INVESTING ON ENERGY FOR THE FUTURE

Annual Report

2005

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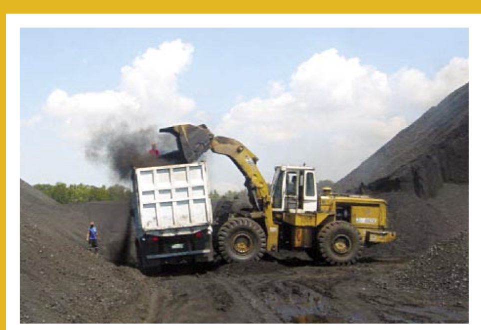


PNOC Mission

To be a world-class Philippine energy enterprise.

PNOC Vision

To develop and implement projects and programs in a financially prudent and responsible manner aimed at:

- Increasing self-sufficiency in oil, gas and other energy sources;
- Ensuring security of supply; and
- Maintaining energy price stability

PNOC Core Vaues

Professional integrity
Professional excellence
Company loyalty
Belongingness/Teamwork

Report of the Chairman and the President

We are continuously scanning the horizon for modern technologies that we can introduce to our energy sector here or for promising projects that can accelerate our journey towards genuine energy independence.

Dear Shareholders,

The enormity of the Philippine National Oil Company's responsibilities is irrefutable. PNOC is a leader. Our job is to point the energy industry toward the right direction by spearheading meaningful projects that impact the energy industry in the most constructive way. The company currently operates in a climate of skyrocketing oil prices, relentless global warming, environmental degradation, international conflict and other social, political and economic uncertainties here and abroad.

When challenges stare you in the eye, you cannot blink. Two things have kept PNOC afloat in the face of adversity – faith in our vision and the professionalism and dedication of our employees. Our vision is prosperity for our nation, through energy security, aided by the proper utilization of our indigenous energy sources. With national aspirations as our guide and inspiration, we have worked tirelessly toward this vision.

We are happy to announce that in 2005, PNOC achieved triumphs that further cemented our company's distinctive role in nation-building. Once again, PNOC has reinvented itself! It was a year of transitions for us and we have initiated changes that laid the groundwork for the path that we intend to take in the future. This is why we have chosen the theme "PNOC: Investing on Energy for the Future" for this year's annual report. As we look back on the past year, we celebrate our milestones, pay tribute to our employees for a job well done and forge ahead into the future with hope and resolve.

2005 was a landmark year. We signed a Joint Marine Seismic Undertaking (JMSU) with China National Offshore Oil Corporation (CNOOC) and Vietnam Oil and Gas Corporation (PETROVIETNAM) so we could acquire geoscientific data in select areas in the South China Sea and be able to assess their petroleum resource potential. We, likewise, signed a Service Contract for an Offshore Mindoro project with the Department of Energy and Petronas Carigali of Malaysia. Further lined up is a Joint Venture Agreement for coal development and production with Indonesia in 2006. These collaborative ventures shall provide us with yet another opportunity to work side-by-side with our Asian neighbors and learn from their experiences.

We are also making good progress with our projects on natural gas. On the home front, the Malampaya Deepwater Gas-to-Power Project remained the main source of gas of the Santa Rita, San Lorenzo and Ilijan power plants – all located in Batangas. Total natural gas off-take from the three plants combined was approximately 115.9 billion cubic feet (bcf) for 2005. In Isabela, the San Antonio Gas and Power Plant generated a total of 4,968.8 megawatt hours (MWh) of electricity and 93.8 million standard cubic feet (mmscf) of gas when it started using new control systems in September. Due attention was also given to PNOC's project on the Bataan Liquefied Natural Gas terminal (LNG) and the Bataan to Manila Natural Gas Pipeline Project (BATMAN 2) to get the ventures underway soon.

We are proud that our geothermal steam and electricity generation reached a total of 7,078.2 gigawatt hours (GWh) in 2005. By generating this much electricity, we were able to effectively avoid using an equivalent of 11.8 million barrels of fuel oil. This means we have contributed total foreign exchange savings of about US$ 579.6 million for the country (at RP's average crude oil import cost of about $49.13/barrel). We are 71% underway with the construction of transmission lines for the 40 MW Northern Negros Geothermal Project and by December, construction of the plant itself was already 31.81% in progress.

On the global front, PNOC won a geothermal drilling services contract from the Lihir Management Company of Papua New Guinea and forged an agreement related to the marketing of drilling and technical expertise in Malaysia. We hope that by keeping our geothermal businesses strong, we can keep contributing to the country's goal of being energy independent.

PNOC is currently deep into the development of our first Wind Power Project in Burgos, Ilocos Norte. Elsewhere in other regions, our Solar Home Systems are lighting the homes of many families in the countryside. Soon, our Light Emitting Diode or light-in-the-box systems shall also be distributed to un-electrified barangays in Leyte.

We achieved a milestone in the field of Clean Development Mechanism (CDM) in 2005. The World Bank, as trustee of a Netherlands Clean Development Mechanism facility, had committed to purchase the first 440,000 tons of Certified Emissions Reductions (CER's) from our Nasulo Geothermal Project. PNOC-EDC and the World Bank have already signed an Emission Reduction Purchase Agreement (ERPA) related to this groundbreaking endeavor. This collaboration is an auspicious event that further strengthens the Philippines's involvement with CDM and encourages the development of even more environment-oriented projects in the country. As always, we endeavor to keep abreast of global developments that advance worthy causes like CDM. It is one way for us to remain responsive to the call of the times.

In 2005, PNOC-EDC became the recipient of the prestigious International Association of Business Communities' (IABC) Gold Quill Award for its Corporate Social Responsibility (CSR) brochure entitled "Building Lives, Strengthening Communities". This is an honor we wish to share with you. This award, given annually to honor excellence in the field of professional communications, is important to us because we are not just an energy company. We are also an organization with a conscience. Likewise, our Bacman Geothermal Production Field (BGPF) officially became an Eco-tourism destination – a distinction bestowed by the Department of Tourism (DOT). This was the first time a geothermal plant in the country has received such a citation.

In the field of rural electrification, 74 barangays in Leyte, Southern Leyte, Negros and Cotabato benefited from the completion of electrification works in their areas. Furthermore, our commitment to social responsibility remained steadfast as we maintained tree plantation sites, spearheaded livelihood projects for the people who live at our sites, lead reforestation efforts, conducted educational campaigns and helped establish schools. We also devoted our efforts working on our Persistent Organic Pollutants (POPs) Project to honor our commitment to the Vienna Convention and the United Nations Development Programme.

In 2005, our Energy Supply Base was granted a Certificate of Registration and permit to operate as a private commercial port by the Philippine Ports Authority (PPA). We acquired the MT Yong Jie No. 28 and have re-christened it MT. Dr. Jose Rizal. PNOC also worked hand in hand with the government in a socialized housing scheme through GMA's AboKayang PaBAHAY at PaLUPA program.

For now, we are confident that we are poised well for the future. We are continuously scanning the horizon for modern technologies that we can introduce to our energy sector here or for promising projects that can accelerate our journey towards genuine energy independence.

PNOC has, through the years, swam with the tide and rolled with the punches, but we have always prevailed. Now considered an institution in the industry, PNOC is a company that is living its life and crafting its place in energy history – still vibrant, still energetic and truly an asset to the country's future.

EDUARDO V. MAÑALAC
President & Chief Executive Officer

RAPHAEL P. M. LOTILLA
Secretary, Department of Energy


MALAMPAYA

Company Profile

In 2005, PNOC opted to take a different path. Instead of diversifying, we chose to pour our resources and our people's talents into developing our core businesses.

The Philippine National Oil Company (PNOC) has a long history of evolving with the times. Since its birth, it has already undergone numerous transitions, been under the helm of different presidents and engaged in various undertakings. All through these years, we have managed to rise to the challenges of the times and we have been triumphant. PNOC's journey had not been without pains and uncertainties, though. We had to contend with global challenges, economic instability, political upheavals and a significant reorientation of our mission and purpose as they relate to national goals. But trials have made us stronger. They have made PNOC into what it is today.

In 2005, PNOC opted to take a different path. Instead of diversifying, we chose to pour our resources and our people's talents into developing our core businesses. It was a strategic decision that we took and it paid off. We directed our exploration arm to concentrate on Oil and Gas with very favorable results. In fact, our business with Malampaya remains one of the most successful in our portfolio. The same can be said of our businesses involving Geothermal energy and coal trading.

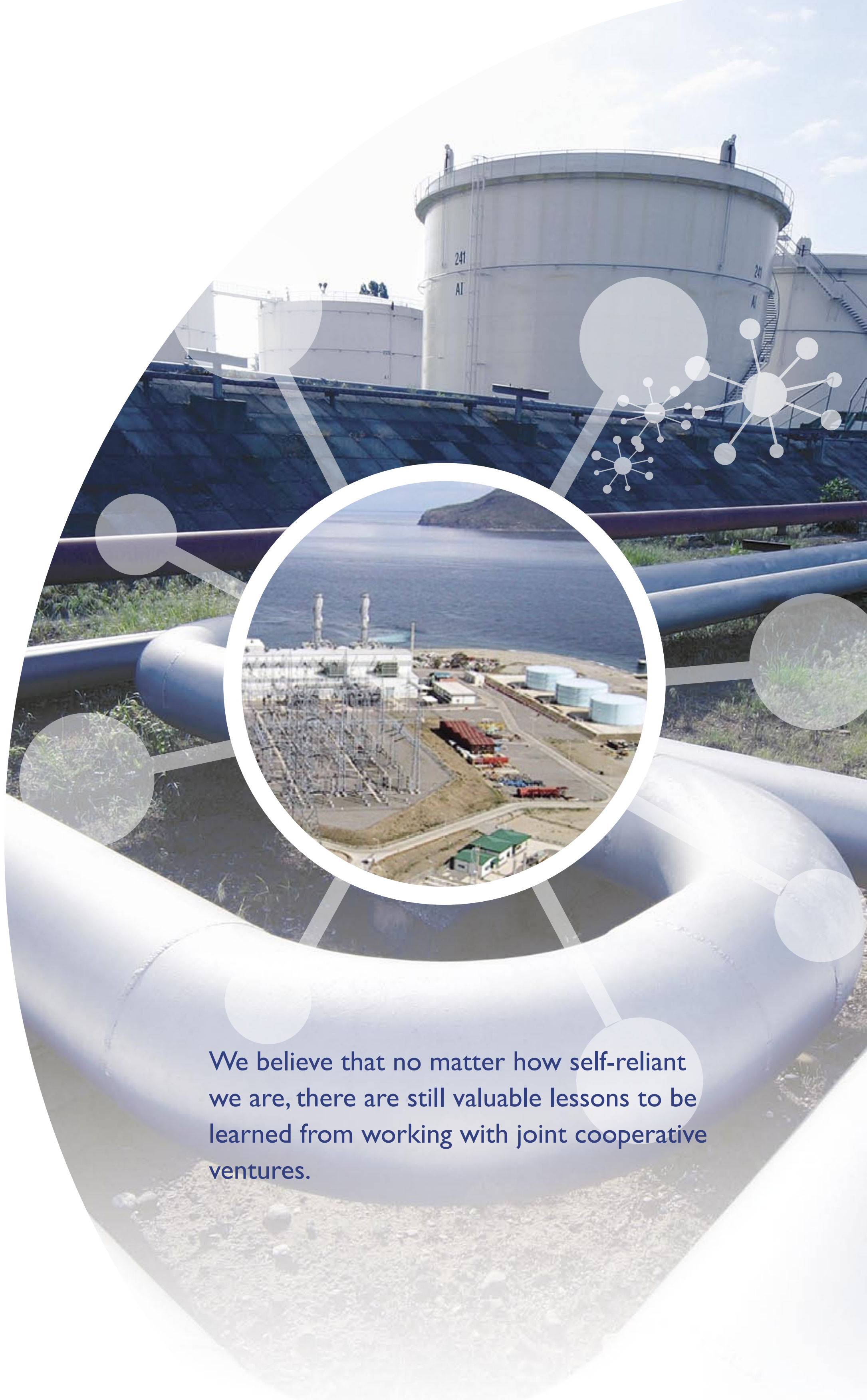
We pride ourselves in being a company with a conscience and we take our corporate social responsibilities to heart. As we have, time and again, done in the past, we provided host communities with livelihood possibilities out of a deep and sincere sense of duty. We are grateful to them for their openness and acceptance and it is just fair that we give them back something in return. Most of all, we wish to be one with them in their struggles and joys as they endeavor to make a living for their families.

PNOC is aware that corporate social responsibility extends beyond the social aspect of it. It is a concept that pertains to environmental concerns too. It is easy to get lost in the rush for progress and forget about nature and our surroundings. We are cautious that our projects do not in any way impact the environment negatively. In fact, a few years ago, we started seriously pursuing projects that directly promote environmental protection and awareness. We owe it to future generations to respect and care for the environment so that they, too, may enjoy its gifts.

All in all, 2005 had been a year of changes and challenges but we are certain, we have moved one year closer to realizing our dreams for our people and our country – lasting progress through the wise and efficient use of energy. This shall be our legacy.

Oil and Gas

We are constantly on the lookout for ways to collaborate with foreign and local institutions. We intend to establish long-term business relationships, as we believe there is much that we can share with and learn from others.



We believe that no matter how self-reliant we are, there are still valuable lessons to be learned from working with joint cooperative ventures.

We Tap into Nature's Reserves

Faithful to its original mandate, PNOC's exploration arm, PNOC Exploration Corporation (PNOC EC), concentrated on oil and gas exploration with remarkable success. The company's thrust of focusing on oil and gas, among others, allowed it to devote its people's talents on one of its core businesses resulting in technical triumphs for the company and for us who are the people behind it. We are certain our investments in oil and gas, especially in Malampaya, will bring immense benefits to the country in the years to come.

The Philippine Government, in its bid to liberate the county from the uncertainties of relying solely on fossil fuels and to help address the current fluctuations in world crude oil prices, mandated the Department of Energy (DOE), through PNOC and its subsidiaries, to spearhead the development and production of the oil reserves in the Malampaya field in offshore Northwest Palawan, in what is referred to as the Camago-Malampaya Oil Leg (CMOL) Project.

The Malampaya Deepwater Gas-to-Power Project remains one of PNOC EC's most successful ventures. More popularly known only by the single name "Malampaya", this project was the source of gas fuel of three (3) power plants in Batangas, namely: Santa Rita, San Lorenzo and Ilijan. Together, the three plants benefited from an equivalent of 115.9 billion cubic feet (bcf) of natural gas in 2005.

Condensate production from the Malampaya project yielded approximately 5.6 million barrels and condensate was shipped to buyers in Singapore and China during the year. Production was slightly lower than target but significant, nevertheless. We are certain Malampaya shall remain a reliable source of natural gas for many years to come.

In March 2005, the Privatization Council approved the sale of 49% of PNOC EC's 10% participating interest in the Malampaya Project. Subsequently, because of poor market conditions, we did not push through with the sale so PNOC EC retains complete control of its 10% stake. We should only get the best deal possible for the company. It is our duty to our company and stakeholders to be wise and prudent with our decisions, knowing that what and how we decide would have long-term consequences.

In 2005, our 3 megawatt San Antonio Gas and Power Plant generated a total of 4,968.8 megawatt hours (MWh) of electricity. In terms of gas production, a total of 93.8 million standard cubic feet (mmscf) was produced. The San Antonio Plant is the first natural gas-fired power plant in the Philippines and it has consistently delivered through the years – providing the gas needs of at least 10,000 households in the municipalities of Echague, Jones, San Agustin and part of Santiago City, Isabela. San Antonio's steady and reliable performance is something that we are truly proud of.

We, at PNOC, believe that no matter how self-reliant we are, there are still valuable lessons that we can learn from working with others in cooperative ventures. We are constantly on the lookout for ways to collaborate with foreign and local institutions. We intend to establish long-term business relationships, as we believe there is much that we can share with and learn from others.

Our exploration efforts continue. In 2005, we worked jointly with countries like China, Vietnam and Malaysia on a number of ventures by laying the groundwork for several projects. PNOC EC, China National Offshore Oil Corporation (CNOOC) and Vietnam Oil and Gas Corporation (PETROVIETNAM) signed a Joint Marine Seismic Undertaking (JMSU) for the acquisition of geo-scientific data to assess the potential of a number of areas in the South China Sea. We also completed surveys for the Ragay Gulf project, signed the Offshore Mindoro Service Contract with DOE and PETRONAS of Malaysia and acquired the Service Contracts for Northwest Palawan.

For years, PNOC envisioned constructing a natural gas pipeline to run from Batangas to Manila. Fondly called BATMAN 1 within the PNOC Family, this intended pipeline will boost ready supply of natural gas within Region IV and help accelerate the development of the natural gas industry. But because we perceived certain uncertainties in the commercial aspects of the Batangas to Manila Natural Gas Pipeline Project (BATMAN 1), we, together with DOE decided to put the project on hold. We have chosen, instead, to give priority to our project on the Bataan Liquified Natural Gas (LNG) terminal and the Bataan to Manila Natural Gas Pipeline Project (BATMAN 2).

Our natures are a lot like oil, mix us with anything else, and we strive to swim on top.

- Francis Beaumont

Geothermal Energy

Geothermal energy is a geologic and geographic gift. This is why we continuously keep our geothermal industry alive and strong.

Our geothermal resources are the country's pride and our superiority in this area is known all over the world.

We Build on our Strengths

There is a reason why the geothermal energy industry in the Philippines is second in the world, next only to the USA's. Our geothermal resources are the country's pride and our superiority in this area, known all over the world. Responsible for the country's success with geothermal energy is PNOC.

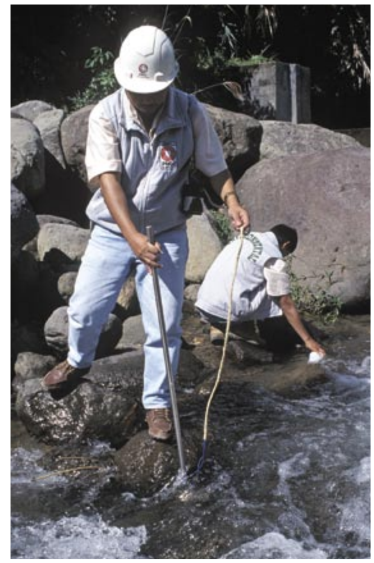
The PNOC Energy Development Corporation (EDC) further solidified its leadership in the field of geothermal energy in the Philippines and abroad as it remained a reliable partner of the country in facing the challenges of the new millemium. With a considerable aggregate capacity of 1,148 megawatts (MW), PNOC EDC's nine geothermal plants accounted for 60.3% of the country's total installed geothermal capacity of 1,905.4 MW in 2005. Having supplied 7.4% of the country's 15,576 MW installed power-generating capacity, PNOC EDC remains at the top of its game. Based on the most up-to-date estimates, the company was responsible for 12.9% of the total power generated for 2005. Coming from just one company, this is a significant contribution.

The year 2005 saw PNOC EDC's generation of geothermal steam/ electricity reach a total of 7,078.2 gigawatt hours (GWh). If we are to explain this amount in terms of oil displaced by the use of geothermal energy, it amounts to an equivalent of 11.8 million barrels of fuel oil. The figure gains even more significance because the reduction in oil imports made possible by geothermal energy production brought the country a total of about US$ 579.6 million in foreign exchange savings (at RP's average crude oil import cost of about $49.13/barrel).

