name Petrobras with the permission of Petrobras.

## **QUALITY, SAFETY, ENVIRONMENT AND HEALTH**

We are a socially and environmentally responsible corporation in continued search for excellence in management. This commitment lies in the core of our corporate identity and is part of our corporate mission. We believe that caring for the environment in which we operate and for the safety and health of individuals is an essential condition for the activities we develop. Along these lines, our strategic and business plans include goals involving excellence in management and performance in Quality, Safety, Environment and Health (QSEH).

Within the scope of this philosophy, in April 2004, we launched a new QSEH policy. The quality policy provides a more comprehensive, executable and applicable approach. The Safety, Environment and Health (SEH) Policy incorporates state-of-the-art concepts, including: efficiency, life cycle, continuous improvement and leadership. This is implemented through the use of 15 guidelines for practical and customary action, each aimed at behavior-based responsible development. The foregoing policies and actions have been enhanced through our relationship with Petrobras.

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While implementing these changes, we complied with international audits and certifications with respect to environmental management, quality, safety and occupational health. We have 23 assets certified, including ISO 14001, ISO 9001 or OHSAS 18001/IRAM 3800, which are maintained through regular third-party audits.

### *Excellence in Management*

In order to achieve high standards of excellence in management, we implemented a cycle of evaluations aimed at measuring the global quality of corporate performance. This cycle was started at key units – Genelba, Innova, E&P-Venezuela and E&P-Argentina – and involved the participation of over 1,000 employees in evaluator training courses, sensitivity lectures, training courses and management report writing courses. Currently, each of these units is developing its respective Plan for Management Improvement.



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### *New policy and guidelines, new management tools Process Safety Program*

To guarantee the effective implementation of the new SEH policy and guidelines, we have developed a set of corporate management tools in the Process Safety Program (PSP). This program was launched in April 2004 with a diagnosis of management that encompassed 23 production units and centralized functions and included interviews with over 300 members of management, our employees and contractors.

During a second stage, PSP sought to review business production unit action plans, production and centralized functions through the progress and enhancement of several projects.

### *Safety*

To minimize the occurrence of operation-related casualties and contingencies, we developed a series of preventive measures, including technical audits, behavioral audits with their respective deviation analyses, corrective actions to address the deviations detected in both technical and behavioral audits, training and implementation of a learning process based on the analysis of individual accidents and accidents occurred within the entire Petrobras system.

Road safety management was identified as an area with great potential for improvement. To minimize and control the risks involved in this operation, we designed and implemented a new plan, the 2004 Road Safety Plan, which is one of the main prevention tools in terms of resource mobilization.

Quick and correct decisions-making is crucial to minimize eventual damages and rapidly restore previous conditions in the event of an accident. It is essential to have reliable, qualified and updated information available for this purpose. Geographical data platforms are among the newest technological tools used internationally to obtain this type of data.

We have developed a support system for contingencies named Geodatabase, which includes all relevant facilities and the information available at each operating unit. Geodatabase provides detailed geographical information and also interrelates spatial references with a powerful database. In this manner, each spatial reference is accompanied by additional information: satellite images, plans, digital photographs, process sketches and other documents. In addition, the database is supplemented with information on resources, either human or material, available in over two thousand population centers.

Another technological tool used by us to solve contingencies is INFOPAE. INFOPAE was created to specifically respond to each scenario where an accident occurs, by providing key information for the initial decision-making process and the guidance of response groups prior to (through emergency simulation), during (on-time assistance to response personnel) and after (during the preparation of reports and the evaluation of actions taken) the accident.

In 2004, we signed a Mutual Assistance Agreement with Petrobras to help each other in coping with possible spill situations in our road and maritime operations.

*Environment*

We implemented several actions to minimize the environmental impact of operations and reduce associated risks. Among them, we implemented a maintenance and replacement pipeline program, waste treatment plans and projects for the improved performance of effluent treatment plants.

Since July 2003, we have put into operation a project called Inventory System of Atmospheric Emissions, which was initiated in September 2002 by Petrobras. The main goal of this project is the creation of a tool for the management of atmospheric emissions. The work consists of the creation of a collection, utilization and communication data system that permits the systematic environmental evaluation of our emissions, the identification of critical issues and the technological analysis of improvements that can be put into place to reduce these emissions.

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Through the application of this system, we have obtained consolidated numbers with respect to our Green House Gases Inventory (GHG) and other regulated pollutants for the year 2004.

### *Environmental audit*

Following the change of our controlling shareholder and pursuant to our goal of continuously improving our environmental, health and safety management, in 2003, we hired an international consulting firm to conduct an environmental and safety audit of all our operations.

The final audit report issued by this consulting firm confirmed the high environmental standards of our operations and identified a series of actions necessary for our operations to be in full compliance with current laws and regulations, to satisfy future requirements and, in the absence of local laws, to comply with applicable international standards. Consequently, we have implemented a plan aimed to improve, among other things, our prevention systems and production facilities at a cost of approximately US\$23 million. In addition, we will implement several corrective and remediation actions, for which a P\$45 million loss provisions was recorded in fiscal year ended December 31, 2003. During the year 2004, a general remediation plan was implemented scoping several units of the company, and 44 environmental projects were initiated at a cost of approximately US\$7 million.

Pursuant to the objectives of the SHE policy launched in 2004, an environmental study was produced for the fiscal year ended December 31, 2004, as a supplement to the audit performed in 2003. Under the standards of the new policy, the study enabled us to identify the need for additional remediation measures, in relation to which we recorded loss provisions amounting to P\$33 million in 2004.

### *Health*

We have implemented a Health Promotion and Protection Program (HPPP), which prioritizes the quality of life of our employees. The principal components of the program are health promotion, stress management, physical activity, healthy diet and accident prevention actions. Program activities include workshops on stress, sedentary life-style, healthy diet and a smoking reduction plan. In order to encourage physical activity, we opened health promotion centers gyms and aerobics tracks in several plants and executed agreements with fifteen private gyms in Buenos Aires.

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**REGULATION OF OUR BUSINESSES**

**ARGENTINE REGULATORY FRAMEWORK**

**Petroleum**

The Argentine oil and gas industry operates under Law No. 17,319, which we refer to as the Hydrocarbons Law, enacted in 1967, and the Natural Gas Act No. 24,076, enacted in 1992. The Hydrocarbons Law allows the federal executive branch of the Argentine government to establish a national policy for the development of Argentina's hydrocarbon reserves, with the principal purpose of satisfying domestic demand.

A new regulatory framework was required in order to respond to several changes in the Argentine oil and gas industry after the privatization of Yacimientos Petrolíferos Fiscales Sociedad del Estado, or YPF, and Gas del Estado, or GdE. Pursuant to Law No. 24,145, which is referred to as the Privatization Law, the Argentine government transferred to the provinces ownership of oil and gas reserves located within their territories. The transfers will be implemented once (1) the Hydrocarbons Law is modified for the purpose stated in Law No. 24,145 and (2) the rights of holders of existing exploration permits and production concessions, as applicable, have expired. In connection with this legislation, certain issues remain unresolved with respect to the relevant regulatory authority of the federal executive branch and the provinces, regarding oil and gas exploration, production, and transportation activities.

*Exploration and Production*

The Hydrocarbons Law sets forth the basic legal framework for the current regulation of oil and gas exploration and production in Argentina. The Hydrocarbons Law permits surface reconnaissance of territory not covered by exploration permits or production concessions upon authorization of the Secretary of Energy and with permission of the property owner. Information gained as a result of surface reconnaissance must be provided to the Secretary of Energy, who is prohibited from disclosing such information for a period of two years, without the permission of the party that conducted the reconnaissance, except in connection with the grant of exploration permits or production concessions.

The Hydrocarbons Law provides for the grant of exploration permits by the federal executive branch following submissions of competitive bids. Permits granted to third parties in connection with the deregulation and demonopolization process were granted in accordance with procedures specified in certain decrees, known as the Oil Deregulation Decrees, issued by the federal executive branch. In 1991, the federal executive branch established a program under the Hydrocarbons Law, known as the Argentina Exploration Plan, pursuant to which exploration permits may be auctioned. The holder of an exploration permit has the exclusive right to perform the operations necessary or appropriate for the exploration of oil and gas within the area specified by the permit. Each exploration permit may cover only unexplored areas up to 10,000 km<sup>2</sup> (15,000 km<sup>2</sup> offshore), and may have a term of up to 14 years (17 years for offshore exploration).

In the event that the holder of an exploration permit discovers commercially exploitable quantities of oil or gas, the holder may apply for, and is entitled to receive, an exclusive concession for the production and development of such oil and gas. A production concession vests in the holder the exclusive right to produce oil and gas from the area covered by the concession for a term of 25 years (plus, in certain cases, a part of the unexpired portion of the underlying exploration permit), which may be extended for an additional ten-year term by application to the federal executive branch. A production concession also entitles the holder to obtain a transportation concession for the transport of the oil and gas produced.

Holders of exploration permits and production concessions are required to carry out all necessary works to find or extract hydrocarbons, using appropriate techniques, and to make the investments specified in such holders' permits or concessions. In addition, these holders are required to avoid damage to oil fields and waste of hydrocarbons, to adopt adequate measures to avoid accidents and damage to agricultural activities, the fishing industry, communications networks and the water table, and to comply with all applicable federal, provincial and municipal laws and regulations.

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Holders of production concessions are also required to pay a 12% royalty to the government of the province in which production occurs, calculated on the wellhead price (equal to the FOB price less transportation costs and certain other reductions) of crude oil and natural gas produced. The Hydrocarbons Law authorizes the government to reduce royalties up to 5% based on the productivity and location of a well and other special conditions. Any oil and gas produced by the holder of an exploration permit prior to the grant of a production concession is subject to the payment of a 15% royalty.

Resolution No. 435/04 issued by the Secretary of Energy, which updates Resolution No. 155 dated December 23, 1992, (1) imposes additional reporting requirements with respect to royalties, (2) introduces certain changes, which affect provincial empowerment, (3) amends certain parts of the royalty determination system, including applicable deductions and exchange rates and (4) establishes penalties upon default of a reporting duty. This resolution has been applicable to permit and concession holders since June 2004.

Concession holders are required to file sworn statements with the Secretary of Energy and the relevant provincial authorities, informing them of:

The quantity and the quality of extracted hydrocarbons, including (1) the computable production levels of liquid hydrocarbons and (2) a break down of the crude oil (specifying the type), condensate and total natural gas recovered (with a 0.1% maximum error tolerance);

The sales to domestic and foreign markets;

Reference values for transfers made at no cost for purposes of further industrialization;

Freight costs from location where marketable condition is acquired to location where commercial transfer takes place; and

Description of sales executed during the month.

In addition to the sworn statement, concession holders shall file receipts evidencing payment of royalties. Upon breach of any reporting duty, provincial authorities are entitled to make their own assessment of royalties.

Resolution No. 435/04 also provides that if a concession holder allots crude oil production for further industrialization processes at its or affiliated plants, the concession holder is required to agree with provincial authorities and the Secretary of Energy, as applicable, to the reference price to be used for purposes of calculating royalties and payments. Upon default by the concession holder, provincial authorities may fix this reference price. The concession holder is eligible for certain deductions including (1) inter-jurisdictional freight costs, which can be deducted from the selling price, as long as transportation is made by means other than pipeline and monthly invoices and any relevant agreements are provided and (2) internal treatment costs (not exceeding 1% of the payment) incurred by authorized permit or concession holders.

Exploration permits and production or transportation concessions are subject to termination in the event of certain breaches or defaults of laws or regulations or upon the bankruptcy of the concessionaire. Upon the expiration or termination of a production concession, all oil and gas wells, operating and maintenance equipment and facilities ancillary thereto automatically revert to the Argentine government, without payment to the concessionaire.

*Net Worth Requirements*

Resolution No. 193/03 of the Secretary of Energy implements mandatory minimum net worth requirements for companies that wish to acquire or maintain exploration permits, exploration concessions, and hydrocarbon transportation concessions in Argentina.

The Secretary of Energy has historically required companies that wish to obtain these permits or concessions to comply with certain minimum net worth and economic and financial solvency requirements. Along

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these lines, the Hydrocarbons Law and subsequent regulations provide for certain economic and financial solvency requirements for carrying out these activities. Prior to the issuance of Resolution No. 193/03, there were no resolutions that established specific required amounts, but rather, the Secretary of Energy determined the amount that would be required to comply with the solvency requirement on a case by case basis. Resolution No. 193/03 sets forth minimum net worth requirements, as well as, alternative economic and financial guarantees that can be complied with to obtain permits or concessions.

This resolution also provides that, in order to be a holder of a permit or concession, the company or group of companies (for example, companies associated through a joint operating or joint venture agreement) shall have a minimum net worth of P\$2,000,000 for land-based areas and US\$20,000,000 for off-shore areas. This minimum net worth amount must be maintained during the whole term of the permit or concession. The breach of this obligation may result in sanctions, including fines, or even the revocation of a company's registry with the Secretary of Energy as a petroleum company. To comply with these requirements other local Argentine companies or foreign companies may grant financial support or guarantees of up to 70% of the minimum net worth requirements in favor of the entity requesting a permit or concession.

### *Transportation*

The Hydrocarbons Law grants hydrocarbon producers the right to obtain from the federal executive branch a 35-year transportation concession for the transportation of oil, gas and their by-products through public tenders. Producers granted a transportation concession remain subject to the provisions of the Natural Gas Act, and in order to transport their hydrocarbons do not need to participate in public tenders. The term of a transportation concession may be extended for an additional ten years upon application to the federal executive branch.

Transporters of hydrocarbons must comply with the provisions established by Decree No. 44/91, which implements and regulates the Hydrocarbons Law as it relates to the transportation of hydrocarbons through oil pipelines, gas pipelines, multiple purpose pipelines and/or any other services provided by means of permanent and fixed installations for transportation, loading, dispatching, tapping, compression, conditioning infrastructure and hydrocarbon processing. This decree is applicable currently and primarily to oil pipelines and not to gas pipelines. (Gas pipelines are subject to ENARGAS regulations, see Gas ENARGAS. )

The transportation concessionaire has the right to transport oil, gas, and petroleum products and to construct and operate oil pipelines and gas pipelines, storage facilities, pumping stations, compressor plants, roads, railways and other facilities and equipment necessary for the efficient operation of an oil, gas and petroleum product pipeline system. While the transportation concessionaire is obligated to transport hydrocarbons on a non-discriminatory basis on behalf of third parties for a fee, this obligation applies only if such producer has surplus capacity available, and after such producer's own transportation requirements are satisfied.

Depending on whether it is gas or crude oil that is transported, transportation tariffs are subject, respectively, to approval by ENARGAS or the Secretary of Energy. Resolution No. 5/04 of the Secretary of Energy sets forth:

Maximum amounts for tariffs on hydrocarbon transportation through oil pipelines, and multiple purpose pipelines, as well as the tariffs on storage, use of buoys, and the handling of liquid hydrocarbons; and

Maximum deduction amounts that may be applied in connection with crude oil transportation by producers that, as of the date of the regulation, transport their production through their own unregulated pipelines, for the purpose of assessing royalties.



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Upon expiration of a transportation concession, ownership of the pipelines and related facilities is granted to the Argentine government at no cost.

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### *Refining*

Hydrocarbon refining activities by oil producers and other third parties are regulated, ever since the enforcement of National Decree No. 1212/89, by the regulations under the Hydrocarbons Law. Together with several other norms that were dictated by the Secretary of Energy, this legal framework essentially regulates the commercial, environmental and security matters with respect to refineries and gas stations. This law made possible free imports, abolishing oil assignments by the Secretary of Energy, and deregulated the installation of refineries and gas stations. The Secretary of Energy's regulatory authority has also been delegated to provincial and municipal authorities and, therefore, refining and the sale of refined products must also comply with provincial and municipal technical, health and safety and environmental regulations.

The refining of hydrocarbons is subject to requirements established by the Secretary of Energy, including registration by oil companies. Approval of registration is granted on the basis of financial, technical and other standards. As further described below, liquid fuel retail outlets, points of sale locations for fuel fractioning, the resale to large users and supply contracts between gas stations and oil companies are all also subject to registration requirements set by the Secretary of Energy.

Refiners are authorized to freely commercialize their products in the domestic market as they would otherwise in the international market (except for, diesel and liquified petroleum gas exports, are subject to prior approval by the Secretary of Energy) and to freely install gas stations identified by their own or third-party flags, provided that their own gas stations or those directly operated by oil companies do not exceed 40% of their distribution network.

As from November 2004, norms have been put into effect that have impacted the refinery segment, including:

Secretary of Energy Resolution No. 1104/04. This resolution created price information modules for oil wholesalers and retailers, obligating refinery and gas station owners to submit monthly sales information. In cases where gas station owners fail to supply the required information, they, as well as, brand owners may face financial penalties.

Secretary of Energy Resolution No. 1679/04. This resolution restored the Diesel Oil Exportation Operations Registry, which had been created by National Decree No. 645/02. Pursuant to this resolution, producing, trading and refining companies or any other person with intentions of carrying out diesel oil export operations are required to register for prior approval from the Refining and Marketing National Directive, an organization operating under the Undersecretary of Fuels of the Secretary of Energy, and guarantee sufficient product supply for oil suppliers who are commercially connected with exporters. Additionally, oil suppliers are required to apply for approval prior to undertaking export operations, in order to ascertain that the demand of all refineries authorized to operate in the country has been satisfied and/or those refineries have been given the opportunity to acquire the oil which is earmarked for exportation.

