PNOC
The Energy Company

# Meeting the Country's Growing Needs

2007 Annual Report

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Cover: Skyline photo by Coni Fajardo

## PNOC Mission

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 Vision

To be a world-class Philippine energy enterprise.

## PNOC Core Values

Professional Integrity
Professional Excellence
Company Loyalty
Teamwork

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# Report of the Chairman and President

In the past 34 years, PNOC has continuously addressed the Philippines' evolving and growing energy needs. However, PNOC's contribution to the country produces an impact that goes beyond merely providing energy. We are aware that we affect lives much as we move the economy.

**OIL AND GAS PRODUCTION.** The PNOC-EC's Malampaya Deepwater Gas-to-Power Project continued to provide the gas fuel requirements of three (3) power plant customers in Batangas, namely Santa Rita (1,000 MW), San Lorenzo (500 MW), and Ilijan (1,200 MW), for a combined natural gas offtake of approximately 126.03 billion cubic feet (bcf), 16 percent higher than last year's 105.45 bcf production.

As the search for oil continues, PNOC-EC also conducted the acquisition, completion, processing, and evaluation of 2D seismic data in Calamian, West Calamian, West Balabac, and East Sabina, and prepared for the drilling of its first exploration well, Monte Cristo, in the Ragay Gulf. PNOC-EC likewise continued its Joint Marine Seismic Undertaking (JMSU) with CNOOC and PETROVIETNAM, with the Phase II seismic acquisition consisting of about 12,000 line-km 2D seismic data, followed by the selection and cataloguing of well samples in preparation for analysis.

**BARANGAY ELECTRIFICATION.** PNOC concluded the Solar Home Systems (SHS) Distribution Project, with the sale and distribution of the targeted 15,100 solar home systems in the Cordillera Autonomous Region, Ilocos, Cagayan Valley, Central Luzon, Southern Tagalog, Bicol, Western Visayas, and Central Visayas. The last 2,820 units were installed in 2007, completing the project's target installations since its inception in 2001.

**ALTERNATIVE FUELS.** The spin-off of PNOC Alternative Fuels Corporation (PNOC-AFC), formerly the PNOC Petrochemical Development Corporation (PNOC-PDC), has been making strides in their field, after only a year in operation.

A nursery/model plantation was established in Fort Magsaysay, Nueva Ecija with an aggregate area of 500 hectares. As of end-2007, the total area was planted with 1.61 million jatropha trees, while the nursery also raised 780,000 jatropha seedlings. In Cagayan de Oro, another nursery/provenance testing plantation was also set up with a total area of 500 hectares. Around 920,000 jatropha trees were planted in 280 hectares, with about 2.3 million seedlings raised in the nursery, by end of 2007.

**PETROCHEMICALS.** In the Petrochemical Park in Limay, Bataan, raw and firewater, power supply within the Park and other commercial areas, and jetty services are continuously being provided by PNOC-AFC for its locators. As of end-2007, the Industrial Park incurred higher revenues amounting to P48.5 million, as compared to P20.5 million in 2006.

**SHIPPING AND TRANSPORT.** The PNOC Shipping and Transport Corporation's (PSTC) fleet utilization was at its peak of 87.4 percent, a little short of last year's 88 percent utilization. The fleet, consisting of MTs JP Rizal, A Luna, Gomburza and GBB1, was continuously monitored and retrofitted to conform with international and local safety standards, especially those set by Petron Corporation.

**REAL ESTATE MANAGEMENT.** PNOC Development and Management Corporation (PDMC) has consistently improved its performance, resulting in a net income of P406 million for 2007, which is 22 times more than last year's P19.76 million earnings. Housing opportunities were provided by its Costa Verde Project and the El Pueblo Sta. Mesa Condominium Project. For socialized housing, PDMC continued to distribute lots under the GMA Abot Kayang Pabahay at Palupa Project. Likewise, it sponsored the PNOC Gawad Kalinga Village in Cavite as part of its Corporate Social Responsibility Program.

**BOOSTING THE NATION'S COFFERS.** Most laudable of the company's achievements in 2007 was the timely sale of PNOC-EDC to Red Vulcan Holdings Corporation. The sale was touted as the biggest and the most transparent privatization deal ever and contributed a total of P48 billion to the government's coffers. The sale was bigger than what was anticipated and ably filled the government's need for additional resources.

**MOVING ON.** With the disposal of one of our crown jewels, comes the challenge of still becoming a world-class energy enterprise. We shall not be daunted. We shall endeavor to carry on with the same trailblazing attitude that has brought PNOC to where it is now.

**"We shall endeavor to carry on with the same trailblazing attitude that has brought PNOC to where it is now."**

**Antonio M. Cailao**
President and Chief Execuitve Officer

**Angelo T. Reyes**
Secretary, Department of Energy

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# Company **Profile**

The onset of the 1973 energy crisis gave birth to the Philippine National Oil Company (PNOC), a government-owned and controlled corporation, through Presidential Decree (PD) No. 334, with the primary purpose of providing and maintaining an adequate and stable supply of oil and petroleum products for domestic requirements.

## HOW OUR CORE BUSINESSES STARTED

The passing of the years has shown PNOC's areas of responsibilities evolving to meet the country's complex and growing needs. This is shown through the numerous subsidiaries created over time to address specific areas for development. In 1974, after purchasing Esso Phils., Inc., (now Petron Corporation), the largest oil firm in the country, three tanker corporations were created. A stevedoring corporation, the pre-cursor to the PNOC Shipping and Transport Corporation (PSTC), was acquired soon after to facilitate the movement of oil products throughout the country.

After the discovery of oil in Palawan in 1976 and seeing the potential of energy sources other than oil, PD 927 was enacted to promote the exploration and development of oil and other indigenous energy sources, effectively expanding PNOC's scope of operations. The Coal Development Act of 1976 set to establish a coal development program, which later on led to the creation of the PNOC Coal Corporation (PCC).

This year also saw the creation of two of PNOC's more lucrative subsidiaries – the PNOC Energy Development Corporation (PNOC EDC) and PNOC Exploration Corporation (PNOC EC). PNOC EDC has put the company on the map by making the country the second largest producer of geothermal energy in the world. This geothermal energy has contributed considerably to reducing the country's dependence on imported oil to 50 percent. Meanwhile, the US$5 billion Malampaya Deepwater Gas-to-Power Project heralds PNOC EC's participation in the largest and most important investment of its kind in the history of the Philippines.

PNOC's recent ventures into business deal with petrochemicals and real estate development. The PNOC Petrochemical Development Corporation's (PPDC) Petrochem Park was declared a flagship project under the Ramos Administration. The PNOC

Development and Management Corporation (PDMC), on the other hand, has been able to balance and maximize the use of PNOC land, both by earning from it through rentals and providing housing for displaced informal dwellers.

## WHERE WE ARE NOW

Following a successful Initial Public Offering in late 2006, the PNOC Energy Development Corporation (EDC) completed a Secondary Offering for the sale of the additional 20% of EDC's common shares in July. Favorable financial market conditions and high investor interest proved an advantage to fully privatize EDC. By December, Red Vulcan Holdings Corporation won the public bidding for the government's remaining 60% stake in EDC earning 58.5 billion pesos for the company.

Thirty-four years later, PNOC is busy trying to meet the country's demand for energy through its subsidiary, the PNOC Alternative Fuels Corporation (PAFC), as the need to develop alternative sources of fuel becomes imperative.

**PNOC's contribution to the country's development produces an impact that goes beyond merely providing energy. We affect lives much as we move the economy, for a better tomorrow.**

Photo by Coni Fajardo

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# Oil and Gas

**As PNOC's upstream oil and gas subsidiary, various onshore and offshore oil and gas exploration activities were undertaken by PNOC EC in many parts of the country, all performed with dedication and commitment.**

**Philippine petroleum reserves is estimated at 456 million Barrels of Fuel Oil Equivalent (BFOE). This consists of 25 million barrels of oil, 2,135 billion cubic feet of gas and 54 million barrels of condensate. PNOC continues to explore and prudently consider these investment opportunities.**

PNOC EC, our exploration arm, continues to fulfill its mandate to be at the forefront in oil and gas exploration, and is very much actively engaged in the country's search for indigenous sources of energy. As PNOC's upstream oil and gas subsidiary, various onshore and offshore oil and gas exploration activities were undertaken in many parts of the country, all performed with dedication and commitment.

## MALAMPAYA

The Camago-Malampaya Oil Leg (CMOL) Project was initiated to address the unpredictability of surges in world crude oil prices. The project was aimed at developing the production of oil reserves in the Malampaya field in offshore Northwest Palawan. After conducting a technical and commercial review, PNOC EC presented to DOE on April 25, 2007, the proposed bidding guidelines for the selection of a potential Joint Venture partner, and the project timetable.

The Malampaya Deepwater Gas-to-Power Project continued to provide the gas fuel requirements of three (3) power plant customers in Batangas, namely: Santa Rita (1,000 MW), San Lorenzo (500 MW), and Ilijan (1,200 MW). The Pilipinas Shell Petroleum Corporation (PSPC) in Tabangao, was also provided with its gas requirements. The year's total natural gas offtake from these power plants was approximately 126.03 billion cubic feet (bcf), 16 percent higher than last year's 105.45 bcf production.

The total condensate production of the Malampaya project increased to 5.75 million barrels, from last year's production of 5.04 million barrels. The condensate produced was shipped to buyers in Singapore, Thailand, and China.

## NATURAL GAS PRODUCTION

The 3MW San Antonio Gas and Power Plant, commissioned in 1994, is the first gas-fired power plant in the country, and supplies electricity to about 10,000 households in the municipalities of Echague, Jones, San Agustin, and parts of Santiago City, Isabela. The plant has been in operation for 14 years, and is expected to be decommissioned in 2008, as gas pressure nears its abandonment level. The plant produced 324.8 mmscf of gas, and generated 14.7 GWH of electricity for 2007, understandably lower than last year's 327.27 mmscf, and 16.67 GWH of electricity produced, due to the declining gas pressure.

## OIL EXPLORATION AND DEVELOPMENT

PNOC EC has ventured into seven projects, namely: Ragay Gulf, Offshore Mindoro, Calamian, West Calamian, West Balabac, East Sabina, and the Joint Marine Seismic Undertaking (JMSU).

The projects are in various stages of development in acquiring, completing, processing, and evaluating 2D seismic data, specifically for Calamian, West Calamian, West Balabac, and East Sabina. Ragay Gulf has made preparations for the drilling of its first exploration well, Monte Cristo, after approvals and permits were secured from DOE, DENR, and other local government units. The drilling in Offshore Mindoro unfortunately did not lead to an oil discovery despite oil shows that were encountered.

## JOINT MARINE SEISMIC UNDERTAKING (JMSU)

PNOC, consistent with the Declaration on the Conduct of Parties in the South China Sea, made a big step towards this end by pursuing a tripartite agreement with China National Offshore Oil Corporation (CNOOC) and Vietnam Oil and Gas Corporation (Petrovietnam). The three companies have agreed to jointly acquire geoscientific data to assess the petroleum resource potential of particular areas in the South China Sea. This is a joint marine seismic undertaking (JMSU) for the acquisition of 10,000 line-kilometers of 2D seismic data for a period of three years in search of petroleum resource potential covering an area of about 143,000 square kilometers.