PNOC does not rest on its laurels. In 2005, PNOC EDC successfully drilled a total of 8 wells. Moreover, in the same year, transmission lines for our 40 MW Northern Negros Geothermal Project were 71% complete. We marked our progress with the Northern Negros Project with a concrete laying ceremony at the plant and by December 31, 2005, construction was already 31.81% underway. This shall increase our geothermal capacity even more and enable us to bring electricity to the homes of more users.

PNOC EDC continued to make its presence felt in the international scene when the Lihir Management Company of Papua New Guinea awarded it a geothermal drilling services contract in April 2005. We also forged a Training Agreement with SJA Trade and Services for the marketing of drilling and technical expertise in Malaysia. Our association with Papua New Guinea and Malaysia shall give us the opportunity to share our expertise and at the same time learn from the experiences of others. These valuable ties shall keep us attuned to recent trends and developments in the field.

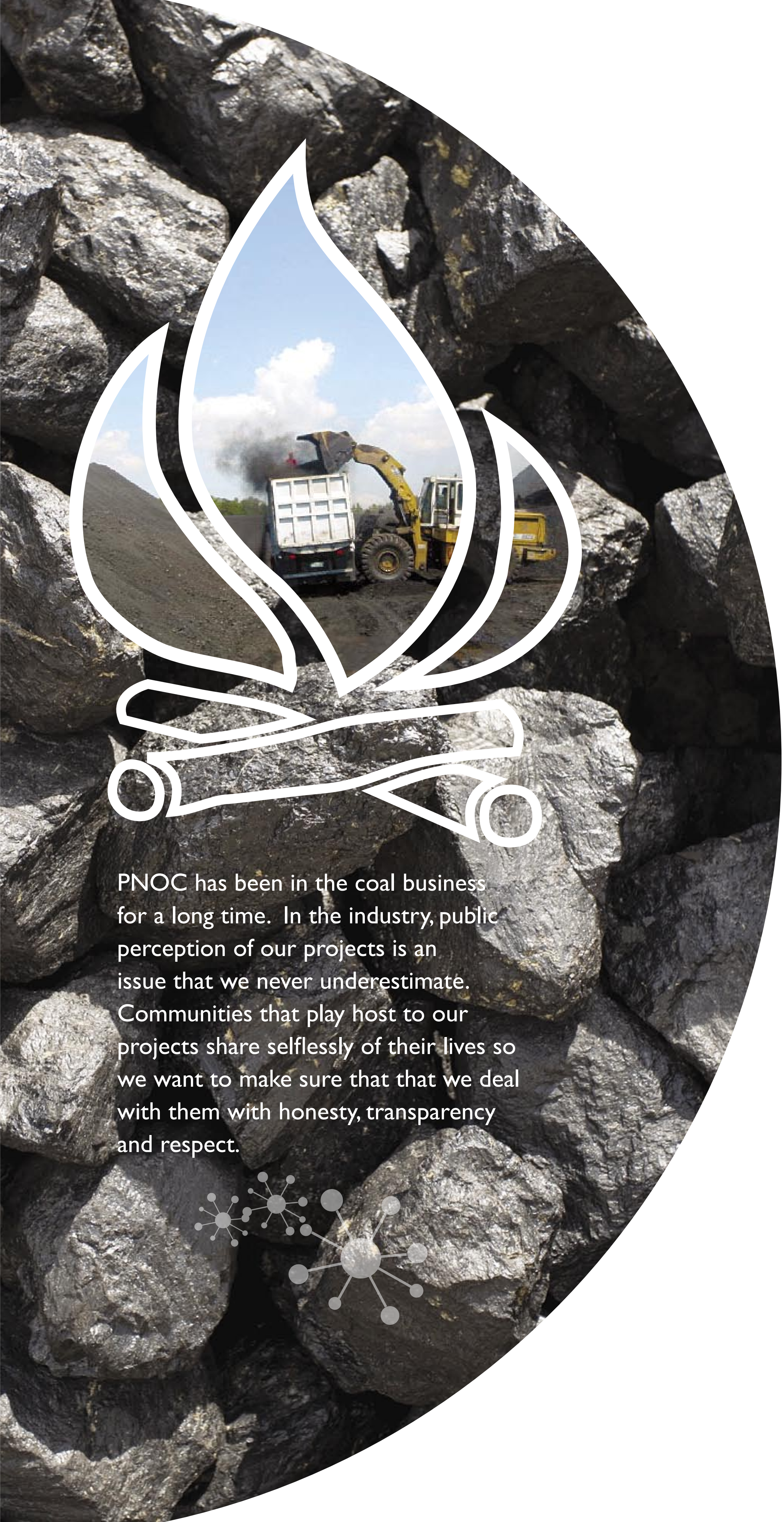
Geothermal energy is a geologic and geographic gift. This is why we continuously keep our geothermal industry alive and strong. It is a wise investment that will pay us tremendous dividends in the future.



Love is a power, like money, or steam or electricity. It is valueless unless you can give something else by means of it.

- Anne Morrow Lindbergh

Coal



PNOC has been in the coal business for a long time. In the industry, public perception of our projects is an issue that we never underestimate. Communities that play host to our projects share selflessly of their lives so we want to make sure that that we deal with them with honesty, transparency and respect.

We have had our share of difficulties in this business but we have finally found our niche in the Philippine coal industry - that of coal producer and supplier.

We Provide Alternatives

One of PNOC's earliest undertakings was related to coal and its coal business has been one of its most enduring endeavors. We have had our share of difficulties in this business but we have finally found our niche in the Philippine coal industry - that of coal producer and supplier.

PNOC has been in the coal business for a long time. In the industry, public perception of our projects is an issue that we never underestimate. Communities that play host to our projects are consulted, informed and educated about our undertakings through information and education campaigns, coordination meetings, house-to-house campaigns, barangay assemblies, focus group discussions, medical missions and technical trainings.

In April and May of 2005, PNOC and Maunsell Philippines, Inc. (MPI) conducted perception surveys at different barangays in Isabela for the Integrated Coal Minemouth Power Project. The response of most barangays surveyed was favorable, indicating acceptance of our project.

Other projects in our pipeline include a possible joint venture for the development and production of coal with the Purta Asyano Mutiara Timur of Indonesia and a project in Surigao del Sur. In the meantime, coal production from the already-existing Little Baguio (ILB), Shaft 3, and small-scale miners reached 136.3 thousand metric tons (MT).

Because of the prohibitive prices of imported coal, direct coal sales in 2005 dipped 20% lower from last year's sales of 752.8 MT. Moreover, the cement market in the country had been a bit sluggish so demand was not too high. But we remained a major supplier of coal to the Philippine cement industry and the Naga Power Plant in Cebu. With our continuing efforts and new partnerships we are forging, we shall be able to continuously satisfy the coal demands of the cement industry and power plants in the Philippines in the years to come.

We also managed to maintain our business in Integrated Services like discharging foreign and local coal shipments, stockpiling, screening, blending and hauling of coal to cement plants in the Philippines.

Despite its outdated image, coal generates half of our electricity, far more than any other source. Demand keeps rising, thanks in part to our appetite for new electronic gadgets and appliances; with nuclear power on hold and natural gas supplies tightening, coal's importance is only going to increase.

Jeff Goodell
Author, Big Coal

If we can stay awake when our lives are changing, secrets will be revealed to us--secrets about ourselves, about the nature of life, and about the eternal source of happiness and peace that is always available, always renewable, already within us.

- Elizabeth Lesser

Renewable Energy Barangay Electrification

We Expand our Horizons

PNOC is aware that it is not possible for the country to ceaselessly rely on oil because the world's entire oil supply would be used up someday. There are other sources of energy which, if developed properly, would bring genuine energy security to the country. But alternative or new and renewable energy sources take time and huge investments to develop. There is a need, therefore, to look at alternative energy projects as investments, not expenses. We have to be bold and willing to take some risks so we can show the way to real energy independence.

PNOC remained dedicated to bringing the country its much-awaited 30 MW Wind Power Project in Burgos, Ilocos Norte. We worked on a re-validation study in close coordination with Japan Bank for International Cooperation (JBIC) as we plan to redefine the scope of our project from 40 MW to 30 MW because this seems most sustainable for the future.

Our commitment to total electrification goes beyond mere promises. The company strives hard to make electricity available to as many households as possible in the country's outlying areas. In 2005, we successfully completed works in 74 barangays in Leyte, Southern Leyte, Negros and Cotabato to prime them for commercial electrification under PNOC's Rural Electrification Program.

In the field of Solar Energy, our Solar Home Systems (SHS) Distribution Project is still ongoing, with 4,977 units so far installed in 2005. This brings total installation to 8,944 units since the project started in 2001.

PNOC EDC's Light Emitting Diode (LED) Project carried on in 2005. The company turned over 1,000 units of light-in-the-box system for installation in remote and un-electrified barangays in Leyte. It also conducted training sessions on how to install, operate and maintain an LED Solar Light-in-the-Box system to the municipal staff of the cities of Silay and Bacolod. We are very happy that in 2005, the design of the new electronic switch for LED streetlights, as well as two LED flashlight prototypes, were completed.

Other Businesses

We are a Focused yet Flexible Enterprise

In keeping with PNOC's tradition of reliability and excellence, our Energy Supply Base (ESB) in Mabini, Batangas continued to serve the docking, storage and warehousing needs of various oil and energy-related companies.

Our services are not exclusive to the energy sector. Last year, the Philippine Ports Authority (PPA) granted us a Certificate of Registration and permit to operate as a private commercial port. The permit is co-terminus with the 25-year foreshore lease agreement of ESB with the Department of Environment and Natural Resources (DENR). We also entered into a 25-year long-term lease contract with Zamboanga Development and Management Corporation (ZDMC) for a one-hectare land area for Grains Bulkhandling, Storage and Jetty Facilities - the first in Southern Luzon to achieve a Sustainable Logistics Development Program for the country.

All of us need assistance. Those who sustain others themselves want to be sustained.
- Maurice Hulst

Social Responsibility

There is another way through which we have been able to help our host communities. Because of the presence of power plants in their areas, royalty payments are remitted to them and these payments are used to subsidize power rates and finance development projects in their respective areas.

PNOC believes that progress should not be achieved at the expense of the environment.

We Take Social Responsibility to Heart

Despite its successes in the field of energy exploration and development, PNOC remains unwavering in its commitment to the promotion of sustainable development.

The principles of environmental management and protection and socio-economic upliftment for our host communities underlie all our projects and activities. The company believes that progress should not be achieved at the expense of the environment. We owe it to future generations of Filipinos to keep the environment protected so they, too, may benefit from its gifts. In the same way, it is our human and moral duty to help our less fortunate brothers in our sites in any manner we can. This way, we can concretely demonstrate that we are grateful to them and genuinely concerned about their plight.

In line with President Gloria Macapagal-Arroyo's pro-poor thrust, PNOC had undertaken a variety of activities to advance the socioeconomic welfare of its host communities over and above its major programs of environmental protection and preservation. The company continued to maintain order and organize activities for the residents in the vicinities of our various project sites.

A number of our sites benefited from medical missions and tree planting activities, as well as, access to loans for cooperatives for various livelihood projects.

At our geothermal sites, we continued carrying out regular monitoring activities of river, air and noise quality. We are very happy that we have been able to comply with government environmental standards. We also helped organize multi-sectoral monitoring teams in our sites to ensure our compliance with DENR standards.

We are pleased to announce that in 2005, we bred a total of 755,542 seedlings in different nurseries. These shall be used in the establishment of new plantations and the maintenance of existing ones. To further help the communities where our projects are located, we provided local employment for the maintenance of plants and nurseries. This scheme provided upland farmers with alternative means of livelihood. Also, through this system that we adopted, we were able to minimize, if not eliminate, kaingin-making/illegal tree cutting activities in these areas.

One of our foremost concerns at our sites is crime prevention. In order to preserve peace and order, our law enforcement representatives performed forest patrols and apprehensions, confiscated illegally-cut logs and filed cases against violators especially within the reservation. In 2005, our routine patrols resulted in the confiscation of illegally-logged timber. We also successfully halted a number of "kaingin"-related incidents. There is still so much to be done but we are determined and consistently committed to keeping our sites safe.

For 2005, around 62 associations that we monitored benefited from the different programs implemented. An estimated 2,798 households became beneficiaries of these schemes. We awarded contracts on reforestation and social forestry projects to the associations/cooperatives to provide them with employment opportunities and alleviate their plight. We also conducted 16 meetings/trainings/development programs on social development, financial management and technical skills development. The training activities were conducted to organize/maintain 1,301 old and 1,497 new livelihood projects in various geothermal sites.

As a testament to PNOC's commitment to its Corporate Social Responsibility (CSR) program, we, together with the Department of Education (DepEd), Local Government Units (LGUs) and Parents Teachers Community Association (PTCA) signed a Memorandum of Agreement (MOA) on May 2005 for the establishment of Schools for Excellence. In August 2006, we proudly inaugurated the program with the opening of two (2) schools in Ormoc and one (1) school in Kananga.

There is another way through which we have been able to help our host communities. Because of the presence of power plants in their areas, royalty payments are remitted to them and these payments are used to subsidize power rates and finance development projects in their respective areas. For 2005, actual royalty payments to DOE and LGUs amounted to P415.59 million.

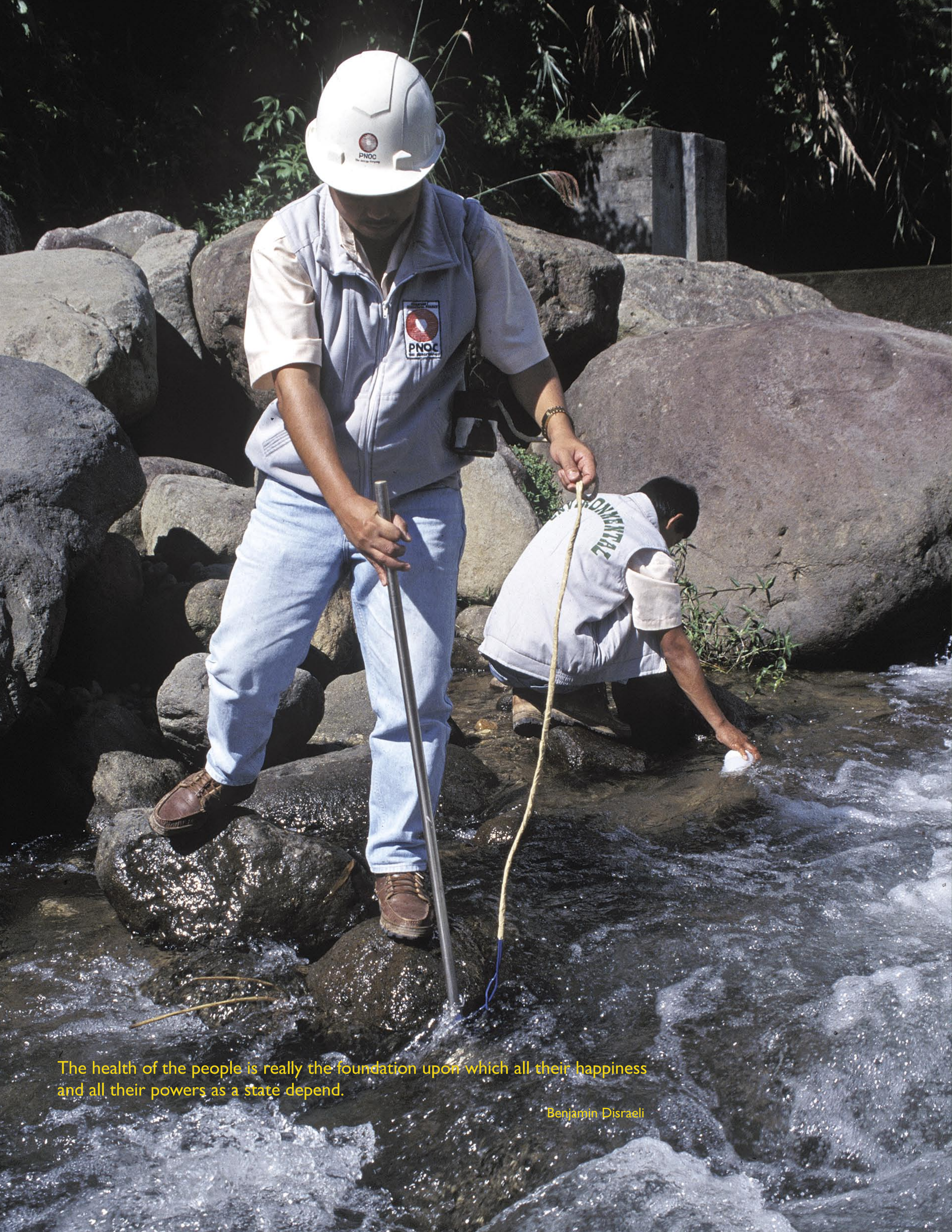
The company has regularly remitted royalty payments to the national and local government, provided sources of livelihood for its host communities, promoted environmental protection and actively participated in the government's Accelerated Barangay Electrification Program. The year 2005 was no exception for PNOC.

The Department of Tourism (DOT) formally acknowledged Bacman Geothermal Production Field (BGPF) – as an Eco-tourism Destination, making it the first-ever geothermal facility in the country to be bestowed with such an honor.

Our efforts were further recognized when we were awarded the Gold Quill Award for our Corporate Social Responsibility brochure entitled "Building Lives, Strengthening Communities". This award is given annually by the International Association of Business Communities (IABC) to honor achievements in professional communications in the country.

Our responsibility as privileged human beings is to payback for the opportunities we received.

- Kathryn Anastos



The health of the people is really the foundation upon which all their happiness and all their powers as a state depend.