Secretary of Energy Resolution No. 1102/04. This resolution abolished Resolution No. 79/99 of the Secretary of Energy, and created a regulatory framework for new gas stations, other fuel-sale outlets and distribution channels. Application to the Registry is a prerequisite to participation in the liquid fuel market. There are stiff sanctions for the execution of commercial transactions with un-authorized parties and repetitive violations may result in suspension and withdrawal from the registry. The resolution also establishes several requirements for all fuel market participants and makes brand owner companies jointly responsible for breaches by companies operating under their flags.

Secretary of Energy Resolution No. 1103/04. This resolution establishes an economic sanction structure applicable to owners of facilities that are registered in the Registry of Liquid Fuel Gas Stations, as well as other distributors, resellers, traders of

refined products and owners of bulk oil and liquid fuel stores and compressed natural gas stores, who breach certain fuel quality

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specifications (regulated under, or in connection with, Resolution No. 54/96 of the former Works and Public Services Minister). Pursuant to Article 17 of National Decree No. 1212/89, brand owner companies are liable for failure to comply with commercialized products specifications, including quality and quantity requirements, in those gas stations belonging to the commercialization chain of a company registered in the Registry of Oil Companies created by Resolution No. 419/98 of the Secretary of Energy.

National Law No. 26.022. Under this law, because of the economic emergency, many import operations are temporarily exempt from the Fuel Liquids and Gas Natural Tax, as well as, the Diesel Oil Tax on volumes up to 500,000 cubic meters. This law also establishes sanctions applicable to the solid, liquid and gaseous oil sector, that imposes stiff penalties for any breaches related to health, security, environmental, product quality and information provision issues.

Resolution No. 398/03. The Secretary of Energy, pursuant to this resolution, set forth new maximum standards as to the contents of sulphur and/or benzene and/or total fragrant hydrocarbons. These standards are applicable to (1) regular and special gasolines as from January 1, 2006, (2) gas oil as from January 1, 2008 and (3) fuel oil as from January 1, 2009.

Resolution No. 824/03. This resolution defines those urban areas that are under the jurisdiction of the Secretary of Energy. The secretary's jurisdiction classifies the city of Rosario, in the Province of Santa Fe, as a new urban area, which is under the Secretary of Energy's jurisdiction with respect to the control of certain sulphur contents of gasolines, gas oil and fuel oil.

### *Market Regulation*

Under the Hydrocarbons Law and the Oil Deregulation Decrees, the holders of exploitation concessions have the right to freely dispose of their production either through sales in the domestic market or abroad.

Pursuant to Decree No. 1589/89, relating to the deregulation of the upstream oil industry, companies engaged in oil and gas production in Argentina are free to sell and dispose of the hydrocarbons they produce and are entitled to keep out of Argentina up to 70% of the foreign currency proceeds they receive from crude oil and gas sales, while being required to repatriate the remaining 30% through Argentine exchange markets. During 2002, as a result of the reestablishment of a system that requires exporters of domestic products to repatriate foreign currency amounts generated by their exports, many controversies arose among producers and the authorities regarding the enforceability of the right to freely dispose of up to 70% of their foreign currency. These controversies were even subject to legal suit, and many federal judges have pronounced on and recognized the prima facie validity of producers' rights. In December 2002, we filed before a federal court of the Province of Santa Cruz, a temporary injunction against the federal executive branch, requesting the maintenance of the status quo which allows us to freely dispose of up to 70% of our export proceeds. This right was prima facie admitted by the court. On December 31, 2002, Decree No. 2703/02, effective as of January 1, 2003, was enacted. This decree declared the right to dispose of 70% of foreign currency but had no provisions related to this right during 2002. Therefore, in order to avoid any uncertainty regarding the application of this right during 2002, in February 2003, we filed a civil action of certainty, requesting that the court recognize our right to freely dispose of up to 70% of our foreign proceeds in 2002, based on the effectiveness of Decree No. 1589/89.

The Hydrocarbons Law authorizes the federal executive branch to regulate the Argentine oil and gas markets and prohibits the export of crude oil during any period in which the federal executive branch finds domestic production to be insufficient to satisfy domestic demand. In the event the federal executive branch restricts the export of oil and petroleum products or the free disposal of natural gas, the Oil Deregulation Decrees provide that producers, refiners and exporters shall receive a price, in the case of crude oil and petroleum products, not lower than that of similar imported crude oil and petroleum products and, in the case of natural gas, not less than 35% of the international price per cubic meter of Arabian light oil, at 34 degrees.

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On May 23, 2002, the Argentine government issued Decree No. 867/02 declaring an emergency in the supply of hydrocarbons in Argentina through October 1, 2002. This decree authorized the Secretary of Energy to

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determine quotas on the minimum volumes of petroleum and liquified petroleum gas produced in Argentina that must be sold on the domestic market. By means of Resolution No. 140/02, the Secretary of Energy established that in June, July, August and September of 2002, only 36% of the oil produced in each preceding month could be exported. In addition, during this emergency period, no producer or exporter of oil was permitted to export a volume of oil higher than the volume it exported during the equivalent months of 2001. The emergency resolution was amended and finally repealed on July 26, 2002.

Argentina is currently suffering an energy crisis, and there is an agreement in principle, subject to the approval of the federal executive branch, for gas producers to sell a minimum specified amount in the local market in exchange for price increases. This proposal may change during the approval process. See Item 3. Key Information Risk Factors Factors Relating to Argentina Limits on exports of hydrocarbons have and may continue to lower our anticipated US dollar-denominated cash receipts.

### *Taxation*

Holders of exploration permits and production concessions are subject to federal, provincial, and municipal taxes and regular customs duties on imports. The Hydrocarbons Law grants such holders a legal guarantee against new taxes and certain tax increases at the provincial and municipal levels. Permit holders and concessionaires must pay an annual surface tax based on the area held.

On January 6, 2002, the Argentine Congress enacted the Public Emergency Law. Pursuant to the Public Emergency Law, all foreign-denominated bank deposits were converted into peso-denominated bank deposits at a rate of P\$1.4 per US dollar, and all US dollar-denominated debts with Argentine financial institutions were converted into peso-denominated debts at a rate of one-to-one. Under the Public Emergency Law, the Argentine Congress delegated the right to issue secured government bonds to the federal executive branch in order to compensate it for the effect of pesification and to ameliorate the situation of financial institutions.

The Public Emergency Law established a five-year export tax on hydrocarbon exports as security for these bonds and empowered the federal executive branch to establish the applicable tax rate. By virtue of Decree No. 310/02, the federal executive branch determined that the applicable tax rate would be 20% on crude oil and 5% on petrochemical and oil by-products. On May 13, 2002, by Decree No. 809/02, the federal executive branch temporarily extended the 20% export tax to other hydrocarbon exports, such as petrochemical and oil by-products, stating that the 20% export tax applicable to hydrocarbon exports would be reduced to 5% on October 1, 2002.

Through Resolution No. 77, the Secretary of Energy regulates the payment of tolls by persons and companies that are subject to audit and control under technical and security regulations for the fractionation and sale of liquid gas and the transportation of liquid hydrocarbons and its derivatives through pipelines. It provides the methods and terms and conditions for payment of the tolls.

### *Stability of Diesel Prices Supply to the Domestic Market*

Decrees No. 645/02 and 652/02 and Resolution No. 38/02 of the Secretary of Energy were published in the *Official Gazette* on April 22, 2002 and were aimed at overcoming the diesel fuel supply shortage.

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Decree No. 645/02 provides that diesel exports must be registered and empowers the Secretary of Energy to expand the list of hydrocarbons subject to registration, depending on the condition of the domestic market. The Secretary of Energy has also been authorized to discontinue the registration system if the situation in the domestic market so warrants.

Resolution No. 202/02 of the Secretary of Energy, dated December 19, 2002, modified Decree No. 645/02 by canceling the registration system established by that decree for crude oil export transactions. This resolution also provides for the automatic registration and approval of diesel oil and liquefied petroleum gas exports such that simple evidence of a receipt of the form signed by an attorney of the export company is considered sufficient evidence of the registration and approval of the transaction.

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By means of Decree No. 652/02, the federal executive branch ratified the diesel supply stability agreement for public transportation services, dated April 19, 2002, among the national government and hydrocarbon producing and refining companies. Under the agreement:

Refining companies agreed to supply the domestic market with diesel for the public transportation service at a set maximum price until July 31, 2002;

Hydrocarbon manufacturers agreed to supply local refineries with the same amount of crude oil that they had supplied in the first quarter of 2002, plus an additional amount (with a fixed price and exchange rate), until July 31, 2002; and, in turn,

The national government agreed to allow manufacturing companies to offset against export duties:

The amount of any costs, penalties and indemnities incurred due to the total or partial cancellation of supply to third parties, which were incurred for purposes of complying with the stability agreement; and

Any differences between the fixed price and exchange rate set by the agreement and market prices and rates.

The parties also agreed that, if the fixed price and exchange rate at which manufacturers have agreed to sell their products exceeds a certain limit, either party may request that the agreement be renegotiated. If no agreement is reached in this respect, then the agreement may be terminated.

Decree No. 652/02 has been extended by means of Decree Nos. 1,912/02, 704/03, 447/03 and 301/04 until December 31, 2003.

Subsequently, Decree No. 1,912/02 ratified the agreement on extension of the stability agreement and the first quarterly agreement. Under the extension to the stability agreement, the national government agreed to issue a resolution that would provide for the reduction of export duties imposed on diesel, from a 20% rate to a 5% rate, retroactive as of August 1, 2002.

The first quarterly agreement aimed at limiting diesel volumes that must be provided to public transportation companies at contractually discounted prices, by establishing an information and verification system. The refining companies were entitled to compensation for any differences between the net income that refining companies obtained from the sale of diesel at the market price compared to that obtained from sales at agreed upon prices. The amount of that economic compensation is verified by the Secretary of Energy, who issues a certificate permitting the refining companies to obtain from producers a rebate on the unit price of crude oil equal to the value of the compensation. Producers, in turn, may discount the amount of such rebate from export duties.

Since ratification of the first quarterly agreement, a series of extension agreements has been executed and ratified through Decrees No. 704/03 and No. 447/03. In turn, Decree No. 576/03 empowered the Cabinet of Ministers until December 31, 2003 to execute new agreements with the companies, as well as to enter into amendments to these agreements, in order to secure a continued supply of diesel at a discounted price.

*Stability of Fuel Prices*



With respect to crude oil prices, in January 2003, at the federal executive branch's request, hydrocarbon producers and refineries executed a temporary agreement in connection with crude oil, gasoline and diesel oil price stability in the domestic market. After successive renewals, the term of this agreement was extended until May 2004. This agreement provided for crude oil deliveries to be invoiced and paid based on the WTI of US\$28.5 per barrel instead of the actual relevant WTI. Any positive or negative difference between the actual relevant WTI, not exceeding US\$36 per barrel, and the reference price would be paid out of any balance generated in periods where the actual WTI is below US\$28.5 per barrel. Refineries, in turn, would reflect the crude oil reference price in domestic market prices. In February 2004, a new agreement corresponding to the period beginning on March 1,

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2004 and ending on April 30, 2004 was reached between producers and refineries, but the Secretary of Energy has not yet approved this agreement because it contains a difference concerning the interest rate to be used to calculate the debt between producers and refiners. If the situation continues in the future, producers shall be forced to reinvoice refiners in order to adjust prices. Notwithstanding this situation, beginning in May 2004, hydrocarbon producers and refineries have informally agreed that while the WTI per barrel ranges between US\$32 and US\$42, crude oil deliveries will be invoiced and paid based on a reference price equal to (1) 86% of the WTI as long as this price does not exceed US\$36 per barrel, or (2) 80% of the WTI, in cases where this price exceeds US\$36 per barrel.

### *Royalties*

The national government has provided that the Central Bank will be responsible for issuing the regulations that may be required to apply the provisions of Section 5 of Decree No. 1,589/89, which will permit producing companies to dispose of their proceeds from sales in the domestic market, and the national government has described the manner in which these regulations shall apply during the course of the Argentine economic crisis.

Under Resolution No. 76/02 of the Ministry of Economy, royalties on oil exports must be fixed taking into account the seller exchange rate of Banco de la Nación Argentina on the day before the royalty is paid.

However, from December 2001 until May 2002, producers and refiners agreed to negotiate a reduced exchange rate in order to moderate the impact of the devaluation in product price. Producers calculated and paid royalties according to this reduced exchange rate. These calculations have been rejected by Argentine Provinces, which have presented claims for any shortfall arising from this agreement.

### **Gas**

In 1992, the Natural Gas Act and related decrees of the federal executive branch were passed providing for the privatization of GdE. The Natural Gas Act and the related decrees provided for, among other things, the transfer of substantially all the assets of GdE to two transportation companies and eight distribution companies. The transportation assets were divided into two systems on a geographical basis, the northern and southern area pipeline systems, designed to give both systems access to gas sources and to main centers of demand, including the greater Buenos Aires region. The distribution assets were also divided on a geographical basis.

A majority stake in each of the ten companies was sold to private bidders through a public tender process. Each consortium of bidders was required to be qualified on the basis of technical merit, including having a consortium participant with previous experience as an operator of gas transportation or distribution facilities. Accordingly, each consortium included one or more significant international operators.

The Natural Gas Act and related decrees granted each privatized company a license to operate the transferred assets, established a regulatory framework for the privatized industry based on open, non-discriminatory access, and created ENARGAS to regulate the transportation, distribution, marketing and storage of natural gas. The Natural Gas Act also provided for the regulation of wellhead gas prices in Argentina for a period of between one and two years beginning in June 1992 with prices to be deregulated no later than June 1994. Pursuant to a subsequent decree, gas prices were deregulated as of January 1, 1994. Since the deregulation, prices have risen with variances based on the basin and the season of the year.

As part of the privatizations, the concessionaires assumed a series of obligations aimed at correcting the previous situation. In particular, concessionaires agreed to incorporate modern technology and make greater investments in equipment, thereby improving quality and safety levels to comply more closely with international standards and ensuring a supply necessary to meet a growing demand. In addition, operating efficiencies were sought, with a view to sharing these benefits with the consumers through tariff rebates.

In exchange, the companies were entitled to tariff levels that ensured a reasonable and fair profit, comparable with profits at the domestic and international levels. In line with that objective, tariffs were to be denominated in US dollars, in order to permit companies to better match their income with their expenses and investments, which in large part were tied to foreign markets, both through the import of specialized equipment and foreign financing.

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### *Regulatory framework*

Natural gas transportation and distribution companies operate in an open access, non-discriminatory environment under which producers, large users and certain third parties, including distributors, are entitled to equal and open access to the transportation pipelines and distribution system in accordance with the Natural Gas Act, applicable regulations and the licenses for privatized companies. In addition, a regime of concessions under the Hydrocarbons Law is available to exploitation concessionaires to transport their own gas production.

The Natural Gas Act prohibits gas transportation companies from buying and selling natural gas. Additionally, gas producers, storage companies, distributors and consumers who contract directly with producers may not own a controlling interest (as defined in the Natural Gas Act) in a transportation company. Furthermore, gas producers, storage companies and transporters may not own a controlling interest in a distribution company, and no seller of natural gas may own a controlling interest in a transportation or distribution company (unless such seller neither receives nor supplies more than 20% of the gas received or transported, on a monthly basis, by the relevant distribution or transportation company).

Contracts between affiliated companies engaged in different stages in the natural gas industry must be reported to ENARGAS. ENARGAS may disapprove such contracts only if it determines that they were not entered into on an arm's-length basis.

### *ENARGAS*

ENARGAS is an autonomous entity which functions under the Ministry of Economy and Public Works and Services of Argentina and is responsible for a wide variety of regulatory matters, including the approval of rates and rate adjustments and transfers of controlling interests in the distribution and transportation companies. ENARGAS is governed by a board of directors composed of five full-time directors who are appointed by the federal executive branch subject to confirmation by the Argentine Congress.

ENARGAS has its own budget which must be included in the Argentine national budget and submitted to congress for approval. ENARGAS is funded principally by annual control and inspection fees that are levied on regulated entities in an amount equal to the approved budget, net of collected penalties, and allocated proportionately to each regulated entity.

Conflicts between two regulated entities or between a regulated entity and a third-party arising from the distribution, storage, transportation or marketing of natural gas must first be submitted to ENARGAS for its decision. ENARGAS's decisions may be appealed through an administrative proceeding to the Ministry of Economy or directly to the federal courts.

### *Rate Regulation*

Since the adoption of the Public Emergency Law and the other emergency measures taken by the Argentine government in early 2002, the regulation of public utility tariffs including those for gas transportation and distribution has changed dramatically. The rapid implementation of these rate changes has resulted in a complex and often conflicting legal framework. Although the rate regulations described below are still in

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effect, in practice, they have for the most part been superseded by new regulations which we summarize below. See Public Emergency Law. We cannot provide assurance on which regulatory scheme will ultimately be implemented by the Argentine government once it acts to conform the conflicting regulations.

