

## Risk Factors

### ***Negative Economic, Political and Regulatory Developments in Argentina May Adversely Affect Our Domestic Operations***

*Economic conditions and government policies.* The Argentine economy has experienced significant volatility in recent decades, characterized by periods of low or negative growth and high variable levels of inflation. Inflation reached its peak towards the end of the 1980s and beginning of the 1990s. The annual inflation rate as measured by the consumer price index was approximately 388% in 1988, 4,924% in 1989 and 1,344% in 1990, and the annual inflation rate as measured by the wholesale price index was approximately 432% in 1988, 5,386% in 1989 and 798% in 1990. 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 U.S. dollar. To address these pressures, past Argentine governments implemented various plans and utilized a number of exchange rate systems during this period.

Since 1991, following the adoption of the Convertibility Law and for a period of seven years, inflation declined progressively and the Argentine economy enjoyed seven years of growth. In the last quarter of 1998, the Argentine economy was affected by an adverse change in international financial conditions, and started to show signs of stagnation, entering into a recession, causing Argentine's gross domestic product to decrease by 3.4% in 1999, 0.8% in 2000 and 4.4% in 2001.

By the end of 2001, Argentina suffered a deep social and economic deterioration accompanied by high political and economic instability. The restrictions on bank deposits withdrawals, the imposition of exchange controls, the suspension of payment of Argentina's public debt and the abrogation of the peso's one-to-one peg to the dollar (and the consequent depreciation of the peso against the dollar) resulted in a deep negative shock to the Argentine economic system, resulting in contraction of the economic activity (GDP declined 10.9% in 2002), increasing inflation (41% in the year) and high volatility of the exchange rate. The political and economic instability curtailed commercial and financial activities in Argentina and affected the country's access to international financing.

Throughout 2003, Argentina began to recover from the profound crisis that began at the end of 2001. The severe devaluation of the peso permitted the expansion of exporting activity and the decrease of imports, in an international market context of favorable pricing of raw materials. The manufacturing and construction industries have driven GDP growth of 8.7% in 2003. As a result of this recovery, inflation stabilized, at only 3.7% year-on-year in December 2003. In the currency markets, the peso appreciated relative to the U.S. dollar, in the context of the global downward trend of the U.S. dollar. Private economic forecasts for the year 2004 are optimistic. The growth outlook has improved, and in February 2004 the consensus is forecasting a 6% GDP growth for the year. The inflation rate is projected below 10%.

The uncertainties surrounding the inauguration of the new government that assumed office in May of 2003, create political risks and uncertainties for YPF's operations in Argentina. General elections took place on April 27, 2003, but no candidate obtained the minimum number of votes necessary to win the election. A subsequent run-off between Carlos Menem, who obtained 24.3% of the votes, and Nestor Kirchner, who obtained 22% of the votes, was cancelled after Mr. Carlos Menem withdrew from the presidential race. Nestor Kirchner took office on May 25, 2003 and Roberto Lavagna, the former government's lead negotiator with the IMF, was ratified as Minister of Economy. Several provincial and legislative elections took place along the second half of 2003. At the end of 2003, Kirchner's political party, the Justicialismo, maintained a majority in both houses of Congress, and held the majority of the provincial governorships.

On January 24, 2003, the International Monetary Fund (IMF) granted Argentina a US\$6.8 billion loan through a transitional agreement. In September 2003 this agreement was replaced by a three-year

Stand-By Credit Arrangement for US\$13.2 billion The loan agreement allows the IMF to perform periodic reviews to assess the level of compliance with the conditions and covenants contained in the Stand-by Credit Arrangement. The IMF has completed and approved two separate reviews, one in January 2004 and the other one in March 2004.

However, no assurance can be given that Argentina will fulfil its commitments under the IMF program, or that the IMF will approve the following evaluations. The difficulties faced by the government to complete the restructuring of Argentina's public debt may negatively affect the relationship between Argentina and the IMF. The failure by the government to successfully maintain good relations with the IMF may completely block Argentina's access to international financing, which may further complicate the economic recovery and affect the new government's ability to implement reforms required to restore economic growth and public confidence.