Benjamin Disraeli

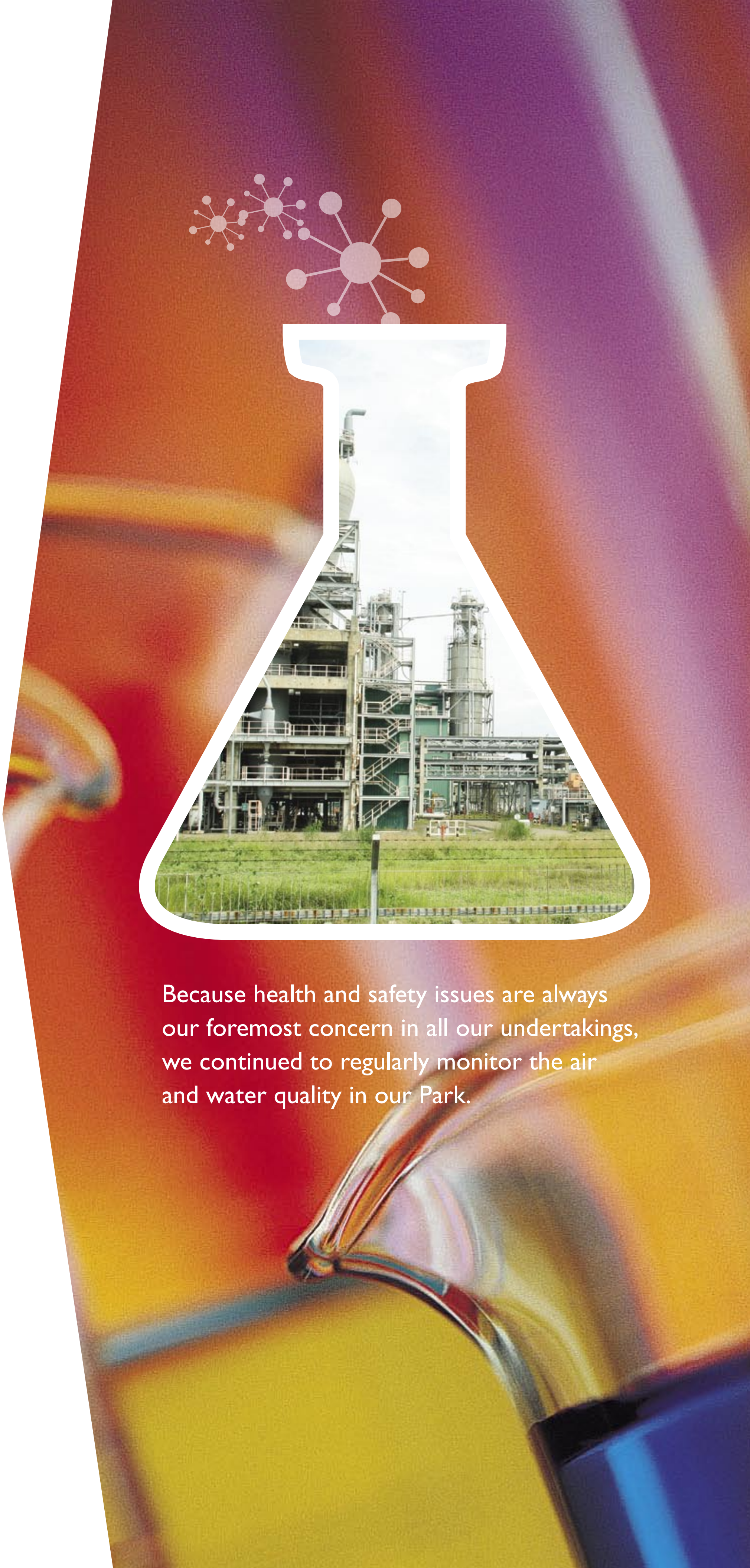
Environment

We are One with the World on the Environment

PNOC is committed to the preservation of the environment because we believe that gross disrespect of Mother Nature comes at a price.

Currently, there is a system that revolutionizes the way countries deal with environment issues – the Clean Development Mechanism (CDM). CDM allows certain countries to implement project activities that reduce emissions in other countries in return for Certified Emissions Reductions (CERs). These CERs can be used by countries implementing the projects to help meet their emissions targets as prescribed by the Kyoto Protocol. The cost of limiting emissions differs from region to region but the benefit for the atmosphere does not vary.

CDM, although more widely popular globally, is still quite in its early stages of utilization here in the Philippines. The country is catching up, though. PNOC has entered the game, with confidence and purpose. PNOC EDC and the World Bank signed the first-ever Emissions Reduction Purchase Agreement (ERPA) for a geothermal power plant in the Philippines on December 9, 2005 for the Nasulo Project, making PNOC one of the CDM pioneers in the Philippines. With this, the World Bank committed itself to purchasing the first 440,000 tons of CERs to be generated by the project. This is in itself a milestone, not only for PNOC but for the country as well. Our participation in this endeavor will give us the opportunity to honor and strengthen our commitment to the vision of the Kyoto Protocol and to participate in a noble undertaking to help halt the escalation of global warming. With PNOC on board the CDM wagon, we can motivate other institutions in the country to mount CDM projects so they too can benefit financially from CDM while helping preserve the environment.



Because health and safety issues are always our foremost concern in all our undertakings, we continued to regularly monitor the air and water quality in our Park.

Petrochemicals

We are Committed to National and Global Initiatives

When the huge tract of land that is now the Petrochemical Park in Limay, Bataan first came under PNOC's stewardship, a petrochemical park was just a dream. Now, this land is a thriving petrochemical industrial zone.

PNOC has a sprawling petrochemical park in Limay, Bataan and in order to promote safety and keep the park production-ready and in top condition, we conduct maintenance activities on a regular basis. In 2005, we undertook maintenance activities and upgraded the park's existing facilities such as firewater systems, lighting systems and jetty and perimeter-fenced areas for our locators. We, likewise, conducted on-site development activities and prepared designs and estimates for the construction of additional structures in the Park.

We continued implementing our health, safety, security and environment programs and we are happy to announce that in July 2005, the Philippine Ports Authority (PPA)/Philippine Department of Transportation and Communications Office for Transportation Security (DOTC-OTS) declared our port facility as International Ship and Port Security Code (ISPS)-compliant. In the spirit of transparency, we consulted with our locators for our Response Plan. We also conducted an Emergency Response Program for security people and fire-fighting medical rescue training sessions for our locators.

Because health and safety issues are always our foremost concern in all our undertakings, we continued to regularly monitor the air and water quality in our Park. We even conducted tree-planting activities. In fact, we have already planted 3,000 trees in different areas in the Park. We are happy to announce that results of tests show that effluent samples of locators and ambient air at the Park are all within DENR standards.

Our Petrochemical Park sits on a huge tract of land and because we have many locators, property issues sometimes become a problem. In 2005, we worked on the settlement of issues affecting the various properties in the Park. We conducted ocular inspections and surveys and brokered negotiations so the parties concerned could settle property matters amicably. Also, based on available documents, we conducted a table survey on inventory and reconciliation of Transfer Certificates of Title (TCTs) versus location maps. The survey will be finalized when an actual survey takes place.

As for our community/social development program, we, together with the locators, awarded a P50,000 loan to Kaizen Multi-Purpose Cooperative for a fish and processing livelihood project.

Because PNOC is a signatory to the Vienna Convention and in fulfillment of PNOC's commitment to the United Nations Development Programme (UNDP), we particularly concentrated on the development of our "Persistent Organic Pollutants" (POPs) Project, through the efforts of the PNOC Alternative Fuels Corporation (PAFC), in 2005. We, together with our Board, approved the creation of a Project Monitoring Office (PMO), as well as, financing arrangements for the project.

We have already, through the Hazardous Waste Management Section of the Environmental Management Bureau (EMB), submitted the necessary documents on site selection, as well as, the business plan, Terms of Reference for technology selection and the Environmental Impact Assessment (EIA) processes to UNIDO in March 2005. We are happy to announce that the Global Environment Facility (GEF) has already approved PNOC's Project Document in principle. Likewise, GEF has already forwarded its comments to UNDP.

The MOA between PNOC and DENR has already been revised and endorsed to DENR. We have also conducted validation activities for our stockpile inventory.

The POPs project is moving smoothly so far. We are truly looking forward to its realization, as this gives us the opportunity to honor our commitment to UNDP's and the Vienna Convention's noble cause of preserving the environment. This also gives us a chance to be one with the rest of the world by being a participant to a global mission. Our small contribution to the thrust of the Vienna Convention will go a long way and will benefit many people long after we have all gone.

Effective leadership is putting first things first. Effective management is discipline, carrying it out.

- Stephen Covey

Shipping and Transport

We Believe Mobility is Freedom

One of PNOC's most enduring businesses is it's petroleum shipping and transport business. Transportation is necessary as it allows movement of resources to people and industries that need them most.

In early 2000, the PNOC Shipping and Transport Corporation (PSTC) decided that to maintain our strength in petroleum transport, we should modernize our shipping and transport business. Modernization of our fleet and services that started in 2003 were carried over to 2005, further improving PNOC's current and future position in the tanker industry.

We started the first quarter of 2005 on a positive note with the acquisition of the MT Yong Jie No.28 - now the youngest tanker vessel in the Philippines with a 25,600-barrel capacity. After retrofitting it, we re-christened the vessel MT Dr. Jose P. Rizal. With Petron Corporation as the charterer, his launching voyage started on May 8, 2005.

A contract extension was granted for MT M. Malvar on Consecutive Voyage Charter Party (CVCP). MT Gomburza was on spot CVCP but was able to get a long term Time Charter (TC) with Delsan Corporation towards the end of 2005. The TC duration will be up to the end of 2006. The latter vessel, although dry-docked last June 2005 was back in operation in July 2005. MT Gomburza will be a tanker hauling crude oil from the hilo drill Nido Oil Field in Palawan to the Shell Tabangao Refinery.

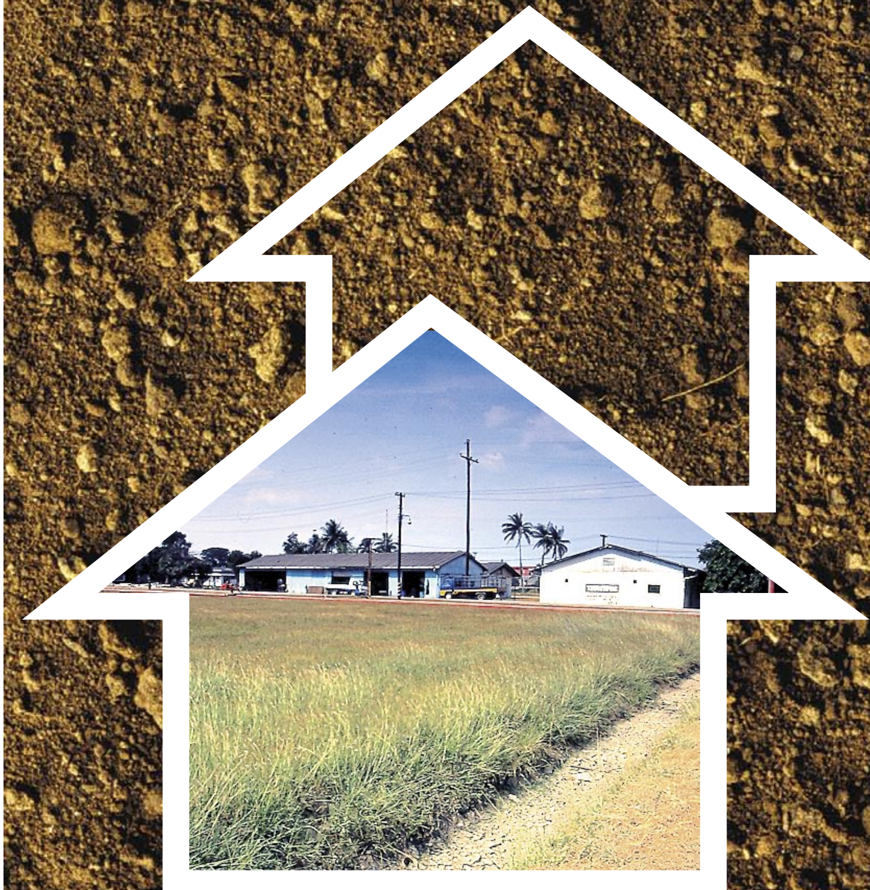
The vessels' performance is consistent with last year's performance, completing a total of 176 voyages compared to 177 in 2004. Together, all vessels were able to load 639,233 thousand liters of petroleum cargo and navigated a total of 167,364 miles. Though in real terms, total cargo load decreased from 2004 figures, in nominal terms total revenues improved by 12% from ₱356 million in 2004 to ₱399 million in 2005 – the revenue increase brought about by the higher prices of services prevailing in 2005. Average vessel utilization was posted at 80.64%.

In accordance with Government's Austerity Measures (A.O. 103), we implemented saving and conservation measures in the company. We devoted our resources to activities that we deemed vital for our company operations. One of these activities is employee development. We managed to conduct trainings and seminars for our people to strengthen employee competence and efficiency.

Despite the political upheavals of the 20th century, world trade continued not only to grow but also to accelerate. By the beginning of the 21st century, the prosperity of millions of people - entire countries, in fact - depends on markets that lie thousands of miles away, often on the other side of the world. Their ability to supply these markets depends primarily on ships and the sea.

- Ocean Atlas

MT Gomburza will be hauling crude oil from the Philodrill Nido Oil Field in Palawan to the Shell Tabangao Refinery.



Our activities gain more meaning when we do it in the context of where the country wants to go and when we do it in partnership with the government.

Estate Management

We are a Partner of Government

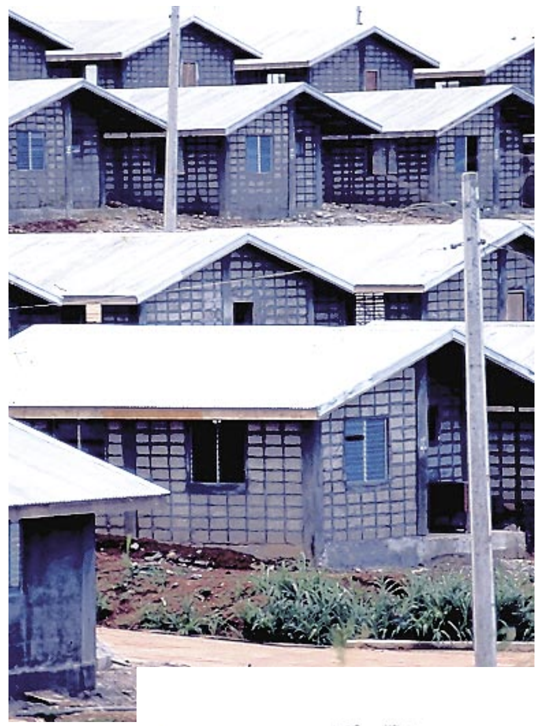
Our activities gain more meaning when we do it in the context of national aspirations and we gain more purpose when we perform our responsibilities in partnership with the government. As a Third World country with a huge population, one of the biggest needs our people is land. Land is important because it keeps people rooted and provides them with a base from where they can perform their unique roles in society.

The PNOC Development and Management Corporation (PDMC) has provided the Municipality of Rosario with informal dweller solutions for four straight years and transformed slum colonies into model communities with dignity. By 2005, PNOC had already awarded titles and certificates of occupancy to 2,563 tenants (out of 3,438 informal dwellers) through a socialized housing scheme designed to make housing affordable to informal occupants through the GMA AbotKayang PaBAHAY at PaLUPA.

Because of the solutions we have undertaken to help solve a 20-year old problem involving informal dwellers, our Rosario properties have increased in worth from an appraised value of P990 million in 2002 to P1.49 billion in 2005. That is a significant 51% appreciation in value during a period of slow growth in the industry.

El Pueblo Manila is a condominium housing community. With PDMC as Project Manager, El Pueblo starts construction of its first cluster of buildings in the second quarter of 2006. The housing complex is complete with amenities for employees of the Department of Energy and its attached agencies, PNOC and Subsidiaries, and other government employees.

Our PDMC subsidiary also undertook company downsizing. Now a leaner organization with an employee complement of 19 (from a complement of 52 in 2005), PDMC is now more cost-efficient. The current set-up is also more appropriate for it as a real estate company.



A candle loses nothing by lighting another candle.

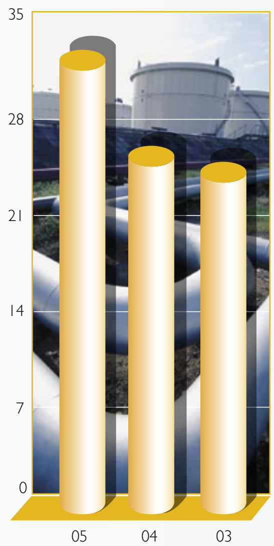
- Fr. James Keller

3-Year Financial Highlights

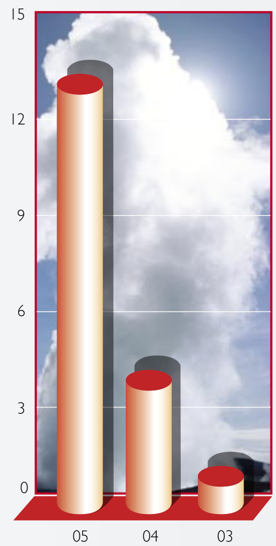
(In Million Pesos)

	2003	2004	2005
Sales	24,054	25,573	28,720
Net Income	646	4,352	13,627
Operating Expenses	3,162	2,807	2,576
Income (Loss) from Operations	6,773	8,781	12,493
Total Assets	127,289	108,696	108,708
Total Liabilities	93,347	94,908	81,019
Total Equity	33,943	13,788	27,690

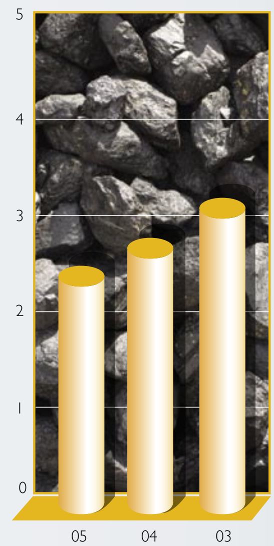
SALES



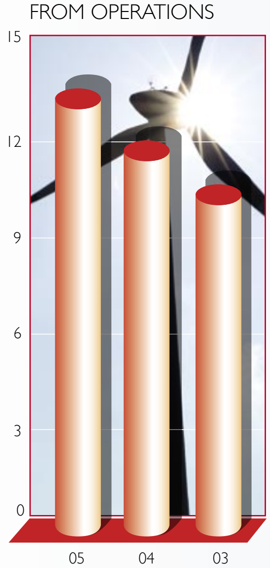
NET INCOME



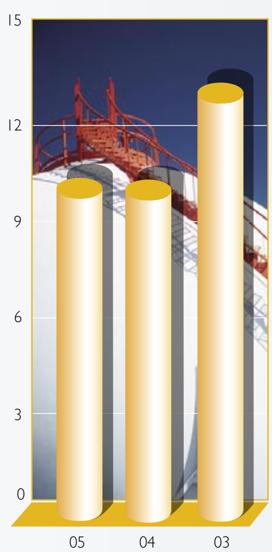
OPERATING EXPENSES



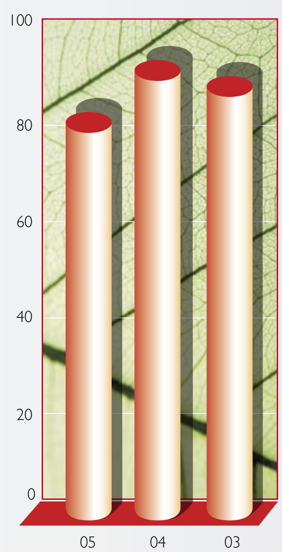
INCOME (LOSS)
FROM OPERATIONS



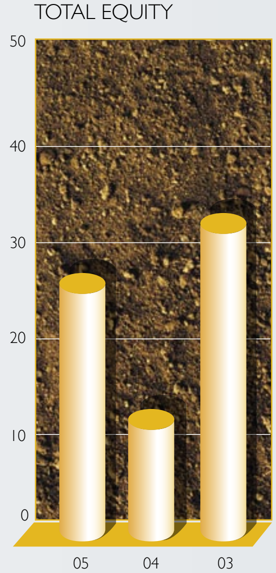
TOTAL ASSETS



TOTAL LIABILITIES



TOTAL EQUITY



Financial Ratios

	2003	2004	2005
1. Profitability Ratios (%)			
Gross Profit Margin	41	45	52
Return on Assets	1	4	13
Return on Equity	2	32	49
2. Liquidity Ratios			
Current Ratio	1.14	1.31	1.28
Quick Ratio	1.03	1.19	1.17
3. Leverage Ratios			
Debt Ratio	0.73	0.87	0.75
Debt-to-Equity Ratio	2.75	6.88	2.93

Financial Position

In 2005, the Total Consolidated Net Income is ₱13.63 billion, representing a phenomenal 213% surge in growth from 2004's level of ₱4.35 billion. This monumental upsurge was primarily due to robust economic conditions that prevailed in the country and to the company's clear-cut determination to reduce costs, thus attain financial prosperity.