The Natural Gas Act regulates the rates for gas transportation and distribution services, including those of TGS. Under the TGS license, TGS is permitted to adjust rates (1) semi-annually to reflect changes in the US producer price index, and (2) every five years in accordance with efficiency and investment factors to be determined by ENARGAS. In addition, subject to ENARGAS' approval, rates may be adjusted from time to time to reflect cost variations resulting from changes in the tax regulations (other than income tax) applicable to TGS, and for objective, justifiable and non-recurring circumstances.

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The Natural Gas Act provides that the tariffs for natural gas charged to end users by distribution companies shall consist of the sum of three components: (1) the price of gas purchased; (2) the transportation tariff for transporting gas from the production area through the distribution system; and (3) the distribution tariff. The rates of TGS are expressed in US dollars and are adjusted every five years in accordance with efficiency and investment factors determined by ENARGAS. The ratemaking methodology contemplated by the Natural Gas Act and the TGS license is the price-cap with periodic review methodology, a type of incentive regulation which allows regulated companies to retain a portion of the economic benefits arising from efficiency gains.

Under the terms of the TGS gas transportation license, TGS could increase rates semi-annually based on the U.S. producer price index. In January 2000, ENARGAS, TGS and the other gas transportation and distribution companies agreed to postpone the Producers Price Index adjustment scheduled for January 2000. In August 2000, Decree No. 669/00 was issued which (1) allowed TGS to bill its customers retroactively for the January 2000 producer price index rate adjustment over a 12-month period, and (2) postponed any further producer price index rate adjustments until July 2002. Decree No. 669/00 allows TGS to bill its customers retroactively for these postponed producer price index rate adjustments beginning in July 2002. Decree No. 669/00 also allows TGS to add an interest charge to its bills in order to compensate it for the delay in billing these producer price index rate adjustments.

In late August 2000, a court proceeding was commenced, which challenged the legality of Decree No. 669/00, claiming that the producer price index rate adjustments contradict the Convertibility Law. The court suspended the application of Decree No. 669/00 and, subsequently, ENARGAS notified TGS that it should not apply any producer price index rate adjustments until the court proceeding is resolved. As a result of the enactment of the Public Emergency Law, ENARGAS notified TGS of the suspension of the second five-year review of its tariffs. This review had begun in 2000. Because of certain provisions of the Public Emergency Law and our contract renegotiation efforts, we do not expect that Decree No. 669/00 will be upheld nor do we expect that TGS will ultimately be able to retroactively bill its clients for producer price index rate adjustments.

Notwithstanding the foregoing, through Decree No. 689/02, the federal executive branch exempted the following from the pesification required by the Public Emergency Law and Decree No. 214/02: (1) tariffs for the regulated transportation of natural gas destined for export; (2) agreements for the transportation of natural gas destined for export; and (3) purchase and sale contracts for natural gas destined for export whose terms had been originally fixed in a currency other than the Argentine peso (these contracts are to be invoiced and paid in US dollars at an exchange rate of P\$1/US\$1).

Decrees No. 689/02 and 704/02 excluded from pesification the obligations to pay in foreign currency incurred by individuals or companies residing or located outside Argentina, payable with funds coming from abroad, to individuals or companies residing or located in the country. Under Resolution No. 2,774/02, which was based on these decrees, ENARGAS reinstated the producer price index as an adjustment coefficient for transportation tariffs in respect of gas destined for exportation, and consequently, with respect to natural gas destined for exportation, approved the tariff schedules presented by TGS effective as of July 1, 2002, and permitted the denomination of the charges related to each type of service to be in US dollars.

### *Public Emergency Law*

The Public Emergency Law established that in contracts related to public works and services, clauses setting forth the price of such works and services in foreign currencies and indexation clauses based on foreign price indices or any other indexation mechanisms are no longer valid. Prices and tariffs resulting from those clauses had to be converted into pesos at a conversion rate of P\$1=US\$1. Pursuant to this law, the Argentine federal executive branch is authorized to renegotiate the terms of these contracts. See Electricity UNIREN.

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On December 4, 2003, Law 25,820 was promulgated, which extended up to December 31, 2004 the public emergency declared by Law 25,561 on social, economic, administrative, financial and foreign exchange matters, and the delegation of powers provided to the federal executive branch to renegotiate the tariffs of the public services and

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license contracts. This law empowers the federal executive branch to negotiate tariffs without being constrained by the applicable regulatory frameworks. Any legally permitted revisions of any current tariff must be authorized by the applicable regulatory agency to the extent these revisions fall within the scope of the renegotiation process led by the executive branch. Also, any agreed transitory changes to the utility service agreements and/or licenses must be considered in the definitive agreements.

### *Modifications to the regulatory framework*

On February 16, 2004, Decree No. 180/04 was published in the Official Gazette providing for:

Creation of a trust fund (the trust will be funded by tariffs payable by users of the service, special credit programs and contributions from direct beneficiaries);

Creation of an electronic market to coordinate spot transactions of the sale of natural gas and secondary market transactions for transportation and distribution of natural gas;

Expansion of section 34 of Decree No. 1738 that regulates Gas Law 24,076 to prohibit distributors or their shareholders from having a controlling participation in more than one dealing company; and

Authorization by the Secretary of Energy to take all necessary measures to maintain an adequate level of services in the event that it verifies that the system could face a supply crisis.

On February 16, 2004, Decree No. 181/04 was published in the Official Gazette that instructed the Secretary of Energy to design a framework for the normalization of prices of natural gas at the wellhead. This framework is to be applicable to both distributors and major consumers. The decree authorizes the Secretary of Energy to negotiate with gas producers on a price framework for the adjustment of prices in sale contracts to distributors. It also authorizes the Secretary of Energy to determine a category of users who will not be able to buy gas from distributors but, rather, must buy directly from producers. A new mechanism for protection of this new category of consumers must be established to guaranty supply and price, and must be extended to July 31, 2005.

The decree further states that prices resulting from sales pursuant to the agreement with producers shall be the prices used as a reference for calculating and paying royalties. These prices will also be used by ENARGAS in calculating any necessary adjustments in tariffs that result from variations in the price of purchased gas. The decree also states that the framework shall adjust tariffs corresponding to form R for Residential Services and P for General Services. In addition, the decree states that all agreements for the sale of natural gas shall be filed with the gas electronic market, and the Secretary of Energy has the authority to regulate the sale of gas (1) between producers and (2) between producers and the dealers who they either control or are affiliated with.

On April 2, 2004, the Secretary of Energy entered into an agreement with natural gas producers, in which the following was agreed to:

Minimum volumes that natural gas producers must supply to the local market, including specified amounts for: (1) distributors who supply industrial users, (2) clients of distributors, or new direct consumers, who are prohibited from buying directly from distributors and must buy directly from producers and (3) power stations that generate electricity for the local market;



Authorization of the producers to increase the prices of natural gas according to a price roadmap which differs for each basin and that culminates in complete deregulation of the wellhead price of natural gas by January 1, 2007;

Obligation of the distribution and generation companies to renegotiate the price and volumes of their supply contracts with producers who are also a party to the agreement. If an agreement is not reached after a 45-day period, producers are released from their obligation to supply natural gas to these distribution and generation companies;

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New direct customers have regulated prices through June 31, 2005; and

Notice of all new supply agreements must be given to the Secretary of Energy and will be published in the electronic gas market once this market starts functioning.

This agreement was further approved by Resolution No. 208 of the Ministry of Federal Planning, Public Investments and Utilities. The public hearings at ENARGAS took place on May 6, 2004.

In addition, on March 24, 2004, under Resolution No. 265/04 the Secretary of Energy imposed certain restrictions in order to avoid a crisis in the supply of gas to the domestic market. Specifically, export authorizations and exports of natural gas surplus volumes were suspended and the Undersecretary of Fuels was instructed to create a program for the rationalization of gas exports and the use of the country's transportation capacity.

Under Resolution No. 27/04, which was issued by the Undersecretary of Fuels, a Program for the Rationalization of Natural Gas Exports was approved and is in effect as long as natural gas volumes in the Argentine system fail to satisfy the domestic demand. In addition, an order of priority for the selection of companies that will be subject to export suspension restrictions was established taking into account the following factors: (1) the degree of compliance with the producers' commitment of gas supply to the domestic market (these commitments were established by each producer at the time the corresponding gas export authorization was granted), (2) the history of sales to the domestic market, and as divided between sales to distributors and sales to direct consumers and (3) the impact that this suspension would have on the domestic market supply.

Except as expressly authorized by the Undersecretary of Fuels, no export authorizations will be granted if such authorizations would result in export volumes (not including surplus volumes) higher than those exported in 2003. For calculation purposes, volumes for each month will be compared with figures from the corresponding month of the previous year. In addition, excess volumes, if any, already exported by a producer will be offset until the end of the third quarter of 2004.

Producers that have not maintained the level of sales to the domestic market committed at the time of requesting their export authorizations will receive the average basin price for the domestic market as published by ENARGAS. On the other hand, producers who have complied with their obligations with respect to the supply of the domestic market will receive a value for their natural gas equal only to the value actually received under their respective export agreement.

On June 18, 2004, the Secretary of Energy passed Resolution No. 659/04 by which the Complementary Program to Supply the Domestic Market of Natural Gas, which we refer to as the Complementary Program, was approved. The Complementary Program replaces the Program of Natural Gas Exportations and Transportation Capacity Rationing, which had been approved by Disposition 27/2004 issued by the Undersecretary of Fuels. The Complementary Program commenced on June 24, 2004 and partially eliminates the monthly and quarterly limits on the export of natural gas which was applicable under Disposition 27/2004.

On April 21, 2004, the Argentine government reached a six-month agreement with the Bolivian government. This agreement allowed Argentina to import up to 4 million cubic meters of natural gas from Bolivia per day. Also in April 2004, Resolution No. 185/04 of the Ministry of Federal Planning, Public Investment and Utilities was issued creating trust funds with the objective of financing infrastructure works in gas transportation.

On May 26, 2004, under Resolution No. 503/04 the Secretary of Energy approved a method for priority use of transportation for the supply by distributors of uninterrupted natural gas. This resolution is effective through August 31, 2004.

Also in May 2004, under Executive Order 645/04, the government imposed a 20% export tax on all natural gas exports.

On May 23 2005, pursuant to Resolution No. 752/05 the Secretary of Energy established a mechanism by which new direct consumers will be able to buy natural gas directly from producers. If no agreement is reached, new

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direct consumers will be able to buy natural gas by posting an irrevocable offer in the electronic gas market, which was originally created for spot transactions and is now open for long-term operations. The irrevocable offer, which will require on December 31, 2006, is required to contain the following minimum terms:

Term: 36 months;

Price: export parity; and

Volume: 1,000 cubic meters per day.

If the irrevocable offer is not accepted, new direct consumers may require the Secretary of Energy to provide natural gas for a period of six months pursuant to the prices approved by Resolution No. 208 of the Ministry of Federal Planning, Public Investments and Utilities. The Secretary of Energy will order the export producers to provide this natural gas.

Transportation companies are prohibited from transporting natural gas for exportation purposes as long as local demand is not satisfied.

## **Liquefied Petroleum Gas**

Prior to the enactment of Law No. 26,020 on April 8, 2005, the Argentine liquified petroleum gas market was regulated by the Hydrocarbons Law, as supplemented by several technical and commercial rules, and regulations issued by the Undersecretary of Fuels, which covered all activities related to liquefied petroleum gas, including production, transportation, fractionation, domestic and international marketing and relationship management between consumers and the national government. Under Resolutions No. 49/01 and No. 52/01, the Secretary of Energy became the enforcement authority for the liquified petroleum gas industry and a liquified petroleum gas board, which reports to the National Refining and Marketing Board, which, in turn, reports to the Undersecretary of Fuels, became the controlling authority.

The Argentine Congress established, pursuant to Law 26020, a new regulatory framework for the liquified petroleum gas industry that is intended to guarantee regular, reliable and economical provision of liquified petroleum gas to low-income residential sectors who currently are without natural gas network services. This new regime regulates production, fractionation, transportation, storage and distribution of liquified petroleum gas, as well as, port services and trading of liquified petroleum gas. These activities, pursuant to Section 5 of Law 26020, are considered of public interest. The enforcement authority in charge of complying with the purposes of Law 26020 is the Secretary of Energy, which may delegate supervision and control tasks to ENARGAS. The relevant portions of this law are summarized below:

Prices. The Secretary of Energy determines reference prices (below export parity prices) with the goal of guaranteeing regular supply in the domestic market and may establish price stabilization mechanisms in order to avoid price fluctuation in the domestic market. The Secretary of Energy will determine and disseminate a reference price for liquified petroleum gas, which is sold in containers of up to 45 kg in size, in each region every six months for domestic use. Market participants found selling liquified petroleum gas at significantly different prices will be sanctioned.

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Market limitations. The Secretary of Energy together with the Antitrust Commission, or CNDC, will perform an analysis of the sector, including behavioral patterns of its agents, for the purpose of fixing limits at certain levels at each stage of vertical integration of the industry.

Open Access. An open access regime is established in connection with liquified petroleum gas storage, with the Secretary of Energy providing conditions and regulations in order to determine the maximum tariffs to be paid for this service.

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Imports/Exports. Free import of liquified petroleum gas without authorization is allowed and, as long as the necessary volumes for provision of domestic supply are guaranteed, the Secretary of Energy authorizes restriction-free exports of liquified petroleum gas.

Trust Fund. A trust fund for subsidizing the liquified petroleum gas residential consumption, funded mainly with the resources obtained from the sanctions set forth in Law 26020 and from amounts allotted by the National Budget Law, is created for the purpose of attending to liquified petroleum gas needs of the low-income sector and to expand natural gas distribution networks to areas without service.

Resolution No. 168/05 of the Undersecretary of Fuels makes liquified petroleum gas subject to Resolution No. 1679/04. See Petroleum Refining. Pursuant to the framework of Resolution No. 168/2005, Petrobras Energía and the remaining liquified petroleum gas producing companies entered into an agreement with the Undersecretary of Fuels to continue supplying liquified petroleum gas to the domestic market without complying with the procedures established in Resolution No. 168/05 because no actual domestic supply difficulties exist.

## **Electricity**

Prior to 1991, virtually all of the electricity supply industry in Argentina was controlled by the public sector. Inefficient management and inadequate capital expenditures under that regime resulted in the deterioration of quality in service and physical equipment, poor financial condition and high rates for poor service.

Accordingly, the Argentine government enacted Decree No. 634/02 in March 1991, and the Argentine Congress enacted Law 24,065, known as the Regulatory Framework Law, in January 1992, establishing guidelines for the restructuring and privatization of the electricity sector within the framework of Law 23,696. The new regulatory framework of the sector established, as separate areas, the generation, transportation and distribution of electricity, and adopted separate regulatory regimes for each, thereby moving to a decentralized model with an increased participation in the private sector.

The privatization process began in February 1992 with the sale of several large thermal generation facilities, previously operated by Servicios Eléctricos del Gran Buenos Aires, and has continued with the sale to the private sector of transmission and distribution facilities, as well as additional thermoelectric and hydroelectric generation facilities. The companies that have received concessions have also assumed a series of commitments to improve the quality and safety of the industry. They also plan to ensure supply by incorporating modern technologies and by making large investments in equipment and works.

Due to privatization, a higher level of quality has been achieved, with fewer losses of grid capacity during peak times. Wholesale prices have also been reduced as a direct result of new generation equipment in place of less cost-efficient power plants.

In order for the flow of revenues to be more closely associated with expenses and investments, the operations of the sector were denominated in US dollars. This was because private operators often funded their large works through foreign lending institutions due to difficulty in obtaining significant amounts of financing at adequate rates in the domestic market.

## *Regulatory Framework*

The Secretary of Energy regulates electric power supply and grants and controls electricity sector concessions at the national level through the National Directorates for Coordination and Regulation of Prices and Rates and for Electricity Planning. The Federal Board of Electric Power, made up of representatives from each province, is an advisory body to the Secretary of Energy, which coordinates policies for the electricity sector. The Federal Entity of Electricity Regulation, or ENRE, is an autonomous body which reports to the Secretary of Energy and has overall supervisory power in the electricity industry. It is managed by a board of five members selected by the federal executive branch, two of whom are individuals from a list proposed by the Federal Board of Electric Power. The members of the board of directors of ENRE are not allowed to have any economic interest in the areas under their jurisdiction.

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ENRE's purpose is to pursue the objectives set out in the Regulatory Framework Law and provide regulations regarding security, the standard quality of service, and procedures for technical areas such as metering and interpretation. Accordingly, ENRE's specific duties, among others, include: (1) establishing a tariff collection mechanism; (2) establishing the criteria and conditions for awarding concessions; and (3) safeguarding public safety, environmental protection and property rights relating to the construction and operation of generation, transmission, and distribution facilities.

ENRE has mandatory jurisdiction over all disputes between generators, transmitters and distributors in matters relating to the public supply, distribution and transportation of electricity. If ENRE becomes aware of practices that are inconsistent with the Regulatory Framework Law and other regulations, it is empowered to notify the interested parties, hold hearings and take the appropriate authorized action. In particular, ENRE can apply penalties for noncompliance with the Regulatory Framework Law and initiate and pursue legal actions to ensure compliance therewith. Appeals to ENRE's decisions may be filed directly before the Secretary of Energy and the courts.