The JMSU began with the Phase II seismic acquisition consisting of about 12,000 line-km 2D seismic data. In addition, JMSU selected and cataloged well samples in preparation for analysis.

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# Coal

PNOC EC continued to cater to the coal requirements of its industrial and power plant customers, leading to direct coal sales of 776.83 thousand MT, higher than last year's 480.1 thousand MT.

Photo taken by Edilbert Corsarne

**Coal still accounts for the biggest share in the Philippine generation mix in terms of installed capacity. The Philippines has a vast potential for coal resources. The demand for coal has remained steady even with the current stringent standard on environmental concerns owing to the new clean coal technologies. PNOC continues to cater to the demand for this energy resource.**

In 2002, PNOC assumed the operations of coal trading and integrated services from the PNOC Coal Corporation (PCC). As such, coal production remains a core business activity of the company, with the demand needing more possible sources in order to be able to meet the requirements.

While there is no dearth in new sources of coal, the identified areas usually accompanied issues pertaining to the environment, and how this would affect the local people. A period is devoted to introduce the project, and provide consultations and focus group discussions, to showcase the potential benefits of the project to those who will be affected by the development.

The Integrated Coal Minemouth Power Project in Isabela, which initially showed favorable promise, continued to encounter significant opposition from barangays affected by the project. The project involved putting up a 50 MW power plant and coal mining operation. After temporarily shelving it in July 2006, social development initiatives were again undertaken in the direct impact barangays, as a means to sustain and develop community participation and support.

The Surigao Coal Project, which was initially recommended for suspension, had its Coal Operating Contract (No. 140) extended until July 4, 2009. This was made possible because PNOC EC submitted to the DOE its plans and programs for the implementation of information, education and communication campaigns. The two-year work program for this project was revised and approved by the DOE, effectively extending the term of contract.

PNOC EC intends to venture into a coal mining business in Indonesia in order to ensure a stable and competitive supply of coal for the Philippine market. In 2007, PNOC EC visited prospective coal mine areas to conduct reconnaissance geologic surveys. PNOC EC also sent a Memorandum of Agreement to PT Sumber Kurnia Buana and PT Berkat Banua Inti for the conduct of due diligence in the offered coal mines. Preliminary evaluation of various Indonesian Coal Mine concessions were completed, and all Indonesian coal samples were analyzed at the Malangas and Naga coal laboratories.

## COAL PRODUCTION

PNOC EC operates Coal Operating Contract (COC) 41 within the Malangas Coal Reservation in Zamboanga Sibugay. As holder of the COC, the company supervises mining operations of various small-scale coal miners and operates the Lumbog Satellite Mine. PNOC EC also oversees the operations of a large-scale coal mine known as the Integrated Little Baguio (ILB) colliery, which is currently the largest semi-mechanized underground coal mine in the country.

Total coal production for 2007 amounted to 149.51 thousand metric tons, 14 percent higher than the target volume. The increase can be attributed to heightened production activities in both the ILB and small-scale mines.

## COAL SALES

PNOC EC continued to cater to the coal requirements of its industrial and power plant customers, leading to direct coal sales of 776.83 thousand MT, higher than last year's 480.1 thousand MT. The increase in sales can be attributed to new customers and the growing demand for local coal because of the volatile prices of imported coal.

Aside from coal sales, integrated services consisting of discharging foreign and local coal shipments, stockpiling, screening, blending, and hauling of coal to cement plants in the country, are also offered. For 2007, the actual volume handled was 149.19 thousand MT, slightly higher than 139.7 thousand MT handled in 2006.

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# Renewable Energy
## / Barangay Electrification

**PNOC has committed to provide electricity to families in far-flung areas to improve their lives and give them better access to basic services.**

**Utilizing renewable energy (RE) is an integral part of the government strategy to provide a sustainable and self-sufficient energy supply for the country. RE is foreseen to provide up to 40 percent of the country's primary energy requirements in the next 5 years. PNOC is unwavering in its commitment to be an important contributor in realizing this goal.**

PNOC has committed to provide electricity to families in far-flung areas to improve their lives and give them better access to basic services. The Solar Home Systems (SHS) Distribution Project, which involves the sale and distribution of 15,100 solar home systems to the Cordillera Autonomous Region, Ilocos, Cagayan Valley, Central Luzon, Southern Tagalog, Bicol, Western Visayas, and Central Visayas, is one way to achieve this objective. 2,820 units more were installed in 2007, completing the projects target since its inception in 2001.

# Alternative Fuels

**The PNOC Alternative Fuels Corporation (PAFC), formerly the PNOC Petrochemical Development Corporation (PPDC), has been making strides in their field, after only a year in operation.**

**Tapping alternative fuels is part of a long term goal to develop indigenous and renewable energy fuels for long term energy security. The continuous engagement of PNOC is an active contribution to achieving the desired sustainable growth.**

PNOC's baby, the PNOC Alternative Fuels Corporation (PAFC), formerly the PNOC Petrochemical Development Corporation (PPDC), has been making strides in their field, after only a year in operation. The primary mandate of PAFC is to explore, develop, and accelerate the utilization and commercialization of alternative fuels in the country, in order to minimize dependence on basic oil and gas for the country's fuel needs.

## JATROPHA

PAFC actively re-assessed a total of 1,500 hectares of potential sites for mega-nurseries and plantations, mostly located in Mindanao and Fort Magsaysay in Nueva Ecija, for possible sources of planting materials, and to determine the availability of planting materials required in the mega-nurseries/model plantations.

A nursery/model plantation was established in Fort Magsaysay, Nueva Ecija with an aggregate area of 500 hectares. As of end-2007, the total area was planted with 1.61 million jatropha trees, while the nursery also raised 780,000 jatropha seedlings.

In Cagayan de Oro, another nursery/provenance testing plantation was also set up with a total area of 500 hectares. Around 920,000 jatropha trees were planted in 280 hectares, with about 2.3 million seedlings raised in the nursery, by end of 2007.

## COMMERCIAL PLANTATIONS

PNOC-AFC has forged several agreements with various potential partners for establishing commercial plantations. Possible areas are continuously assessed and evaluated for jatropha commercial plantations sites, and PAFC has even partnered with Government Financial Institutions (GFIs) to provide financing/loan facility for jatropha-related projects. It also signed agreements with local government units (LGUs) and private entities for contract farming arrangements, which have proven to be crucial in this industry.

# Shipping and Transport


**PSTC is not remiss in implementing various cost-saving measures in accordance with the Government's Austerity measures under A.O. 103. At the same time, trainings and seminars are provided for employees to strengthen competence and expertise.**

**The transport of petroleum products is a critical and important component in the energy supply and distribution chain. This ensures that the products are delivered to consumers when and where they are needed. PNOC continues to service these available needs.**

The year 2007 was a challenging year for the PNOC Shipping and Transport Corporation (PSTC), as it tried out new avenues of improvement.

On its present fleet, MT JP Rizal ended the year with a total of 54 completed voyages, loaded 160,759.47 MT, and navigated 49,893.55 NM. MT A Luna completed a total of 39 trips, loaded 121,773.62 MT, and navigated 40,012 NM, before it was drydocked in July of 2007.

After serving PSTC for 26 years and finishing a total of 700 voyages, MT Gomburza was disposed of in October 2007. It carried crude for Delsan's Philodrill Nido Oilfield Operations, completing a total of 33 voyages, loading 102,664.01 MT, and traveling 31,815.6 NM, before it finished its run.

The acquisition of two double-hulled tankers has been in the year's priority list, pending the completion of various trading documents needed prior to its delivery. In the meantime, PSTC chartered-in MT GBB1, which completed 18 voyages, loaded 34,562.12 MT, and navigated 16,092 NM from July – October 2007, while the two tankers have not been delivered yet.

Fleet utilization was at its peak of 87.4 percent, a little short of last year's 88 percent utilization. The fleet is continuously monitored and retrofitted to conform with international and local safety standards, especially those set by Petron Corporation.

PSTC is not remiss in implementing various cost-saving measures in accordance with the Government's Austerity measures under A.O. 103. At the same time, trainings and seminars are provided for employees to strengthen competence and expertise.

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# Estate Management

**PDMC's performance is laudable, proof of which is its increasing net income for the past years. Its net income of P406 million for 2007, is 22 times more than last year's P19.76 million earnings.**

**The management of the company assets continues to be an important operational concern. PDMC strives to employ ways to maximize the utilization and potentials of these valuable assets for the company's benefit.**


PNOC Development and Management Corporation (PDMC) is PNOC's real estate arm. PDMC's performance is laudable, proof of which is its increasing net income for the past years. Its net income of P406 million for 2007, is 22 times more than last year's P19.76 million earnings. This was due to management driving expenses down to 18 percent of sales and bringing up the return of sales to 82 percent.

## HOUSING PROJECTS

PDMC entered a Joint Venture with Sta. Lucia Realty Corporation to develop the Costa Verde Project, valued at around P449 million. Almost half of the property, valued at P206 million has been sold to the general public, with a remaining inventory of 284 lots.

The 25 hectares devoted to the GMA Abot Kayang Pabahay at Palupa under Executive Order 59, is a socialized housing scheme, which involves the subdivision, titling and distribution of parcels of land. A total of 3,598 lots have been intended for informal dwellers. 3,143 lots have been distributed and disposed as of yearend 2007.

PDMC, as the Project Manager for the El Pueblo Sta. Mesa condominium project, was able to successfully negotiate for the full payment of the purchase price with Phoenix Sun International Corporation. Construction is still ongoing, and PDMC is hoping to sell its P15 million investment and to liquidate this entire amount by 2008.

A legacy that PDMC hopes to leave as part of its Corporate Social Responsibility Program is the PNOC Gawad Kalinga Village. This 1.1 hectare area in Cavite will be host to 122 homes made possible by PDMC in partnership with concerned Filipino-American donors.

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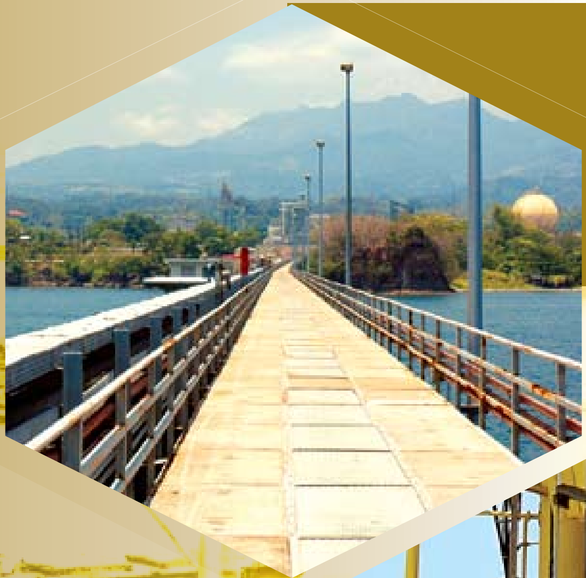
# Other Businesses



**PNOC and its subsidiaries occupy ESB facilities for the upkeep of equipment. Marketing efforts were intensified to increase the number of energy-related industries.**

**Energy related businesses on petrochemical and energy supply base are still important pieces of the overall energy infrastructure. PNOC continues to cater to these customers and make sure they get the best service expected from a reputable company.**

## ENERGY SUPPLY BASE

Our Energy Supply Base (ESB) in Mabini, Batangas, continued to serve the energy industry and commercial clients by providing docking, warehousing and other related services. PNOC and its subsidiaries occupy ESB facilities for the upkeep of equipment. Marketing efforts were intensified to increase the number of energy-related industries.