Total Consolidated Net Sales in 2005 amounted to ₱28.75 billion, ₱3.10 billion or 12% increase from the 2004 level of ₱25.65 billion. Largely contributing to the ₱3.10 billion increase is the Oil and Gas Production which yielded ₱5.07 billion, ₱2.07 billion or 69% increase from the 2004 level of ₱3.00 billion. Driving the revenue growth of the oil and gas business unit is the increase in production of natural gas by 28.622 billion cubic feet and condensates by 1.154 million barrels as well as the increase in offtake/selling price of these commodities, it being indexed to crude oil prices. It is also a reflection of the company's strategic and investment savvy – concentrating on core projects and investing in the right activities.

The company's resolve to reduce costs and expenses was achieved with the ₱335.63 million decrease in the Cost of Sales and ₱230.13 million decrease in Operating Expenses due to the strict adherence to the provisions of Administrative Order (AO) No. 103, Directing the Continued Adoption of Austerity Measures in the Government.

Finally, the strong economic conditions have favorable effect on the financial position of the company because of the huge foreign exchange gains in 2005. This was attributed to the realignment of foreign loans due to the Peso's appreciation and the Yen's depreciation against the US dollar. In December 2005, one US Dollar is equivalent to ₱53.062 or 117.855 Yen while in December 2004, one US Dollar is equivalent to ₱56.341 or 103.05 Yen.

Financial Condition

Total Consolidated Assets reached ₱108.71 billion at the end of 2005, a slight increase of ₱11.86 million from the 2004 level of ₱108.70 billion. Total Consolidated Current Assets was reported at ₱23.37 billion, reflecting a ₱1.50 billion increase from the 2004 level of ₱21.87 billion. The bulk of the increase is from the Accounts and Notes Receivable account which is due to PNOC-EDC's billings to the National Power Corporation for the sale of electricity and steam production supplied to their power plants. Moreover, Total Consolidated Non-Current Assets and Non-Current Assets Held for Sale is at ₱85.34 billion, ₱1.48 billion less than the 2004 level of ₱86.82 billion which is due to the decrease in the Unrealized Foreign Exchange Losses under the Deferred Tax Asset account.

Total Consolidated Liabilities was reported at ₱81.02 billion, ₱13.89 billion lower than the 2004 level of ₱94.91 billion. The reduction in liabilities is due to the increasing principal repayments for loans contracted with the International Bank for Reconstruction and Development (IBRD) and Japan's Overseas Economic Cooperation Fund (OECF). Moreover, it was also the company's strong resolve to pay-off long term loans to be able to contribute to National Government's policy of reducing Contingent Liabilities and containing the Consolidated Public Sector Deficit.

Total Equity is at ₱27.69 billion, an increase of ₱13.90 billion from the 2004 level of ₱13.79 billion which is mainly due to the Net Income earned in 2005 in the amount of ₱13.63.billion.

[1] *The average price per barrel of Dubai crude in 2004 was at US$ 33.64 and rose to US$ 49.31 in 2005. Source: NEDA 2005 Socio-Economic Report*

Republic of the Philippines
COMMISSION ON AUDIT
Commonwealth Avenue, Quezon City, Philippines

STATE AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

The Board of Directors
Philippine National Oil Company
Energy Center, Fort Bonifacio
Taguig City

We have audited the accompanying consolidated balance sheet of the **Philippine National Oil Company and Subsidiaries** as of **December 31, 2005** and the related consolidated statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with generally accepted state auditing standards in the Philippines. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the **Philippine National Oil Company and Subsidiaries** as of **December 31, 2005** and the results of its operations and its cash flows for the year then ended in accordance with generally accepted state accounting principles in the Philippines.

COMMISSION ON AUDIT

JAIME P. NARANJO
Assistant Commissioner
Corporate Government Sector

October 25, 2006

PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Consolidated Balance Sheet

DECEMBER 31, 2005 (With comparative figures for 2004)
(In Thousand Pesos)

	Notes	2005	2004 (as restated)
ASSETS			
Current Assets			
Cash and cash equivalents	4	**5,561,952**	1,989,139
Cash - restricted	5	-	3,284,181
Short-term investments	6	**4,367,762**	4,163,624
Accounts and notes receivable - net	7	**6,954,327**	6,075,679
Inventories - net	8	**1,921,587**	2,012,454
Investment in available-for-sale securities	9	**2,726,591**	-
Prepaid expenses and other current assets	10	**1,837,740**	4,349,317
Total Current Assets		**23,369,959**	21,874,394
Non-Current Assets			
Long-term receivables	11	**182,353**	154,403
Investments	12	**6,917,127**	5,854,962
Property, plant and equipment - net	14	**41,673,858**	42,458,144
BOT power plants - net	13	**20,870,005**	21,845,063
Exploratory and development costs	15	**5,252,483**	4,735,134
Investment property	16	**979,159**	983,552
Deferred tax asset	36	**4,742,266**	7,007,619
Deferred charges and other assets	17	**4,671,364**	3,703,067
Total Non-Current Assets		**85,288,615**	86,741,944
Non-current assets held for sale	18	**49,584**	79,959
TOTAL ASSETS		**108,708,158**	108,696,297
LIABILITIES AND EQUITY			
LIABILITIES			
Current Liabilities			
Accounts payable and accrued expenses	19	**6,124,925**	5,398,955
Income tax payable	35	**2,097,515**	829,114
Dividends payable	28	**302,412**	613,000
Current portion of long-term loans	22	**4,720,728**	3,477,450
Current portion of BOT lease obligations	21	**5,058,281**	6,352,690
Total Current Liabilities		**18,303,861**	16,671,209
Non-Current Liabilities			
Long-term loans-net of current portion	22	**44,910,781**	55,362,809
BOT lease obligations-net of current portion	21	**2,777,311**	8,319,072
Other long-term liabilities	23	**7,006,594**	7,123,465
Royalty fee payable - net of current portion	20	**1,529,979**	1,196,282
Other credits	24	**6,490,128**	6,235,502
Total Non-Current Liabilities		**62,714,793**	78,237,130
TOTAL LIABILITIES		**81,018,654**	94,908,339
EQUITY		**27,689,504**	13,787,958
TOTAL LIABILITIES AND EQUITY		**108,708,158**	108,696,297

See accompanying Notes to Financial Statements.

PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)
AND SUSIDIARIES

Consolidated Statement of Income

For the year ended December 31, 2005 (With comparative figures for 2004)
(In Thousand Pesos)

	Notes	2005	2004 (as restated)
NET SALES	31	**28,753,945**	25,651,487
COST OF SALES	32	**(13,650,344)**	(13,985,970)
GROSS MARGIN		**15,103,601**	11,665,517
UNREALIZED GROSS PROFIT FROM INSTALLMENT SALES		**(56,433)**	(87,066)
REALIZED GROSS PROFIT		**15,047,168**	1,578,451
REALIZED GROSS PROFIT FROM PREVIOUS YEAR'S			
INSTALLMENT SALES		**22,551**	8,637
TOTAL REALIZED GROSS PROFIT		**15,069,719**	11,587,088
OPERATING EXPENSES	33	**(2,576,431)**	(2,806,562)
INCOME FROM OPERATIONS		**12,493,288**	8,780,526
OTHER INCOME (CHARGES) - NET	34	**5,426,157**	(3,202,060)
INCOME BEFORE INCOME TAX		**17,919,445**	5,578,466
PROVISION FOR INCOME TAX	35	**(4,292,674)**	(1,226,827)
NET INCOME		**13,626,771**	4,351,639

See accompanying notes to Financial Statements .

PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Consolidated Statement of Changes in Equity

DECEMBER 31, 2005 (With comparative figures for 2004)
(In Thousand Pesos)

	Authorized Capital (Note 25)	Donated Capital (Note 26)	Treasury Stock	Retained Earnings (Note 27)	Revaluation Surplus (Note 29)	Fair Value and other reserves (Note 30)	Minority Interest	Total Equity
Balance at January 1, 2004 as previously reported	3,114,595	553,357	(424)	29,295,668	972,991		6,333	33,942,520
Cumulative effect of transition to PFRS		(423,068)	(311)	(22,504,671)	(972,991)		427	(23,900,614)
Balance at January 1, 2004 as restated	3,114,595	130,289	(735)	6,790,997	-	-	6,760	10,041,906
Net Income				4,351,639				4,351,639
Cash Dividends				(613,829)				(613,829)
Deferred tax benefit				8,242				8,242
Balance at December 31, 2004 as restated	3,114,595	130,289	(735)	10,537∆,049			6,760	13,787,958
Balance at January 1, 2005	**3,114,595**	**130,289**	**(735)**	**10,537,049**			**6,760**	**13,787,958**
Net Income				13,626,771			6,037	13,632,808
Cash Dividends				(303,495)				(303,495)
Realignment of Deferred Tax assets @ 35% Income Tax rate				(13,210)				(13,210)
Deferred tax benefit				13,304				13,304
Correction of prior year's losses/expenses				(5,340)				(5,340)
Revaluation of Land					467,170			467,170
Unrealized Holding Gain on Av ailable for Sale Investment						110,309		110,309
Balance at December 31, 2005	**3,114,595**	**130,289**	**(735)**	**23,855,079**	**467,170**	**110,309**	**12,797**	**27,689,504**

See accompanying Notes to Financial Statements.

PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Consolidated Cash Flow Statement

For the Year Ended December 31, 2005 (With Comparative Figures for 2004)
(In Thousand Pesos)

	2005	2004 (as restated)
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers	**27,090,261**	24,339,676
Cash paid to suppliers and employees	**(10,023,825)**	(18,770,330)
Interest income received	**944,225**	834,491
Interest expenses paid	**(2,379,618)**	(1,560,723)
Income taxes paid	**(648,134)**	(898,050)
Net cash provided by operating activities	**14,982,909**	3,945,064
CASH FLOWS FROM INVESTING ACTIVITIES		
Exploratory & development costs	**(1,159,101)**	(1,124,975)
Investments	**(959,935)**	(1,101,755)
Capital expenditures	**(719,963)**	(415,674)
Cash dividends	**375,579**	751,740
Proceeds from disposal of assets	**31,554**	1,329
Others		613
Net cash used in investing activities	**(2,431,866)**	(1,888,722)
CASH FLOWS FROM FINANCING ACTIVITIES		
Additional loan drawdowns	**2,557,778**	4,482,701
Short-term loans proceeds	**346,334**	2,010,000
Repayment of long-term debt	**(4,756,460)**	(3,354,560)
Repayment of short-term loans	**(159,834)**	(2,441,974)
Cash dividends paid to the National Government	**(614,083)**	(142,784)
Net cash used in financing activities	**(8,978,230)**	(5,495,340)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	**3,572,813**	(3,438,998)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	**1,989,139**	5,428,137
CASH AND CASH EQUIVALENTS AT END OF YEAR	**5,561,952**	1,989,139

See accompanying Notes to Financial Statements.

PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Amount in Thousand Pesos, Unless Otherwise Specified)

1. CORPORATE HISTORICAL BACKGROUND

The Philippine National Oil Company (PNOC) was created under Presidential Decree No. 334 on November 9, 1973, to provide and maintain an adequate and stable supply of oil in the country. Its charter was amended to include energy exploration and development. Today, the Philippines is the world's largest user of wet steam technology in geothermal operations. It is ranked second to the United States in terms of total megawatts generated from geothermal energy. Thirty-two years after its creation, the company serves as the key institution in the exploration, development and utilization of indigenous energy sources. Development in the country, as well as the global front, makes it imperative for the company to get more involved in new and renewable energy activities and projects. It has ventured into several projects carried out by the following subsidiaries:

a) PNOC Energy Development Corporation (PNOC-EDC) was established in 1976 to undertake exploration and development of geothermal energy sources in the country. At present, it operates nine (9) geothermal steam fields with an aggregate capacity of 1,149 megawatts accounting for about 60% of the country's total installed geothermal capacity. It also operates six (6) power plants, which were built through the Build-Operate-Transfer scheme.

   It engaged in integrated power generation and the sale of steam to the National Power Corporation (NPC).

   PNOC-EDC is undertaking a 3-phase development of the Northern Luzon Wind Power Project, which include initially the design and construction of the wind farm and a 230 KV transmission line to NPC's substation in Laoag city.

b) PNOC Exploration Corporation (PNOC-EC), established in 1976, serves as the oil and gas exploration arm of PNOC. It is actively engaged in the country's search for indigenous sources of energy.

   The Company is currently involved in several petroleum exploration projects, either on its own or in partnership with other companies in the Philippines. It owns ten percent (10%) working interest in SC 38 Malampaya Deepwater Gas-to-Power Project producing condensate and gas that fuels the Ilijan, Sta. Rita and San Lorenzo power plants in Batangas. The Company's gas production from the San Antonio gas field fuels a small power plant in Isabela. In June 2002, the Company assumed the operation of coal trading and integrated services from PNOC Coal Corporation. The Company is also mandated to construct and operate the planned Batangas-Manila Gas Pipeline Project.

c) PNOC Alternative Fuels Corporation (PPDC) was organized in 1993 to develop the country's first integrated petrochemical industry. The complex, located in Limay and Mariveles, Bataan, which is approximately 530 hectares, is to be developed in phases.

   Phase I of the petrochemical complex includes common facilities, such as feedstock pier, road network and power and water distribution systems. Three (3) petrochemical plants are currently located in the complex, namely: polypropylene, polyethylene and polyvinyl chloride plants all established through the use of local and foreign equity.

d) PNOC Shipping and Transport Corporation (PSTC) is engaged in the business of shipping, tankering, lighterage, barging, towing, transport and shipment of goods, chattels, petroleum and other products, marine and maritime commerce in general.

e) PNOC Development and Management Corporation (PDMC), formerly Filoil Development and Management Corporation, is engaged in industrial estate development and management. Its assets consist mainly of landholding in Rosario, General Trias and Noveleta, Cavite. The Company develops its real estate properties, consisting of twenty five (25) hectares, and disposed them to bona-fide informal dwellers under the socialized housing program of the government through installment sales contracts ranging from one (1) to twenty-five (25) years.

f) PNOC Coal Corporation (PCC) was organized in 1981 to serve as a coal-trading arm of PNOC. Its objective was to provide a steady supply of good quality and low-priced coal in the country through expansion and diversification of existing supply sources and ensuring coal price stability in the market.

   Effective May 31, 2002, the company ceased to operate. The Company's coal trading activities was absorbed by PNOC-EC.

g) PNOC Dockyard & Engineering Corporation (PDEC) was incorporated in 1978 to provide support to PNOC's fleet of domestic and international tankers in terms of repair and maintenance services. In line with the privatization plan as approved by the Committee on Privatization, the Company sold its shipyard's facilities through public bidding on December 16, 1992. The dissolution of the Company was approved by the Board of Directors effective December 31, 1996. Processing of the dissolution with the Securities and Exchange Commission was placed on hold since PDEC will be used as the corporate vehicle for PNOC's prospective projects.

h) Tanker Companies namely PNOC Tankers, Petron Tankers, Petrophil Tankers and PNOC Oil Carriers, Inc. ceased operating in 1995 due to continued losses. Final audit reports of the tanker companies were issued by the Commission on Audit for the period ended June 1996. The companies' balance sheet accounts were still included in the consolidation of financial statements pending approval of their dissolution by the Securities and Exchange Commission and the Bureau of Internal Revenue.

2. BASIS OF FINANCIAL STATEMENT PREPARATION

The consolidated financial statements of PNOC and subsidiaries have been prepared in compliance with accounting principles generally accepted in the Philippines as set forth in Philippine Financial Reporting Standards (PFRS). PFRS include standards named PFRS and Philippine Accounting Standards (PAS), including interpretations issued by the Philippine Accounting Standards Council (PASC). This is the Company's first consolidated financial statements prepared in compliance with PFRS.

Basis of Consolidation

The consolidated financial statements include the accounts of Philippine National Oil Company (PNOC) and all its subsidiaries where it owns more than 50% of the voting stock. All significant intercompany accounts and transactions are eliminated to the extent practicable.

The subsidiaries included in the consolidation are the following: PNOC Development and Management Corporation (PDMC), PNOC Tankers Corporation, Petron Tankers Corporation, Petrophil Tankers Corporation, PNOC Oil Carriers, Inc. (POCI), PNOC Shipping and Transport Corporation (PSTC), PNOC Dockyard and Engineering Corporation (PDEC), PNOC Coal Corporation (PCC), PNOC Energy Development Corporation (PNOC-EDC), PNOC Exploration Corporation (PNOC-EC), and PNOC Alternative Fuels Corporation (PPDC).

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. Actual results may differ from these estimates.

In preparing the opening balance sheets, the Company adjusted amounts previously reported in the financial statements prepared in accordance with Philippine Generally Accepted Accounting Principles (GAAP).

The new accounting standards adopted by the Company which prescribe new accounting measurement and disclosure practices are summarized as follows.

PAS 1, "Presentation of Financial Statements," provides a framework within which an entity assesses how to present fairly the effects of transactions and other events. It provides the criteria for classifying liabilities as current or non-current, solely on the conditions existing at the balance sheet date. It prohibits the presentation of items of income and expenses as extraordinary items, specifies disclosures about the judgments made by management in the process of applying accounting policies, and specify disclosure about the key sources of estimation uncertainty at the balance sheet date that have significant risks.

PAS 2, "Inventories," clarifies the scope to exclude producers of agricultural and forest products, agricultural produce after harvest, minerals and mineral products. The standard reduces the alternatives for the measurement of inventories, prohibiting the use of Last-In, First-Out (LIFO) formula. It requires disclosure of the carrying amount of inventories carried at fair value less cost to sell and the amount of any write-downs to inventories recognized as an expense in the period.

PAS 8, "Accounting Policies, Changes in Accounting Estimates and Errors," eliminates the concept of fundamental error and the allowed alternative to retrospective application of voluntary changes in accounting policies and retrospective restatement to correct prior period errors. The standard defines material omissions or misstatements and describes how to apply the concept of materiality when applying accounting policies and correcting errors.

PAS 10, "Events After the Balance Sheet Date," clarifies that dividends declared after balance sheet date are not to be recognized as a liability at the balance sheet date. The standard also requires disclosure in the financial statements information received after the balance sheet date even when the information does not affect the amount it recognized in its financial statements.

PAS 12 "Income Taxes," prescribes the accounting treatment for deferred income taxes. This standard requires the use of the balance sheet liability method in accounting for deferred income taxes. It requires the recognition of deferred tax liability and, subject to certain conditions, deferred tax assets for all temporary differences with certain exceptions. This standard provides for the recognition of a deferred tax asset when it is probable that taxable income will be available against which the deferred tax asset can be used.

PAS 16, "Property, Plant and Equipment," prescribes the accounting treatment for property, plant and equipment and related disclosure requirements. The standard contains a limited revision to provide additional guidance and clarification on recognition and measurement of items of property, plant and equipment. It provides guidance on initial and subsequent recognition as well as measurement after recognition. It requires depreciation for each significant part of an item of property, plant and equipment. The standard also provides guidance on the determination of carrying amount of the assets, the residual value, depreciation period and derecognition principles to be observed.