ENRE is required to prepare an annual budget and to submit it to the regulated entities for approval. These regulated entities are required to pay a fee to ENRE on the basis of the approved budget and their respective share in the total gross profit of all regulated entities. In addition to revenues from regulated entities from this fee, ENRE is entitled to retain cash from fines and seizures.

### *Structure*

Under the current regulatory structure, generation of electricity in Argentina is organized as a competitive market, the wholesale electricity market in which independent generators sell the power they produce to other generators, distribution companies, large scale users and into the spot market. The generation of electricity is characterized under the law as a public utility and as such is not highly regulated. In contrast, the transmission and distribution of electricity are considered public services and as such are licensed by the national and/or the provincial government. Transporters are obliged to permit third parties to have access to any available transmission capacity, but are not themselves authorized to buy or sell electricity, and are entitled to charge a toll for the provision of transmission services. Distributors are also regulated through the establishment of rates and specifications for quality of service. They are required to satisfy demand in their markets and, as long as they have any distribution capacity available, they have to permit large scale users, who have purchased electricity from a different source, to transmit such electricity through their network. Large scale users include (1) major large users, meaning consumers with a demand of at least 1.0 MW of electricity who are willing to execute contracts with a duration of at least one year and who purchase electricity through contracts that require that the suppliers meet at least 50% of their demand and (2) minor large users, meaning consumers with a demand between 0.1 MW and 2.0 MW of electricity who are willing to execute contracts with a duration of at least two years and who purchase electricity through contracts that require that the suppliers meet 100% of their demand.

### *Management and operations of the wholesale electricity market*

The activities of participants in the wholesale electricity market are governed by the terms of the Regulatory Framework Law. Additionally, CAMMESA was specifically created by the federal government to perform the necessary administrative functions of the wholesale electricity market. CAMMESA's capital stock is distributed equally among the entities representing generation companies, transmission companies, distribution companies, large scale users and the Secretary of Energy, each of which has the right to nominate two of CAMMESA's directors. The Secretary of Energy has a veto right over the decisions taken by CAMMESA. CAMMESA's operating costs are covered by mandatory contributions made by all the members of the wholesale electricity market. CAMMESA does not itself buy or sell electricity, but it manages the physical transactions of the system and commercial transactions on the spot market.



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In addition to the national structure of the wholesale electricity market, medium-voltage transmission and distribution of electricity (except in the city of Buenos Aires, the greater Buenos Aires area and the city of La Plata)

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are also subject to provincial regulation. In particular, provincial governments may, in certain cases, forbid the direct sale of electricity to large scale users within their own jurisdiction. Large scale users connected to the national interconnected system (described below), however, cannot be prevented from purchasing electricity directly from generators.

### *Dispatch*

The dispatch of generating units into the wholesale electricity market is managed by CAMMESA based on the short-run marginal cost of each unit on the system. CAMMESA defines the marginal cost of thermoelectric generating units for dispatching purposes as the cost of fuel delivered (natural gas, fuel oil, diesel oil or coal) for such unit to produce 1kWh. The marginal cost of hydroelectric plants with reservoirs that are overflowing is determined by a model that takes into account existing reservoir levels and projected hydroelectrical conditions for the subsequent six months. The marginal cost associated with flow-through hydroelectric generating units is zero, meaning that such units are the first to be dispatched.

Generation companies advise CAMMESA on a weekly basis of their anticipated available energy and other relevant information such as fuel type, price and anticipated consumption. CAMMESA then ranks each generating unit according to that unit's marginal costs, taking into consideration the minimum operating load needed to keep generating units on line and expenses incurred in shutting down and restarting generating units. Based on this ranking, and in order for CAMMESA to obtain the lowest overall system cost, generating units are dispatched to the network successively from the lowest cost generating unit to the highest cost generating unit until the demand for electricity is met. CAMMESA is responsible for administering all transactions through the wholesale electricity market, but is not involved in the actual settlement of transactions between generators, distributors and large users that have entered into either long-term or medium-term contracts.

CAMMESA makes optimum dispatch arrangements without taking into account the existence of long-term and medium-term agreements between generators, distributors and large scale users. CAMMESA also administers an option market in which generators may enter into option contracts known as cold reserve contracts. Finally, CAMMESA coordinates the dispatching of generators in the spot market.

As a consequence of the crisis in Argentina, the Secretary of Energy issued Resolution 2/02, which specified the prices of power and the reference prices of fuels at an exchange rate of P\$1=US\$1. This placed a limit on the generators' stated prices. Resolution No. 8/02 established market prices that accounted for part of the variable costs in production declared by the generators, and it also established a maximum price of \$120/MWh. Resolution No. 82/03 suspended the last seasonal increase of prices. Under Resolution No. 240/03, in connection with the spot market, generators are able to set a market price without considering potential restrictions in the supply of gas, and those generators, with costs higher than the established price, are individually paid their variable costs of production. By means of Resolution No. 406/03 the Secretary of Energy established that all credits pending of payment by CAMMESA as a consequence of the deficit of the Stabilization Fund (due to the suspension of the seasonal increase of prices) should be consolidated and paid once this fund has sufficient monies.

Resolution No. 984/03 of the Secretary of Energy authorized the wholesale electricity market to call for bids for reserve of available capacity fuel for the Argentine winter period from May through October 2004. We participated with a bid of 550 MW from Genelba and were awarded an advance of US\$29,072,736.

During 2004, the Secretary of Energy started to increase seasonal prices for certain tariff segments without increasing residential tariffs. (Taking into consideration the seasonal price demand, the residential tariff is 44%.) Changes in seasonal prices were insufficient, however, and the deficit between the funds and accounts administered by CAMMESA continued to grow.

Given the foregoing situation, during 2004 the electricity market scenario was characterized by energy-producing companies having limited financing ability and uncertainty as to gas availability for thermal power plants. For this reason, the Secretary of Energy implemented short and long-term measures to secure electric power supply, the main measures of which are summarized below:

Pre-financing of diesel oil was provided in order to allow generation companies to pay in advance liquid fuel estimated to be used at each power plant.

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Additional income was provided to negotiate gas and liquid fuel supply with suppliers.

The Secretary of Energy instructed CAMMESA to import energy from Brazil through an International Public Bidding process at Garabí 1 and 2 Converter Stations for the June-November period.

A comprehensive cooperation agreement was entered into between Argentina and the Bolivarian Republic of Venezuela.

A redistribution of export gas for the electricity market was undergone to avoid supply shortages due to the inability to generate electricity from alternative fuels.

Given that, due to financial and regulatory adjustments made in the electricity market, capital is expected to be limited for investments and that, according to annual CAMMESA studies, there is high risk of not meeting medium-term demand for electric power, the Secretary of Energy issued successive resolutions throughout the year under which an investment fund, called FONINVEMEM, was created to administer economic resources and increase the electric power supply by 2007. Under Resolution No. 826/04, wholesale electricity market generators were invited to voluntarily contribute a percentage of their marginal profit for the 2004 - 2006 period to increase generation supply by one or two combined cycles (between 800 and 1,600 MW).

In December 2004, 72.5% of private generators, including Petrobras Energía, agreed to contribute with 65% of their credits with the wholesale electricity market to FONINVEMEM, or an amount equivalent to P\$923.9 million as estimated by CAMMESA. Petrobras Energía's contributions account for approximately 11% of the total funds provided to FONINVEMEM.

*UNIREN*

The Public Emergency Law pesified tariffs for public utility services and prohibited the increase of these tariffs based on indexation factors. Tariffs were converted into pesos at a P\$1=US\$1 parity. Pursuant to this law, the Argentine federal executive branch is authorized to renegotiate the terms of contracts relating to the provision of public utility services. The criteria for such renegotiation must take into account the following factors, among others:

Impact of tariffs on economic competitiveness and on income distribution;

Quality of services to be provided and/or the capital expenditure programs provided for in the contracts;

Interest of customers and accessibility to the services;

The safety of the systems; and

The company's profitability.

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On February 12, 2002, the federal executive branch issued Decree No. 293/02 under which the Ministry of Economy was empowered to renegotiate utility contracts. In July 2003, UNIREN was created with the purposes, among others, to provide assistance in the public works and services renegotiation process, to execute comprehensive or partial agreements, and to submit regulatory projects related to transitory rate adjustments.

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In 2004, the following resolutions were entered into:

Resolution No. 712/04 of the Secretary of Energy. This resolution created FONINVEMEM, through which the economic resources necessary to increase the supply of electric power by 2007 are to be managed.

Resolution No. 826/04 of the Secretary of Energy. This resolution provided an invitation to generation companies to contribute to FONINVEMEM a percentage of their marginal profit for the 2004- 2006 period. Generation companies voluntarily contributing to this fund will become shareholders of the new installations and will participate in its operations.

Resolution No. 1427/04 of the Secretary of Energy. This resolution provided an invitation to generation companies to formally state their decision to participate in FONINVEMEM. It also included a Memorandum of Agreement for adjustment of the wholesale electricity market, pursuant to which private generation companies committed themselves to contribute between 65% to 100% of their marginal profit for the 2004- 2006 period as security and agreed to take all necessary measures to complete the projects.

Resolutions No. 93/04, 842/04, 1434/04 of the Secretary of Energy. Under these resolutions, the Secretary of Energy sets forth, as from February 2004, seasonal prices for energy with increases to non-residential users (66% of seasonal demand). The value resulting from this increase is estimated at 220% on values pesified and was frozen in November 2002.

### *Generation*

Power plants in Argentina are classified by the type of energy source used hydroelectric, nuclear and thermoelectric (gas, fuel oil, diesel oil or coal). Power plants are also classified by capacity, defined as the net output the station is capable of sustaining for an indefinite period without causing damage to the station, which is referred to as declared net capacity.

### *Transmission*

In Argentina, bulk transfer of electricity is achieved by means of a national interconnected system, or NIS, which consists mainly of overhead lines and substations and covers approximately 90% of the territory of Argentina. Practically all of the NIS 500 kV transmission lines have been privatized and are owned by Transener. Apart from Transener, there are five other regional subtransmission companies in charge of transmitting energy at 132 kV and 330 kV voltages, and almost all large power plants use the NIS. Supply points connect the NIS to distribution systems and large users. In addition, there are two international connections: one between the Argentine transmission system and the Uruguayan transmission system, and the other between Argentina and Brazil, which permit the import or export of electricity between these systems. The cost of transmission is charged to generators, distributors and large users. The transportation cost is made up of a variable charge corresponding to the energy transmitted across the system, and a fixed charge for (1) connection to the system, (2) transformation and (3) transmission capacity. Transmission companies operate as common carriers and must provide open access to all generation companies. Transener's rates are set by the concession contract and are to be subject to revision by ENRE. The law provides that services provided by transmission companies must be offered at fair and reasonable rates which yield sufficient income to meet reasonable operating costs applicable to service, taxes, depreciation and a reasonable rate of return. The rate of return should bear a relationship to (1) the energy costs, (2) the use of transmission lines and (3) the degree of operating efficiency of the business, and should be similar, as an industry average, to that of other domestic or international activities of similar or comparable risk. The rates that Transener may charge have been modified by the Public Emergency Law. See Petroleum.

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Pursuant to Resolution No. 1650/98, ENRE approved an 8% overall reduction of Transener's tariffs for the second tariff period, July 1998 – July 2003, retroactive to July 17, 1998. In addition, a bonus subject to compliance with certain quality parameters was approved, and currently, Transener's quality levels entitle it to a bonus of approximately P\$2.5 million.

Since the beginning of the second tariff period, Transener's income from transportation capacity and connection has been reduced annually through the application of an efficiency ratio established by ENRE. Pursuant to Resolution No. 1319/98, the efficiency ratio applicable to the second tariff period is approximately 0.5% per annum.

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### *Distribution*

Electricity is transferred from the NIS supply points to consumers by means of distribution systems consisting of a widespread network of overhead lines, underground cables and substations having successively lower voltages (220 kV and below). In general, electricity users in Argentina are the users of the distributor within whose area of distribution the premises of such consumer are located. Each user is charged in accordance with the applicable tariff. Distributors' charges seek to recover the various costs associated with supply, including the electricity purchase costs and transmission and distribution charges, in addition to, the added value of distribution. In accordance with Law 24,065, and in the case of transmission companies, services provided by electricity distributors must be offered at fair and reasonable rates which yield sufficient income to meet reasonable operating costs applicable to service, taxes, depreciation and a reasonable rate of return. The rate of return should bear a relationship to the degree of operating efficiency of the business, and should be similar, as an industry average, to that of other domestic or international activities of similar or comparable risk. Similarly, distributors are required to include a representative figure for the acquisition cost of electricity from the wholesale electricity market in the electricity sales price to end-users.

Each distributor operates in accordance with a concession agreement executed between itself and the Argentine government or provincial government, depending on whether the distributor is under federal or provincial jurisdiction, which provides for, among other things, the area of its concession, the quality of service that it is required to provide, the tariffs it is permitted to charge and its obligation to satisfy demand. ENRE, in the case of distributors under the federal jurisdiction (Edenor, Edesur and Edelap), and the provincial regulatory agencies in each of the provinces, monitor compliance by the distributor with the provisions of the concession agreement and the regulatory framework and provide a mechanism for public hearings at which complaints against the distributor can be heard and resolved.

### *Rate adjustment method*

Under the terms of the concession contract, the rate adjustment structure applicable by Edesur is calculated in US dollars but stated in Argentine pesos, taking into account the exchange rates in Item 3. Key Information Exchange Rates and Decree No. 2128/91, which contains the regulations under Law 23,928. Distribution costs are adjusted on an annual basis and, among other things, are subject to the application of the U.S. wholesale price index for industrial products.

Since the adoption of the Public Emergency Law and other emergency measures taken by the Argentine government in early 2002, the regulation of public utility tariffs, including those related to transportation and distribution of electricity, has changed dramatically. The rapid implementation of these rate changes has resulted in a complex and oftentimes conflicting legal framework. Although the rate regulations described below are still in effect, in practice they have been superseded by the new regulations described under Petroleum Taxation. We cannot assure which regulatory scheme will ultimately be implemented by the Argentine government once it acts to conform the conflicting regulations.

On December 2, 2003, Law 25,820 was promulgated, which extended until December 31, 2004 the public emergency declared by Law 25,561 on social, economic, administrative, financial and foreign exchange matters, and the delegation of powers therein provided to the federal executive branch to renegotiate the tariffs of the public services and license contracts. This authorization empowers the national executive branch to negotiate such tariffs without being constrained by the applicable regulatory frameworks. The legally permitted revisions of any current tariff should be decided by the applicable regulatory agency to the extent that these revisions fall within the scope of the renegotiation process led by the federal executive branch. In addition, the transitory changes made to the utility service agreements and/or licenses should be considered in the definitive agreements that may be reached with respect thereto.



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During 2004, Transener and Transba negotiated with the government appointed renegotiation unit, UNIREN, the terms and conditions for the comprehensive renegotiation of its concession contract (the amendments

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to which will be effective between January 6, 2002 and the end of the concession contract), and the application of a transitional tariff regime to be applied until a general tariff review is conducted with, and approved by, ENRE. This general review, which will be finished by November 2005, will establish a five-year tariff regime for the following five-year period. The agreement reached was implemented under a letter of intent signed on February 2, 2005 and was subject to a public hearing held on March 18, 2005. Once the federal executive branch sends the definitive proposal to the congress bicameral commission in charge of monitoring the renegotiation process, congress will have 60 days to approve or reject it. If rejected, the federal executive branch shall reopen the renegotiation process with Transener and Transba. See UNIREN.

## **VENEZUELAN REGULATORY FRAMEWORK**

### **Petroleum and Gas**

The Venezuelan state is owner of all hydrocarbon fields and as such has established methods different from Argentina for the regulation of the exploitation of hydrocarbon located in Venezuelan fields.

The Gas Hydrocarbons Organic Law published on September 23, 1999 in Official Gazette No. 36,793, was issued to regulate the exploitation of free gas and the transportation, distribution, collection, storage, industrialization, handling and internal and external commerce of associated gas and free gas, permitting the private sector's participation in these activities. This was later regulated by Decree No. 840 of May 31, 2000.

In December 1999, the new Venezuelan Constitution became effective, which contains provisions related to petroleum activity. Article 12 of the Constitution states that oil fields are the property of the Venezuelan state. Article 302 of the Constitution reserves petroleum activity to the Venezuelan state. Article 303 of the Constitution states that, PDVSA or the entity created for the management of petroleum activity (except for affiliates, strategic associations, companies or any other company set up to develop PDVSA's business) is owned by Venezuelan state.

The new Hydrocarbons Organic Law published on November 13, 2001 in Official Gazette No. 37,323 was issued, effectively reversing most prior related legislation, except for the Gas Hydrocarbons Organic Law, and granted ample opportunity for the private sector to participate in the industry, limiting the activities reserved by the Venezuelan state to primary activities and to the sale of crude oil and specific products.

The purpose of the Hydrocarbons Organic Law is to regulate everything related to the exploration, exploitation, refinery, industrialization, transportation, storage, commercialization and conservation of hydrocarbons, and everything related to refined products and works that the performance of these activities require. The law sets forth the following principles: (1) hydrocarbon fields are public property, (2) hydrocarbon activities are activities of public utility and of social interest and (3) activities described in the law are subject to decisions of the Venezuelan state adopted in connection with international treaties and agreements on hydrocarbons.