197 domestic vessels and 38 foreign vessels berthed at ESB's port in 2007, compared to 185 domestic and 36 foreign vessels that berthed in 2006.

## PETROCHEMICAL PARK MANAGEMENT AND OPERATIONS

Our Petrochemical Park in Limay, Bataan is now under the management of the PNOC Alternative Fuels Corporation (PAFC), formerly the PPDC.

Raw and firewater, power supply within the Park and other commercial areas, and jetty services are continuously being provided in the Park for its locators. As of end-2007, the Industrial Park incurred higher revenues amounting to P48.5 million, as compared to P20.5 million in 2006. Administrative dues totaled P7.8 million, while last year's was P8.0 million. These revenues were mainly sourced from payment of thruput, water, and right of way, as well as administrative dues.

As part of the Corporate Social Responsibility Program of the Park, health, safety, security and environment (HSSE) programs are being implemented such as emergency response seminars, environmental training and organizational meetings of the Multi-Partite Monitoring Team, regular water and ambient air quality monitoring, medical/dental outreach, tree planting and livelihood programs.

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# Privatization of PNOC EDC

Called as the biggest and the most transparent privatization deal ever, PNOC EDC sold for P58.5 billion to Red Vulcan Holdings Corporation. Red Vulcan outbid the others by offering P9.75 per share for 60 percent control of the company, and effectively making PNOC EDC a private corporation.

The road to privatization started with an Initial Public Offering of 5.22 million shares in December 2006, which generated P19.2 billion at P3.20 per share for 20 percent of the world's largest geothermal company. The Secondary Offering of an additional 20 percent of EDC's common shares in July 2007 generated another P17 billion, at P5.70 per share. The government's remaining 60 percent stake in PNOC EDC – 40 percent in common shares and 20 percent in preferred shares – was auctioned in November 2007. The sale of PNOC EDC to Red Vulcan was completed on December 1, 2007.

PNOC EDC was considered a good buy because of its reputation as a global leader in geothermal energy. It is also a green and renewable energy company with experienced managerial and technical expertise.




**PNOC EDC was considered a good buy because of its reputation as a global leader in geothermal energy. It is also a green and renewable energy company with experienced managerial and technical expertise.**

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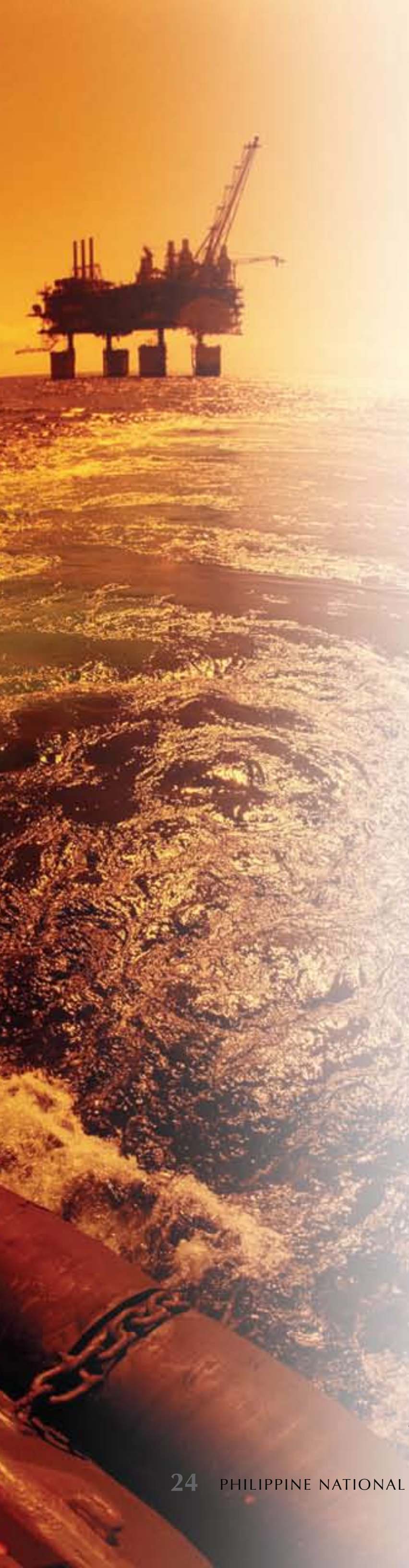


Republic of the Philippines
**COMMISSION ON AUDIT**
Commonwealth Avenue, Quezon City, Philippines

# State Auditor's Report

**The Board of Directors**
Philippine National Oil Company
PNOC Building 6, Energy Center
Merritt Road, Fort Bonifacio, Taguig City

We have audited the accompanying consolidated financial statements of the **Philippine National Oil Company** (a corporation wholly-owned by the Government of the Republic of the Philippines) **and Subsidiaries** which comprise the consolidated balance sheets as of December 31, 2007 and 2006 and the consolidated income statements, consolidated statements of changes in equity and consolidated cash flow statements for the years then ended, and a summary of significant accounting policies and other explanatory notes.

*Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Philippine Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

*Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Philippine Standards on Auditing. These standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

Our audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making these risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the **Philippine National Oil Company and Subsidiaries** as of December 31, 2007 and 2006, and its financial performance and its cash flows for the years then ended in accordance with Philippine Financial Reporting Standards.

**COMMISSION ON AUDIT**

**SABINIANO G. CABATUAN**
Director IV

November 07, 2008

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

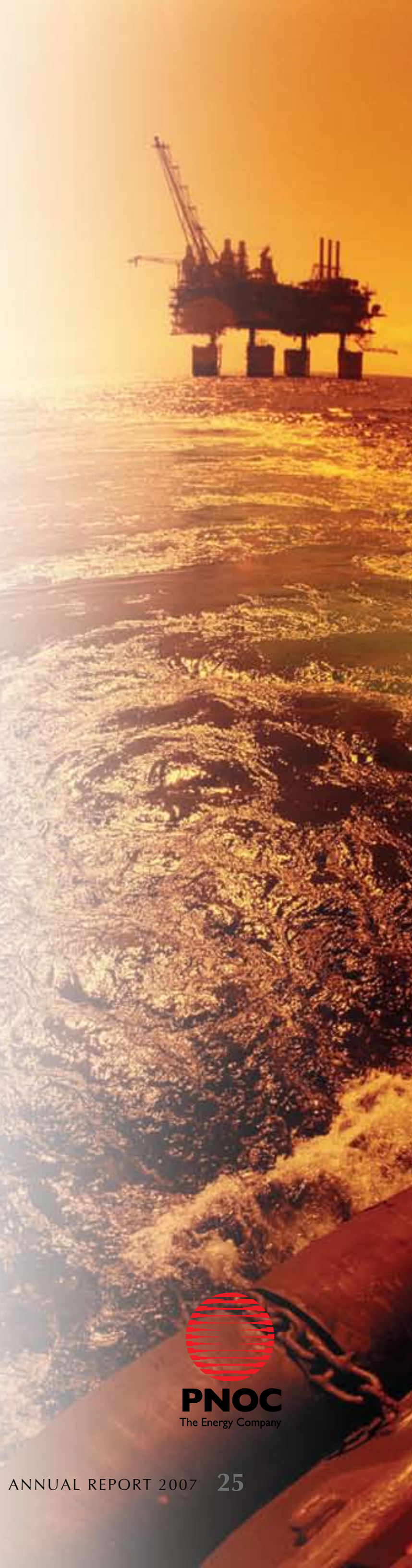
# Consolidated Balance Sheet

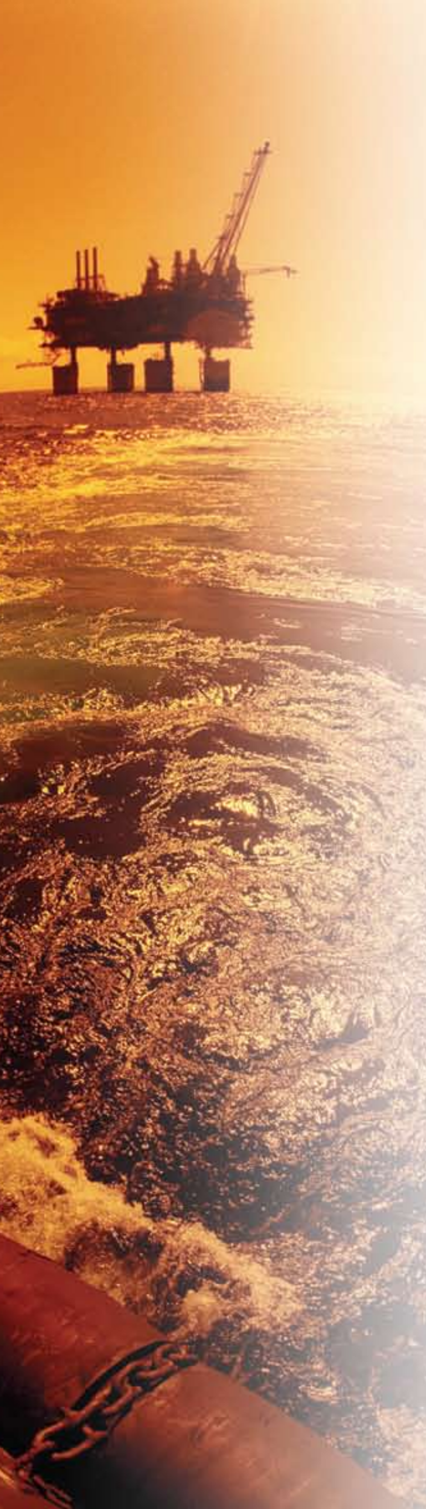
December 31, 2007 and 2006
(In Philippine Peso)