PAS 17, "Leases," provides limited revision to clarify the classification of a lease of land and buildings and prohibits expensing of initial direct costs in the financial statements of lessors.

PAS 19 "Employee Benefits," applies to all employee benefits offered by an employer to employees and their dependents and beneficiaries. This standard applies to employee benefits under: (i) formal plans and agreements between an enterprise and its employees, (ii) national, local, industry or multi-employer plans; and informal practices giving rise to a constructive obligation. This standard also identifies the following categories of employee benefits such as short-term employee benefits, post employment benefits, other long-term employee benefits and termination benefits.

PAS 21, "The Effects of Changes in Foreign Exchange Rates," prescribes the accounting treatment for foreign currency transactions and provides guidance on the translation method and on determining the functional and presentation currencies of a reporting entity. The standard removes the limited option in the previous version of SFAS 21/IAS 21 to capitalize exchange differences resulting from a severe devaluation or depreciation of a currency against which there is no means of hedging. Under the standard, such exchange differences are now recognized in profit or loss since capitalization of such exchange differences is no longer permitted in any circumstances.

PAS 24, "Related Party Disclosures," provides additional guidance and clarity in the scope of the standard, the definitions and the disclosures for related parties.

PAS 27, "Consolidated and Separate Financial Statements," reduces alternatives in accounting for subsidiaries in consolidated financial statements and in accounting for investments in the separate financial statements of a parent company. PNOC now accounts for its investments in subsidiaries under cost method in the separate financial statements. Prior year's parent company financial statements are restated accordingly.

PAS 36, "Impairment of Assets," prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described to be impaired and the standard requires the entity to recognized an impairment loss. The standard also specifies when an entity should reverse and impairment loss previously recognized. The revised standard clarifies the elements that should be reflected in the calculation of an asset's value in use.

PAS 37, "Provisions, Contingent Liabilities and Contingent Assets," provides the criteria for the recognition and bases for measurement of provisions, contingent liabilities and contingent assets. It also specifies the disclosures that should be included with respect to these items.

PAS 39, "Financial Instruments: Recognition and Measurement," establishes the accounting and reporting standards for the recognition and measurement of the company's financials asset and financial liabilities. The standard requires a financial asset or financial liability to be recognized initially at fair value. Subsequent to initial recognition, the company should continue to measure financial assets at their fair values, except for loans and receivables and held-to-maturity investments, which are to be measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as "at fair value through profit and loss" and derivatives, which are subsequently to be measured at fair value.

PAS 40, "Investment Property," provides a limited revision to permit a property interest held by a lessee under an operating lease to qualify as investment property under specified conditions. The standard applies to property (land or a building – or part of a building – or both) to earn rentals or for capital appreciation or both, rather than for: used in the production or supply of goods or services or for administrative purpose; or sale in the ordinary course of business.

PFRS 1, "First Time Adoption of PFRS," sets out the procedures that an entity must follow when it adopts PFRS for the first time as the basis for preparing its general purpose financial statements. It provides guidance on the accounting policies, reporting periods, recognition, derecognition, reclassification and measurement of assets and liabilities. The standard set out optional and mandatory exemptions from the general restatement and measurement principles of assets and liabilities.

PFRS 5, "Non-Current Assets Held for Sale and Discontinued Operations," adopts the classification "held for sale" and introduces the concept of a disposal group by sale together as a group in a single transaction and liabilities directly associated with those assets that will be transferred. It specifies that assets or disposal groups classified as held for sale be carried at lower of carrying amount and the fair value less costs to sell and no be depreciated. It requires that assets classified as held for sale and the assets and liabilities included within a disposal group classified as held for sale be presented separately on the face of the balance sheet.

Prospective Adoption

PFRS 6, " Exploration for and Evaluation of Mineral Resources," specifies the financial reporting for the exploration for and evaluation of mineral resources. It requires: a) limited improvements to existing accounting practices for exploration and evaluation expenditures; b) entities that recognize exploration and evaluation assets to assess such assets for impairment in accordance with PAS 36, Impairment of Assets; c) disclosures that identify and explain the amounts in the entity's financial statements arising from the exploration for and evaluation of mineral resources and help users of those financial statements understand the amount, timing and certainty of future cash flows from any exploration and evaluation assets recognized.

The prospective adoption of PFRS 6 will not have a significant impact on the financial position, results of operation and statement of cash flows of the entity.

3. SUMMARY OF SIGNIFICANT ACCOUTING POLICIES

The following accounting policies have been applied consistently to all periods presented in these financial statements. The comparative figures for the 2004 consolidated financial statements were restated to reflect the changes in accounting policies, except those relating to financial instruments.

a) Cash and Cash Equivalents

Cash includes cash on hand and in banks. Cash equivalents are short-term, highly liquid instruments that are readily convertible to known amounts of cash, with original maturities of three months or less from date of acquisition and that are subject to an insignificant risk of change in value.

b) Cash Restricted

Cash restricted is composed of investments in money market instruments which are intended to meet specific fund requirement, i.e. financing foreign exchange requirements, payments of indebtedness, etc.

c) Short-term Investments

Short-term investments are money market placements in the form of treasury bills and special savings deposits with maturity of more than three months but less than one-year.

d) Trade Receivables

Trade receivables are stated at their nominal value reduced by appropriate allowance for doubtful accounts.

PNOC and its subsidiaries provide an allowance for doubtful accounts when there is basis to doubt the collectibility of accounts receivable and is computed based on the aging schedule of the outstanding receivables. The adequacy of the allowance for doubtful accounts is reviewed yearly.

e) Inventories

Inventories are stated at the lower of cost and net realizable value. Cost includes invoice amount, service fees and other delivery charges, net of trade and cash discounts. Cost is determined as follows: moving average for materials and supplies as well as coal inventories, specific identification for saleable land, prevailing market price for condensate inventory, and first-in, first-out (FIFO) method for uninstalled solar home systems (SHS) units.

An allowance for obsolescence is provided for products and/or materials that are determined to be obsolete, slow or non-moving based on a regular review of stocks on hand.

f) Investments

Investments classified as available-for-sale are measured at subsequent reporting dates at fair value. Gains and losses arising from changes in fair value are recognized directly in equity, until the security is disposed or is determined to be impaired, at which time the cumulative gain or loss previously recognized in equity is included in the net profit or loss for the period.

Investments in shares of stocks, in which PNOC and its subsidiaries are not the controlling stockholders, are carried at cost. An allowance is set up for any substantial and apparent permanent decline in the carrying values of these investments.

g) Investment Property

Investment property, which is property held to earn rentals and/or capital appreciation, is stated at cost, less any subsequent accumulated depreciation and impairment losses.

Depreciation is computed on the straight-line method based on the 30 years estimated useful life of the building.

The useful life and method of depreciation are reviewed periodically to ensure that the period and method of depreciation are consistent with the expected pattern of economic benefits from items of investment property.

h) Property, Plant and Equipment

Property and equipment are initially measured at cost, less any subsequent accumulated depreciation and impairment losses. The cost of an asset consists of its purchase price and costs directly attributable to bringing the asset to its working condition for its intended use.

Subsequent expenditures relating to an item of property and equipment that have already been recognized are added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the Company. All other subsequent expenditures are recognized as expenses in the period in which those are incurred.

Major spare parts and stand-by equipment qualify as property and equipment when the Company expects to use them for more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property and equipment, they are accounted for as property and equipment.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets ranging from 5 to 30 years.

The useful life and method of depreciation are reviewed periodically to ensure that the period and method of depreciation are consistent with the expected pattern of economic benefits from items of property and equipment.

Construction in progress is stated at cost and is not depreciated until such time that the assets are completed and/or put into operational use.

Stand-by equipment is depreciated from the date it is made available for use over the shorter of the life of the stand-by equipment or the life of the asset for which the stand-by equipment is part of while major spare parts should be depreciated over the period starting when it is brought into service, continuing over the lesser of its useful life and the remaining expected useful life of the asset to which it relates.

Gain or loss arising from the disposal or retirement of an asset is determined by computing the difference between the sales proceeds and the carrying amount of the asset and is recognized in income.

For Service Contract (SC) 38 Project-related Wells, platforms and other facilities, the cost includes acquisition costs and capitalized exploration and development costs incurred by the Company and the Capitalized estimated future development costs. The carrying values of wells, platforms and other facilities are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. If any such indication exists and where the carrying values exceed the estimated recoverable amount, the assets or cash-generating units are written down to their estimated recoverable amount.

Depreciation, depletion and amortization of wells, platforms and other facilities for all capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves, are computed using the unit-of-production method based on the estimated proved reserves. On the other hand, SC 38 Project-related other facilities and equipment are computed using the straight-line method over 21 years.

Geothermal production wells are initially measured at costs less any subsequent accumulated amortization and impairment losses. The cost of an asset includes all operating and non-operating costs pertaining to the wells hooked to the fluid collection and re-injection system (FCRS) of the operating plants and those which are utilized either for re-injection or waste disposal, and provided with the appropriate amortization over the useful life of the property.

Upon commercial operation of a plant, all drilling costs, including related costs, of wells hooked to the FCRS and those wells that are to be utilized for re-injection or waste disposal which are capitalized under exploratory and development costs are transferred to Production Wells account and amortized over the estimated useful life of the property.

The amortization of production wells is computed on the straight-line method based on the estimated useful life of 30 years.

The direct costs, including related expenses, of wells drilled but not hooked remain in the account " exploratory and development costs" until such time those wells are hooked to the operating plants or all the plants under a particular service contract area are fully operational and producing and an evaluation as to the economic value of all the remaining wells drilled but not hooked to any plant is made. The accumulated direct and related costs of the wells evaluated to have an economic value to a plant are transferred under Production Wells. And amortized over the remaining life of the plant while wells evaluated to have no economic value are charged outright to expense.

Direct costs and related expenses of wells subsequently drilled in fully operational and producing areas are also capitalized under Exploratory and Development Costs and eventually transferred to Production Wells once completed and hooked to the operating plants. The direct costs and related expenses of newly hooked wells are amortized over the remaining life of the plants where they are attached.

i) Exploratory and Development Costs

All costs incurred in the geological and geophysical activities such as costs of topographical, geological and geophysical studies; rights of access to properties to conduct those studies; salaries and other expenses of geologists, geophysical crews, or others conducting those studies are charged outright to expense.

If the results of initial geological and geophysical activities reveal the presence of geothermal resource that will require further exploration and drilling, subsequent exploration and drilling costs are accumulated and deferred. After tests conducted on the exploratory wells drilled reveal that the well cannot produce proved reserves, the capitalized costs, net of any salvage value, are charged to expense except when management decides to use the unproductive well for re-injection or waste disposal.

On the other hand, wells that have commercial steam quantity and good steam quality are further developed and costs associated with these wells are accumulated and deferred.

Upon commercial operation of a plant, all costs of wells hooked to the FCRS and those wells that are to be utilized for waste disposal are capitalized and depreciated over the estimated useful life of the property.

The costs of the wells drilled but not hooked remain in the account "exploratory and development costs" until such time that those wells are hooked to the operating plants or all the plants under a particular service contract area are fully operational and producing and an evaluation as to the economic value of all the remaining wells drilled but not hooked to any plant is made. The accumulated costs of the wells evaluated to have an economic value to a plant are transferred under Production Wells and amortized over the remaining life of the plant while wells evaluated to have economic value are charged outright to expense.

Costs of wells subsequently drilled in fully operational and producing areas are capitalized and depreciated over the remaining life of the plant it will serve. Costs of work-over on wells supporting an operating plant are charged to expense.

In accounting for oil and gas operations, PNOC-EC uses full-cost method. Under this method, all costs directly incurred in the acquisition, exploration and development of a project area, including directly related overhead costs are capitalized. However, all exploration costs are tentatively deferred pending determination whether the area contains oil and gas reserves of commercial quantity. Recovery of these costs is dependent on the success of the Company's exploratory and development operations.

j) Impairment of Assets

At each balance sheet date, the Company reviews the carrying amounts of its tangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. When the asset generates cash flows that are dependent from other assets, the Company estimates the recoverable amount of the cash-generating unit to which the asset belongs. An intangible asset with an indefinite useful life is tested for impairment and whenever there is an indication that the asset may be impaired.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing the value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying value, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognized as an expense immediately, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

When an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognized as income immediately, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

k) Non-current Assets Held for Sale

Non-current assets classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Non-current assets are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset is available for immediate sale in its present condition. Management must be committed to the sale that should be expected to qualify for recognition as a completed sale within one year from the date of classification.

l) Revenue Recognition

Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods and services provided in the normal course of business.

Sale of steam is recognized when the steam generated by the Company or its by-product passes to the flowmeters installed at the interface point for conversion by the buyer into power use for a consideration called the sales price, net of sales discounts in case of generation beyond the contracted capacity.

Sale of electricity is consummated whenever the electricity generated by the Company was transmitted to the transmission line of the buyer for a consideration.

Revenue from sale of gas, condensate and oil is recognized upon delivery in accordance with the provisions of SC No. 38, Gas Sales and Purchase Agreements (GSPA) and Joint Operating Agreements entered into by the Company. Billings for undelivered gas under the take-or-pay provisions of the GSPAs are credited to deferred income and are recognized as revenue upon delivery.

Sale of real estate is recognized using installment method and upon receipt of sufficient down payment. Under the installment method, gross profit on sale is initially deferred and recognized when the principal payments on the related installment contracts receivable are collected. Realized income is computed based on the collections multiplied by the average gross profit rate of the project.

Interest income is accrued on a time proportion basis, by references to the principal outstanding and at the effective interest rate.

Rental income from investment properties is accounted for on a straight-line basis over the term of the lease.

m) Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

The Company as Lessor

Amounts due from lessees under the finance leases are recorded as receivables at the amount of the Company's net investment in the leases. Finance lease income is allocated to accounting periods so as to reflect a constant periodic rate of return on the Company's net investment outstanding in respect of the leases.

The Company as Lessee

Assets held under finance leases are recognized as assets of the Company at their fair vale or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income, unless they are directly attributable to qualifying assets, in which case they are capitalized in accordance with the Company's general policy on borrowing costs.

n) Build-Operate-Transfer (BOT) Projects

The Company adopts the finance lease accounting method for its BOT projects. Under this method, the present value of the stream of future cash payments (for capital costs recovery fee) during the ten-year cooperation period is recognized as the capitalized cost of the BOT plant and the corresponding liability is set up. The capitalized costs will be amortized as depreciation expense over the useful life of the asset.

o) Borrowing Costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time the assets are substantially ready for their intended use or sale. Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs eligible for capitalization.

All borrowing costs are recognized in profit or loss in the period in which they are incurred.

p) Foreign Exchange Transactions

Transactions in currencies other than Philippine peso are recorded at the rates of exchange prevailing on the dates of the transactions. At each balance sheet date, monetary assets and liabilities that are denominated in foreign currencies are retranslated at the rates prevailing on the balance sheet date. Non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Gains and losses arising on retranslation are included in net profit or loss for the period, except for exchange differences arising on non-monetary assets and liabilities where the changes in fair value are recognized directly in equity.

q) Retirement Benefit Costs

For defined benefit retirement benefit plan, the cost of providing benefits is determined using the Projected Unit Credit Method, with actuarial valuations being carried out at each balance sheet date. Actuarial gains and losses are amortized over the expected average remaining working lives of the employees participating in the plan. The amortized portion of these actuarial gains and losses is recognized as income or expenses for the period.

The retirement benefit obligation recognized in the balance sheet represents the present value of the defined benefit obligation as adjusted for unrecognized past service costs and unrecognized actuarial gains and losses and as reduced by the fair value of plan assets.

r) Taxation

The tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are neither taxable nor deductible. The Company's liability for current tax is calculated using the applicable tax rates.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences and deferred tax assets are recognized to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

4. CASH AND CASH EQUIVALENTS

This account consists of:

	2005	2004
Cash in bank	588,807	195,921
Petty cash	5,094	4,901
Marketable Securities	4,968,051	1,788,317
	5,561,952	1,989,139

Cash in banks earn interest at the respective bank deposit rates. Cash Equivalents consist of money market placements which are made for varying periods of up to three months depending on the immediate cash requirements of the Company and earned interest at the respective money market placement rates.

5. CASH-RESTRICTED

This account pertains to the balance of the proceeds of the US$75 million 5-year Term Loan Facility from Standard Chartered Bank acquired on August 4, 2004 and invested in fixed term deposits with the Bangko Sentral ng Pilipinas. The loan is intended for the payment of indebtedness due and payable under certain build-operate-transfer (BOT) contracts. This account was fully drawn on October 3, 2005.

6. SHORT-TERM INVESTMENTS

This consists mainly of money market placements in the form of government securities and savings deposits amounting to ₱1.329 billion and ₱3.038 billion, respectively, with maturity of more than three months but less than one year.

7. ACCOUNTS AND NOTES RECEIVABLE

This account consists of:

	2005	2004
Trade receivables	6,465,797	5,650,854
Others	632,917	640,645
	7,098,714	6,291,499
Allowance for doubtful accounts	(144,387)	(215,820)
Net	6,954,327	6,075,679

Trade receivables pertain mainly to PNOC-EDC's billings to the National Power Corporation amounting to ₱4.31 billion for the sale of electricity and steam production supplied to their power plants. These trade receivables already reflected the net adjustments in NPC receivables totaling ₱1.074 billion as a result of the DOE mediated resolution of PNOC-EDC and NPC contract implementation issues. The bulk of the adjustment amounting to ₱758.7 million pertained to Unified Leyte agreed nominated energy of 4,370 GWh per year for the period July 25, 2000 to July 23, 2004.

It also includes PNOC-EC's receivables on SC 38 Malampaya project for its gas and condensate sales amounting ₱1.64 billion, receivables on coal sales and integrated services, receivables from Energy Supply Base which refers to rentals, pier services, supply of fuel as well as other fees for the usage of EC's facilities and equipments by customers from the energy and commercial sectors and, PSTC's receivables from hauling or transporting of refined petroleum products to local oil companies.

Other receivables consist mainly of accrued interest on short-term investments, claims from the Bureau of Internal Revenue and employees and contractors/suppliers.

8. INVENTORIES

This account consists of:

	2005	2004
Parts and supplies	1,148,090	1,199,312
Land	761,570	760,836
Coal	19,599	40,910
Condensate	16,045	50,397
	1,945,304	2,051,455
Allowance for obsolescence	(23,717)	(39,001)
Net	1,921,587	2,012,454

Parts and supplies inventories consist mainly of PNOC-EDC's landed inventories amounting to ₱907.5 million, net of uninstalled inventory of major spare parts for the fluid collection and re-injection system (FCRS). It also includes PNOC-EC's 10% share in the inventory of SC 38 Malampaya project.

Land inventory consists of the balance of PDMC's saleable properties in Rosario, Cavite, comprising of about 38,792 square meters for Socialized Housing and 55,707 square meters for Costa Verde Subdivision. It also includes PPDC's saleable land in Bataan.

The coal inventory represents PNOC-EC's undelivered stock to various Coal Terminals with a total volume of 10,920.816 metric tons, while condensate inventory pertains to the undelivered stock of SC 38 Malampaya project as stored in its offshore Concrete Gravity Structure in offshore Palawan and valued at current market prices.