YPF's business and results of operations have been, and may continue to be, materially and adversely affected by economic, political and regulatory risks and developments in Argentina. In particular, in the past years the energy sector and YPF have been affected by lower sale volumes, restrictions on transferring money out of Argentina, difficulties in transferring the impact of prices of crude oil and derived products quoted in dollars to domestic prices fixed in pesos, difficulties in increasing domestic natural gas sale prices and the creation of a tax specifically targeted at the export of hydrocarbons.

Even if the growth trends and macroeconomic stability noted in 2003 continue, the energy sector and YPF will continue to face significant risks of an economic and political slowdown.

The main economic risks we face because of our operations in Argentina are the following:

- difficulties in passing through the movements in international prices of crude oil and exchange rates to domestic prices;
- difficulties in increasing local prices of natural gas for our residential customers households (see "Item 4. Information on the Company–Natural Gas and Electricity Markets and Distribution–Natural Gas Markets and Distribution.");
- higher taxes on exports of hydrocarbons;
- quantitative restrictions on natural gas exports;
- political pressure to carry out hydrocarbon import activities even if unprofitable or loss-making;
- higher taxes on domestic sales of fuel; and
- in the event that negotiations regarding Argentina's public debt do not progress positively, the possibility that a deterioration in Argentina's relations with multilateral credit institutions, such as the IMF, will impact negatively on the local capital controls, and a deterioration of the business climate.

The difficult social situation and frequent street demonstrations, may affect our normal operations particularly at wells, refineries, distribution terminals, pipelines and at YPF's administrative headquarters.

The new Argentine government still faces a wide array of formidable tasks, such as rebuilding Argentina's banking system, restructuring public debt, establishing a new regulatory framework for privatized utilities, restoring investor confidence and stimulating investment in Argentina, developing a sound medium-term budgetary policy and addressing the fundamental flaws in Argentina's long-term fiscal policies that caused the country's current economic crisis.

There can be no assurances that Argentina's government will be able to accomplish these tasks and that the Argentine economy will show a steady recovery in the foreseeable future, that the measures

announced so far will achieve their intended results, or that the political and socio-economic conditions currently prevailing in Argentina will enable the government to develop and implement other measures and policies necessary to achieve the goals of macroeconomic stabilization.

***Fluctuations in Foreign Exchange Rates, the Imposition of New Taxes and the Enactment of Exchange, Price and Export Controls in Argentina Could Adversely Affect Our Performance and Materially Affect Our Capacity to Service Our Financial Obligations.***

**Exchange Rates.** The prices at which we sell crude oil and natural gas are generally set either in U.S. dollars or by reference to U.S. dollars, while costs are incurred in both pesos and dollars, in many cases by reference to international prices. Because our cash inflows and outflows are denominated in more than one currency, any devaluation of the peso against the dollar and other hard currencies, may have a material adverse effect on our business and results of operations. In January 2002, the Congress abandoned the fixed exchange rate mechanism of the Convertibility Law, allowing the peso to float freely against the U.S. dollar. Under this new mechanism, the Central Bank is no longer obligated to maintain foreign currency reserves to back up the amount of outstanding pesos, nor is it obligated to sell or buy U.S. dollars at a certain fixed exchange rate.

Following a deep depreciation of the peso in the first half of 2002, the peso has steadily appreciated in recent months, mainly as a consequence of the current account surplus. Within the framework of the agreement with the International Monetary Fund, the Central Bank has been intervening to avoid further appreciation of the peso, by buying dollars in the exchange rate market.

No prediction of either the direction or the magnitude of future fluctuations in exchange rates can be made. In the event of a reversal of the current Argentine peso appreciation trend, additional depreciation of the peso in relation to foreign currencies could adversely affect the financial condition or results of operations of Argentine companies and the ability of Argentine companies to meet their foreign currency obligations.