| | Notes | 2007 | 2006 (As restated) |
|---|---|---|---|
| **ASSETS** | | | |
| **Current Assets** | | | |
| Cash and cash equivalents | 4 | **3,361,003,626** | 15,099,360,738 |
| Cash-restricted | 5 | - | 33,212,957 |
| Short-term investments | 6 | **17,239,125,511** | 5,253,238,040 |
| Accounts and notes receivables - net | 7 | **2,820,907,235** | 5,475,774,745 |
| Inventories - net | 8 | **906,484,308** | 2,141,565,936 |
| Investment in available-for-sale securities | 9 | **-** | 1,278,631,449 |
| Prepaid expenses & other current assets | 10 | **1,517,602,852** | 3,189,025,045 |
| **Total Current Assets** | | **25,845,123,532** | 32,470,808,910 |
| **Non-Current Assets** | | | |
| Long-term receivables | 11 | **4,894,831,917** | 1,140,017,684 |
| Investment in available-for-sale securities | 9 | **3,198,011,572** | 2,452,976,187 |
| Investments | 12 | **5,205,295,649** | 5,333,959,391 |
| Property, plant and equipment - net | 18 | **11,012,040,244** | 40,694,980,641 |
| BOT power plants - net | 13 | **-** | 17,637,817,500 |
| Exploratory & development cost | 14 | **319,833,512** | 5,866,232,902 |
| Investment property | 15 | **8,540,548,516** | 977,360,704 |
| Deferred tax asset | 36 | **698,374,740** | 8,684,936,863 |
| Deferred charges and other assets | 16 | **2,061,593,054** | 2,826,250,878 |
| **Total Non-Current Assets** | | **35,930,529,204** | 85,614,532,750 |
| **Non-current assets held for sale** | 17 | **424,249,207** | 40,054,728 |
| **TOTAL ASSETS** | | **62,199,901,943** | 118,125,396,388 |

| | Notes | 2007 | 2006 (As restated) |
|---|---|---|---|
| **LIABILITIES AND EQUITY** | | | |
| **Current Liabilities** | | | |
| Accounts payable and accrued expenses | 19 | **1,410,855,129** | 5,786,437,933 |
| Income tax payable | 20 | **51,373,415** | 517,837,260 |
| Dividends payable | 30 | **793,353,014** | 2,195,314,331 |
| Current portion of long-term loans | 22 | **1,312,712,048** | 3,264,561,183 |
| Current portion of BOT lease obligations | 21 | **-** | 2,766,401,494 |
| **Total Current Liabilities** | | **3,568,293,606** | 14,530,552,201 |
| **Long-Term Liabilities** | | | |
| Long-term loans - net of current portion | 22 | **7,029,085,418** | 37,724,862,947 |
| BOT lease obligations - net of current portion | 21 | **-** | 413,180,565 |
| Deferred tax liabilities | 36 | **346,784,961** | 5,792,054,459 |
| Other long-term liabilities | 23 | **62,648,991** | 1,182,268,376 |
| Royalty fee - net of current portion | 24 | **-** | 1,816,945,624 |
| Other credits | 25 | **8,088,249,840** | 6,019,876,438 |
| **Total Non-Current Liabilities** | | **15,526,769,210** | 52,949,188,409 |
| **TOTAL LIABILITIES** | | **19,095,062,816** | 67,479,740,610 |
| **EQUITY** | | | |
| **Equity Attributable to Equity Holder** | | | |
| Capital Stock | 26 | **3,114,595,519** | 3,114,595,519 |
| Donated Capital | 27 | **89,308,406** | 95,720,890 |
| Reserves | 28 | **-** | 131,462,811 |
| Revaluation Surplus | 29 | **8,360,917,280** | 467,598,815 |
| Retained Earnings | 30 | **31,510,344,538** | 34,398,114,975 |
| **Total Equity Attributable to Equity Holder** | | **43,075,165,743** | 38,207,493,010 |
| **Minority Interest** | | **29,673,384** | 12,438,162,768 |
| **TOTAL EQUITY** | | **43,104,839,127** | 50,645,655,778 |
| **TOTAL LIABILITIES AND EQUITY** | | **62,199,901,943** | 118,125,396,388 |

*See accompanying Notes to Consolidated Financial Statements.*





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

# Consolidated Statements of Income

For the years ended December 31, 2007 and 2006
(In Philippine Peso)

| | Notes | 2007 | 2006 (As restated) |
|---|---|---|---|
| NET SALES | 31 | **6,917,731,018** | 27,669,028,731 |
| COST OF SALES | 32 | **3,205,030,009** | 12,309,307,274 |
| GROSS MARGIN | | **3,712,701,009** | 15,359,721,457 |
| UNREALIZED GROSS PROFIT FROM INSTALLMENT SALES | | **39,897,948** | 21,505,387 |
| REALIZED GROSS PROFIT | | **3,672,803,061** | 15,338,216,070 |
| REALIZED GROSS PROFIT FROM PREVIOUS YEAR'S INSTALLMENT SALES | | **24,440,253** | 33,837,592 |
| TOTAL REALIZED GROSS PROFIT | | **3,697,243,314** | 15,372,053,662 |
| OPERATING EXPENSES | 33 | **805,807,786** | 2,362,117,151 |
| INCOME FROM OPERATIONS | | **2,891,435,528** | 13,009,936,511 |
| OTHER INCOME (CHARGES) - NET | 34 | **65,345,628,359** | 7,871,336,950 |
| INCOME BEFORE TAX | | **68,237,063,887** | 20,881,273,461 |
| INCOME TAX | 35 | | |
| Current | | **(1,216,027,204)** | (2,577,405,930) |
| Deferred | | **(112,159,489)** | (1,828,290,800) |
| NET INCOME | | **66,908,877,194** | 16,475,576,731 |
| Attributable to: | | | |
| Equity holder | | **66,897,374,030** | 16,328,600,461 |
| Minority interest | | **11,503,164** | 146,976,270 |
| | | **66,908,877,194** | 16,475,576,731 |
| EARNINGS PER SHARE | | | |
| Attibutable to equity holder | | | |
| Company - basic | 37 | **8,332** | 2,034 |

*See accompanying Notes to Consolidated Financial Statements*

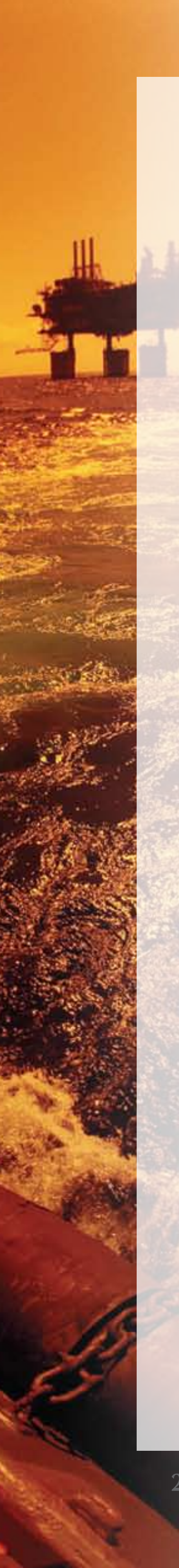
**PHILIPPINE NATIONAL OIL COMPANY AND SUBSIDIARIES**
(A Corporation Wholly-Owned by the Government of the Republic of the Philippines)

# Consolidated Cash Flow Statement

For the years ended December 31, 2007 and 2006
(In Philippine Peso)

| | Note | 2007 | 2006 (As restated) |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Cash receipts from customers | | **8,280,728,708** | 28,348,732,121 |
| Cash paid to suppliers and employees | | **(3,373,816,350)** | (12,979,686,942) |
| Interest income received | | **587,548,250** | 997,084,305 |
| Interest expenses paid | | **(364,801,153)** | (3,078,128,841) |
| Income taxes paid | | **(1,141,158,829)** | (3,581,752,465) |
| Net cash provided by operating activities | | **3,988,500,626** | 9,706,248,178 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Net proceeds from PNOC EDC's privatization | | **74,316,381,163** | 18,549,279,055 |
| Cash dividends | | **822,353,492** | 376,733,578 |
| Proceeds from disposal of assets | | **419,017,747** | 33,723,500 |
| Share of National Government in PNOC EDC's privatization | | **(62,169,358,565)** | (4,568,017,027) |
| Exploratory & development costs | | **(21,876,007)** | (621,355,222) |
| Short-term investments | | **(11,985,887,470)** | (885,476,285) |
| Long-term investments | | **(83,670,619)** | (153,401,483) |
| Investments in available-for-sale-securities | | **(900,835,386)** | 839,213,678 |
| Capital expenditures | | **(227,593,008)** | (3,021,002,592) |
| Drydocking costs | | **(33,878,949)** | - |
| Net cash provided by investing activities | | **134,652,398** | 10,549,697,202 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Repayment of long-term debt | | **(3,584,032,870)** | (8,009,722,119) |
| Payment of cash dividends | | **(2,263,419,583)** | (353,745,907) |
| Share buyback program | | **(191,936)** | - |
| Additional loan drawdowns | | **-** | 2,725,632,762 |
| Short-term loan proceeds | | **-** | 1,150,000,000 |
| Payment of BOT lease obligations | | **-** | (5,042,087,781) |
| Repayment of short-term loans | | **-** | (1,166,300,000) |
| Net cash used in financing activities | | **(5,847,644,389)** | (10,s696,223,045) |
| NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS | | **(1,724,491,365)** | 9,559,722,335 |
| EFFECT OF EXCHANGE RATE CHANGES IN CASH AND CASH EQUIVALENTS | | **(14,663,520)** | (22,316,911) |
| PNOC EDC's 2006 CASH BALANCE EXCLUDED IN THE CONSOLIDATION DUE TO PRIVATIZATION | | **(9,999,202,227)** | - |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | | **15,099,360,738** | 5,561,955,314 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | 4 | **3,361,003,626** | 15,099,360,738 |

*See accompanying Notes to Consolidated Financial Statements.*



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

# Consolidated Statements of Changes in Equity

For the years ended December 31, 2007 and 2006
(In Philippine Peso)