9. INVESTMENTS IN AVAILABLE-FOR-SALE SECURITIES

	2005	2004
Bonds and other investments	2,726,591	-
	2,726,591	-

The investments included above pertain to PNOC-EDC's investments in long-term government debt securities (peso and foreign-currency denominated) which were reclassified to the new account "investment in available-for-sale securities" in compliance with PAS 32 and PAS 39. The fair values of these securities are based on quoted market prices as at balance sheet date. Unrealized holding gain on bonds and other investments reached ₱105.3 million.

10. PREPAID EXPENSES AND OTHER CURRENT ASSETS

This account consists of:

	2005	2004
Special deposits	733,048	695,834
Prepaid expenses	303,172	352,030
Other prepaid and deferred charges	801,520	3,301,453
	1,837,740	4,349,317

Other prepaid and deferred charges mainly pertain to the current portion of PNOC-EDC's 25% advance payment to contractor, Kanematsu Corporation for the Northern Negros Power Plant Project. The decrease in this account was mainly brought about by the reclassification of PNOC-EDC's bonds and other investments to the new account "investments in available-for-sale securities" in compliance with PAS 32 and PAS 39.

11. LONG-TERM RECEIVABLES

This account consists of receivables from:

	2005	2004
Socialized housing	116,936	94,217
Residential and commercial subdivision	65,417	60,186
Total	182,353	154,403

This account covers the principal portion of the mortgage receivables of PDMC from the development and sale of its real estate in Rosario, Cavite which are to be collected within long periods ranging from two (2) to twenty-five (25) years.

12. INVESTMENTS

This account consists of investments in:

	2005	2004
Petron Corporation	4,448,444	4,448,444
Treasury bonds	2,007,732	1,071,470
National Development Corp. - 7% Preferred shares	369,151	369,151
Petrochemicals Corporation of Asia Pacific (Petrocorp)	245,968	96,453
Goodyear Philippines, Inc.	245,968	96,453
Gulf Oil Philippines, Inc.	54,978	54,978
Others	591,713	466,013
	7,814,439	6,752,477
Allowance for decline in value of shares of stocks	(897,312)	(897,515)
Net	6,917,127	5,854,962

13. BOT POWER PLANTS

This account pertains to the capitalized present value of the stream of future cash payments for capital cost recovery (CCR) fees for the BOT power plants during the ten-year cooperation period discounted at the buy-out rate indicated in the BOT contracts.

This account consists of the capitalized costs of the following BOT plants:

	Malitbog	Mahanagdong	Upper Mahiao	Mindanao I	Mindanao II	Tongonan I Optimization	Total
COST							
January 1, 2005	12,287,865	7,853,474	3,670,775	2,186,030	2,798,178	470,881	29,267,203
Additions	-	-	-	-	-	-	-
Disposals	-	-	-	-	-	-	-
December 31, 2005	12,287,865	7,853,474	3,670,775	2,186,030	2,798,178	470,881	29,267,203
ACCUMULATED DEPRECIATION							
January 1, 2005	(3,193,376)	(1,966,734)	(1,052,723)	(571,869)	(522,334)	(115,104)	(7,422,140)
Provision	(409,585)	(261,504)	(122,243)	(72,819)	(93,210)	(15,697)	(975,058)
Disposal	-	-	-	-	-	-	-
December 31, 2005	(3,602,961)	(2,228,238)	(1,174,966)	(644,688)	(615,544)	(130,801)	(8,397,198)
Carrying Amount December 31, 2005	**8,684,904**	**5,625,236**	**2,495,809**	**1,541,342**	**2,182,634**	**340,080**	**20,870,005**
Carrying Amount December 31, 2004	9,094,489	5,886,740	2,618,052	1,614,161	2,275,844	355,777	21,845,063

Depreciation expenses amounted to ₱975.1 million in 2005 and ₱975.4 million in 2004.

The corresponding liability account set up for BOT Power Plants is the BOT Lease Obligations.

14. PROPERTY PLANT AND EQUIPMENT

The details of this account are as follows:

	Land, Leases & Improvements	Buildings and Improvements	Wells, Platform and other Faciliti es	Plant Facilities	Pier Facilities	Tankers	Machinery and Equipment	Transportation Equipment	Furniture, Fixtures & Equipment	Construction in Progress	Others	Total
COST												
January 1, 2005	2,625,728	14,001,267	34,789,408	165,409	315,845	282,565	1,986,104	340,795	354,919	485,841	1,711	55,349,592
Additions	42,066	307	368,004	1,695	491	226,108	14,090	1	11,801	599,872		1,264,435
Reclassification	465,401	247,111				51	(11,049)	5,126	19,817	(441,924)	(1,596)	282,937
Disposals		(9,764)	(1)				(16,554)	(10,959)	(16,499)			(53,777)
December 31, 2005	3,133,195	14,238,921	35,157,411	167,104	316,336	508,724	1,972,591	334,963	370,038	643,789	115	56,843,187
ACCUMULATED DEPRECIATION												
January 1, 2005	(2,256)	(3,843,206)	(6,962,951)	(114,753)	(154,173)	(81,989)	(1,203,604)	(244,890)	(281,915)		(1,711)	(12,891,448)
Provision	(249)	(764,230)	(1,305,468)	(8,852)	(21,930)	(29,484)	(120,413)	(43,278)	(33,446)			(2,327,350)
Disposal	(52)	5,506				(661)	18,714	9,369	14,997		1,596	49,469
December 31, 2005	(2,557)	(4,601,930)	(8,268,419)	(123,605)	(176,103)	(112,134)	(1,305,303)	(278,799)	(300,364)	-	(115)	(15,169,329)
Carrying Amount December 31, 2005	**3,130,638**	**9,636,991**	**26,888,992**	**43,499**	**140,233**	**396,590**	**667,288**	**56,164**	**69,674**	**643,789**	**-**	**41,673,858**
Carrying Amount December 31, 2004	2,623,472	10,158,061	27,826,457	50,656	161,672	200,576	782,500	95,905	73,004	485,841	-	42,458,144

The wells, platform and other facilities represent the ten percent (10%) share of PNOC-EC in the aggregate assets of SC 38 Malampaya Project and PNOC-EDC's geothermal production wells.

PNOC-EDC valued its properties and equipment at fair value at the date of transition to PFRS, and use that fair value as deemed cost at that date.

Depreciation and depletion charged to operations amounted to ₱2.3 billion in 2005 and ₱2.1 billion in 2004, excluding depreciation charged to exploratory and development costs amounting to ₱53.9 million in 2005 and ₱30.2 million in 2004.

15. EXPLORATORY AND DEVELOPMENT COSTS

This account pertains to the deferred costs of exploration and development for various projects of PNOC-EDC and PNOC-EC on geothermal, wind, coal mine, oil and gas projects including investment in pre-joint venture projects.

The exploratory and development costs include capitalized borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale.

The increase in exploratory and development costs was mainly due to the additional development and drilling costs in the geothermal projects mainly in Negros, Upper Mahiao and Malitbog in Leyte and Cabalian, So. Leyte reduced by the transfer to Production Wells of five (5) wells hooked to the operating plants.

In 2005, certain evaluated impaired and inactive pre-joint venture projects of PNOC-EC, including unallocated deferred costs aggregating to ₱331.07 million were written-off.

16. INVESTMENT PROPERTY

This account includes PNOC's land leased out mainly to Petron Corporation where its refinery and other facilities are located. A long-term lease agreements was executed between the Company and Petron for continued use of these properties for a period of 25 years from September 1, 1993 to August 31, 2018, subject to renewal.

It also includes PNOC-EDC's land and building, occupied by PNOC and PNOC-EC, respectively, carried at its appraised value as certified by the Asian Appraisal Company. The said valuation was treated as deemed cost upon transition to PFRS and was arrived at by reference to market evidence of transaction prices for similar properties.

Also included is PPDC's land totaling approximately 910,935 square meters and is presently leased to Orica Explosives Philippines, Inc., for an extended period of five years from March 1, 2004 to February 28, 2009, excluding a one-year clear-up period from March 1, 2009 to February 28, 2010.

17. DEFERRED CHARGES AND OTHER ASSETS

This account consists of:

	2005	2004
Claims receivable from BIR	**2,707,007**	2,836,898
Long-term receivables	**3,316,264**	2,999,469
Purchase price adjustment fund	**809,757**	809,757
Guarantee fee – Miyazawa II	**452,552**	504,218
Deferred royalty fee	**697,795**	425,227
Prepaid expenses	**457,486**	-
Deposit for sinking fund	**282,805**	193,827
Collateral for bonds issued	**52,297**	55,528
Special deposits and funds	**34,653**	18,176
Others	**157,091**	266,325
	8,967,707	8,109,425
Allowance for doubtful accounts	**(4,296,343)**	(4,406,358)
	4,671,364	3,703,067

Claims receivables from BIR pertain to PNOC-EDC's refund of input VAT on BOT fees amounting to ₱74.95 million in 2005 and ₱286.82 million in 2004 (net of allowance for doubtful accounts amounting to ₱2.63 billion in 2005 and ₱2.55 billion in 2004. The BIR regional level denied EDC's claims for the refund of Input VAT on BOT fees amounting to ₱1.89 billion on July 2, 2002. Subsequently, PNOC-EDC submitted a letter of reconsideration on September 2, 2002. The request for reconsideration was endorsed by RDO 50 to the BIR legal department for an opinion. On January 2006, PNOC-EDC received tax credit certificates pertaining to input VAT claims amounting to ₱811.22 million.

Long-term receivables comprised mainly of long overdue trade accounts from NPC for PNOC-EDC's steam sales and PNOC-EC's 10% share in SC 38 Malampaya project.

The purchase price adjustment fund is a trust fund under the Stock Purchase Agreement for the privatization of Petron Corporation executed by and between PNOC, Saudi Arabian Oil Company and ARAMCO Overseas Company (AOC). This amount is to be held in trust approximately until 2014 to be used when and if necessary, to satisfy indemnity payment obligations of PNOC to Saudi Aramco and AOC arising out of representations and warranties of PNOC under the Stock Purchase Agreement.

Guarantee fee on Miyazawa II pertains to the upfront fees subject to amortization starting on the 5th year towards the end of the 10-year loan period.

Prepaid expenses pertains to the non-current portion of the 25% advance payment to Kanematsu Corporation for the construction of Northern Negros Geothermal Power Plant Project.

Deposit for sinking fund represents PNOC-EC's prepayment of its Citibank loan to PNOC, deposited to the special Dollar account with the Bangko Sentral ng Pilipinas. This is in compliance with the Department of Finance's condition on the Sovereign Guaranty of the US$175 million loan used for the Malampaya Deepwater Gas to Power Project. The deposit to the fund shall be used partially to settle the loan.

Collateral for bonds issued represents cash deposits with the Bangko Sentral ng Pilipinas, as security of debts exchanged for bonds, in accordance with the 1992 Philippine Financing Program.

18. NON-CURRENT ASSETS HELD FOR SALE

This account consists of:

	2005	2004
Property, plant & equipment	**42,429**	41,324
Materials and supplies inventory for disposal	**7,155**	38,635
	49,584	79,959

The property, plant and equipment consists mainly of real estate properties made available for sale and for disposal as of year-end. These properties are not suitable for the Company's long-term energy projects and other viable energy-allied industrial and commercial undertakings and are located within residential and agricultural areas with minimal potential to attract prospective lessees / joint venture partners.

19. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

This account consists of:

	2005	2004
Liabilities not invoiced	**3,471,335**	2,828,592
Accrued interest	**877,996**	977,886
Royalty fee payable	**613,509**	474,268
Short-term loans payable	**207,000**	139,934
Other current liabilities	**955,085**	978,275
	6,124,925	5,398,955

Liabilities not invoiced comprised mainly of PNOC-EDC's accrued capacity fees for BOT plants and other accrued expenses as of December 31, 2005.

Short-term loans payable pertains to peso and dollar loans obtained from Land Bank of the Philippines for the acquisition of PSTC's vessel, MT Dr. Jose Rizal. Interest rates for peso loans range from 6.646% to 9.37%.

Other current liabilities include tax liabilities, guaranty fee and other liabilities payable to various government agencies, employees and private institutions.

20. ROYALTY FEE PAYABLE

This account consists of:

	2005	2004
Due to LGUs	**413,303**	273,008
Due to DOE	**1,730,139**	1,396,299
Total	**2,143,442**	1,669,307
Less: Current Portion	**613,463**	473,025
Net	**1,529,979**	1,196,282

21. BOT LEASE OBLIGATIONS

This account consists of:

	Minimum Lease Payments		Present Value of Minimum Lease Payments	
	2005	2004	**2005**	2004
Amounts Payable under finance leases:				
Within one year	**5,538,025**	7,442,766	**5,058,281**	6,352,690
In the second to fourth years inclusive	**2,934,961**	8,979,357	**2,777,311**	8,319,072
Less: Future finance charges	**637,394**	1,750,361		
Present value of lease obligations	**7,835,592**	14,671,762	**7,835,592**	14,671,762
Less: Amount due for settlement within 12 months (shown under current liabilities)	**5,058,281**	6,352,690	**5,058,281**	6,352,690
Amount due for settlement after 12 months	**2,777,311**	8,319,072	**2,777,311**	8,319,072

This account pertains to the liability set up for the present value of the stream of future cash payments [for capital cost recovery (CCR) fees] for the BOT power plants during the ten-year cooperation period discounted at the buy-out rate indicated in the BOT contracts. The BOT lease obligations are denominated in US dollar and realigned to Philippine peso based on the year-end closing rate at the balance sheet date.

22. LONG-TERM DEBT

Long-term debt is summarized as follows:

Creditor/Project Name		Maturities	Interest Rate	2005	2004
International Bank for Reconstruction and Development					
2969 PH Bacon Manito Geothermal Power Project			1/2 of 1% over cost of		
- US$41.0 million	PNOC EDC	1994 to 2008	qualified borrowings	**700,991**	1,048,273
164 PH Energy Sector Project			1/2 of 1% over cost of		
- US$150.0 million	PNOC and EDC	1995 to 2010	qualified borrowings	**3,086,281**	4,233,305
3702 PH Geothermal Exploration Project			1/2 of 1% over cost of		
- US$64.0 million	PNOC EDC	1999 to 2013	qualified borrowings	**1,751,831**	2,217,932
3747 PH Geothermal Exploration Project					
- US$114.0 million	PNOC EDC	1999 to 2014	1/2 of 1% over cost of	**1,950,461**	2,455,434
- JPY 12.4 billion		1999 to 2014	qualified borrowings	**1,573,036**	2,136,193
Overseas Economic Cooperation Fund (OECF)					
8th Yen Tongonan I Geothermal Power Project					
- JPY 5.8 billion	PNOC EDC	1990 to 2010	3%	**577,411**	856,945
- JPY 1.5 billion (restructured)			3.2%	**210,575**	295,087
9th Yen Palipinom I Geothermal Power Project					
- JPY 10.8 billion	PNOC EDC	1991 to 2011	3%	**1,028,717**	1,476,340
15th Yen Palinpinon II Geothermal Power Project					
- JPY 4.0 billion	PNOC EDC	1999 to 2019	5.7 %	**943,362**	1,230,418
18th Yen Palinpinon II Geothermal Power Project					
- JPY 77.4 billion	PNOC EDC	2003 to 2023	3%	**29,739**	38,177
19th Yen Mt. Labo Geothermal Power Project					
- JPY 10.8 billion	PNOC EDC	2004 to 2024	4.9%	**133,568**	170,733
21st Yen No. Negros Geothermal Project					
- JPY 14.5 billion of which JPY2.0 billion has been drawn during the year.	PNOC EDC	2007 to 2027	2.7% / 2.3%	**2,056,852**	1,403,636
MIYAZAWA INITIATIVE I					
- JPY 5.2 billion	PNOC EDC	June 1, 2009	Tranche A = 3.78 %	**2,341,202**	2,843,011
JPY 6.8 billion			Tranche B - LIBOR + 1.60 %	**3,061,571**	3,717,785
MIYAZAWA INITIATIVE II	PNOC EDC	June 26, 2010	2.37%	**9,905,084**	12,028,127
- JPY 22.0 billion					
Citibank Syndicated Loan					
- US$175 million Malampaya Deepwater-Gas-to-Power Proj.	PNOC-EC	2008	LIBOR plus 3.5%	**8,277,672**	9,859,675
Landbank of the Philippines					
- PHP 1.5 billion	EDC	June 29, 2008	Average 91 day T-bills + 2%	**1,387,500**	-
	PNOC- PSTC	2005 to 2013		**119,434**	100,000
J P Morgan Chase Manhattan					
- US$ 110 million	PNOC EDC	Oct. 19, 2006	3.85% + LIBOR (2.42375)	**1,167,366**	2,479,004
Bank of Tokyo Mitsubishi					
- US$ 30 million	PNOC EDC	Dec. 14, 2006	3.85% + LIBOR (1.90875)	**318,371**	676,092
Standard Chartered					
- US$ 75 million	PNOC EDC	August 4, 2009	2.22% + LIBOR	**3,979,651**	4,225,575
US$90 Million Five Years Guaranteed Loan Facility					
- US$45.7 million	PNOC EDC	Feb. 21, 2008	Tranche 1 = 3.7 % + 6 mos. LIBOR	**2,424,933**	2,574,784
- US$44.3 million			Tranche 2 = 3.39 % + 6 mos. LIBOR	**2,350,647**	2,495,906
National Government					Principal
Collaterized Interest Reduction Bonds (PCIR)	PNOC and EDC	1992 to 2017	Year 1 4 1/4 %	**231,564**	245,873
			Year 2 5 1/4 %		
			Year 3 5 3/4 %		
			Year 4 - 5 6 1/4 %		
			Year 6 - 25 6 1/2 %		
Interest Reduction Bonds (IRB)	PNOC	1992 to 2008	Year 1-2 4 %	**1,923**	3,062
			Year 3-5 5 %		
			Year 6 6 %		
			Year 7 - 15 LIBOR plus		
			13/16 of 1% LIBOR		
Philippine New Money Bonds	PNOC	1992 to 2010	plus 13/16 of 1%	**21,767**	28,892
TOTAL				**49,631,509**	58,840,259
Less: Current portion				**4,720,728**	3,477,450
TOTAL				**44,910,781**	55,362,809

Outstanding balances of these foreign obligations were restated into Philippine pesos based on the prevailing foreign exchange rates at year-end (USD1=JPY 117.855; USD1=₱53.062 in December 2005 and USD1 = JPY 103.050; USD1=₱56.341 in December 2004.

A substantial portion of these obligations are guaranteed by the Philippine Government in consideration for surety given to creditor banks, the Philippine Government, through Department of Finance (DOF) Order No. 35-89 dated September 1, 1989 and DOF Memorandum Circular dated March 1, 1991, directed government-owned and controlled corporations to pay to the Bureau of Treasury a guarantee fee of 1% per annum on the outstanding balances of guaranteed borrowings.