**New Taxes.** As part of the Government's efforts to reduce fiscal deficit and find new sources of public revenues, new duties were imposed on exports. Since March 2002, oil and gas companies must pay a 20% tax on the proceeds from the export of crude oil, 5% tax on the proceeds from the export of oil products for a five-year period. Under the IMF agreement, the government committed to lower gradually export taxes beginning in January 2005. These duties on exports were increased on May 11, 2004, by resolutions 335/04, 336/04 and 337/04 issued by the Ministry of Economy and Production, as follows: export of crude oil, 25%, exports of butane, methane and LPG, 20% and exports of gasoline and diesel at a rate of 5%. On May 26, 2004, a new duty of 20% on exports of natural gas and LNG was imposed by Decree No. 654/04.

However, given the need to increase fiscal primary surplus and the difficulties of the government in generating additional revenues, there can be no assurances that the government will reduce or even increase or extend the duration of export taxes. In such an unstable environment, the financial results of YPF's operations in Argentina, as well as YPF's ability to meet its foreign currency obligations may be adversely affected by the changes in the Argentine tax regime.

**Exchange and Capital Controls.** From March 1991 to December 2001, the Argentine foreign exchange market was completely free of any restrictions on converting pesos into U.S. dollars. Capital controls were imposed in December 2001 and reinforced in January 2002 after the devaluation of the peso. Restrictions on transfers of funds abroad were eased in the beginning of 2003, but exporters still have to convert proceeds from their export operations into domestic currency. Pursuant to the Decree 1589/89 of the year 1989, and a new Decree (2703/2002) signed at the end of 2002, companies in the oil & gas sector believe they are partially exempted from this requirement being allowed to keep abroad up to 70% of their export proceeds. This regulation allows YPF to service its financial and other obligations denominated in U.S. dollars. In July 2002, Argentina's Attorney General issued an

opinion which would have effectively required YPF to liquidate 100% of its export receivables in Argentina. On December 5, 2002, the Central Bank stated that it would follow the Attorney General's opinion. YPF filed a lawsuit before a federal court in Argentina requesting confirmation of YPF's right to freely dispose of up to 70% of its export receivables in accordance with the provisions of Decree 1589/89. YPF obtained an injunction that prohibited the Central Bank and the Ministry of the Economy from interfering with YPF's access to foreign exchange proceeds as stipulated by the original decree. The injunction was subsequently appealed by the Central Bank and the Ministry of the Economy. On December 1, 2003 the National Administrative Court of Appeals decided that the issuance of Decree No.2703 in 2002, which allows companies in the oil & gas sector to keep abroad up to 70% of the export proceeds, rendered the injunction unnecessary. On December 15, 2003, YPF filed a motion for clarification asking the court to clarify whether the exemption was available during the period between the issuance of Decree No. 1606/01 and the issuance of Decree 2703/02. On February 6, 2004, the court of appeals dismissed YPF's motion for clarification, indicating that the Decree 2703/02 was sufficiently clear, and confirmed the lifting of the injunction that prohibited the Central Bank and the Ministry of Economy from interfering with YPF's access to foreign exchange proceeds, as described above. On February 19, 2004, YPF filed an extraordinary appeal before the Supreme Court challenging the December 1, 2003 decision of the Court of Appeals and requested the restatement of the injunction against the Central Bank and the Ministry of Economy.

**Price Controls.** Since January 2002, YPF raised the retail prices of gasoline and diesel, to reflect the effect of currency devaluation and rising international prices for crude oil and derivative products. During the second half of 2002, oil companies in Argentina signed an agreement with the government to defer in time the effect of high crude oil prices on gasoline and diesel retail prices. This agreement was extended all over 2003 and through May 2004. We cannot guarantee that the government will not put in place implicit or explicit price controls in an attempt to reduce prices and curb inflation. If YPF's domestic sales are subjected to implicit or explicit price controls, YPF's business and results of operations may be adversely affected.