| | Attributable to Equity Holder of Parent | | | | | | | Minority Interest | Total Equity |
|---|---|---|---|---|---|---|---|---|---|
| | Capital Stock (Note 26) | Donated Capital (Note 27) | Appropriated Retained Earnings (Note 30) | Unappropriated Retained Earnings (Note 30) | Revaluation Surplus (Note 29) | Fair Value and other reserves (Note 28) | Total | | |
| Balance at January 1, 2006 | 3,114,595,519 | 95,720,890 | 6,750,000,000 | 18,200,559,168 | 467,170,815 | 110,309,139 | 28,738,355,531 | 13,152,951 | 28,751,508,482 |
| Net Income for 2006 | | | | 16,328,600,461 | | | 16,328,600,461 | 146,976,270 | 16,475,576,731 |
| Cash Dividends | | | | (2,246,606,395) | | | (2,246,606,395) | (42,100) | (2,246,648,495) |
| Share on National Government from PNOC EDC's Initial Public Offering | | | | (4,568,017,027) | | | (4,568,017,027) | | (4,568,017,027) |
| Appropriation for investment projects & capital requirements | | | 3,321,315,043 | (3,321,315,043) | | | - | | - |
| Prior period adjustments | | | | 33,578,768 | | | 33,578,768 | | 33,578,768 |
| Appraisal of PSTC's vehicles | | | | | 428,000 | | 428,000 | | 428,000 |
| Unrealized Holding Gain on Investment in Available-for-Sale Securities | | | | | | 21,153,672 | 21,153,672 | | 21,153,672 |
| PNOC EDC's minority interest | | | | | | | - | 12,278,075,647 | 12,278,075,647 |
| Close-out of Petron Tankers and Petrophil Tankers | | | | (100,000,000) | | | (100,000,000) | | (100,000,000) |
| Balance at December 31, 2006 | 3,114,595,519 | 95,720,890 | 10,071,315,043 | 24,326,799,932 | 467,598,815 | 131,462,811 | 38,207,493,010 | 12,438,162,768 | 50,645,655,778 |
| Balance at January 1, 2007 | 3,114,595,519 | 95,720,890 | 10,071,315,043 | 24,326,799,932 | 467,598,815 | 131,462,811 | 38,207,493,010 | 12,438,162,768 | 50,645,655,778 |
| Net Income for 2007 | | | | 66,897,374,030 | | | 66,897,374,030 | 11,503,164 | 66,908,877,194 |
| Appraisal increment on various PNOC landholdings | | | | | 8,262,230,217 | | 8,262,230,217 | | 8,262,230,217 |
| Share of National Government in PNOC EDC's secondary and final offer | | | | 62,169,358,565) | | | (62,169,358,565) | | (62,169,358,565) |
| Cash dividends | | | | (1,306,326,754) | | | (1,306,326,754) | (631,512) | (1,306,958,266) |
| Adjustment of appraisal increment of sold real properties | | | | | (368,881,752) | | (368,881,752) | | (368,881,752) |
| Appropriation for investment projects & capital requirements | | | 1,482,000,000 | (1,482,000,000) | | | - | | - |
| Close-out of PNOC EDC's equity account (see note 1) | | | (1,653,315,043) | (4,641,691,151) | | (131,462,811) | (6,426,469,005) | (12,419,309,148) | (18,845,778,153) |
| Adjustment of appraisal increment of PSTC's vehicles | | | | | (30,000) | | (30,000) | | (30,000) |
| PDMC's share buy back program | | | | (140,048) | | | (140,048) | (51,888) | (191,936) |
| Prior period adjustment | | (6,412,484) | | (3,747,671) | | | (10,160,155) | | (10,160,155) |
| Winding-up expenses | | | | (10,565,235) | | | (10,565,235) | | (10,565,235) |
| | | | | | | | - | | - |
| **Balance at December 31, 2007** | **3,114,595,519** | **89,308,406** | **9,900,000,000** | **21,610,344,538** | **8,360,917,280** | **-** | **43,075,165,743** | **29,673,384** | **43,104,839,127** |

*See accompanying Notes to Consolidated Financial Statements.*

# Notes to Consolidated Financial Statements

(In Philippine Peso)

## 1. CORPORATE INFORMATION

The Philippine National Oil Company (the Parent Company or 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-four years after its creation, the Parent 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 Parent 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 Exploration Corporation (PNOC EC),** established in 1976, serves as the oil and gas exploration arm of the Parent Company. It is actively engaged in the country's search for indigenous sources of energy. The PNOC EC 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 PNOC EC's gas production from the San Antonio gas field fuels a small power plant in Isabela. The gas field is expected to be operational only until February or March of 2008 due to depleting gas reserves.

On the other hand, the PNOC EC's management and the Department of Energy (DOE) decided to put the Batangas to Manila Natural Gas Pipeline Project (BATMAN-1) on hold due to perceived uncertainties in the commercial aspects. The PNOC EC, however, continues its efforts for the development of the Bataan LNG terminal project and the associated Bataan to Manila (BATMAN-2) gas pipeline project.

In February 2007, the Boards of Directors of the PNOC EC and the Parent Company approved a plan to privatize the PNOC EC through an Additional Public Offering of its authorized capital stock. (See Note 38).

b) **PNOC Alternative Fuels Corporation (PAFC),** formerly known as PNOC Petrochemical Development Corporation (PPDC) is mandated to explore, develop and accelerate the utilization and commercialization of existing and emerging alternative sources of energy and technologies and carry on the business of alternative fuels and other related activities.

At present, the PAFC is actively engaged in developing jatropha commercial plantations wherein it has forged agreements with various plantation partners. The PAFC, in partnership with the Department of National Defense (DND) and the Armed Forces of the Philippines (AFP), established a nursery/model plantation in a 500-hectare area in Fort Magsaysay, Nueva Ecija planting 1.62 million jatropha trees and raising 800,000 jatropha seedlings. Another nursery testing plantation was setup in Cagayan de Oro in partnership with the Tribal Community Association of the Philippines – Region 10 (TRICAP 10) for a total of 500 hectares wherein 930,000 jatropha trees were planted in 287 hectares and about 2.4 million seedlings were raised in the nursery.

The PAFC has retained its secondary purpose, to manage, operate, and develop some 530 hectares of land in Bataan as a petrochemical industrial estate, known as Petrochemical Park. The park is located in two barangays within two adjacent municipalities of Bataan: Barangay Lamao in the municipality of Limay and Barangay Dos in the municipality of Mariveles. The PAFC initially developed about 85 hectares of the park for the midstream plants.

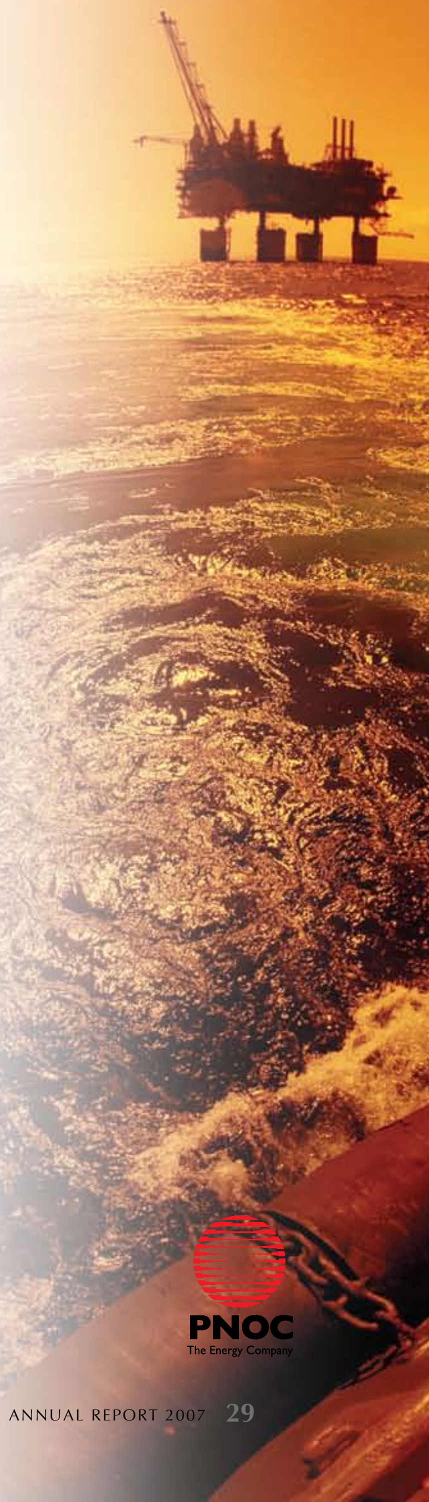
c) **PNOC Shipping and Transport Corporation (PSTC)** is engaged in the business of shipping, tankering, lighterage, barging, towing, transport and shipment of goods, chattels, petroleum and other products, marine and maritime commerce in general.

d) **PNOC Development and Management Corporation (PDMC)** is engaged in industrial estate development and management. Its assets consist mainly of landholdings in Rosario, General Trias and Noveleta, Cavite. The PDMC developed twenty five (25) hectares of its real estate properties 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. In July 2003, it entered into a joint venture agreement for the development of its 32 hectare property in Rosario, Cavite into a mixed residential/commercial subdivision.

e) **PNOC Coal Corporation (PCC)** was organized in 1981 to serve as a coal-trading arm of the Parent Company. 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 PCC ceased to operate and its coal trading activities was absorbed by PNOC EC. The PCC is still on its winding-up process administered by the Parent Company, being the Trustee-Receiver.

f) **PNOC Dockyard & Engineering Corporation (PDEC)** was incorporated in 1978 to provide support to the Parent Company'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 PDEC sold its shipyard's facilities through public bidding on December 16, 1992. The Board of Directors effectively approved the dissolution of the PDEC on December 31, 1996. Processing of the dissolution with the Securities and Exchange Commission (SEC) was placed on hold since the PDEC will be used as the corporate vehicle for the Parent Company's prospective projects.



PNOC
The Energy Company

g) **Tanker Companies** namely PNOC Tankers, Petron Tankers, Petrophil Tankers and PNOC Oil Carriers, Inc. ceased operations in 1995 due to continued losses suffered. The Commission on Audit (COA) issued final audit reports of the tanker companies for the period ended June 1996. In 2003, the SEC has issued a certificate for the revocation of registration of these four (4) tanker companies. Likewise, the Bureau of Internal Revenue (BIR) has issued a certificate of no outstanding liability to Petron Tankers Corporation and Petrophil Tankers Corporation on June 29, 2005 and July 2, 2005, respectively.

h) **PNOC Energy Development Corporation (PNOC EDC)** was a wholly-owned subsidiary of the Parent Company established in 1976 to undertake exploration and development of geothermal energy sources in the country. It operated nine (9) geothermal steam fields with an aggregate capacity of 1,145 megawatts accounting for about 60% of the country's total installed geothermal capacity. It also operated six (6) power plants, which were built through the Build-Operate-Transfer (BOT) scheme.

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

The Parent Company sold 40% of its equity on PNOC EDC through an Initial Public Offering (IPO) on December 16, 2006. On November 29, 2007, PNOC EDC was fully privatized when the remaining Parent Company's holdings with PNOC EDC was sold through public bidding to Red Vulcan Holdings Corporation, a subsidiary of First Gen Corporation.

## 2. BASIS OF FINANCIAL STATEMENT PREPARATION

Statement of Compliance

The consolidated financial statements of the Company were prepared in compliance with Philippine Financial Reporting Standards (PFRS).

The financial statements have been prepared on the historical cost basis in accordance with the applicable Philippine Accounting Standards (PAS) issued by the Accounting Standards Council (ASC) of the Philippines now called Financial Reporting Standard Council (FRSC) of the Philippines.

Changes in Accounting Policies

The accounting policies adopted are consistent with those of the previous financial years, except for the policies related to the following new and amended PFRS and Philippine Accounting Standard (PAS) effective in 2007. Adoption of these new and amended standards did not have any significant effect on the Company's consolidated financial statements. These, however, required additional disclosures on the consolidated financial statements.

- *PFRS 7, Financial Instruments: Disclosures,* became effective for financial years beginning on or after January 1, 2007. The standard introduces new disclosures to improve the information about financial instruments. It requires the disclosure of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk, as well as sensitivity analysis to market risk. It replaces PAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions, and the disclosure requirements of PAS 32, Financial Instruments: Disclosure and Presentation. This standard is applicable to all entities reporting under PFRS. PFRS 7 disclosures are required to be made for all periods presented.

- *Amendment to PAS 1, Presentation of Financial Statements*, became effective for financial years beginning on or after January 1, 2007. The amendment introduces disclosures about the level of an entity's capital and how it manages capital.

The following new and revised standards and interpretations have been approved but are not yet effective:

- *PFRS 8, Operating Segments*, will become effective on January 1, 2009 and will replace PAS 14, Segment Reporting. The standard requires an entity to disclose information about the nature and financial effects of the types of business activities in which the Company engages and the economic environment it operates following a management approach to reporting segment information.