### *The Performance of Hydrocarbon Related Activities*

The primary activities expressly reserved by law to the Venezuelan state can only be performed by: (1) the executive branch, (2) wholly owned state entities or (3) companies in which the Venezuelan state owns at least 50% of the capital stock. Activities related to the internal and external

sale of natural hydrocarbons and the derivatives, specifically mentioned by the executive branch, can only be performed by wholly owned state entities. Installations and existing facilities dedicated to the refining of natural hydrocarbons in the country and to the transportation of products and gas are reserved to the Venezuelan state.

Hydrocarbon refining activities may be carried out by the Venezuelan state and private entities, in a joint effort or separately. Those activities relating to the internal and external sale of derivative products, which have not been reserved by the executive branch to be carried out by wholly owned state entities, may be carried out directly by (1) the Venezuelan state, (2) by wholly owned state entities, (3) by entities with public and private capital in any proportion or (4) by private entities. Pursuant to Decree No. 1,648 dated January 15, 2002, activities related to the exportation and importation of products derived from hydrocarbons that have been carried out in the past by wholly owned state entities shall continue to be carried out in such manner until those products are specifically excluded in

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order to create an international market for them. Internal commercial activities regarding services deemed as public may be performed by anyone who obtains a permit. The sale of refined hydrocarbons may be performed by (1) the Venezuelan state, (2) its wholly owned state entities, (3) entities with public and private capital in any proportion, and (4) private entities.

In order for the Venezuelan state to carry out its activities, the executive branch is authorized to create, through a Council of Ministers, wholly owned state entities of any kind, including corporations. These entities may also create other entities, with the approval of their shareholders, or modify their corporate purpose, merge, enter into joint ventures, liquidate, and create affiliates. These wholly owned state entities are regulated by (1) Decree No. 1,648 and its regulations, (2) their by-laws, (3) dispositions of the executive branch and certain entities connected with the Ministry of Energy and Mines and (4) applicable law. They are also subject to local and international inspection and audit and must comply with guidelines and policies of the executive branch administered through the Ministry of Energy and Mines.

The private sector may participate in primary hydrocarbon related activities only through entities in which the Venezuelan state holds the majority of the capital. The creation of these entities and the conditions under which they will carry out their activities must be previously approved by the National Assembly, which may modify the conditions proposed or set forth conditions that it, itself, considers suitable. These entities must meet the following minimum conditions: (1) must have a maximum duration of 25 years (which may be extended for 15 years), (2) must provide information regarding location, orientation and extension of the area, (3) all of their assets must be reserved and turned over to the Venezuelan state once the activity ends and (4) any dispute among its shareholders must be resolved through private negotiations or arbitration and shall be subject to the Venezuelan legal system.

### *Licenses and permits*

Entities that wish to carry out activities related to the refining of natural hydrocarbons must obtain a license from the Ministry of Energy and Mines. This license is subject to certain conditions. Entities that wish to carry out activities related to the processing of refined hydrocarbons must obtain a permit from the Ministry of Energy and Mines. This permit is also subject to certain conditions. Entities that wish to carry out activities related to the domestic sale of refined hydrocarbons must obtain a permit from the Ministry of Energy and Mines.

### *Relevant Tax Features*

#### Income tax

Venezuelan income tax law imposes a tax at a rate of 50% on the net taxable income of persons involved in hydrocarbon related activities, or activities related to the purchase or acquisition of hydrocarbons and derivatives for exportation. These persons may be authorized to deduct from their income tax 8% of the value of new investments in fixed assets up to a maximum amount equal to 2% of their annual income for the relevant fiscal year. Any excess may be used in the following three fiscal years. Four percent of certain investments in high waters may also be deducted. Accelerated amortization and depreciation of fixed assets and direct or indirect expenses necessary for the drilling of oil wells is permitted.

Activities related to the exportation of extra-heavy hydrocarbons through vertically integrated projects or the exploration or exportation of natural non-associated gas are subject to a 34% rate.

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Contractors dedicated to exploration and production activities under operative agreements with state companies are subject to a 34% rate.

### Value Added Tax

Subject to certain exceptions, in particular for exporting companies, imports and local purchases of goods and services are subject to a value added tax, or VAT, at a rate of 15%, with a limited number of goods and services subject to a VAT at a rate of 8%.

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In operative contracts for the rehabilitation of marginal fields, the VAT on goods and services acquired by the contractor in the name of the state company shall be considered directly charged, under the Third Round Agreements, to that entity and, therefore, will have no economic effect on the contractor.

### Municipal taxes

Hydrocarbon activity is not subject to municipal taxes, as taxes on this activity are exclusively reserved for the national executive branch.

Income from contractors that have entered into operative contracts with state companies for the rehabilitation of marginal fields is subject to a tax on gross income. The municipality in which the contractors perform their activities sets this rate. Under the second round operating agreements, municipal taxes paid by a contractor can be recovered from the state. However, under the third round operating agreements, only municipal taxes in excess of 41% of gross income may be recovered from the state, subject to certain conditions.

### *Additional Matters*

### OPEC

Venezuela is a founding member of OPEC. In the past, PDVSA, under instructions from the Ministry of Energy and Mines, has adjusted its own production to assure that Venezuela as a whole complies with the production ceilings set forth by OPEC.

The Venezuelan government has created a policy of strict compliance with the production quotas decided within OPEC. Article 6 of the new Hydrocarbons Law extends reductions such as those that may be set forth by OPEC to all persons that perform activities regulated by the Hydrocarbons law. As a result of this, if there are production cuts, these cuts may directly affect private producers and contractors as well as PDVSA.

Under agreements that specifically contemplate production costs (e.g., the third round operating agreements), the reductions that may be imposed on the contractor may not exceed the percentage of reduction in production requested from petroleum companies that operate in Venezuela as a whole, including PDVSA, and its affiliates. These reductions must be determined in each case with respect to available production capacity. If the contractor cannot recuperate losses resulting from these production cuts by increasing production to an adequate level, it has the right to extend the original 20 year term of its operating agreement in order to produce the same quantity that it would have produced without the production cut.

### Exchange control system

On February 5, 2003, the Venezuelan government set forth an exchange control system. These regulations state that companies set up for the purpose of developing any of the activities described in the Hydrocarbons Organic Law may maintain outside of Venezuela accounts in currency other than the currency of Venezuela in banking or similar institutions only for purposes of meeting their obligations outside Venezuela, which obligations must be verified by the Central Bank of Venezuela. Any other foreign currency generated by such companies must be sold to the

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Central Bank of Venezuela. These companies do not have the right to acquire foreign currency from the Central Bank of Venezuela to make foreign currency payments. These limitations do not apply to contractors who have entered into operative agreements, and, thus, act on account of the PDVSA. These companies are only obligated to sell to the Central Bank of Venezuela any foreign currency that they voluntarily bring into Venezuela.

### **ECUADORIAN REGULATORY FRAMEWORK**

#### **Petroleum and Gas**

Petroleum activity in Ecuador is regulated by (1) the Hydrocarbons Law (of Ecuador) and its regulations, (2) certain Ministry of Energy and Mines regulations and (3) the specific terms of a tender for public auction.

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The executive branch, led by the President of the Republic, regulates hydrocarbon policies. The Ministry of Energy and Mines sends hydrocarbon policies to the President for his consideration.

The National Directorate of Hydrocarbons, who is under the authority of the Ministry of Energy and Mines, is the technical and administrative entity in charge of controlling and auditing hydrocarbon operations. The National Directorate for Environmental Protection, who is also under the authority of the Ministry of Energy and Mines, is in charge of approving environmental impact studies and environmental management plans.

### *Exploration and Exploitation of Hydrocarbons*

Hydrocarbons and related products are the property of the Ecuadorian state. Hydrocarbon activities are performed by the Empresa Estatal de Petroleos Ecuador, which we refer to as Petroecuador, by and through third parties.

The award of exploration and exploitation agreements is performed through a special tender mechanism implemented by relevant authorities. In order to reach the exploitation phase, the contractor may only retain those areas with commercially exploitable hydrocarbons. If the contractor fails to comply with this requirement, it will be forced to return those areas to the state. The exploration and exploitation agreements for crude oil in Ecuador are generally divided into two stages. The first stage, or the exploration period, lasts four years and is renewable for another two years. The second stage, or the exploitation period, may be up to 20 years in duration and is renewable. Both exploration and exploitation agreements require an exploratory program agreeable to all parties. A minimum average investment of US\$120 to US\$180 per hectare, either on land and/or in seawater, shall be made during each of the first three years of the exploration period. Royalties are paid as follows: (1) 12.5% for daily gross production levels less than 30,000 barrels, (2) 14% when these daily levels are between 30,000 and 60,000 barrels, and (3) 18.5% when gross production exceeds 60,000 barrels per day. With respect to contracts for specified services or for marginal or participation fields, the contractor is not obliged to pay royalties. The contractor may not sell any of the assets related to the agreement without authorization from the Ministry of Energy and Mines. At the end of the term of the agreement, the contractor shall deliver to Petroecuador, at no cost, all these assets.

The contractor assumes at its own risk and expense all investments, costs and expenses required to perform these hydrocarbon related activities, and, in turn, it has the right to receive a portion of the production of the area covered by the agreement, with Petroecuador having the right to the other portion. Petroecuador may enter into joint venture agreements by contributing rights over areas, fields, hydrocarbons or other rights. Petroecuador's joint venture party, in turn, acquires these rights and is obligated to make the investments agreed to by the parties. In services agreements, the contractor shall provide exploration and exploitation services in the agreed area at its own risk and expense. If the contractor finds commercially exploitable fields, it shall have the right to be reimbursed for its investments, costs and expenses and will also have the right to be paid for its services.

Prior to initiating any work, an environmental impact study and an environmental management plan must be prepared. Consultation and participation procedures, referred to in the National Constitution, must be complied with while taking into consideration local rules of the citizens in the affected area, as well as the rules applicable to all other citizens.

## **OTHER COUNTRIES REGULATORY FRAMEWORK**



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In addition to Argentina, Venezuela and Ecuador, our businesses must comply with regulations in the other countries where we are located, including Peru, Bolivia and Brazil.

In Peru, the petroleum, transportation, gas and liquefied petroleum gas industry are each regulated under Peru's regulatory framework, which includes taxation, environmental codes and payments of royalties. In 1993, Perupetro, a state owned company functioning under private law, was created under the Organic Hydrocarbon Law No. 26221 and has assumed significant powers within the Peruvian energy industry. It represents the Peruvian State as contracting party and is given authority to grant areas for hydrocarbon exploration and exploitation activities and supervise the activities carried out in those areas. Perupetro was also given the authority to negotiate contracts, including the payment of royalties, which payment is further governed by a series of national decrees.

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In Bolivia, the petroleum and gas industry is regulated by the System of Regulation by Sectors, which has the responsibility to regulate, control and supervise telecommunications, electricity, hydrocarbons, transportation and water activities, to assure that they operate efficiently, protecting the interest of users, service providers and the Bolivian state by contributing to the development of the country. Pursuant to Hydrocarbons Law 1689 of April 30, 1996, the right to explore and exploit hydrocarbon fields and to commercialize their products is exercised by the Bolivian state through YPFB, which enters into shared risk agreements that may not exceed 40 years for the exploration, exploitation and commercialization of hydrocarbons. YPFB also administers and audits the shared risk agreements. All controversies arising between YPFB and the contractors under shared risk agreements must be resolved through arbitration with application of Bolivian law. There has been recent political instability in Bolivia that may impact the Bolivian regulatory framework. See Item 3. Key Information Risk Factors Factors Relating to Us Our activities may be adversely affected by events in other countries in which we do business.

In Brazil, the petrochemical industry is regulated by laws affecting petrochemicals, as well as, certain environmental, health and safety regulations, which affect our subsidiary Innova.

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**ORGANIZATION STRUCTURE**

As of the date of this annual report:

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After the consumation of the expected merger of EG3, PAR and PSF into Petrobras Energía, which still needs to be registered with the Argentine Public Registry of Commerce:

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The following is a summary diagram of our material subsidiaries and affiliates as of the date of this annual report, including information about ownership, business segment and location:

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\* Following the expected merger of EG3, PAR and PSF into Petrobras Energía, PEPSA's stake in Petrobras Energía is expected to decline to 75.82%. (See Our History and Development Petrobras Energía Merger. )

\*\* In addition to the companies diagrammed in this chart, we have holding companies in Spain, Austria, Bolivia, Cayman, the Bermudas and Argentina, which are not reflected in the chart.

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**PROPERTY, PLANTS AND EQUIPMENT**

We have freehold and leasehold interests in various countries in South America, but there is no specific interest that is individually material to our company. The majority of our property, consisting of oil and gas reserves, service stations, refineries, petrochemical plants, power plants, manufacturing facilities, power distribution systems, stock storage facilities, gas pipelines, oil and gas wells, pipelines and corporate office buildings, is located in Argentina. We also have significant interests in crude oil and natural gas operations outside Argentina in Venezuela, Ecuador, Bolivia and Peru, a petrochemical plant in Brazil and interest in two refineries and a gas station network in Bolivia. For a more detailed description of our property, plants and equipment, including information on our oil and gas reserves and production see Oil and Gas Exploration and Production.

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### **Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following discussion should be read in conjunction with, and is entirely qualified by reference to, our consolidated financial statements and the notes to those financial statements. Our consolidated financial statements were prepared in accordance with Argentine GAAP, which differs in certain significant respects from U.S. GAAP. Note 22 to our consolidated financial statements provides a description of the principal differences between Argentine GAAP and U.S. GAAP as they relate to us, and note 23 provides a reconciliation to U.S. GAAP of net income, shareholders' equity and certain other selected financial data.

#### **PROPORTIONAL CONSOLIDATION AND PRESENTATION OF DISCUSSION**

In accordance with the procedures set forth in Argentine GAAP, beginning in 2003, we were required to consolidate on a proportional basis the financial statements of companies over which we exercise joint control. Joint control exists where all shareholders, or shareholders representing a voting majority, have resolved on the basis of written agreements to share control over defining and establishing operating and financial policies. When consolidating companies over which we exercise joint control, the amount of our investment in the companies under our joint control and the interest in their income (loss) and cash flows are replaced by our proportional interest in that company's assets, liabilities and income (loss) and cash flows. In addition, related party receivables, payables, and transactions within the consolidated group and companies under joint control are eliminated on a pro rata basis pursuant to our ownership share in that company.

There are three companies over which we exercise joint control:

Citelec, which is engaged in the electricity transmission business in Argentina through its subsidiary, Transener. Citelec is considered part of our electricity business segment.

CIESA, which is principally engaged in the gas transportation business in the south of Argentina through its subsidiary, TGS. CIESA is considered part of our hydrocarbon marketing and transportation business segment.

Distrilec, which is engaged in the electricity distribution business in the southern area of the Federal Capital and the 12 districts of the province of Buenos Aires through its subsidiary, Edesur. Distrilec is considered part of our electricity business segment.

Despite being a company under our joint control, we did not consolidate proportionally the financial statements of Citelec because we have committed to sell our interest in Transener as required in connection with the Argentine Antitrust Commission's Resolution approving the transfer of our control to Petrobras. See Item 4. Information About the Company Electricity Electricity Transmission: Transener, Yacylec and Enecor Transener.

We consolidated proportionally line-by-line the assets, liabilities, income (loss) and cash flow of CIESA and Distrilec for all periods covered by the financial statements included in this annual report, except, in the case of CIESA, for the year ended December 31, 2002. CIESA was not consolidated that year because our equity interest as of December 31, 2002 had a P\$33 million negative value and, since we had not assumed any commitments to make capital contributions or provide financial assistance to CIESA, we valued our shareholding of CIESA at zero.

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Even though we consolidate the results of CIESA and Distrilec proportionally in our financial statements, our management analyzes our results and financial condition separately from the results and financial condition of these companies. Accordingly, we believe financial information without proportional consolidation is useful to investors in evaluating our financial condition and results of operations.

Unless otherwise provided, the discussion below is presented on the basis of our consolidated financial data without proportionally consolidating CIESA or Distrilec, and, therefore, is not directly comparable to the corresponding financial data set forth in our financial statements. For the results of CIESA and Distrilec (both of which are presented under proportional consolidation in our consolidated financial statements) and Citelec (which is



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presented under the equity method of accounting in our consolidated financial statements) please refer to our discussion under Discussion of Results Equity in Earnings of Affiliates and Companies under Joint Control. See also Reconciliation Tables.

The table below presents selected consolidated financial data of us and our subsidiaries, including the proportional consolidation of CIESA and Distrilec, as compared to such data excluding the proportional consolidation of such companies under joint control, in each case for the fiscal years indicated.