**Export restrictions.** YPF is subject to the risk of exports restrictions being imposed on it. Any export restrictions imposed on YPF may adversely affect its ability to service its foreign currency obligations. Law No. 17.319 established that the Federal Executive allows Hydrocarbons exports as long as they are not required for the domestic market and they are sold at reasonable prices. In May 2002, the Argentine government, through Decree No. 867/02, declared a temporary national emergency and authorized the Secretary of Energy to establish the volumes of crude oil and LPG that must be compulsory sold in the domestic market, hence restricting the volumes of crude oil and LPG that may be exported. In March 2004, the Secretary of Energy, through Resolution 265/04 established certain restrictions on export sales of surplus natural gas that may be needed for internal consumption. Pursuant to Resolution 265/04, the Sub-Secretary of Fuels issued Regulation 27/04 which, among other things, establishes that absent an express authorization by the Government, natural gas export authorizations may not be granted for volumes exceeding natural gas exports registered during 2003. See "Item 4. Information on the Company-Regulatory Framework and Relationship with Argentine Government."

***The Argentine economy may be negatively affected by developments in other countries***

The Argentine financial and securities markets are, to varying degrees, influenced by economic and market conditions in other countries. Although economic conditions are different in each country, investor reaction to developments in one country can have significant effects on the price of the securities of issuers in other countries, including Argentina. For example, political and economic developments in December 1994 and early 1995 in Mexico, in the second half of 1997 in several Asian nations, and the Brazilian Real devaluation in January 1999 had a negative impact on the financial and securities markets in many emerging market countries, including Argentina. There can be no assurances

that the Argentine financial and securities markets will not continue to be adversely affected from time to time by events elsewhere, especially in other emerging markets.

#### ***Fluctuations in Oil and Gas Prices Affect Our Level of Capital Expenditures***

Fluctuations in the market price of oil may affect the timing and the amount of our projected capital expenditures related to exploration and development activities, which, in turn, could have a material adverse effect on our ability to replace our reserves in the future. Oil prices in Argentina reflect world market prices. World oil prices have fluctuated widely over the last ten years and are determined by global supply and demand factors over which YPF has no control. In 2003, the average international crude oil price was US\$ 31.07 per barrel, compared to US\$26.07 per barrel in 2002. In addition, our prices for domestic oil market are approximately 20% lower than international oil markets.

Natural gas market prices affect the timing and the amount of our projected capital expenditures related to gas exploration, development and distribution activities, which could have a material adverse effect on our ability to replace our gas reserves and develop our natural gas business. Current natural gas prices charged by us to natural gas distribution companies, which are set in pesos, are subject to indirect price controls. Therefore, further devaluation of the peso, not accompanied by a corresponding increase in natural gas prices, may result in our delaying capital expenditures related to the natural gas business.

#### ***We May Not Be Able to Replace Our Reserves***

The rate of production from oil and gas properties generally declines as reserves are depleted. Without successful exploration and development activities or reserve acquisitions, our proved reserves will decline as oil and gas are produced from our existing proved developed 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.

#### ***The Oil and Gas Industry is Subject to Particular Operational Risks***

Oil and gas exploration and production activities are subject to particular economic risks, some of which are beyond the control of YPF. They are subject to production, equipment and transportation risks, natural hazards and other uncertainties including those relating to the physical characteristics of an oil or natural gas field. The operations of YPF may be curtailed, delayed or cancelled as a result of weather conditions, mechanical difficulties, shortages or delays in the delivery of equipment and compliance with governmental requirements. If these risks materialize, YPF may suffer substantial losses and disruptions to its operations. Drilling may involve unprofitable efforts, not only with respect to dry wells, but also with respect to wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs are taken into account. These activities are also subject to the payment of royalties and taxation, which tend to be high compared with those payable in respect of other commercial activities.