- *PAS 1 (Revised 2007), Presentation of Financial Statements*, which will become effective on January 1, 2009, requires an entity to present all items of income and expense recognized in the period in a single statement of comprehensive income or in two statements: a separate statement of income and a statement of comprehensive income. The statement of income shall disclose income and expense recognized in profit and loss in the same way as the current version of PAS 1. The statement of comprehensive income shall disclose profit or loss for the period, plus each component of income and expense recognized outside of profit and loss classified by nature (e.g., gains or losses on available-for-sale assets or translation differences related to foreign operations). Changes in equity arising from transactions with owners are excluded from the statement of comprehensive income (e.g., dividends and capital increase). An entity would also be required to include in its set of financial statements a statement showing its financial position (or balance sheet) at the beginning of the previous period when the entity retrospectively applies an accounting policy or makes a retrospective restatement.

- *PAS 23, Borrowing Costs* will become effective on January 1, 2009. The standard has been revised to require capitalization of borrowing costs when such costs relate to a qualifying asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

- *Philippine Interpretation IFRIC 11, PFRS 2 - Company and Treasury Share Transactions* will become effective on January 1, 2008. This interpretation requires arrangements whereby an employee is granted rights to an entity's equity instruments to be accounted for as an equity settled scheme by the entity even if (a) the entity chooses or is required to buy those equity instruments (e.g., treasury shares) from another party, or (b) the shareholder(s) of the entity provide the equity instruments needed.

- *Philippine Interpretation IFRIC 12, Service Concession Arrangement,* will become effective on January 1, 2008. This interpretation covers contractual arrangements arising from public-to-private service concessions arrangements if control of the assets remain in public hands but the private sector operator is responsible for construction activities as well as for operating and maintaining the public sector infrastructure.

- *Philippine Interpretation IFRIC 13, Customer Loyalty Programs*, will become effective on January 1, 2008. This interpretation requires customer loyalty award credits to be accounted for as a separate component of the sales transactions in which they are granted and therefore part of the fair value of the consideration received is allocated to the award credits and deferred over the period that the award credits are fulfilled.

- *Philippine Interpretation IFRIC 14, PAS 19, Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* will become effective on January 1, 2008. This interpretation provides guidance on how to assess the limit on the amounts of surplus in a defined benefit scheme that can be recognized as an asset under PAS 19, Employee Benefits. It also explains how pension asset or liability may be affected when there is a statutory or contractual minimum funding requirement.

<u>Basis of Consolidation</u>
The consolidated financial statements comprise the financial statements of the Parent Company and its subsidiaries where it owns more than 50% of the voting stock as of December 31 of each year. The financial statements of the subsidiaries are prepared for the same reporting year as the Parent Company, using consistent accounting policies.

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

All significant intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions are eliminated in full in the consolidation.

Subsidiaries are fully consolidated from the date on which control is transferred to the Company or Parent Company. Control is achieved where the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Consolidation of subsidiaries ceases when control is transferred out of the Company or Parent Company.

The results of subsidiaries acquired or disposed during the year are included in the consolidated statement of income from the date of acquisition or up to the date of disposal, as appropriate.

<u>Minority Interests</u>
Minority interests represent the portion of profit or loss and the net assets not held by the Company and are presented separately in the consolidated statements of income, changes in equity and within equity in the consolidated balance sheets, separately from parent stockholders' equity.

<u>Use of Estimates, Assumptions and Judgments</u>
The preparation of the financial statements in accordance with Philippine Accounting Standards requires the Company to make estimates and assumptions that affect the reported amounts of resources, liabilities, income and expenses and the disclosures of contingent resources and contingent liabilities. Future events may occur which can cause the assumptions used in arriving at the estimates to change. The effects of any change in estimates are reflected in the financial statements as they become reasonably probable.

Estimates and judgments are continually evaluated and are based on historical experiences and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

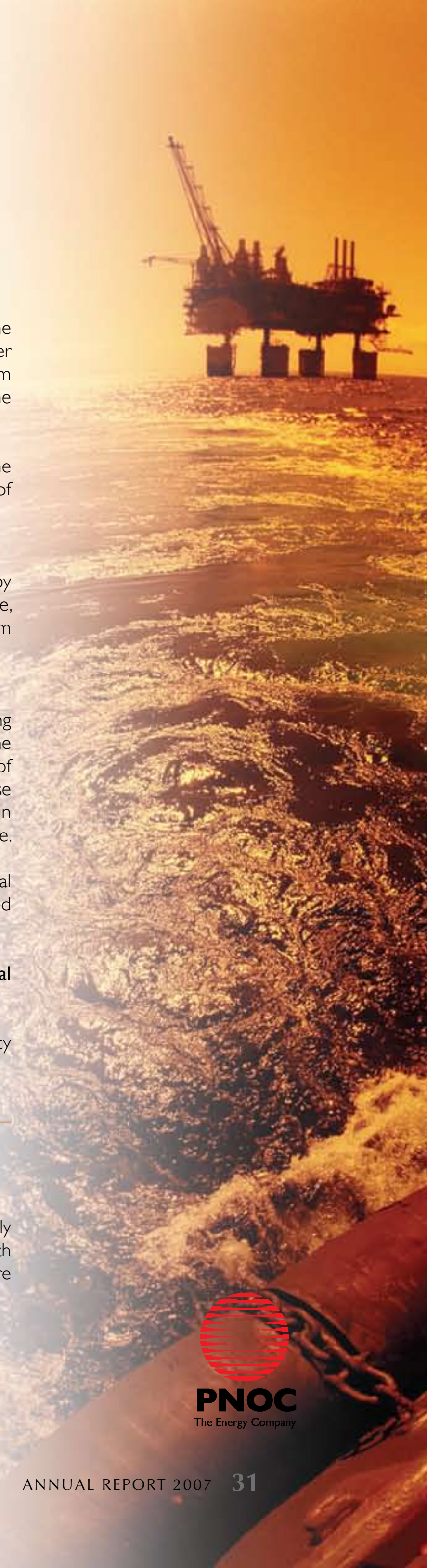
**Due to the full privatization of PNOC EDC, the comparative figures in the financial statements showed significant variances.**

These financial statements are presented in Philippine peso because this is the currency of the primary economic environment in which PNOC and its subsidiaries operate.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) <u>Cash and Cash Equivalents</u>

Cash includes cash on hand and in banks. Cash equivalents are short-term, highly liquid investments 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.



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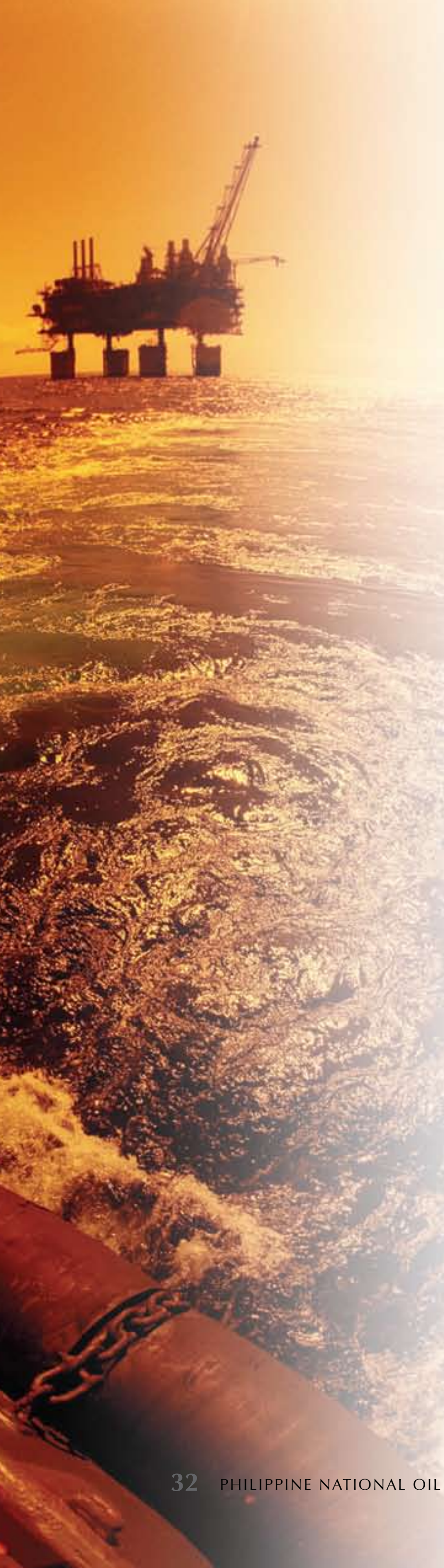
The Energy Company



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 more than three months maturity but less than one-year term.

d) Trade and Other Receivables

Trade and other receivables are stated at face value, net of allowances for doubtful accounts. The allowance is established by charges to income.

The Parent Company and its subsidiaries perform a regular review of the age and status of the accounts relative to historical collections, changes in customer payment terms, assessment of current economic environment and other factors that may affect ability to collect payments.

The receivables of PNOC EC's SC 38 Malampaya Project are not provided with allowance for doubtful accounts. This is in view of the Project being in operation as specialized industry where both the SC 38 Project Consortium and its customers strictly adhere to their reciprocal obligations. Moreover, the Project's Gas Sales and Purchase Agreement (GSPA), as well as the related contracts, provides reasonable assurance to the SC 38 Project Consortium for the appropriate collection of its accounts receivable.

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.

Net realizable value represents the estimated selling price less all estimated costs to sell.

f) Investments

Investments in shares of stocks, in which the Parent Company 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.

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.

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 as income or expense for the period.

The cost of Service Contract (SC) 38 project-related wells, platforms and other facilities includes acquisition costs and capitalized exploration and development costs. The carrying values 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 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 based on the estimated useful life of 21 years.

i) Exploratory and Development Costs

PNOC EC adopts the successful efforts method of accounting for its oil and gas operations. All exploration costs, except the cost of exploratory wells, are charged to expense as incurred. Costs of exploratory wells (including stratigraphic tests wells) are initially capitalized and deferred pending the outcome of the drilling operation. If proved reserves are discovered, the associated costs are capitalized and amortized, as the related proved developed reserves are produced. However, if the exploratory well or stratigraphic test well proves to be dry, the accumulated drilling costs are charged to expense.

Development costs, which include the costs of drilling development wells, are capitalized regardless of whether or not proved reserves are found while production costs are expensed as incurred.

Capitalized cost is amortized using the "unit-of-production method" whereby property acquisition costs (net of accumulated DD & A) are amortized over the estimated proved reserves.