	With Proportional Consolidation			Without Proportional Consolidation		
	For the Year Ended December 31,			For the Year Ended December 31,		
	2004	2003	2002	2004 <sup>(1)</sup>	2003 <sup>(1)</sup>	2002 <sup>(1)</sup>
Net sales	6,974	5,494	5,106	5,967	4,615	4,587
Costs of sales	(4,210)	(3,386)	(3,284)	(3,542)	(2,817)	(2,878)
Gross profit	2,764	2,108	1,822	2,425	1,798	1,709
Administrative and selling expenses	(640)	(559)	(609)	(558)	(464)	(532)
Exploration expenses	(89)	(196)	(58)	(89)	(196)	(58)
Other operating expenses, net	(304)	(121)	(28)	(265)	(104)	(28)
Operating income	1,731	1,232	1,127	1,513	1,034	1,091
Equity in earnings of affiliates	76	163	(638)	79	371	(647)
Financial income (expense) and holding gains (losses)	(1,261)	(417)	(1,827)	(1,097)	(568)	(1,659)
Other expenses, net <sup>(2)</sup>	(27)	(421)	(187)	(31)	(408)	(178)
Income (loss) before income tax and minority interest in subsidiaries	519	557	(1,525)	464	429	(1,393)
Income tax provision	198	(18)	(82)	224	(47)	(209)
Minority interest in subsidiaries	(39)	(158)	28	(10)	(1)	23
Net income (loss)	678	381	(1,579)	678	381	(1,579)

(1) For a reconciliation of our results to our results as adjusted to reflect the elimination of proportional consolidation see Reconciliation Tables.

(2) Includes impairment charges for some of our assets, including our assets in Ecuador.

**OVERVIEW**

We are an integrated energy company engaged in:

The exploration and production of oil and gas;

Refining;

Petrochemicals;

Electricity generation, transmission and distribution; and

Hydrocarbon marketing and transportation.

Our long-term strategy is to grow as an integrated energy company with a leading presence in Latin America, while focusing on profitability as well as social and environmental responsibility.

Our principal place of business has historically been Argentina, but we also conduct operations in Bolivia, Brazil, Ecuador, Peru, Venezuela and Mexico. Approximately 55% of our total assets, 61% of our net sales, 53% of our combined crude oil and gas production and 36% of our proved oil and gas reserves were located in Argentina as of December 31, 2004. Fluctuations in the Argentine economy and actions adopted by the Argentine government have had and will continue to have a significant effect on Argentine private sector entities, including us. See Item

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3. Key Information Risk Factors Factors Related to Argentina. In recent years, our international operations have grown in importance. As of December 31, 2004, 64% of our proved oil and gas reserves were located outside of Argentina, as compared to 60% in December 31, 2003.

Year to year fluctuations in our income are a result of a combination of factors, including principally:

The volume of crude oil, oil products and natural gas we produce and sell;

Changes in international prices of crude oil and oil products, which are denominated in US dollars;

Fluctuations in the Argentine peso/US dollar exchange rate;

Inflation;

Interest rates;

Changes to our capital expenditures plan;

Price controls; and

Changes in laws or regulations affecting our operations, including tax and environmental matters.

## **The Petrobras Energía Merger**

On January 21, 2005, the special shareholders meetings of Petrobras Energía, EG3, PAR, and PSF, approved the merger of EG3, PAR and PSF into Petrobras Energía. On March 3, 2005, the final merger agreement was signed providing that, once implemented, following receipt of necessary governmental approvals and registration with the public registry, the merger would be given retroactive effect to January 1, 2005. On June 28, 2005, the CNV approved the merger. The merger is in the process of being registered with the Argentine Public Registry of Commerce. After the merger, Petrobras Energía will be the surviving entity. See Item 4. Information About the Company Our History and Development Petrobras Energía Merger. As of December 31, 2004, EG3, PAR and PSF had combined revenues of P\$2,511 million, of which P\$621 million would have been eliminated in consolidation with our financial statements, and combined operating losses of P\$64 million.

The merger is a merger of companies under common control, and Argentine GAAP does not provide specific guidance with respect to these kinds of mergers. Nonetheless, Argentine GAAP contemplates that matters not specifically covered by its principles should be resolved pursuant to generally applicable international standards, particularly those applicable in the markets regulating the issuer of the financial statements. Because we also list our shares on the New York Stock Exchange, we look to U.S. GAAP, or in this case SFAS No. 141, which requires the use of the pooling of interest consolidation method for mergers of companies under common control. Accordingly, in 2005, we plan to account for the effects of the merger using the pooling of interest consolidation method. Under that method, the assets, liabilities and shareholders equity items of the entities under reorganization are booked in the combined entity based on their carrying amounts, without recognizing any new

positive or negative goodwill. In addition, for comparative purposes, we will be required to show the financial statements of all periods presented, including those with respect to periods prior to the merger, as if the merger had occurred at the beginning of the first period presented.

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**FACTORS AFFECTING OUR CONSOLIDATED RESULTS OF OPERATIONS**

**Economic and Political Developments in Argentina**

The most important factors arising from Argentina's economic crisis that have affected and may affect our future results of operations are the following:

*Argentine Peso Devaluation*

Pursuant to the Convertibility Law, between April 1, 1991 and January 5, 2002, the peso was freely convertible into US dollars at a fixed one-to-one exchange rate and, as a result, Argentine currency experienced a period of stability. In 2002, however, following the government's termination of the peso's one-to-one exchange rate parity, the peso significantly depreciated against foreign currencies, losing 238% of its value against the US dollar and, as of December 31, 2002, the exchange rate was P\$3.38 to US\$1. Since all of our financial debt and a significant portion of our affiliates' debt are denominated in US dollars, the marked devaluation of the peso in 2002 adversely affected our results and financial position. We recorded significant foreign exchange losses in 2002, as a result of the devaluation.

Prior to the enactment of this law, our cash flows were usually denominated in US dollars or US dollar-adjusted, which provided hedging against exchange rate risks. The new Argentine regulatory framework, including the pesification of utility rates, however, limited our ability to mitigate the impact of peso devaluation and prevented us from increasing the prices of our products in the domestic market to offset the devaluation of the peso. Our foreign operations, which have cash flows primarily denominated in US dollars, provided us with limited hedge against our US dollar-exposure.

In 2003, the peso began to recover its value. The balance of trade yielded a strong surplus, which, together with the continuing default in partial foreign debt payments, caused an excess supply of foreign currency. Only numerous currency purchases by the Central Bank, supported by the explicit intention of the Argentine government to maintain a high rate of exchange, prevented greater appreciation of the Argentine peso against the US dollar. As of December 31, 2003 and 2004, the peso exchange rate stood at P\$2.94 to US\$1 and P\$2.98 to US\$1, respectively. For more information on the impact of peso fluctuations on our results of operations, see *Discussion of Results Year ended December 31, 2004 compared to year ended December 31, 2003 Financial income (expense) and holding gains (losses)* and *Discussion of Results Year-ended December 31, 2003 compared to year ended December 31, 2002 Financial income (expense) and holding gains (losses)*.

We have aggressively pursued a trade policy of opening and consolidating export markets to capitalize on domestic and export price asymmetries. As a result of this, the solid positioning of our foreign operations with cash flows primarily denominated in US dollars and the increase in some domestic prices in line with their respective export reference prices, our exposure to fluctuations in the peso has decreased as we have substantially recovered our ability to naturally hedge our cash exposure to US dollar liabilities.

On January 1, 2003, Technical Resolutions Nos. 16, 17, 18, 19 and 20 of the FACPCE became effective and introduced material changes in the guidelines regarding the recognition and disclosure of exchange differences. Formerly, exchange differences were charged to income, as gains and losses on foreign currency translation. The new regulations provide that exchange differences arising from liabilities in foreign currency assumed to hedge the net investment in foreign entities are not charged to income but rather are recorded as *Transitory differences foreign currency translation* where the effect from the translation of financial statements into Argentine pesos is also recorded. As required by these new

standards, the change is to be applied prospectively and, therefore, affects the comparability of the financial statements.

*Inflation*

Historically, the Argentine economy has experienced significant volatility, characterized by periods with high levels of inflation. During the 1990s, however, the Argentine economy experienced a period of low inflation levels and, in accordance with professional accounting standards, we suspended the use of the adjustment-for-inflation method from September 1995 to December 2001.

In 2002, in light of the peso devaluation and the economic instability that the country suffered during this year, Argentina experienced a significant increase in inflation (41% and 118.2% measured in terms of the consumer price index and the wholesale price index, respectively).

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As a result of the high inflation in 2002, Argentine GAAP reintroduced inflation accounting, which is applicable to financial statements for fiscal years or interim periods ending on or after March 31, 2002. The most important impacts of inflation on results were the effect of exposure of our monetary assets and liabilities to inflation and the restatement in constant currency of our income statement accounts.

Since the second semester of 2002, the economy started to recover and the peso began to appreciate at an accelerated pace, which helped maintain monthly inflation at very low levels. In March 2003, in response to the stabilization of the economy, the CNV, under Resolution No. 441, provided that starting on March 1, 2003, financial statements must be stated in nominal currency. Accordingly, we discontinued inflation accounting and the corresponding restatement of our financial statements. Our financial results as of and for the year ended December 31, 2002 are stated in constant pesos as of March 1, 2003. This method was not in accordance with professional accounting standards effective in the city of Buenos Aires. The CPCECABA, through Resolution No. 287/03 discontinued the application of the restatement method as from October 1, 2003.

In 2004, the consumer price index increased 6.1%. The strong recovery of domestic demand caused an acceleration of retail inflation, due to, in large part, the fluctuations in utility prices. Wholesale inflation in 2004 also showed clear signs of acceleration driven by the high growth pace. The wholesale price index recorded a 7.9% increase during the year, with a significant rise in prices for manufactured product, electric power and mineral products and, to a lesser extent, imported products. Increases in these items contrast with the slight rise in the price of the remaining primary products.

In the past, inflation has materially undermined the Argentine economy and the government's ability to stimulate economic growth. See Item 3. Key Information Risk Factors Factors Related to Argentina Inflation may escalate and undermine economic growth in Argentina and adversely affect our financial condition and results of operations.

### *Investments in Utility Companies*

The new macroeconomic scenario after enactment of the Public Emergency Law impacted the economic and financial balance of utility companies in Argentina. The combined effect of (1) the devaluation of the peso, (2) the unchanged level of revenues due to the pesification of rates and (3) financial debts primarily denominated in foreign currency, adversely affected the utility companies' financial position, results of operations and ability to fulfill financial obligations.

The Public Emergency Law ordered the pesification of utility rates payable in US dollars, fixing them at the exchange rate of P\$1= US\$1 and the elimination of certain indexation clauses in utility contracts. In addition, the Public Emergency Law granted the Argentine government broad authority to renegotiate utility contracts, which authority has been extended to December 2005. See Item 3. Key Information Risk Factors Factors Relating to Argentina The pesification of utility rates has negatively affected and may continue to affect utility companies' financial position, result of operations and their ability to generate cash. and Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework. UNIREN is currently in the process of renegotiating contracts with our affiliates Edesur, TGS, Transener and Transba. See Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework Electricity UNIREN. Congress has authorized the government to fix utility rates until completion of the renegotiation process. We cannot assure you that these renegotiations will be concluded to the satisfaction of our utility companies.

In light of the adverse conditions faced by utility companies, during 2002, CIESA, TGS and Transener declared default on their debt. TGS has recently concluded a debt restructuring process with its creditors. Transener proposed an exchange offer to its creditors, which in April 2005 was accepted by 98.8% of them. Pursuant to a restructuring agreement entered into on May 19, 2005, Transener has 45 business days to comply with

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the terms of the exchange offer, otherwise the restructuring agreement may be terminated at creditors' option. CIESA is currently negotiating with creditors to agree on an extension for its defaulted obligations. See Item 4. Information About the Company Hydrocarbon Marketing and Transportation Gas Transportation-TGS Our interests in TGS and Corporate Developments and Item 4. Information About the Company Electricity Electricity Transmission: Transener, Yacylec and Enecor Transener.



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The impact of the measures taken by the Argentine government on the financial statements of these companies was recognized according to the assessments and estimates conducted by their respective managements. Actual future results might differ from the assessments and estimates so conducted and these differences may be significant.

As of December 31, 2004, the value of our investments in CIESA, TGS and Citelec were P\$206 million, P\$151 million and P\$116 million, respectively. As of December 31, 2003, the value of our investments in CIESA, TGS and Citelec were P\$190 million, P\$140 million and P\$158 million, respectively. As of December 31, 2002, the value of our net investments in CIESA, TGS and Citelec were P\$0, P\$88 million and P\$71 million, respectively.

Our equity interest in CIESA for December 31, 2002 would have accounted for a P\$33 million negative shareholders' equity. However, since we did not assume commitments to making capital contributions or provide financial assistance to CIESA, our shareholding in CIESA was valued at zero, limiting the recognition of related losses to such book value. The book value of such shareholdings was below their recoverable value as of such date.

For further detail in connection with our equity interests and the earnings of our affiliated utility companies see "Discussion of Results Year ended December 31, 2004 compared to year ended December 31, 2003 Equity in Earnings of Affiliates and Companies under Joint Control" and "Discussion of Results Year ended December 31, 2003 compared to year ended December 31, 2002 Equity in Earnings of Affiliates and Companies under Joint Control."

### *Price Stabilization and Supply*

For the purpose of lessening inflationary pressures caused by the sharp devaluation of the peso in 2002, the Argentine government issued a set of regulations aimed at controlling the increase in prices payable by the final customer. These regulations have focused particularly on the energy sector.

### Gas

Pursuant to the Public Emergency Law, we were precluded from increasing the price of gas sold in the domestic market. As a result of this and the lack of price adjustments since then, we postponed infrastructure, development and exploration investments to add new gas reserves. With respect to existing gas sales agreements entered into with industrial clients, we have gradually and partially renegotiated the terms and conditions of these agreements in order to adjust them to the new economic scenario and have gradually increased sales prices to reflect the effects of peso devaluation. We have also attempted to maximize export opportunities in an effort to capitalize on higher prices offered by foreign markets. As part of these efforts, during the first quarter of 2003, we started exporting gas to Chile from the Austral basin, which accounted for approximately 15% of the total gas produced by us in Argentina during 2004. In order to secure the supply of gas for domestic consumption and thermal generation, in light of the local energy crisis, during 2004, the Argentine government on several occasions imposed restrictions on gas exports. While these measures had a limited effect on the total volume of our exports to Chile during 2004, we cannot be certain of their future impacts with respect to our gas exports to Chile or other foreign markets.

In February 2004, the Argentine government, through Decree No. 181/04, mandated the creation of a plan to increase natural gas prices. In April 2004, we along with the remaining gas producers entered into an agreement with the Argentine government applicable to industrial clients and electricity generation clients that provided for a schedule of gradual increases in gas prices until July 2005, with differential rates per basin. The

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schedule would increase gas wellhead prices to approximately US\$1.07/MMBTU and US\$0.90/MMBTU in the Neuquén and Austral basins, respectively, representing a price recovery ranging between 100% and 150%. This recovery is applicable to all sales of gas made to generation companies, and applicable on a pro rata basis to distributors based on each distributor's percentage of sales made to industrial clients. With respect to lower consumption users, such as residential consumers, the plan calls for the Secretary of Energy to furnish a normalization schedule in order for lower consumption users to be able to pay the final values as determined in the agreement by January, 2007. As of December 31, 2004, average prices were US\$0.74/MMBTU and US\$0.55/MMBTU for PEPSA's generation company clients and distributor clients, respectively. The agreement provides for a guarantee of supply until 2006, and each producer has committed to make the necessary investments to reach agreed upon volumes.

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## Hydrocarbons

Aiming to mitigate the impact of the significant increase of WTI on local prices and ensure price stability for crude oil, gasoline and diesel oil, in January 2003, at the request of the Argentine Federal Executive Branch, hydrocarbon producers and refineries entered into a temporary agreement, which required crude oil deliveries to be invoiced and paid based on a WTI reference price of US\$28.5 per barrel. Any positive or negative difference between the actual WTI price and the reference price, not exceeding US\$36 per barrel, would be paid out of any balances generated in the periods in which the actual WTI price fell below US\$28.5 per barrel. Refineries, in turn, reflected the crude oil reference price in domestic market prices, a criterion that was equally applied to determine intercompany transfer prices. After successive renewals, this agreement expired in May 2004. Thereafter, hydrocarbon producers and refineries executed a new agreement that was effective until June 2004, which provided that, while the WTI per barrel ranged between US\$32 and US\$42, crude oil deliveries would be invoiced and paid considering a reference price equal to: (1) 86% of the WTI as long as such price did not exceed US\$36 per barrel, or (2) 80% of the WTI if this price exceeded US\$36 per barrel. In August 2004, in light of the WTI having exceeded US\$42, the Argentine government established a cap on the domestic price of crude oil equal to the international market price net of the taxes imposed on exports. As from October 2004, hydrocarbon producers and refiners negotiate crude price based on the export parity reference price.

Within this same framework, as part of the effort to prevent inflationary pressure and to discourage exports to ensure local feedstock, on March 1, 2002, the Argentine government imposed a 20% tax on exports of crude oil and a 5% tax on exports of certain oil by-products, which are due to expire in five years. In May 2004, the tax on exports of crude oil and liquified petroleum gas increased to 25% and 20%, respectively, and a 20% tax was levied on exports of natural gas. Effective August 4, 2004, the Argentine government established increases in crude oil export taxes, starting at a rate of 25% if the price per barrel is less than or equal to US\$32 with additional increased withholdings ranging from 3% to 20%, depending on whether the price per barrel of crude oil varies from US\$32.01 to US\$45, with a maximum tax of 45% if the price exceeds US\$45.

These measures had an impact on the upstream operations' profitability and prevented us from capitalizing fully on the benefits derived from a very favorable international price context. The export parity reference price, however, helped our refining business mitigate the effects of increased crude oil prices.