Our operations are subject to the industry-specific operating risks include the risk of fire, explosions, blow-outs, pipe failure, abnormally pressured formations, and environmental hazards, such as oil spills, gas leaks, ruptures or discharges of toxic gases. The occurrence of these industry-specific operating risks could cause us substantial losses. Such losses may be due to any one of the following occurrences:

- injury or loss of life;
- severe damage to, or destruction of, property, natural resources and equipment;
- pollution or other environmental damage, clean-up responsibilities, regulatory investigation; and

- penalties and suspension of operations.

***YPF's Acquisition of Exploratory Acreage and Crude Oil and Natural Gas Reserves is Subject to Strong Competition***

Oil companies, including YPF, must maintain a certain level of undeveloped oil and natural gas reserves to keep their results from exploration and production activities relatively stable over time. Crude oil and natural gas production blocks are typically auctioned by governmental authorities. YPF faces intense competition in bidding for such production blocks, especially those blocks with the most attractive crude oil and natural gas reserves. Such competition may result in YPF's failure to obtain desirable production blocks or result in YPF's acquiring such blocks at a higher price.

***Governmental Regulations and Political Risks May Interrupt Our Production Activities***

Our foreign petroleum exploration, development and production activities are subject to a variety of regulatory and political risks including:

- expropriation of property and cancellation or modification of contract rights;
- political and economic uncertainties;
- foreign exchange restrictions and other risks arising out of foreign governmental sovereignty over the areas in which our operations are conducted; and
- risks of loss in countries due to civil strife, acts of war, guerilla activities and insurrection.

***We May Incur Significant Costs and Liabilities Related to Environmental and Safety Matters, Including More Stringent Enforcement of Such Laws***

Our operations are subject to a wide range of environmental laws and regulations. These laws and regulations have had and will continue to have a substantial impact on YPF's operations. YPF's 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 YPF's financial position and results of operations. In some jurisdictions, local, provincial and national authorities are moving towards more stringent enforcement of applicable laws. Argentina has adopted regulations that require our operations to meet environmental standards comparable in many respects to those in effect in the United States and in countries within the European Union. These regulations establish the general framework for environmental protection requirements, including the establishment of fines and criminal penalties for violations. We have conducted studies to determine what is likely to be required to achieve compliance with these standards and are in the process of implementing and planning various abatement and remediation projects. Future changes in laws or technology could cause an upward revision of capital expenditures and reserves for environmental remediation estimates. Changes in projected expenditures as a result of changes in the management's plans, in the Argentine or the United States laws and regulations, or in the laws and regulations of other countries in which we operate may affect our results of operations in any given year.

In addition, federal, state and local laws and regulations relating to health and environmental quality in the United States, as well as environmental laws and regulations of other countries in which YPF Holdings Inc. ("YPF Holdings") operates, affect nearly all of the operations of this subsidiary. These laws and regulations set various standards of certain aspects of health and environmental quality, provide for penalties and other liabilities for violations of such standards, and establish remedial obligations in certain circumstances. Particularly strong measures and special provisions may be appropriate or required in environmentally sensitive foreign areas of operations. Many of YPF

Holdings' United States operations, conducted through Maxus, are subject to the requirements of the following U.S. environmental laws:

- Safe Drinking Water Act;
- Clean Water Act;
- Clean Air Act;
- Resource Conservation and Recovery Act;
- Occupational Safety and Health Act;
- Comprehensive Environmental Response, Compensation and Liability Act; and
- various other federal and state laws.

These laws address a variety of environmental issues, including the limits on the discharge of waste associated with oil and gas operations, investigation and clean-up of hazardous substances, workplace safety and health, natural resource damages claims, and toxic tort liabilities. Furthermore, these laws typically require compliance with associated regulations and permits and provide for the imposition of penalties for non-compliance.

Some risk of environmental and other damage is inherent in certain of our operations and we cannot predict what environmental legislation or regulations will be enacted in the future or how existing or future laws or regulations will be administered or enforced. More stringent laws and/or more vigorous enforcement policies in the future or the development of additional information may require us to spend additional funds in order to remain compliant with the applicable laws. Such additional expenditures could be material to our results of operations.