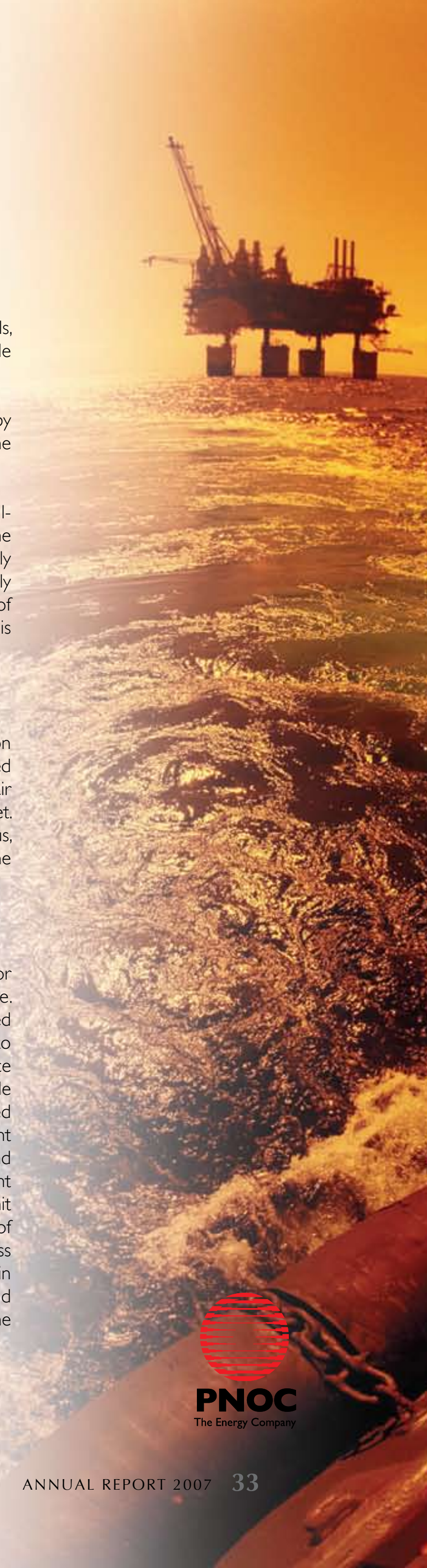
For coal exploration and other projects, the Parent Company uses the full-cost method of accounting. Under this method, all costs directly incurred in the acquisition, exploration and development of a project area, including directly related overhead costs, are capitalized. All exploration costs, likewise, are tentatively deferred pending determination on whether the area contains coal reserves of commercial quantity. When coal reserve of commercial quantity is proved, cost is amortized over proved reserves using the unit-of-production method.

j) Biological Assets

Biological assets, in general, are a living animal or plant. It shall be measured on initial recognition and at each balance sheet date at its fair value less estimated point-of-sale costs except when fair value cannot be measured reliably. The fair value of jatropha seedlings is based on the quoted price in the active market. Jatropha plants on the other hand, do not have an active market at present; thus, the fair value is based on the present value of expected net cash flows from the assets discounted at a current market-determined pre-tax rate.

k) Impairment of Assets

The carrying values of its assets are reviewed for impairment when events or changes in circumstances indicate that the carrying values may not be recoverable. If any such indication exists and where the carrying values exceed the estimated recoverable amounts, the assets or cash-generating units are written down to their recoverable amounts. Recoverable amount is the greater of net selling price and value in use. The net selling price is the amount obtainable from the sale of an asset at arm's-length transaction. In assessing value in use, the estimated future cash flows are discounted to their present value using pre-tax discount rate that reflects current market assessment of the time value of money and the risks specific to the asset. For an asset that does not generate independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs. Impairment losses are recognized in statements of income. If at balance sheet date there is an indication that an impairment loss may be decreased, reversal of an impairment loss is recognized as income in the income statement. The increased carrying amount due to reversal should not be more than what the depreciated historical cost would have been if the impairment had not been recognized.



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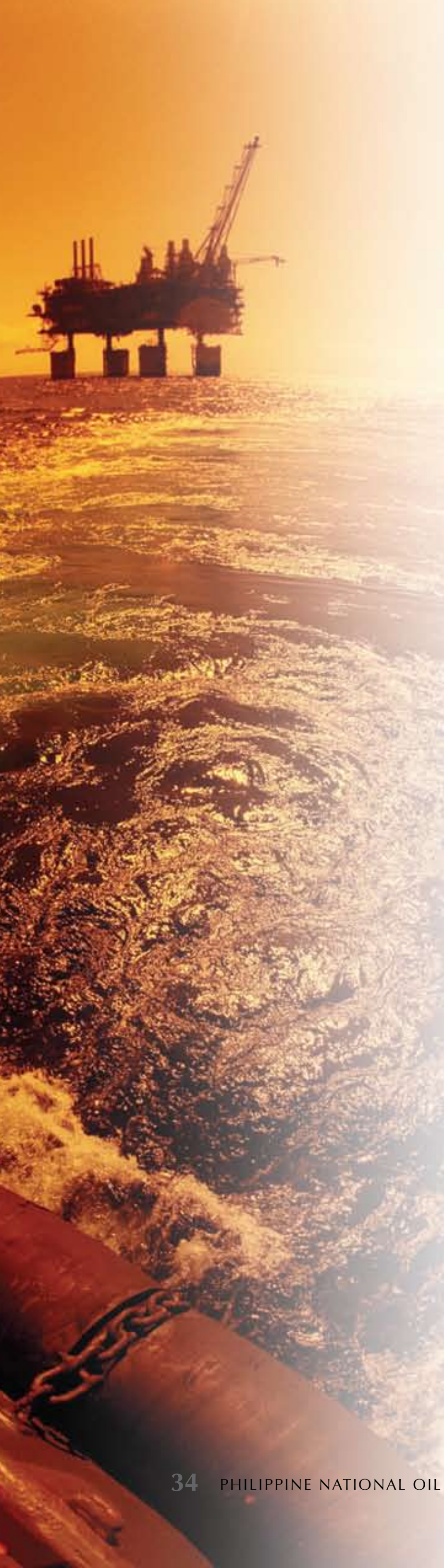


l) Investment in Joint Ventures

A joint venture is a contractual arrangement whereby the group and other parties undertake an economic activity that is subject to joint control.

Where a group of companies undertakes its activities under the joint venture arrangements directly, the group's share of jointly-controlled assets and any liabilities incurred jointly with other ventures are recognized in the financial statements of the ventures and classified according to their nature.

Liabilities and expenses incurred directly in respect of interests in jointly controlled assets are accounted for on an accrual basis. Income from the sale or use of the group's share of the output of jointly-controlled assets, and its share of joint venture expenses, are recognized when it is probable that the economic benefits associated with the transactions will flow to/from the group and their amount can be measured reliably.

PNOC EC reports its 10% interest in SC 38 using joint venture proportionate consolidation. The Company's share of the assets, liabilities, income and expenses are combined with the equivalent items in the Company's financial statements on a line-by-line basis.

Investments in joint venture include accumulated intangible costs directly attributable to exploration and development activities such as the expenses incurred to acquire the legal right to explore, and the costs of exploratory drilling and testing. In accordance with the successful-efforts method of accounting, non-drilling costs and other pre-operating expenses such as corporate overhead, except those expenses, which are directly related to exploratory drilling activities, are expensed as incurred.

m) Non-current Assets Held for Sale

Non-current assets are classified as held for sale if their carrying amounts 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.

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

n) 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.

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 Agreement (GSPA) and Joint Operating Agreement (JOA) entered into by and among the SC 38 partners. 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 arising on investment properties is accounted for on a straight-line basis over the lease term.

o) Leases

Operating Lease

Leases where the Company retains substantially all the risks and benefits of ownership of the asset are classified as operating lease. Operating lease payments are recognized as rental income.

*Finance Lease*

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

*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.

p) Borrowing Costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets are added to the cost of the assets, until such time that the assets are substantially ready for their intended use or sale which necessarily takes a substantial period of time. 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 other borrowing costs are recognized in profit or loss in the period in which they are incurred.

q) Foreign Currency 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.

r) Retirement Benefit Costs

For defined benefit retirement 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 actuarial gains and losses. It is reduced by the fair value of plan assets.

s) Income Taxes

Current tax 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 expenses that are neither taxable nor deductible or items that are taxable or deductible in other years. 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.

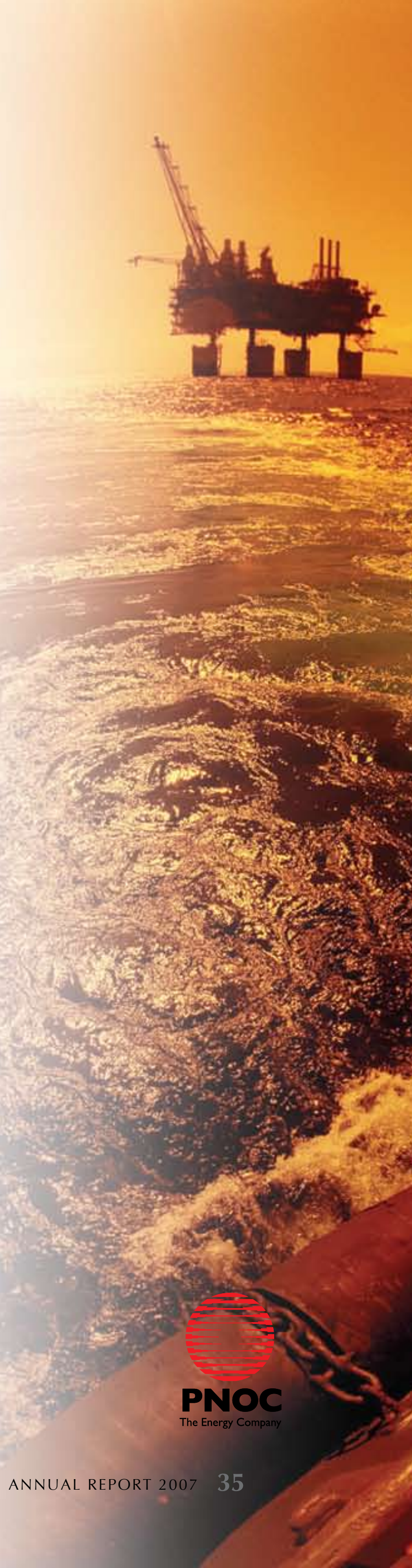
Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred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

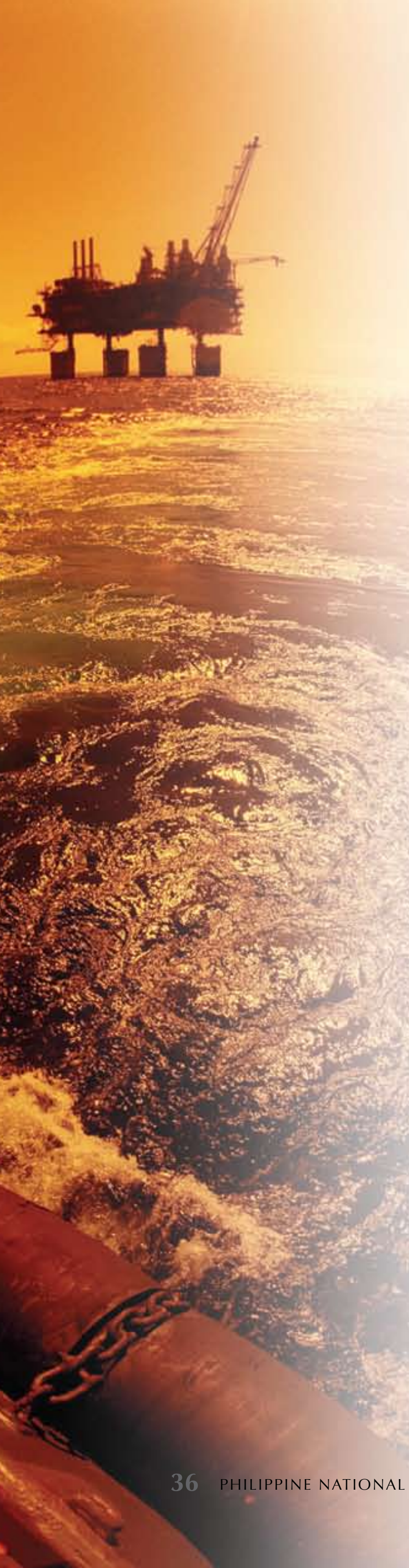
## 4. CASH AND CASH EQUIVALENTS

This account consists of:

| | **2007** | 2006 |
|---|---:|---:|
| Cash in bank | **354,897,884** | 73,829,513 |
| Petty cash | **2,572,973** | 4,636,892 |
| Cash equivalents | **3,003,532,769** | 15,020,894,333 |
| | **3,361,003,626** | 15,099,360,738 |

Cash in banks earn interest at the respective bank deposit rates. Cash Equivalents consist of money market placements that 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

The cash-restricted in 2006 represents PNOC EDC's balance of fixed term deposits and cash in bank with the Land Bank of the Philippines intended for the payment of West-Jec consultancy services advanced by Japan Bank International Cooperation (JBIC) under the OECF 21st Yen Loan (See Note 1).