23. OTHER LONG-TERM LIABILITIES

This account consists of:

	2005	2004
Estimated liability for future development costs	**5,816,329**	5,912,044
Retirement benefit obligations	**903,521**	943,685
Liability for future abandoned costs	**45,478**	38,587
Other long-term liabilities	**241,266**	229,149
	7,006,594	7,123,465

Estimated liability for future development costs pertain to PNOC-EC's future development costs of Wells, platform and other facilities of SC 38 which was capitalized consistent with full cost method of accounting which states that all costs, including future development cost relating to oil and gas assets, are to be capitalized and enter into the computation of amortization.

Retirement benefits obligations pertain to PNOC-EDC's retirement benefit plan covering all of its regular employees. The present value of the defined benefit obligation and related current service costs was measured using the projected unit credit method.

24. OTHER CREDITS

This account consists mainly of PNOC-EC's net entitlements from the "Take-or-Pay" transactions of SC 38 Malampaya Project amounting to ₱3.39 billion. Under the "Take-or-Pay" agreement, the customers are obliged to pay the "Take-or-Pay" quantity under the Gas Sales and Purchase Agreement even if there is no delivery or consumption of the produced gas to customers during the period. In turn, the SC 38 Consortium is bound to deliver the "Take-or-Pay" volumes in the future, thus, the proceeds from "Take-or-Pay" are treated as unearned revenue until the aforementioned delivery is actually effected.

25. CAPITAL STOCK

The Company's authorized capital stock is divided into ten million no par value shares of which two million shares were initially subscribed and paid for by the Philippine Government at ₱50 per share. The remaining shares may be subscribed and paid for by the Republic of the Philippines or by government financial institutions at no less than ₱50 a share. From 1975 to 1988, an additional 6,029,191 shares were subscribed by the Republic of the Philippines at ₱500 per share.

26. DONATED CAPITAL

In 1995, the Canadian International Development Agency (CIDA), through Petro-Canada, donated to PNOC Exploration Corporation a gas turbine for the power plant of San Antonio Gas Project (SAGP). In 1998, PNOC EDC also transferred to PNOC-EC the Kremco Model trailer-mounted drilling rig (Rig I) and a Digitran RS-300 drilling rig simulator, which were also donated by CIDA through Petro-Canada in 1993 and 1994, respectively.

27. RETAINED EARNINGS

PNOC and Subsidiaries' retained earnings on January 1, 2004 were restated to reflect the conversion from Philippine GAAP to PFRS. The cumulative effect of all the adjustments has reduced the consolidated balance sheet by ₱22.50 billion from ₱29.29 billion to ₱6.79 billion as of January 1, 2004. These adjustments came mainly from PNOC-EDC (₱17.96 billion), PNOC-EC (P2.24 billion) and PNOC (₱3.6 billion).

28. DIVIDENDS PAYABLE

Pursuant to the Republic Act 7656, PNOC declared a total cash dividend of ₱302.4 million for its 2005 net earnings. This includes the 50% share of the government from the cash dividend declared by Petron Corporation. In addition, PSTC remitted ₱1.08 million directly to the Bureau of the Treasury on June 15, 2005 representing 50% of its declared cash dividend for its 2004 net earnings.

29. REVALUATION SURPLUS

This account refers to PDMC's revaluation of 588,967 sqm land area located in Rosario, Noveleta and Gen. Trias, Cavite conducted by Valencia Appraisal Corp. in May 2005.

30. FAIR VALUE AND OTHER RESERVES

This account consists of PNOC-EDCs accumulated unrealized gain on investments in bonds and stocks classified as available-for-sale securities charged to equity.

31. NET SALES

This account consists of:

	2005	2004
Electricity	**16,455,495**	15,957,212
Oil and gas production	**5,071,495**	3,005,831
Steam	**4,967,362**	4,685,671
Coal operations	**1,535,582**	1,423,919
Shipping	**398,524**	356,172
Drilling	**149,526**	1,605
Energy supply base	**89,108**	63,281
Socialized housing	**68,289**	132,072
Water	**8,450**	11,285
Thruput	**7,494**	10,333
Right of way	**2,617**	2,379
Others	**3**	1,727
Total	**28,753,945**	25,651,487

32. COST OF SALES

This account consists of:

	2005	2004
Purchased services and utilities	**5,978,013**	7,221,719
Depreciation and amortization charges	**3,149,075**	2,984,412
Employee costs	**1,156,887**	924,008
Coal purchases and landed costs	**1,141,301**	974,969
Royalty fee	**28,840**	373,972
Oil and gas production costs	**483,288**	332,104
Materials and supplies	**362,439**	294,413
Maintenance and repairs	**282,284**	290,706
Rental, insurance and taxes	**221,205**	232,199
Fuel, oil, and TBA	**166,631**	144,550
Shipping and delivery	**80,223**	111,698
Technical support charges	**59,087**	68,567
Business and other expenses	**39,854**	30,858
Land and development costs	**794**	1,568
Miscellaneous expenses	**423**	227
Total	**13,650,344**	13,985,970

33. OPERATING EXPENSES

This account consists of:

	2005	2004
Administrative and allocated charges	**779,130**	960,707
Employee costs	**555,652**	527,165
Provision for doubtful accounts	**272,612**	361,523
Purchased services and utilities	**231,041**	224,448
Rental/insurance/taxes	**216,449**	270,486
Depreciation/amortization	**112,096**	133,483
Business expenses	**63,942**	88,129
Materials and supplies	**50,936**	36,613
Maintenance and repairs	**17,395**	18,042
Provision for materials obsolescence	**-**	1,816
Others	**277,178**	184,150
Total	**2,576,431**	2,806,562

34. OTHER INCOME (CHARGES)

This account consists of:

	2005	2004
Foreign exchange gain/(loss)	**6,814,281**	(2,064,778)
Interest income - net of final tax	**1,180,075**	976,488
Dividend income	**375,579**	750,054
Inflation adjustment on prior year's electricity and steam sales	**290,586**	(344,360)
Lease income	**165,201**	158,982
Interest expense	**(2,884,363)**	(2,542,194)
Impairment loss	**(331,075)**	(417,597)
Adjustments on prior year's foreign exchange losses on BOT lease obligations	**-**	479,990
Accelerated amortization of wells/project	**-**	(361,115)
Other income/(charges)	**(179,127)**	162,470
Total	**5,426,157**	(3,202,060)

The foreign exchange gain/loss refers to foreign exchange differential on repayment and realignment of foreign loans, money market placements in dollar denomination and cash in banks in US dollar and Japanese yen currencies. The 2005 foreign exchange gain was attributed to the realignment of foreign loans because of the appreciation of peso and depreciation of yen against the US dollar currency (US$1=₱53.062 / JPY117.855 in December 2005 vs US$=₱56.341 / JPY103.05 in December 2004.

35. INCOME TAX

Components of income tax expense are as follows:

	2005	2004
Current tax	**2,026,817**	1,404,619
Deferred tax	**2,265,857**	(177,792)
	4,292,674	1,226,827

This account is comprised mainly of PNOC-EDC's current tax of ₱1,677,384 and deferred tax of ₱2,171,591. As of December 31, 2005, the Company has recognized income tax liability under the finance lease method for taxable years 2004 and 2005 and for deficiency VAT and withholding tax liabilities for the taxable years 2000 to 2004.

On May 24, 2005, the President of the Republic of the Philippines signed into law Republic Act No. 9337, which took effect on July 1, 2005, the implementation of the Regular Corporate Income Tax (RCIT) rate for domestic corporations and resident and non-resident foreign corporations. The RCIT rate is increased to 35% (from 32%) beginning November 1, 2005 and will be reduced to 30% beginning January 1, 2009. This rate shall be applied on the amount computed by multiplying the number of months covered by the new rate within the fiscal year by the taxable income of the corporation for the period, divided by 12 months.

36. DEFERRED INCOME TAX

The analysis of deferred income tax for financial reporting purposes follows:

	2005	2004
Deferred tax assets:		
Foreign exchange losses (gains) – BOT Power Plants	**5,607,478**	5,592,727
Unrealized foreign exchange losses (gains)	**2,870,658**	4,908,078
Allowance for doubtful accounts	**1,235,759**	1,103,341
Allowance for decline in value of investments	**314,059**	287,205
Carry forward of unused tax credits	**244,763**	124,811
Net operating loss carry over (NOLCO)	**41,454**	-
Minimum corporate income tax (MCIT)	**15,233**	-
Others	**112,269**	97,411
Total deferred tax assets	**10,441,673**	12,113,573
Deferred tax liability:		
Increase in fair value applied as deemed Cost	**2,232,094**	2,159,510
Deductible expenses per PD 1442	**3,314,354**	2,940,140
Allowance for doubtful accounts	**29,116**	4,858
Unrealized foreign exchange gains / losses	**123,843**	1,446
Total deferred tax liability	**5,699,407**	5,105,954
Net Deferred Tax Assets	**4,742,266**	7 ,007,619

37. RATIONALIZATION / MANPOWER REDUCTION PROGRAM (MRP)

PNOC

The Philippine National Oil Company is exploring avenues by which it can achieve its goal of further focusing and streamlining its operation. An option that is currently being considered is the Rationalization Program of the Government as embodied in Executive Order 366.

The Rationalization Program aims to conduct a strategic review of the operations and organizations of the Executive Branch and the rationalization of its functions and agencies, guided by the following framework and objectives:

1. Focusing Government efforts on its vital/core functions and the priority programs and projects under the 10-point Agenda of the Administration and achieving the poverty-reduction targets under the Millennium Development Goals;
2. Improving the quality and efficiency of government services by eliminating / maximizing overlaps and duplication and by rationalizing delivery and support services, organization structures and staffing;
3. Improving agency accountability for performance and results, and;
4. Implementing programs and projects of government within allowable resources.

Part of the Rationalization Program would be to ensure that overlaps and duplications are eliminated and in doing so, PNOC sees itself offering separation programs for affected employees who may opt to be separated or retired from the Government Service all in accordance with the provisions of Executive Order 366.

The Rationalization Program has a potential of affecting about 50 plantilla positions bringing the total manpower of PNOC from 211 to 178. Currently, PNOC is working with the Department of Budget and Management to further refine its plans of action in relation to E. O. 366 and expects to put into place the Rationalization Plan before the end of the year.

PNOC-EDC

The PNOC-EDC Board of Directors approved, in a special meeting on October 22, 2004, the Manpower Reduction Program (MRP) for implementation effective November 2004 to October 31, 2005.

The program covers employees who are 50 years old and above as of October 31, 2005 and have rendered at least 10 years of service during the period of implementation, and employees specifically identified as excess as a result of the Company's reorganization in 2003. The MRP offered the qualified employees a financial package of 2.5 months base pay (12/12) as of December 31, 2004, multiplied by the service years.

There were 298 employees who availed of the MRP in 2005 with the total cost of ₱1.03 billion. Of this amount, ₱613.83 million pertained to the retirement costs of 193 employees who were at least 50 years old (covering only two months base pay out of the 2.5 financial package multiplied by the service years) which were charged to the retirement fund while the ₱412.93 million cost of 105 employees who were below 50 years old including the 0.5 month base pay differential of separated employees aging at least 50 years old were expensed in 2005.

PNOC-EC

In 2005, Manpower Reduction Program was offered to PNOC-EC employees in compliance with Administrative Order 103 and Executive Order 366 which directed the implementation of cost-cutting and rationalization measures in the government. Part of PNOC-EC's rationalization program included the implementation of its new organizational structure that is responsive to its new mission, vision and corporate objectives. Thirty eight (38) employees availed of the program.

PDMC

PDMC implemented a Manpower Reduction Program (MRP) bringing down the number of regular employees from 52 to 19. The Board of Directors in its Board Resolution No. 28, Series of 2005 dated August 1, 2005, has approved the new Table of Organizations, while Board of Resolution No. 31, Series of 2005 dated August 11, 2005, approved the MRP and its implementing guidelines. The total cost of the program was ₱8.98 million.

38. SIGNIFICANT AGREEMENTS

Service Contracts

Under Presidential Decree No. 334, as amended, PNOC is empowered to undertake exploration, discovery, development and extraction of all forms of energy resources, including geothermal, coal and oil.

Accordingly, the Company thru its subsidiaries, entered into service contracts with the Department of Energy (DOE), for the exploration of oil concession areas and natural gas deposits and the development of geothermal resources and certain coal areas in the country, subject to sharing of net proceeds with the government. The net proceeds is what remains after deducting from the gross proceeds the allowable recoverable costs, which includes development, production and operating costs.

The allowable recoverable costs shall not exceed 90% of the gross proceeds. The Company pays 60% of the net proceeds as government share in the form of royalty fees and income taxes. The royalty fees are shared by the government through DOE (60%) and the LGU (40%).

DOE has approved the application of PNOC-EDC for the 20-year extension of the Tongonan, Palinpinon and Bacon-Manito Geothermal Service Contract (GSCs). The extension is embodied in the fourth amendment to the GSC's dated October 30, 2003. The amendment extends the Tongonan GSC from May 15, 2011 to May 16, 2031, while the Palinpinon and Bacon-Manito GSC's are extended from October 16, 2011 to October 17, 2031.

Geothermal Steam Sales Contracts

The geothermal energy currently produced by the Company's geothermal projects is supplied to its BOT contractors and the power plants owned and operated by NPC pursuant to the following steam sales contracts:

Tongonan I

Under the steam sales contract entered in June 1984 for Tongonan I, NPC agrees to pay the Company a base price per kilowatt-hour of net generation, subject to inflation adjustments and based on a guaranteed take-or pay rate of 75% plant factor for a period of 25 years.

Palinpinon I

The steam sales contract for Palinpinon I provides, among others, that NPC shall pay the Company a base price per kilowatt-hour of gross generation, subject to inflation adjustments and based on a guaranteed take-or-pay rate at 75% plant factor. The contract is for a period of twenty years commencing on December 25, 1988.

Palinpinon II

In June 1996, the Company and NPC signed a steam sales contract for Palinpinon II's four modular plants – Nasuji, Okoy, Sogongon I and Sogongon II. Under the terms and conditions, NPC agrees to pay the Company a base price per kilowatt-hour of gross generation, subject to inflation adjustments and based on a guaranteed take-or-pay rate commencing from the established commercial operation period, using the following plant factors: 50% for the first year, 65% for the second year and 75% for the third and subsequent years. The contract is for a period of twenty-five years for each module commencing on December 13, 1993 for Nasuji; November 28,1994 for Okoy; January 28, 1995 for Sogongon I and March 23, 1995 for Sogongon II.

Bacon-Manito I

The steam sales contract for the Bacon-Manito (Bacman) geothermal resources entered in November 1998 provides, among others, that NPC shall pay the Company a base price per kilowatt-hour of gross generation, subject to inflation adjustments and based on a guaranteed take-or-pay rate of 75% plant factor. The contract is for a period of twenty-five years commencing in May 1993.

Bacon-Manito II

Bacman II's steam sales contract with NPC was signed in June 1996 for its two 20-MW capacity modular plants – Cawayan and Botong. The terms and conditions under the contract contain, among others, NPC's commitment to pay the Company a base price per kilowatt-hour of gross generation, subject to inflation adjustments and based on a guaranteed take-or-pay rate commencing from the established commercial operation period, using the following plant factors: 50% for the first year, 65% for the second year and 75% for the third and subsequent years. The contract is for a period of twenty-five years commencing in March 1994 for Cawayan and December 1997 for Botong.

Build-Operate-Transfer (BOT) Contracts

Pursuant to Republic Act Number 7718 dated May 5, 1994 (Amended BOT Law), PNOC-EDC entered into Energy Conversion Agreements (ECA) to convert the geothermal steam to be supplied by the Company to electricity with various international geothermal power producers for the construction and operation of power plants in Leyte and Mindanao. Under these contracts, the BOT Contractor shall deliver electricity to NPC on behalf of the Company.

Leyte

Under the ECA with BOT Contractors, namely: California Energy for a) 125 MW Power Plant – Upper Mahiao Agreement; b) 231 MW Power Plant – Malitbog Agreement; and c) 180 MW Power Plant – Mahanagdong Agreement and with Ormat Inc. for the Leyte Optimization Project BOT Agreement, the Company shall pay the BOT Contractors monthly energy fees to be computed based on actual energy delivered and capacity fees, which include capital and fixed operating cost recovery fees and service fees, to be computed on a per kilowatt nominated capacity basis.

Except for the capital cost recovery portions, the fees are subject to inflation adjustments. The contracts are for a period of ten years commencing July 1996 for the Upper Mahiao Agreement, July 1997 for the Malitbog and Mahanagdong Agreements and September 1997 for the Optimization Agreement.

Mindanao

Under the terms and conditions of the ECA with Oxbow Power Corporation and Marubeni Corporation, the Company shall pay the BOT Contractor monthly energy efficiency fees and capacity fees, which include capital and fixed operating costs recovery fees and service fees, to be computed on a per kilowatt nominated capacity basis and excess energy fees which are payment for the share of BOT Contractor for the revenues from surplus energy generation on top of the nominated energy. Except for energy efficiency payments and capital cost recovery portion of capacity fees, the fees are subject to inflation adjustments. The contract is for a period of ten years commencing in March 1997 for Mindanao I (47 MW) and June 1999 for Mindanao II (48.25 MW).

Natural Gas Development and Production

Malampaya Deep Water Gas to Power Project (Service Contract No. 38)

PNOC Exploration Corporation owns ten percent (10%) working interest in Service Contract (SC) 38 Malampaya Deepwater Gas-to-Power Project producing condensate and gas that fuels the Ilijan, Sta. Rita and San Lorenzo power plants in Batangas. Commercial gas production commenced on January 1, 2002.

San Antonio Gas Project (SAGP) (SC 37)

The SAGP Power Plant was shut down on October 11, 2004 due to technical problems encountered with the gas power plant controllers and resumed commercial operations on September 27, 2005 after the replacement of the power plant control system. Electricity generation for 2005 was 4.97 megawatt hours. The Gas Plant produced 93.84 million standard cubic feet for power generation and supply to compressed Natural Gas Station.

Petroleum Exploration

Ragay Gulf (SC 43)

A 133-km seismic survey was completed in August 2005, which is part of the work obligation entered into by the Consortium. The operator, Premier Oil (42.5%) has requested a 6-month extension of the 1st sub-phase of the exploration program from the Department of Energy, which was supposed to expire on January 14, 2006, because of the delays in the implementation of the seismic program. The other members of the Consortium are PEARL Energy (42.5%) and PNOC-EC (15%).

Offshore Mindoro (SC47)

The DOE awarded Service Contract 47 on January 10, 2005 to PNOC-EC and Petronas Carigali with participating interests of 20% and 80% respectively. The Service Contract has a well commitment with the Department of Energy and Petronas Carigali, the Operator of the block who has been doing the technical work in Kuala Lumpur to identify the best drilling target.

South China Sea (JMSU)

The Joint Marine Seismic Undertaking was signed by CNOOC (China), PIDC (Vietnam) and PNOC-EC (Philippines) on March 14, 2005. These National Oil Companies have agreed to jointly evaluate the petroleum potential of certain areas of the South China Sea. The expenses will be equally shared by these companies. The acquisition of 11,000 kms of 2D seismic data was completed in November 2005 and processing is on-going.

West Calamian and West Balabac

PNOC-EC has applied for a Service Contract over the West Calamian and West Balabac areas with the DOE. The work program over these blocks has been approved by the DOE and the Service Contract is expected to be signed early next year.

