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Summary:
Petroleos Mexicanos (PEMEX)

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Summary:

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	Local Currency	Foreign Currency
Credit Rating:	A-/Stable/--	BBB+/Stable/--

Rationale

Standard & Poor's Ratings Services' ratings on Petroleos Mexicanos (PEMEX) reflect the United Mexican States' (FC: BBB+/Stable/A-2; LC: A+/Stable/A-1; national scale rating: mxAAA/Stable/--) significant support, Mexico's large oil and gas reserve base, PEMEX's monopoly status in the large Mexican oil and gas market, and its central role in Mexico's energy sector.

Nevertheless, the local-currency rating on PEMEX is two notches below that on Mexico. This reflects PEMEX's highly leveraged financial profile and its unfavorable reserve replacement compared with that of other investment-grade oil companies. The company's after-tax financial measures are very weak for the rating category because of large unfunded pension obligations and a high government take. This has resulted in PEMEX financing most of its capital expenditures with debt during the past several years.

The ratings on PEMEX and Mexico are linked because the Mexican government owns the company, PEMEX has an important role in Mexico's economy, the government depends heavily on oil revenues, and the government exercises considerable oversight of PEMEX, particularly with respect to all fiscal aspects of its management.

PEMEX accounts for about 40% of Mexico's public-sector revenue through taxes and dividends, and petroleum and derivatives account for about 15% of the country's total exports (net of "maquila" imports). We believe PEMEX's importance as a source of tax revenues and export receipts and as a funding vehicle is a strong economic incentive for Mexico to support the issuer during periods of financial distress.

PEMEX enjoys a satisfactory business position. Mexico's extensive base of proved developed and undeveloped hydrocarbon reserves supports this. As of Dec. 31, 2007, reserves were about 14.7 billion barrels of oil equivalent (as determined in accordance with Rule 40[a] of Regulation S-X of the Securities Act of 1933, the reporting standard of the U.S. SEC). Also supporting PEMEX's business position is its constitutionally protected monopoly status in most segments of the large Mexican oil and gas market, including exploration and production (E&P), refining, marketing, and certain petrochemicals. However, commodity price volatility and government interference--including the high transfers to the government that keep the company from appropriate capital spending--are primary risks to its business.

Although the company has made important investments in the past six years, government ownership has created a heavy tax burden that has kept it from increasing investment. This has led to a weak reserve-replacement ratio, other operating inefficiencies, and after-tax financial measures that compare unfavorably with those of other investment-grade oil and gas issuers. We believe the increase in PEMEX's financial obligations has exposed it more to commodity price volatility, which could further weaken its after-tax key financial measures and reduce its liquidity if crude oil prices fall.

PEMEX's strong EBITDA generation (about \$60.5 million in 2007) reflects its extensive proved reserves,

competitive lifting costs, and proximity to the U.S. market. Consequently, the company's upstream operations are profitable in most pricing scenarios, although a high percentage of heavy crude oil in the production mix can exacerbate margin compression when pricing is depressed. In 2007, the company posted ratios for funds from operations (FFO) to total debt, EBITDA interest coverage, and total debt to EBITDA of 11.7%, 11.9x, and 1.7x, respectively. (These ratios consider as debt-like obligations the company's unfunded pension liabilities of about \$48 billion.)

During the past two years, PEMEX has posted more reasonable after-tax cash flow figures as a result of the use of a cash-flow proxy to determine the taxes levied on its E&P operations, coupled with its ability to credit against other duties the negative indirect taxes arising when gasoline reference prices exceed the price at the pump in Mexico. Nevertheless, we expect that taxes will remain an important burden on the company's finances. Therefore, we expect after-tax financial performance to remain weak for the rating, as evidenced by the FFO-to-total debt ratio mentioned above. Without the changes needed to moderate the issuer's growth in unfunded pension liabilities, it is unlikely that PEMEX will improve its key financial ratios significantly.

The outcome of the energy reform proposed by the government in early April 2008 and its effects on PEMEX are still uncertain. Five bills were presented to the Mexican congress. The reforms include important changes to the legal framework under which PEMEX operates, intended to increase the company's accountability, transparency, and managerial autonomy. The package also includes proposals for contracts with the private sector for refinery construction and operation, storage facilities, and pipelines. However, the government has not yet sent a sixth bill with its proposed reform to PEMEX's fiscal regime. Furthermore, opposition in congress has been intense, and the discussion period has been extended to allow for a "national debate" on the energy reform. We expect the discussion to continue until the next legislative period of September-December 2008, when congress reconvenes.

Liquidity

PEMEX's liquidity is adequate. The company has high cash balances and ample access to bank financing and domestic and international capital markets. As of December 2007, PEMEX had cash and cash equivalents of about \$15.9 billion, comparing favorably with short-term debt of \$6.6 billion. The company also has a \$2.50 billion committed revolving credit facility, currently 100% utilized. Despite being free operating cash flow positive in 2006 and 2007, the company more consistently registers negative free operating cash flow because its capital expenditures are higher than its FFO--a figure that is significantly depleted by the high amount taken by the government. This leads us to believe that PEMEX will continue to require external financing to support its investment program. If necessary, PEMEX's oil and gas reserve life of about 9.2 years provides it with flexibility to briefly defer investment in exploration during periods of depressed pricing, without immediately affecting production. PEMEX's 2008 capital expenditures will be about \$19.4 billion.

The company has received approval from the government to fund some of its capital expenditures with cash in hand. This could mean using an important portion of its cash balance, which PEMEX should be able to offset by extending the maturities of its debt.

Outlook

The stable outlook on the foreign-currency rating on PEMEX reflects our outlook on the United Mexican States. Even if some proposals of the energy reform mentioned above are approved, we don't expect PEMEX's relationship with the government to change significantly in the next two to three years, or the government's heavy involvement

in the sector or the company to reduce significantly.

The stable outlook on the local-currency rating reflects our expectations that PEMEX's current tax regime will allow it to retain more cash and that it will slow its growth in debt leverage. We are not likely to raise the local-currency rating in the medium term.

Any upgrade would require a combination of the government contributing sufficient capital to allow significant deleveraging; the government sharply reducing PEMEX's tax burden, so that the company could internally fund the bulk of its capital expenditures for maintenance and expansion; PEMEX improving its operations, particularly in reserve replacement; and a reduction in the company's growing unfunded pension liabilities. We could lower the local-currency rating if PEMEX's leverage continues to climb significantly, pension liabilities grow disproportionately, and reserve replacement trends are not improved.

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