In light of the current scenario, we have redesigned our business strategies to minimize the impact of such measures, giving priority to products with higher margins. With this in mind, we have prioritized crude oil refining and the subsequent sale of refined products in both domestic and foreign markets. Our positioning as an integrated energy company, with growing integration of our upstream and downstream activities and the competitive advantages we have realized through our relationship with Petrobras, are key components of this approach.

As a result, during 2004 and 2003, intersegment sales volumes of crude oil increased 7.2% and 21.6%, respectively, to 34,000 barrels per day and to 31,700 barrels per day, while exports of crude oil in the 2004 to 2002 period declined approximately 75%. In addition, in 2004 and 2003, 466,000 cubic meters and 248,000 cubic meters of refined products were sold to EG3, respectively. As a further result, the sales to EG3 increased the crude oil volumes processed at a profit at the San Lorenzo refinery to levels significantly higher than those recorded over the last few years.

## Downstream Margins

Downstream margins have significantly declined since the enactment of the Public Emergency Law. As part of their effort to avoid inflationary escalation, the Argentine government exerted strong pressures to limit the passing to the retail level of gasoline and diesel oil, the higher costs derived from higher WTI prices, the peso devaluation and domestic inflation. The application of these measures has resulted in an overall reduction in the sector's profitability. Since the enactment of the Public Emergency Law, crude oil costs for Argentine operations increased

67.4%, while gasoline and diesel oil average sales prices increased 21% and 46%, respectively.

Notwithstanding the absence of a formal price control policy, many initiatives on the part of other companies within the refining sector aimed at recovering downstream operation profitability, were thwarted by explicit governmental pressures, including efforts aimed at generating strong public opposition to the companies' initiatives.

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*Electricity Generation*

With respect to electricity generation, following the Public Emergency Law, the Argentine government implemented the pesification of US dollar-denominated prices in the wholesale electricity market and set a price cap for the energy sold in the spot market, which as of 2004 equaled approximately P\$40/MWh. This price is determined by the cost of thermal generation regardless of the use of liquid fuels. This change in regulations was a deviation from the marginal cost system that was previously in effect. See Item 4. Information About the Company Regulation of Our Businesses Argentine Regulatory Framework Electricity.

As a result of the Argentine government's decision to suspend seasonal increases in electricity prices, these prices have failed to reflect total generation costs adequately. This lag led to the gradual depletion of the Stabilization Fund (*Fondo de Estabilización*), causing an increasing deficit thereof, which in turn prevented CAMMESA from settling accounts with market agents. To address this situation, the Secretary of Energy established a methodology to manage the lack of funds. This consisted in the establishment of an order of cancellation of credits with generation companies. In an effort to restore the Stabilization Fund, between December 2003 and August 2004, the Argentine government made a P\$650 million contribution to the fund. In December 2004, the government authorized the National Treasury to grant an additional P\$300 million loan. In addition, seasonal adjustments were reinstated for the February-April and August-October 2004 periods, recognizing the greater costs resulting from the recovery of natural gas prices in the determination of wholesale spot prices. Also in December 2004, the Argentine government approved a new increase of approximately 19% in seasonal prices, which became effective in January of 2005.

In order to definitively adjust the Stabilization Fund deficit, the Secretary of Energy created an investment fund called FONINVEMEM. This fund encourages wholesale electricity market creditors to participate in investments in electric power generation in order to increase the available supply of electric power generation in Argentina and achieve sustainability. FONINVEMEM's funds will be used to expand thermal generation capacity, approximately 1,600 MW, which is estimated to start commercial operations in late 2007. The Secretary of Energy has invited wholesale electricity market's agents to participate and has determined that credit balances resulting from the spread between the sales price of energy and the generation variable cost for agents who choose not to participate in the creation thereof will be paid subject to the positive cash flows generated by the works constructed with FONINVEMEM's resources. We have accepted the invitation and will, therefore, participate with 65% of the credit balances recorded for the 2004-2006 period with respect to this spread. Total credit balances contributed by us in the 2004 fiscal year amounted to US\$5 million in nominal value. Our estimated total contribution for the 2004-2006 period is projected to be US\$35 million, or approximately 8%, of the fund's capital. The final amount will depend on, among other factors, water conditions, the dispatch of our generation units determined by CAMMESA and the resulting prices of energy.

In order to restore the regular operation of the wholesale electricity market as a competitive market that provides sufficient supply, in December 2004, the Secretary of Energy committed to approve successive seasonal price increases to reach values covering at least total monomic costs by November 2006. In addition, it committed to compensate energy with the marginal price obtained in the spot market and power with the U.S. dollar values that were in effect prior to the enactment of the Public Emergency Law when the market returns to normal conditions after the additional capacity contributed by FONINVEMEM commences commercial operations.

During 2004, for the second consecutive year, the Secretary of Energy decided to make a call for bids for fuel reserve aimed at guaranteeing the supply of electricity. Generation companies are paid an additional amount to the market price for electricity in exchange for guaranteed availability. We participated in the bid receiving an additional price of \$12/MWh, which generated total additional income of P\$30 million in 2004 and P\$17 million in 2003.

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### *Recoverability of Assets*

The peso devaluation and the enactment of the Public Emergency Law, in addition to all subsequent events, resulted in a dramatic change in our expectations regarding the future cash flow of certain of our businesses and assets. Considering the prevailing uncertainty regarding Argentina's economic recovery and the recoverability of certain assets and businesses, we adjusted the book value of certain investments and assets.

*Gas areas in Argentina:* Due to (1) the strong deterioration of the domestic price of gas in real terms, (2) the limited possibilities of negotiating price increases within the context of the Public Emergency Law and (3) the decline in gas reserve volumes as a result of reduced expenditures, we recorded impairment charges in the amount of P\$37 million in 2003 and P\$44 million in 2002.

*Argentine government bonds:* Following the default by Argentina on its sovereign debt, the Argentine government did not allow us to apply the nominal value of Patriotic bonds toward the payment of our Argentine federal tax liabilities until a debt exchange was concluded and, therefore, as of December 31, 2002, we created a provision for the decrease in value of our investment in these government bonds in the amount of P\$30 million. As of December 31, 2004 this provision amounted to P\$23 million.

*Tax loss carry forwards:* As of December 31, 2003, we maintained a P\$1,189 million allowance for tax loss carry forwards. Despite a partial recovery in economic activity, the future course of the economy as of December 31, 2003 was still uncertain, and considering the recent actions taken by the Argentine government, the recoverability of such tax loss carry forwards remained uncertain as of December 31, 2003.

As of December 31, 2004, after taking into consideration profitability expectations in connection with our business plan, we partially reversed this allowance and recorded a P\$268 million gain. This reversal was due to, among other factors, expectations of high and sustained prices for commodities, the relative stability of the main macroeconomic variables in Argentina, including positive developments with respect to the recovery of energy prices. As of December 31, 2004, Petrobras Energía maintained a P\$855 million allowance for tax loss carry forwards. In the future, our management will continue to evaluate the reversal of some or all of the allowance. This analysis will focus on positive changes in macroeconomic variables, the recovery of the Argentine economy and the progress attained in the resolution of key issues, including the restructuring of Argentina's sovereign debt and the renegotiation of utility contracts. The tax loss carry forwards can be used until the fiscal year ending December 31, 2007.

*Minimum presumed income tax credit:* Taking into account the prospects of our results of operations and the uncertainty regarding our ability to use amounts paid under minimum presumed income tax credits for the reduction of our future income taxes, we recorded an allowance which, as of December 31, 2004, amounted to P\$72 million, which corresponds to the allowance for the amounts paid as minimum taxes from 1998 to 2002. In 2002, we recorded a P\$19 million loss in connection with the amount paid as minimum taxes.

### **Commodity Prices and Management of Crude Oil Price Risk**

Our results of operations and cash flow are exposed to risks related to the volatility of international prices, mainly crude oil and by-product prices. See Item 3. Key Information Risk factors Factors Related to the Company Decline in oil prices affect the profitability of our operations and capital expenditures. In addition, while our reporting currency is the Argentine peso, a significant portion of our revenues are denominated in or indexed to the US dollar, reflecting in part the important contribution of exports and foreign operations to our business. Accordingly, changes in the peso exchange rate may have a considerable impact on the prices of the commodities we sell as reported in pesos, thereby affecting our

revenues.

In 2004, crude oil prices hit record levels. The WTI closed at US\$43.3 per barrel, with an average of US\$41.5 per barrel during the year (US\$32.4 per barrel and US\$31 per barrel, respectively, in 2003 and US\$31.2 per barrel and US\$26 per barrel, respectively, in 2002). High prices were sustained by both demand and supply factors. Acceleration in world growth, the tension in the Middle East and low inventory levels in the United States, among other factors, led to an escalation of price increases, which does not show signs of a rapid decline. In 2004,

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our average sales prices for crude oil, gasoline, diesel oil, styrene and polystyrene grew 19.4%, 12%, 18%, 41% and 31%, respectively, compared to 2003. In 2003, as compared with 2002, our average prices for crude oil, gasoline, diesel oil and polystyrene rose 4.8%, 16.5%, 7.3% and 2%, respectively, with styrene exhibiting a 9% decline.

In line with the business integration strategy, our risk management policy focuses on measuring our net risk exposure and monitoring the risks that affect our overall portfolio of assets. We use hedging derivative instruments, such as futures, swaps, options and other instruments, to mitigate risks related to results and cash flow volatility as a result of fluctuations in the price of crude oil. In Argentina, as we grow as an integrated energy company, we expect to process more of our crude oil production in our refineries and, therefore, we expect that oil product prices, rather than crude oil prices, will most directly affect our financial results.

On January 1, 2003, Technical Resolutions Nos. 16, 17, 18, 19 and 20 of the FACPCE became effective and introduced material changes in the guidelines regarding the recognition, measurement and disclosure of derivatives and hedging transactions. These new regulations, whose principles are consistent with the international accounting standards issued by the International Accounting Standards Committee, or IASC, provide that derivative financial instruments are recorded at their fair value and allow, on a very restrictive basis, for the implementation of hedge accounting. Under hedge accounting changes in the fair value of derivatives are recognized under Transitory differences Measurement of derivative financial instruments designated as effective hedge and subsequently reclassified to income (loss) for the year or years in which the hedged item affects results. If the financial derivative instrument is not designated as an effective hedge, changes in the accounting measurement of such derivatives are recognized in the income statement under financial income (expense) and holding gains (losses). The new regulations permit hedge accounting on a very restrictive basis, since a hedge is deemed effective if at its inception and during its life its changes offset between 80% and 125% of the changes in the hedged item. Notwithstanding our objectives, some of our derivative instruments do not qualify for hedge accounting. Therefore, in connection with instruments not designated as efficient hedges, a significant asymmetry is shown between recognition of gain or losses for the instruments and gains or losses for the items originally hedged. As of December 31, 2004 and 2003, our derivative portfolio consisted solely of instruments that did not qualify for hedge accounting.

In view of the high crude oil prices recorded during 2004, 2003 and 2002, we recognized (1) for instruments that qualify for hedge accounting, reduced sales in the amount of P\$81 million in 2003 and P\$373 million in 2002, and (2) for instruments that do not qualify for hedge accounting, financial losses of P\$687 million in 2004, P\$298 million in 2003 and P\$470 million in 2002.

As of December 31, 2004, for 2005 we have swaps that do not qualify for hedge accounting in place for 20,000 barrels per day, at an average settlement price of US\$19 per barrel. As of December 31, 2004, the fair value of the instruments amounted to US\$(170) million. See Item 11. Quantitative and Qualitative Disclosures About Market Risk.

### **Political and Economic Situation in Venezuela**

Operations in Venezuela are an important component of our business. In 2004, Venezuela's oil and gas sales volumes accounted for 31.5% of our total volumes of barrels of oil equivalent, and as of December 31, 2004, a significant percentage of our total combined proved reserves were located in Venezuela. Oil production in Venezuela is strictly controlled by the government through PDVSA. Our operations, therefore, are particularly affected by the political and economic events in Venezuela. See Item 3. Key Information Risk Factors Factors Related to Venezuela. Additionally, as Venezuela is a member of OPEC, we are subject to the OPEC-mandated production cut decisions, as was the case in 2002.

Since the end of 2002 and throughout 2003, Venezuela faced one of its worst political and economic crises in the last 40 years. On December 2, 2002, a nationwide strike was organized, which included PDVSA. This situation affected the operations of our three fields located in the east of



the country (Oritupano-Leona, Mata and Acema), significantly reducing their production. Throughout the first quarter of 2003, oil production average volume dropped by 40.2% to 30,400 barrels per day compared to the same quarter of 2002. After the conclusion of the nationwide strike, the situation gradually recuperated.

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The year 2004 was marked by economic recovery, triggered by high prices of hydrocarbons in the international market and recovery of the national oil production, as well as changes within the political environment after a referendum and regional elections, which provided more political stability to the country. Venezuela's economy recorded growth of approximately 17% in 2004, and the country's activity level returned to levels similar to those existing prior to the crisis. The high prices of hydrocarbons and the economic stability experienced in Venezuela throughout 2004 allowed us to carry out our operations smoothly.

Despite the economic improvement in 2004, changes in the Venezuelan legal framework continue to affect our results. The 2001 Hydrocarbons law replaced the Hydrocarbons Law of 1943 and the Nationalization Law of 1975. The new Hydrocarbons Law raised royalties payable by private companies to 20%-30% from the previous 1%-16.66%. Such increase resulted in lower revenues of P\$84 million, P\$57 million and P\$60 million in the years 2004, 2003 and 2002, respectively.

In April 2005, the Venezuelan Energy and Oil Ministry instructed PDVSA to review the thirty-two operating agreements signed by PDVSA with oil companies from 1992 through 1997, including agreements with our affiliates in connection with the areas of Oritupano Leona, La Concepción, Acema and Mata. See Item 4. Information About the Company Oil and Gas Exploration and Production Production Production Outside of Argentina Venezuela. The Venezuelan government has instructed PDVSA to take measures within a six-month term to convert all currently effective operating agreements into mixed-ownership contracts in order to grant the Venezuelan government, through PDVSA, more than 50% ownership of each field. The government has further instructed PDVSA to limit the total accumulated payments to contractors during a calendar year to 66.67% of the value of oil and gas produced under the related agreement. We have begun discussions with PDVSA but cannot predict the outcome of these discussions nor their impact on our Venezuelan operations. See Item 3. Key Information Risk Factors Factors Relating to Venezuela Changes in the regulatory and contractual framework applicable to our operating agreements have and may in the future adversely affect our financial position and results of operations.

On June 23, 2005, we received notice from PDVSA that it would start paying in local currency the amounts due to us under the operating agreements that correspond to national services and materials, instead of US dollars as provided in the relevant agreements. Under the current agreements, all payments from PDVSA are due in dollars outside Venezuela. During an interim period and until PDVSA performs an audit that finally determines the portion of services under the operating agreements that correspond to national services, PDVSA would start paying 50% of the amounts due to us under the operating agreements in local currency, and the remaining 50% would continue to be payable in dollars.

In addition, the Venezuelan tax authorities have recently publicly stated that they are looking into the taxes paid by private oil companies in recent years. The authorities have stated that private oil companies may have under-reported their taxable income in Venezuela. As of the date of this annual report, none of the oil companies operating in Venezuela, including us, have received a claim from the SENIAT in connection with this alleged investigation.

Given the early stage and uncertainty of the overall process, we are unable to predict its outcome or the impact that it may have on our operations, financial results, liquidity or investment plans. Accordingly, we cannot assure you that the changes resulting from this process will not adversely affect our financial position or results of operations.

In 2004, 2003 and 2002, we registered a P\$15 million, P\$27 million and a P\$42 million allowance, respectively, for the book value of loans granted to our joint venture partners in Venezuela. As of December 31, 2004, the total allowance amounts to US\$35 million. Through these loan agreements, we often provide our joint venture partners with the cash required to comply with their joint venture obligations. These allowances were recorded to reflect our estimate of the recoverable value of these loans, which takes into account that these loans are secured by pledges.



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### *Agreements in San Carlos and Tinaco*

In October of 2002, we entered into an association agreement with Teikoku under which we transferred 50% of our rights and obligations in non-associated gas production in the San Carlos and Tinaco Blocks. As a result of this transaction, we recorded a P\$37 million loss. The political and economic crisis that broke out in Venezuela late in 2002 caused the delay of exploratory works in the San Carlos and Tinaco areas. Since as of December 31, 2003, we did not anticipate drilling an additional exploratory well to confirm additional reserves with respect to the San Carlos Block that would have justified performance of infrastructure works for field development, such as gas pipelines and treatment facilities, we charged to income P\$29 million attributable to the remaining capitalized investment in the San Carlos Block.

### **Operations in Ecuador**

We operate two fields in Ecuador Block 18 and Block 31. As of December 31, 2004, we had a 70% and 100% interest, respectively, in these fields. In addition, we had an 11.42% interest in OCP.