Philippine Energy Contracting Round – 2

PNOC-EC joined the Department of Energy's PECR-2 and submitted its bid to/for exploration rights over two areas in offshore Philippines. PECR Block 1 was jointly filed with Nido Petroleum covering SW Palawan while PECR Block 2, covering East Palawan was filed solely by PNOC-EC.

Coal Operating Contracts (COC)

Surigao Coal Exploration – COC No. 140

The DOE granted PNOC-EC the Coal Operating Contract (COC) No. 140 on July 5, 2005 for the two (2) year exploration of Coal Blocks CBS 38 38-L-126, 127 and 167 covering an area of approximately 3,000 hectares within the Barangays of Layog and Carra-an both located in the Municipality of Tago, within the province of Surigao Del Sur, in Eastern Mindanao.

Isabela Coal Exploration – COC No. 141

The DOE granted PNOC-EC the COC No. 141 on July 5, 2005 for the two (2) year exploration of Coal Blocks CBS 14-G-77, 78 and 79 covering an area of approximately 3,000 hectares in the Municipalities of Naguilian and Benito Soliven, all within the province of Isabela, in the Cagayan Valley of Northern Luzon.

Isabela Integrated Coal Mine Mouth Power Plant Project – COC No. 122

With the aim of addressing the concerns of opposing groups and obtain local acceptance of the project, PNOC-EC continued with its implementation of the extensive Information, Education and Communication (IEC) Campaign at the affected cities/municipalities in Isabela namely the Municipalities of Benito Soliven, and Naguilian and the City of Cauayan.

In April and May 2005, PNOC-EC and Maunsell Philippines, Inc. conducted perception surveys in various barangays in Naguilian to measure social acceptability/positive perception and establish the outcome of the IEC Campaign. Results show that the campaign obtained favorable outcome ranging from 42% to 93% support from various barangays.

Malangas Coal Project – COC No. 41

PNOC-EC continues to explore and develop the six (6) coal projects under COC 41 located within the Malangas Coal Reservation. The project area of approximately 6,000 hectares straddles in the Municipalities of Imelda, Diplahan and Malangas, all in the Province of Zamboanga Zibugay. PNOC-EC currently operates the Integrated Little Baguio Coal Project (a joint venture undertaking between PNOC-EC and Taiwan Overseas Mining Co. Inc.), Shaft 3 Satellite Mine and Lumbog Sattelite Mine.

Recently, the Environmental Compliance Certificate (ECC) for the Lalat Coal project, a joint venture undertaking with the Filipinas Systems (Filsystems) was granted by the DENR-EMB. The estimated mineable coal reserves of the project is 4.5 million MT.

PNOC-EC is also planning the development and production of the Lumbog Coal Proejct and Lower Butong Project with the estimated in-situ coal reserves of 6 million MT and 1 million MT, respectively. The Company is currently in the process of entering into a Joint Coal Development and Production Agreement with SK Philkor Corporation.

Energy Supply Base (ESB)

PNOC-EC continues to serve the docking, storage and warehousing needs of various oil and energy-related companies and also caters to the commercial sector with the granting by the Philippine Ports Authority of a Certificate of Registration No. 291 and permit to operate as a private commercial port. The permit is co-terminus with the 25-year foreshore lease agreement of ESB with the Department of Natural Resources (DENR) effective May 3, 1996, which will expire on May 3, 2021.

The Company has negotiated with Petron Corporation for the shared use of the ESB land and facilities covered by the long-term lease contracts between Petron Corporation and PNOC. Henceforth, the company negotiated with PNOC for direct long-term lease for ESB land. The lease agreement started on January 1, 2005 and will end on December 31, 2029.

PNOC-EC has entered into a 25-year long-term lease contract with Zamboanga Development and Management Corporation for a one-hectare land area and 61,100 sqm foreshore area for the Grains Bulkhandling, Storage and Jetty Facilities (the first in Southern Luzon area) to achieve a sustainable logistics development program for the country.

PNOC Solar Home Systems (SHS) Distribution Project

The Solar Home systems (SHS) Project is a rural electrification project that supports the electrification and social reform agenda of the Philippine Government. It involves the sale and distribution of 15,100 units of solar home systems within a period of five (5) years in Regions 1 to 7, the Cordillera Administrative Region and the whole of Minadanao Regions.

The SHS units were initially supplied by Shell Solar Energy B.V. of Netherlands, which was later taken over by Shell Solar Germany. The project involves a total cost of EUR9,318,376.74, of which 60% of EUR5,591,026 is covered by a Grant from the Netherlands Government and 40% or EUR3,727,350.74 is for the account of PNOC. By virtue of the grant, PNOC through the financial intermediaries is responsible for the sale and distribution of the SHS units.

The project is being implemented by PNOC, in partnership with the Netherlands Government, and in cooperation with the Department of Energy. The Shell Solar Philippines Corporation currently acts as PNOC's technical contractor for the project.

The project commenced implementation in June 2002, and set to be completed in May 2007.

39. POWER PURCHASE AGREEMENTS

The electricity produced by PNOC-EDC, through its BOT Contractors, is sold to NPC pursuant to the following Power Purchase Agreements (PPA):

Leyte-Cebu, Leyte Luzon

The PPA provides, among others, that NPC shall pay PNOC-EDC a base price per kilowatt-hour of electricity delivered subject to inflation adjustments. The PPA stipulates a contracted annual energy of 1,370 GWH for Leyte-Cebu and 3,000 GWH for Leyte-Luzon throughout the cooperation period. It also stipulates a nominated energy of not lower than 90% of the contracted annual energy.

On November 12, 1999, NPC agreed to accept from PNOC-EDC a combined average annual nominated energy of 4,455 GWH for the period July 25, 1999 to July 25, 2000 for both Leyte-Cebu and Leyte-Luzon PPA. The combined annual nominated energy starting July 25, 2000 is currently under negotiation with NPC. The contracts are for a period of twenty-five years commencing in July 1996 for Leyte-Cebu and July 1997 for Leyte-Luzon.

47 MW Mindanao I

The PPA provides, among others, that NPC shall pay PNOC-EDC a base price per kilowatt-hour of electricity delivered subject to inflation adjustments. The PPA stipulates a minimum offtake energy of 330 GWH for the first year and 390 GWH per year for the succeeding years. The contract is for a period of twenty-five years commencing in March 1997.

48.25 MW Mindanao II

The PPA provides, among others, that NPC shall pay PNOC-EDC a base price per kilowatt-hour of electricity delivered subject to inflation adjustments. The PPA stipulates a minimum offtake energy of 398 GWH per year. The contract is for a period of twenty-five years commencing in June 1999.

40. COMMITMENTS

Prior to Petron's privatization in 1994, majority of its landholdings amounting to ₱153 million was transferred to PNOC as property dividend in 1993. Portion of these properties specifically bulk plants and service stations was leased back to Petron and a leasehold agreement between Petron and PNOC was executed for a period of 25 years from September 1, 1993 to August 31, 2018 subject to renewal. Annual leasehold rental has reached ₱134.6 million in 2005 and ₱128.9 million in 2004.

41. PRIVATIZATION

PNOC Energy Development Corporation

PNOC–EDC was granted approval by then President Fidel V. Ramos on June 14, 1996 to divest 60% of the National Government shareholdings (through the PNOC) in the company, in line with the government's policy of restructuring power sector.

In April 1997, the Committee on Privatization (COP), approved the proposed privatization plan recommending for the sale of approximately 30% to 40% of PNOC-EDC's shares through an initial public offering (IPO) and the remaining 20% to 30% of shareholdings to strategic investor through an auction process. The plan was approved by then President Fidel V. Ramos in July 1997.

On November 5, 1997, the PNOC Board, upon recommendation of the privatization advisors, decided to postpone the privatization of PNOC-EDC, in view of the unfavorable equity markets conditions.

On November 23, 2004 and December 10, 2004, the Board of Directors of PNOC-EDC and PNOC (mother), respectively, approved the re-activation of plans to privatize PNOC-EDC.

The privatization plan of PNOC-EDC shall involve the (a) issuance and sale of 5 billion new PNOC-EDC's shares and (b) sale of 4 billion existing shares of PNOC in PNOC-EDC.

In February 2005, PNOC-EDC awarded the mandate for financial advisory/ underwriting/global coordinating services to CLSA Exchange Capital Inc.

Under the privatization masterplan, the overall implementing strategy for the Company's privatization involved the sale through public bidding of each geothermal complex to be undertaken only after PNOC-EDC's geothermal steamfields and NPC's generating plants are combined for sale as one package.

During the August 25, 2005 presentation of PNOC-EDC's Privatization Masterplan to the Joint Congressional Power Commission (JCPC), clearance to proceed with the Company's privatization using the proposed implementing strategy was held in abeyance considering certain issued raised by some members of the Commission. As a result of this, PNOC-EDC's approach to its privatization was revised to one involving the sale through public bidding of PNOC-EDC shares of stock after a pre-negotiated Steam Sales Agreement (SSA) between Power Sector Assets and Liabilities Management Corporation (PSALM) and PNOC-EDC is finalized. This was presented to and approved by the PNOC-EDC and PNOC Board last October and November 2005, respectively.

This modified approach to PNOC-EDC's privatization was presented to the JCPC during its November 2005 meeting. As of end December 2005, clearance to proceed under the modified approach is still pending with the JCPC.

PNOC Exploration Corporation

In March 2005, the Privatization Council ("PrC") approved the sale of 49% of PNOC EC's 10% participating interest in SC 38 Malampaya Project. This approval was, however, withdrawn the following month for the reason that the terms thereof were no longer reflective of prevailing market conditions.

42. CONTINGENT LIABILITIES

PNOC

1. **Sukhin Energy, Inc. vs. PNOC**
   Civil Case No. 05-565
   RTC Branch 62, Makati City

   For: Specific Performance, Injunction with prayer for a Temporary Restraining Order and a Writ of Preliminary Injunction

2. **Voltaire Rovira vs. PNOC**
   CA-GR CV No. 80608
   Court of Appeals

   For: Specific Performance and Damages

3. **Flagship Tankers Corp. vs. Petrophil Tankers, PSTC and PNOC**
   Civil Case No. Q-00-39832
   RTC Branch 226, Quezon City

   For: Damages

4. **Keppel Philippines Shipyard, Inc. vs. PNOC/PDEC**
   Civil Case No. 7364
   RTC Branch 84, Batangas

For: Specific Performance

5. Republic of the Philippines (represented by DPWH) vs. Spouses Manuel T. Lim, PNOC, et. Al.
Civil Case No. CEB-25019
RTC Branch 13, Cebu City
For: Expropriation

6. PNOC vs Petron, Opimio Abrahano, Jr. and Maria Soliven
Civil Case No. 04-0009-D
RTC Branch 41, Dagupan City

For: Unlawful Detainer

7. PNOC vs Pacifico Tecson
Civil Case No. 67 M-02
RTC Branch 8, Malolos, Bulacan

For Accion Publiciana

8. PNOC vs Maria Nabong
Civil Case No. 16931
Municipal Trial Court in the City
Branch III, Cabanatuan City

For: Accion Publiciana

9. PNOC vs Sandigan Savings and Loan Bank, Inc.
Civil Case No. SD(05)334
RTC Branch 89, Baloc Sto. Domingo
Nueva Ecija

For: Petition for Cancellation of Annotation/Attachment Lien on the Back of the TCT No. N-32338

10. PNOC (Petitioner)
LRC Case No. 5964-280
RTC Branch 23, Trece Martires City

For: Petition for Issuance of New Owner's Copy of the Transfer Certificate of Title (TCT) No. T-147729

11. PNOC vs Raul B. Saulo, Crown Radio Corp. et al
CA-G.R. CV No. 75321
Court of Appeals, Manila

For: Expropriation

12. PNOC vs Arthur Apolinar
I.S. No. 05-H-9636
City Prosecution Office, Makati City

For: Violation of B.P. 22 / Estafa

13. In Re: Apprehension Case (PNOC's Right Hand Drive Vehicle)
Case No. 005-03-070
Land Transportation Office (LTO)

For: Violation of R.A. 8506 (An Act Banning the Registration and Operations of Vehicles with Right Hand Steering Wheel)

14. PNOC vs. National College of Business Arts (NCBA)
Supreme Court

Appeal of Certiorari

15. Paul Mata vs Petron Corporation and PNOC
CA-G.R. 58185
Court of Appeals

For: Specific Performance of Contract with damages

PNOC-EDC

1. PNOC-EDC vs. PNG Construction and Dev. Corp.
CA GR 962449
Court of Appeals, Manila

For: Breach of Contract and Damages claim against PNG

2. Republic of the Philippines (represented by PNOC-EDC and DOE) vs. City of Kidapawan, et. al.
SC GR 166651
Supreme Court , Manila

For: Prohibition with Prayer for the Issuance of Writ of Preliminary Injunction and/or Temporary Restraining Order with Motion for Reconsideration

3. Frederick Ubag, et.al. vs. PNOC-EDC/NCV/JMQ/RBC
CA GR Sp. No. 81231
Court of Appeals, Cebu City

For: Illegal Dismissal

4. Nationwide Security & Allied Services, Inc. vs. PNOC-EDC
CA GR Sp. No. 81542
Court of Appeals, Manila

For: Injunction and Damages Claims Against PNOC-EDC

PDMC

1. PDMC vs. Adeling O. Abad, et al
Civil Case No. 546
Municipal Trial Court of Rosario, Cavite

For: Ejectment and Damages

2. Filoil Development and Management Corp. vs. Feliciano Abalos, Jr., et al
Civil Case No. 760
Municipal Trial Court of Noveleta, Cavite

For: Ejectment and Damages

3. Filoil Development and Management Corp. vs. Esteban Alde, et al.
DARAB Case No. 0402-194-203-00 dated 01 October 2002
Department of Agrarian Reform Adjudication Board – Region IV

For: Ejectment

4. In re: Application for Exemption Clearance Involving Parcels of Land with a Total Area of 46.8953 hectares, more or less, located at Brgy. Ligtong, Rosario, Cavite.
Department of Agrarian Reform, Elliptical Road, Quezon City
Administrative Case No. A-9999-131-00 dated 18 October 2002

5. Gloria V. Gomez vs. PNOC Development and Management Corp., Jose P. Leviste, Jr. and Bienvenido S. Arellano
NLRC NCR CN. 30-12-00856-99
National Labor Relations Commission
National Capital Judicial Region, Quezon City

43. EVENTS AFTER BALANCE SHEET DATE

PNOC-EDC

Last January 31, 2006, PNOC-EDC received from the Bureau of Internal Revenue a tax credit certificate (TCC) amounting to ₱811.22 million representing refund for excess unutilized input value added tax for the period December 26, 2000 to June 25,2001 (₱626.65 million) and balances for the period December 25,1999 to June 25, 2000 (₱89.13 million). On the same date, the Bureau of Internal Revenue (BIR) issued tax clearances for the years 2000 through 2004.

Consequently, the Company filed last March 9 and 21, 2006 the Motions to Withdraw with the Court of tax Appeals for its Petitions for Review docketed as CTA Case Nos. 7258, 7268 and 7339 filed on April 27, 2005, May 27, 2005 and June 9, 2005, respectively. Accordingly, the CTA granted PNOC-EDC's Motions for Withdrawal and considered CTA Case Nos. 7268, 7339 and 7258 closed and terminated on March 28, 2006, April 4, 2006 and April 12, 2006, respectively.

PSTC

In January 2006, PSTC's outstanding short-term loan with Land Bank of the Philippines with PN Nos. 3073-20 and 3073-30 amounting to ₱20 million and ₱170.7 million, respectively, were converted to long-term loan. Repayments of the principal amount were set on a quarterly mode. This transaction has a significant effect on financial structure and leverage of the Company.

PDMC

The Company's request for a certificate of CARP exemption filed with the Department of Agrarian Reform, a favorable ruling under DARCO Order No. Ex-0512-0281 Series of 2005 (A-9999-131-00) dated December 31, 2005 has been received. The 37 farmers claimants have filed a motion for reconsideration dated January 6, 2006.

Regarding the complaint for alleged illegal dismissal filed by the former Administrator/Corporate Secretary against the Company and its former senior officials, the Court of Appeals – Special Sixth Division has rendered a decision on case PDMC vs. Gloria V. Gomez under CA-GR# Sp. 88819 dated May 19, 2006 on the lack of jurisdiction of NLRC. The complainant has filed a motion for reconsideration dated June 9, 2006.

44. AUTHORIZATION FOR ISSUE

The management approved and authorized for issue the consolidated financial statements on August 25, 2006.

Board of Directors

Raphael Perpetuo M. Lotilla
Secretary of Energy

Eduardo V. Mañalac
President and Chief Executive Officer, PNOC

Leopoldo E. Petilla
Director

Emil P. Jurado
Director

Dante B. Canlas
Director

Edgardo M. del Fonso
Director

Bob D. Gothong
Director

Raymond Democrito C. Mendoza
Director

Ramon B. Mitra
Director

Management Committee

From left to right:

Joselito D. Gonzales (Manager, Treasury), Glenda G. Martinez (Manager, Accounting), Luthgarda M. Lacaba (Manager, Corporate Planning), Eduardo V. Mañalac (President and CEO) and Eleanor Rochelle S. Cruz (Manager, Internal Control)

*Not in picture: Roland F. Rodriguez, (Senior Vice President, Management Services)

From left to right, seated:

Celia R. Tagaro (Manager, Project Management), Bernadette B. Jugan (Manager,Legal Department), Victorino S. Bala (Manager, Energy Research), Pedro A. Aquino, Jr. (Senior Vice President, Legal, Administrative and Estate Management Services), Remedios A. Amor (Manager, Estate Management)

From left to right, standing:

Lino Gerardo G. Calaor (Manager, Administrative Department), Eduardo V. Mañalac (President and CEO)

PNOC
Project List

I. GEOTHERMAL

1. Leyte, Leyte
    - Upper Mahiao
    - Malitbog
    - Optimization Plant
    - Mahanagdong
    - Tongonan I
2. Palinpinon, Negros Oriental
    - Palinpinon I
    - Palinpinon II
3. Bacon Manito, Albay and Sorsogon
    - Bacman I
    - Bacman II
4. Mindanao, North Cotabato
    - Mindanao I
    - Mindanao II
5. Northern Negros, Negros Occidental

II. OIL AND GAS EXPLORATION

6. Malampaya Deep Water Gas-to-Power Project (SC 38)
7. San Antonio Gas Power Plant (SC 37)
8. Calamian (SC 57)
9. West Calamian (SC 58)
10. West Balabac (SC 59)
11. Offshore Mindoro (SC 47)
12. Ragay Gulf (SC 43)
13. Tripartite Agreement Area (South China Sea)

III. COAL

14. Zamboanga-Sibugay Coal Project (COC 41)

IV. RENEWABLE ENERGY

15. Solar Home Systems Distribution Project

V. ENERGY ALLIED ACTIVITIES

16. Energy Supply Base, Mabini, Batangas
17. Petrochemicals in Limay and Mariveles, Bataan

VI. REAL ESTATE

18. Socialized Housing Project

Business Address

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PNOC Energy Development Corporation
PNOC Building 5, Energy Center
Merritt Road, Fort Bonifacio, Taguig, Metro Manila
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Fax No.: 815-2747
Website: www.energy.com.ph

PNOC Exploration Corporation
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Merritt Road, Fort Bonifacio, Taguig, Metro Manila
Telephone No.: 812-6209 ext. 5018, 5020, 5101

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