We may also have liabilities relating to our former operations. In particular, Maxus, an indirectly wholly-owned subsidiary of YPF Holdings, has indemnified Occidental Petroleum for certain environmental liabilities associated with the former operations of Diamond Shamrock Chemicals Company. Tierra Solution Inc., also an indirectly wholly-owned subsidiary of YPF Holdings, has assumed responsibility for most of these liabilities. Maxus and Tierra Solution Inc. have taken reserves of US\$ 66.3 million relating to those liabilities based on current knowledge, including the information with respect to the number and type of claims made to date and the current state of technical and factual information about the environmental issues. It is possible that additional claims will be made, however, and additional information is likely to be developed over time about new or existing claims. As a result, Maxus and Tierra Solutions Inc. may have to incur costs that may be material, in addition to the reserves already taken.

## ITEM 4. Information on the Company

### History and Development of YPF

#### *Overview*

YPF Sociedad Anónima was created on June 2, 1977, under the laws of the Republic of Argentina as a governmental entity. On January 1, 1991, through Decree 2778/90, it became a stock corporation. YPF's term of duration expires on June 15, 2093. The address of YPF is Avenida Pte. R. Sáenz Peña 777, Buenos Aires CP.C. 1035 AAC., Argentina and its telephone number is (54-11) 4329-2000.

YPF, Argentina's largest company, is an integrated oil and gas company engaged in the exploration, development and production of oil and gas ("upstream"), the refining, marketing, transportation and distribution of oil and a wide range of petroleum products, petroleum derivatives, petrochemicals and liquid petroleum gas ("downstream") and natural gas and electricity-generation activities.

As of December 31, 2003 Repsol YPF, which holds 99.04% of YPF's shares, controls YPF. Repsol YPF is a stock corporation (sociedad anónima) duly organized and existing under the laws of the Kingdom of Spain.

Repsol YPF's principal business is the exploration, development and production of crude oil and natural gas, transportation of petroleum products, liquefied petroleum gas ("LPG") and natural gas, petroleum refining, production of a wide range of petrochemicals and marketing of petroleum products, petroleum derivatives, petrochemicals, liquefied petroleum gas and natural gas.

YPF has proved reserves, as estimated at January 1, 2004, of approximately 1,269 mmbbl of crude oil, condensate and natural gas liquids and 7,980 Bcf of natural gas. These reserves are located in Argentina (99,5% of total proved reserves in BOE), Indonesia and the United States. YPF had net sales of Ps. 21,172 in 2003, of which 83% represented sales within or from Argentina.

In Argentina, YPF produced 157 million barrels of crude oil, condensate and natural gas liquids (430 mbpd) in 2003, representing approximately 58% of the total estimated crude oil production in Argentina. YPF's natural gas production in Argentina reached 643 Bcf in 2003, and natural gas sales accounted for approximately 49% of the total estimated domestic and export sales of Argentine natural gas. YPF's domestic refining operations are conducted at three refineries with combined annual refining capacity of approximately 116 million barrels, representing approximately 51% of the total refining capacity in Argentina. YPF's retail distribution network for automotive petroleum products is comprised of approximately 1,877 YPF-branded service stations, representing approximately 29% of all service stations in Argentina.

YPF's international operations are conducted through its subsidiaries, YPF International and YPF Holdings. At December 31, 2003, YPF International had mineral rights in a production block with a net surface area of 245 km<sup>2</sup>. YPF Holdings conduct operations and activities related to exploration and production, downstream activities (through Global Companies LLC) and environmental remediation activities in United States.

Below is an organizational chart of YPF's main subsidiaries as of the date of this annual report, including their country of incorporation, and YPF's ownership interest in those subsidiaries. See Note 17(b) to the Consolidated Financial Statements and Exhibit 8.1 for a complete list of YPF's subsidiaries.