In 2000, as a result of the successful drilling of two exploratory wells, heavy crude oil reserves were discovered in Block 31. The significant volume of reserves would have allowed us to complete the wells and turn them into producing wells as long as significant infrastructure investments were made, such as oil pipelines and facilities. Accordingly, in 2001, OCP began to build an oil pipeline to transport production, and the oil pipeline started operations in late 2003. The reductions made to our investment plan as a consequence of the Argentine crisis in 2002 delayed the development of Block 31. In 2003, two additional wells were drilled, which confirmed the potential of this area. Because as of December 31, 2003 drilling of new exploratory wells was not planned for the near future and as of such date no reserves had been proved in Block 31, in accordance with SFAS 19, we (1) charged to income P\$106 million of previously capitalized exploratory costs in connection with the drilling of the first two wells and (2) capitalized exploratory costs for wells where less than one year had elapsed since the completion of drilling. During 2004, we charged to income P\$80 million of these exploratory costs, as one year had elapsed from completion of drilling.

In August 2004, with the approval by the Ecuadorian Ministry of Energy of the Environmental Impact Studies, all requirements necessary for the approval of Block 31's development plan were met. Following this approval, a 20-year production period started. As of December 31, 2004, we have proved crude oil reserves in connection in Block 31.

With respect to the exploitation of Blocks 18 and 31, we have an agreement with OCP, whereby we secured an oil transportation capacity of 80,000 barrels per day for a 15-year term, starting on November 10, 2003. Under the ship or pay transportation agreement, we must fulfill our ship or pay contractual obligations in full for the 80,000 barrels per day oil volume commitment and pay, even if no crude oil is transported, a fee covering OCP operating costs and financial services. As of December 31, 2004, this fee amounted to US\$2.2 per barrel. Costs in connection with the transportation capacity are invoiced by OCP and charged to expenses on a monthly basis. We have assigned part of our allotted transportation capacity, or approximately 8,000 of our 80,000 barrels per day commitment, for the period starting in July 2004 until January 2012.

We estimate that during the term of our contract with OCP, oil production will be lower than the transportation capacity committed, even after taking into consideration assigned transportation capacity, creating an oil production deficit. Our estimate is based mainly on the forecasted pace of development and revised estimated potential for Block 31. In light of the significant economic effects of this oil production deficit, as of December 31, 2004, we maintained a P\$324 million impairment allowance in connection with our group of assets in Ecuador. In 2003 and 2002, we recorded a loss of P\$309 million and P\$63 million, respectively.

*Agreement with Teikoku*

In January 2005, we entered into an agreement with Teikoku, whereby, following approval by the Ministry of Energy of Ecuador, we will transfer 40% of our rights and interest in Blocks 18 and 31. In addition, once production in Block 31 reaches an average of 10,000 barrels of oil per day for a period of 30 consecutive days,

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Teikoku has agreed to assume 40% of our rights and obligations resulting from the crude oil transportation agreement entered into with OCP. Allocation of the transportation capacity to Teikoku will enable us to reduce the effects of the oil production deficit under the ship or pay contract. Teikoku, in turn, will pay us US\$15 million. In addition, Teikoku has agreed to make investments in Block 31 in excess of its interest in the joint venture, causing accelerated development of the block. Once approval by the Ministry of Energy of Ecuador occurs, our interests in Block 18 would be reduced from our current level of 70% to 30% and our interest in Block 31 would be reduced from 100% to 60%, but we will continue acting as operator for both blocks.

## **Operations in Peru**

In 2004, we, through Petrobras Energía Perú S.A., entered into an agreement with the Peruvian government, whereby we agreed to make investments of about US\$97 million in Lote X during the 2004-2011 period. The Peruvian government, in turn, reduced the royalties it receives for hydrocarbon production from a fixed rate of 24% to a variable scheme, starting at rate of 13% applicable when oil prices are up to US\$23.9 per barrel and increasing 1.8% every US\$5 of increase in the price per barrel. (The royalty rate applicable as of December 31, 2004 was 17.6%.) Investments covered by this agreement include drilling of 51 wells, workover on 526 wells, reactivation of 177 temporarily abandoned wells, and the implementation and expansion of a water injection project.

In light of the significance of this agreement, economic projections in connection with operations in Peru have changed. As a result, in 2004, we recorded a P\$31 million gain from the partial reversal of allowances previously recorded in respect of tax loss carry forwards. In addition, proved reserves were added, since as a result of the new royalties regime certain development projects became profitable.

## **Capital Investments**

As a result of the size and complex nature of the crisis that broke out in Argentina and the limited opportunities to access the capital markets, in 2002, we had to take a new approach to our growth strategy, which resulted in great changes to our short and medium-term outlook and has caused us to prioritize cash generation and the maintenance of adequate liquidity levels. Consequently, in that year, our capital investments totaled P\$641 million, an amount that was significantly lower than our capital investments in 2001, which were approximately P\$1,700 million. During 2002, we also made important divestments of non-core assets amounting to P\$593 million, which helped us to finance our capital investments during that year. The reduced pace of investments during 2002 mainly affected oil and gas production volumes and delayed development of new exploitation areas and related production, including the development of Block 31.

In 2003 and 2004, with the recovery of operating cash flow and liquidity at target levels, we readjusted our investment plan. In 2003, we increased capital investments by P\$252 million to P\$893 million and, in 2004, capital investments increased P\$211 million to P\$1,104 million. In addition, in line with our long-term strategy to grow as an integrated energy company in Latin America, we have increased our levels of capital investments outside of Argentina, which accounted for about 55% of total investments in 2004.

Our level of capital investments overall is expected to gradually increase in the future.

## **Divestment of Assets**

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The following divestments, some of which were consummated as result of the transfer of our control to Petrobras, have helped us to move forward with our strategy of becoming an integrated energy company:

In June 2003, we sold to Geodyne Energy Inc., Argentina Branch, a 50% interest in the Faro Vírgenes area concession, accounting for a P\$11 million loss. Payments in connection with this transaction will be made during a ten year term, in quarterly installments, with a value in US dollars calculated based on 8.8% of the total quarterly gas production from the Faro Vírgenes area. We have the option of receiving directly this gas production.

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In August 2003, we sold to Central International Corporation, Argentine Branch, an 85% interest in the Catriel Oeste area concession. Considering the transfer price (US\$7 million), we recorded a P\$28 million loss.

In July 2002, we sold to Anglogold our 46.25% indirect equity interest in Cerro Vanguardia S.A. and certain related assets. The transaction price amounted to US\$90 million, and the operation accounted for a P\$123 million gain.

In September 2002, we sold to Argentina Farmland Investors LLC our 100% equity interest in Pecom Agropecuaria S.A.'s capital stock. The transaction amounted to US\$53 million, accounting for a P\$27 million gain.

In December 2002, we sold our forestry business assets, including a total area of about 169,000 hectares of forestry land located in the provinces of Misiones, Corrientes and Buenos Aires and a sawmill with 90,000 cubic meters per year capacity. Considering the sale price (US\$53 million), we recorded a P\$153 million loss.

In October 2002, we sold to Sudacia S.A., a company controlled by the Perez Companc Family, a 66.67% equity interest in Conuar, including a 68% interest in Fabricación de Aleaciones Especiales S.A., for US\$8 million. No gain or loss was recorded for the sale.

In April 2002, under an asset swap, we sold to IRHE (Argentine Branch) and GENTISUR S.A. (a company wholly owned by IRHE) our 50% interest in Pecom Agra with a value of US\$30 million, accounting for a P\$81 million gain. In return, the parties transferred to us a 0.75% interest in Puesto Hernández UTE, with a value of US\$4.5 million, a 7.5% interest in Citelec, with a value of US\$15 million, and a 9.187% interest in Hidroneuquén S.A, with a value of US\$5.5 million.

## **Environmental Matters**

Quality control, health and safety and environmental protection are integral components of our business. See Item 4. Information About the Company Quality, Safety, Environment and Health.

In 2002, our environmental remediation expenses totaled P\$15 million.

In 2003, we retained an international consulting company to conduct an environmental audit of our operations. The final audit report set forth an action plan to enforce our Safety, Environmental and Occupational Health Policy. To execute this action plan, we will make investments of approximately US\$23 million to improve, among other things, our prevention systems and production facilities. In addition, we will implement several corrective and remediation actions, for which a P\$45 million loss was recorded for the year ended December 31, 2003. Including this figure, in 2003, we recorded expenses of P\$58 million for environmental remediation.

In April of 2004, we launched new Quality and Safety, Environmental and Occupational Health policies, each of which represents a change from those principles previously in force. The new Safety, Environmental and Occupational Health policies incorporate cutting-edge concepts, such as eco-efficiency, life cycle and sustainability of the operations. Pursuant to the objectives of these policies, an environmental study was conducted during 2004 as a supplement to the audit performed in 2003. Under the standards of the new Safety, Environmental and Occupational Health policies, the study enabled us to identify the need to apply remediation measures, in relation to which we recorded a loss of P\$33 million. Including this figure, in 2004, we recorded expenses of P\$51 million for environmental remediation activities.





**Table of Contents****DISCUSSION OF RESULTS**

The following tables set out net sales, gross profit and operating income for each of our business segments for the years ended December 31, 2004, 2003 and 2002, both including proportional consolidation, which is required by Argentine general accounting standards, and excluding the proportional consolidation of the companies under common control. Our management analyzes our results and financial condition separately from the results and financial conditions of these companies and we believe financial information without proportional consolidation is useful to investors in evaluating our financial condition and results of operations. See Proportional Consolidation and Presentation of Discussion and Reconciliation Tables. Net sales eliminations relate to intersegment sales. Gross profit eliminations relate to adjustments related to intersegment sales and costs associated with such sales.

Substantially all of our intersegment sales are related to sales of oil and gas to our Refining, Petrochemicals and Electricity businesses. The business segment year-to-year comparisons that follow the table do not exclude intersegment sales.

**With Proportional Consolidation**

	For the year ended, December 31,		
	2004	2003	2002
	(in millions of pesos)		
<b>Net Sales:<sup>(1)</sup></b>			
Oil and Gas Exploration and Production	3,359	2,729	2,806
Hydrocarbon Marketing and Transportation	861	521	16
Refining	1,745	1,302	1,008
Petrochemicals	1,877	1,294	1,254
Electricity	825	691	766
Corporate and Other Discontinued Investments and Eliminations <sup>(2)</sup>	(1,693)	(1,043)	(744)
<b>Total</b>	<b>6,974</b>	<b>5,494</b>	<b>5,106</b>
<b>Gross Profit:<sup>(3)</sup></b>			
Oil and Gas Exploration and Production	1,765	1,281	1,206
Hydrocarbon Marketing and Transportation	270	240	5
Refining	182	123	64
Petrochemicals	374	312	362
Electricity	197	168	158
Corporate and Other Discontinued Investments and Eliminations <sup>(2)</sup>	(24)	(16)	27
<b>Total</b>	<b>2,764</b>	<b>2,108</b>	<b>1,822</b>
<b>Operating Income:</b>			
Oil and Gas Exploration and Production	1,182	861	902
Hydrocarbon Marketing and Transportation	247	205	16
Refining	120	54	

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Petrochemicals	278	185	251
Electricity	122	112	89
Corporate and Other Discontinued Investments and Eliminations <sup>(2)</sup>	(218)	(185)	(131)
	<u>          </u>	<u>          </u>	<u>          </u>
Total	1,731	1,232	1,127
	<u>          </u>	<u>          </u>	<u>          </u>

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- (1) Royalties with respect to the oil and gas business in Argentina, Peru and Bolivia are accounted for as a cost or production and are not deducted in determining net sales.
- (2) Eliminations correspond to sales between our business units and their associated costs.
- (3) Net sales less cost of sales.

**Table of Contents****Without Proportional Consolidation**

	For the year ended,		
	December 31,		
	2004	2003	2002
	(in millions of pesos)		
<b>Net Sales:<sup>(1)</sup></b>			
Oil and Gas Exploration and Production	3,359	2,729	2,806
Hydrocarbon Marketing and Transportation	376	75	16
Refining	1,745	1,302	1,008
Petrochemicals	1,877	1,294	1,254
Electricity	290	244	248
Other Investments and Eliminations <sup>(2)</sup>	(1,680)	(1,029)	(745)
<b>Total</b>	<b>5,967</b>	<b>4,615</b>	<b>4,587</b>
<b>Gross Profit:<sup>(3)</sup></b>			
Oil and Gas Exploration and Production	1,765	1,281	1,206
Hydrocarbon Marketing and Transportation	20	4	5
Refining	182	123	64
Petrochemicals	374	312	362
Electricity	111	94	50
Other Investments and Eliminations <sup>(2)</sup>	(27)	(16)	22
<b>Total</b>	<b>2,425</b>	<b>1,798</b>	<b>1,709</b>
<b>Operating Income:</b>			
Oil and Gas Exploration and Production	1,182	861	902
Hydrocarbon Marketing and Transportation	32	11	16
Refining	120	54	
Petrochemicals	278	185	251
Electricity	119	108	57
Other Investments			
Corporate and Other Discontinued Investments	(218)	(185)	(135)
<b>Total</b>	<b>1,513</b>	<b>1,034</b>	<b>1,091</b>

(1) Royalties with respect to the oil and gas business in Argentina, Peru and Bolivia are accounted for as a cost or production and are not deducted in determining net sales.

(2) Eliminations correspond to sales between our business units and their associated costs.

(3) Net sales less cost of sales.

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**Table of Contents****Year ended December 31, 2004 compared to year ended December 31, 2003**

**Net income:** Net income increased P\$297 million, or 78%, to P\$678 million in 2004 from P\$381 million in 2003. Operations for the year were favorably affected by the increase in international crude oil prices, which we were generally able to pass through to prices for the main refined and petrochemical products. As a result, operating income increased significantly. In addition, gains derived from the reversal of certain tax loss carry forward allowances recorded in prior years and a significant decline in other expenses, net had a significant favorable impact on the results for the year. These improvements were partially offset by higher fair value losses derived from derivative instruments that do not qualify for hedge accounting and a decline in equity in earnings of affiliates.

**Net sales:** Net sales increased P\$1,480 million, or 26.9%, to P\$6,974 million in 2004 from P\$5,494 million in 2003. Sales for 2004 reflect P\$485 million and P\$535 million, attributable to our share in CIESA and Distrilec's net sales (net of intercompany sales of P\$13 million), respectively. Net sales for 2003 reflect P\$446 million and P\$447 million, attributable to our share in CIESA and Distrilec's net sales (net of intercompany sales of P\$14 million).

Without proportional consolidation, net sales increased P\$1,352 million, or 29.3%, to P\$5,967 million in 2004 from P\$4,615 million in 2003. The significant increase in the WTI and the related price increases for the main petrochemical and refined products and, to a lesser extent, growth in sales volumes resulted in sales increases in the Oil and Gas Exploration and Production, Petrochemicals and Refining business segments, equal to P\$630 million (23%), P\$583 million (45%) and P\$443 million (34%), respectively (including intercompany sales). The Electricity business segment also experienced sales increases (P\$46 million, or 19%, in 2004), predominantly due to improved generation prices. In addition, and due to changes implemented in the way we allocate certain product sales among different business segments, Hydrocarbon Marketing and Transportation sales increased P\$301 million. As the business operations continue to integrate, intersegment sales increased to P\$1,680 million in 2004 from P\$1,029 million in 2003. The majority of these sales are between our Exploration and Production segment and our Refining segment.

**Gross profit:** Gross profit increased P\$656 million, or 31.1%, to P\$2,764 million in 2004 from P\$2,108 million in 2003. This increase reflects gains of P\$250 million and P\$86 million, attributable to our share of the gross profit of CIESA and Distrilec, respectively, and P\$3 million in eliminations. Gross profit for 2003 reflects gains of P\$236 million and P\$74 million, attributable to our share of the gross profit of CIESA and Distrilec, respectively.

Without proportional consolidation, gross profit for 2004 grew P\$627 million, or 34.9%, to P\$2,425 million from P\$1,798 million in 2003. This increase in gross profit was due to an increase in the gross profit at each of our business segments, particularly in the Oil and Gas Exploration and Production and Refining segments. Gross profit for the Oil and Gas Exploration and Production segment increased P\$484 million, or 37.8%, predominately due to an increase in sales and margins resulting from a 19.4% increase in average sales prices of oil equivalent. Gross profit for our Refining segment increased P\$59 million, or 48%, due in large part to the combined effect of increased sales volumes and improved margins. Gross profits for our Petrochemical, Electricity and Hydrocarbon Marketing and Transportation segments also increased 19.9%, 17% and 13% respectively. For more information as to our gross profit for each of our business segments see Analysis of Operating Results by Business Segment.

**Administrative and selling expenses:** Administrative and selling expenses increased P\$81 million, or 14.4%, to P\$640 million in 2004 from P\$559 million in 2003. The expenses for 2004 reflect P\$16 million and P\$66 million, attributable to our share of the administrative and selling expenses of CIESA and Distrilec, respectively. The expenses for 2003 reflect P\$30 million and P\$65 million, attributable to our share of the administrative and selling expenses of CIESA and Distrilec, respectively.

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Without proportional consolidation, administrative and selling expenses increased P\$94 million, or 20.2%, to P\$558 million in 2004 from P\$464 million in 2003. This increase is primarily due to the increased scale of operations in Ecuador, higher sales volumes and increased corporate advertising expenses.

**Exploration expenses:** Exploration expenses decreased P\$107 million to P\$89 million in 2004 from P\$196 million in 2003. During 2004 and 2003, we expensed certain exploratory drilling costs that had been capitalized in prior years. For an explanation of why these expenses decreased in 2004 see Analysis of Operating Results by Business Segment Oil and Gas Exploration and Production.

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