## 6. SHORT-TERM INVESTMENTS

This consists mainly of money market placements in the form of Government Securities and Savings Deposits with more than three months maturity but less than one year.

## 7. ACCOUNTS AND NOTES RECEIVABLES

This account consists of:

| | **2007** | 2006 |
|---|---|---|
| Trade receivables | **874,625,670** | 5,101,943,446 |
| Others | **2,028,399,638** | 487,626,622 |
| | **2,903,025,308** | 5,589,570,068 |
| Allowance for doubtful accounts | **(82,118,073)** | (113,795,323) |
| | **2,820,907,235** | 5,475,774,745 |

Trade receivables pertain mainly to PNOC EC's receivables on Coal project which consist of coal sales and integrated services (P332.25 million). It also includes PNOC EC's 10% in the SC 38 Consortium's receivables on gas and condensate sales (P192.69 million), 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, PSTC's receivables from hauling or transporting of refined petroleum products to local oil companies and PDMC's mortgage contract receivables.

Other receivables consist mainly of claims from the various government agencies, employees, contractors/suppliers, banks for interests on placements and investments, and insurance firms.

## 8. INVENTORIES

This account consists of the following inventories:

| | **2007** | 2006 |
|---|---|---|
| Land | **759,049,296** | 759,235,983 |
| Parts and supplies | **106,296,951** | 1,309,410,980 |
| Condensate | **36,736,749** | 70,510,935 |
| Coal | **23,772,303** | 23,493,317 |
| Development costs | **2,879,439** | 2,632,221 |
| | **928,734,738** | 2,165,283,436 |
| Allowance for obsolescence | **(22,250,430)** | (23,717,500) |
| | **906,484,308** | 2,141,565,936 |

Land inventory consists of the balance of PDMC's saleable properties in Rosario, Cavite, comprising of about 52.891 square meters for socialized housing and 51,556 square meters for Costa Verde Subdivision. It also includes PPDC's saleable land in Bataan.

Parts and supplies inventories consist mainly of PNOC EC's 10% share in the inventory of SC 38 Consortium (P70.01 million).

Condensate inventory pertains to PNOC EC's undelivered stock of SC 38 Malampaya Project as stored in its offshore Concrete Gravity Structure in offshore Palawan with a volume of 9,092.29 bbls, while the coal inventory represents the undelivered stock to various Coal Terminals with a total volume of 11,582.206 metric tons.

## 9. INVESTMENT IN AVAILABLE-FOR-SALE SECURITIES

The current portion of investment in available-for-sale securities in 2006 pertains to PNOC EDC's investment in peso and dollar denominated government debt securities (See Note 1) while the non-current portion pertains to the Parent Company and PAFC's investments in treasury bonds with more than one year maturity.

## 10. PREPAID EXPENSES AND OTHER CURRENT ASSETS

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Special deposits | **787,977,591** | 765,471,945 |
| Prepaid expenses | **355,301,288** | 301,626,829 |
| Advances to contractors | **-** | 1,053,172,238 |
| Other prepaid and deferred charges | **374,323,973** | 1,068,754,033 |
| | **1,517,602,852** | 3,189,025,045 |

Special deposits account consists mainly of cash of dissolved subsidiaries reserved against future claims.

Prepaid expenses pertains mainly to PNOC EC's prepaid income tax representing the Company's share in the tax component of the unearned revenue on the undelivered gas of the "take or pay" deficiency per Gas Sales and Purchase Agreement (GSPA) with customers of the Camago Malampaya Project.

Advances to contractors in 2006 pertains to PNOC EDC's advance payment to Kanematsu Corporation for the Northern Negros Geothermal Plant Project (See Note 1).

## 11. LONG-TERM RECEIVABLES

This account consists of receivables from the following:

| | 2007 | 2006 |
|---|---|---|
| PNOC Energy Development Corporation | **4,545,507,288** | - |
| Socialized housing | **117,761,257** | 113,268,451 |
| First Gas Power Corporation | **111,484,085** | 155,651,017 |
| Costa Verde Subdivision | **37,341,640** | 45,696,094 |
| Natural Resources Development Corporation | **36,695,598** | - |
| FGP Corporation | **31,784,780** | 44,487,595 |
| National Power Corporation | **14,257,269** | 780,914,527 |
| | **4,894,831,917** | 1,140,017,684 |

The receivables from PNOC EDC represent the Parent Company's pass through loans granted out of the proceeds of its long-term loans from International Bank for Reconstruction and Development and Overseas Economic Cooperation Fund.

The receivables from First Gas Power Corporation, FGP Corporation and National Power Corporation represent PNOC EC's 10% share in receivables including interests for the "take or pay" deficiency or the undelivered gas of the Malampaya Project for the years 2002 to 2006 under the GSPA.

PDMC's mortgage receivables from contractors generated by the socialized housing and mixed residential and commercial housing projects in Rosario, Cavite, shall be collected within long periods ranging from two (2) to twenty-five (25) years.

The receivable from Natural Resources Development Corp. (NRDC) represents the transfer and assignment to the Parent Company by PNOC EDC of its loan receivable from NRDC consisting of the principal loan of P30 million and accrued interests from March 2004 – November 30, 2007.

## 12. INVESTMENTS

This account consists of investments in the following:

| | 2007 | 2006 |
|---|---|---|
| Petron Corporation | **4,448,444,187** | 4,448,444,187 |
| National Development Corporation-7% Preferred shares | **369,151,000** | 369,151,000 |
| Investment in Joint Ventures | **113,117,836** | 268,080,898 |
| Goodyear Philippines | **96,453,000** | 96,453,000 |
| Gulf Oil Philippines, Inc. | **54,978,000** | 54,978,000 |
| Others | **123,151,626** | 96,852,306 |
| | **5,205,295,649** | 5,333,959,391 |

## 13. BOT POWER PLANTS

This account pertains to the BOT power plants owned by PNOC EDC. The corresponding liability account set up for the BOT power plants is presented under the BOT lease obligations account.

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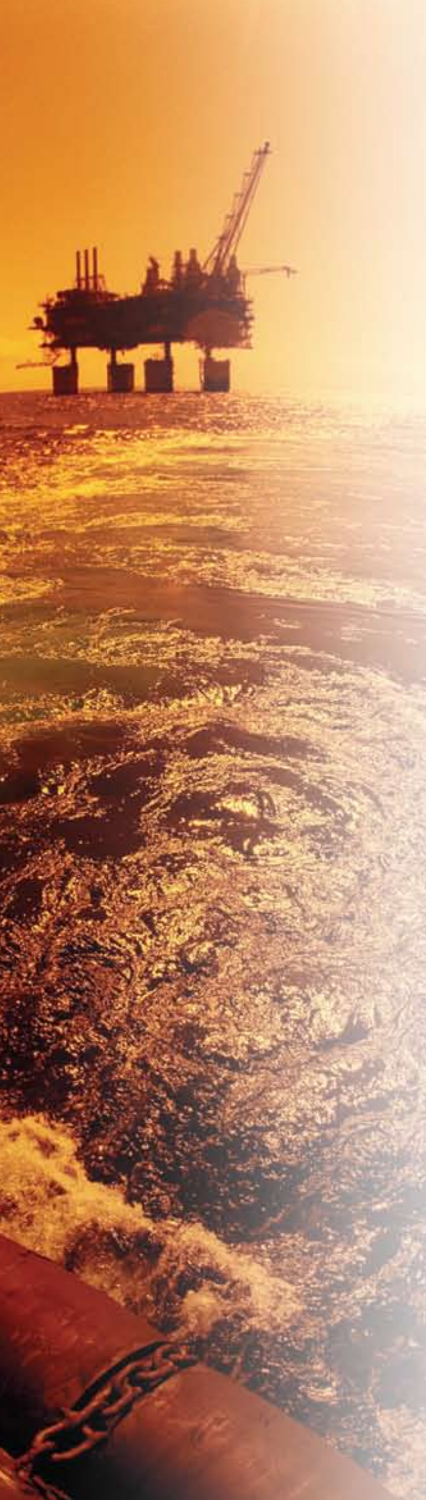


## 14. EXPLORATORY AND DEVELOPMENT COSTS

This account pertains to the deferred costs of exploration and development for various projects of PNOC EC on coalmine, oil and gas projects including investment in pre-joint venture projects. Deferred costs pertaining to impaired or inactive projects in the total amount of P42.83 million in 2007 and P165.10 million in 2006 were written off. Prior year's capitalized cost in the amount of P8.72 million were expensed in 2007 in compliance with successful efforts method of accounting for oil and gas projects.

This account also includes PAFC's development costs on jatropha production and biodiesel manufacture that is capitalized and amortized over the asset's future economic benefits expected to be consumed by the entity.

## 15. INVESTMENT PROPERTY

This account includes the Parent Company's land leased out mainly to Petron Corporation where its refinery and other facilities are located. A long-term lease agreement was executed between the Parent 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 PAFC's land totaling approximately 910,935 square meters and is presently leased to Orica Explosives Philippines, Inc. for a period of five (5) years from March 1, 2004 to February 28, 2009, excluding a one-year clear-up period from March 1, 2009 to February 28, 2010.

The increase in investment property was due to revaluation of real estate properties with a total area of 3,552,920.61 square meters as evaluated by Binswanger Philippines, Cuervo Appraiser, Inc., Evalue Philippines Inc., Asia Appraisal and Royal Asia Appraisal Corporation in various dates of years 2006 and 2007.

## 16. DEFERRED CHARGES AND OTHER ASSETS

This account includes the following:

| | **2007** | 2006 |
|---|---|---|
| Deposit for sinking fund | **967,425,328** | 261,536,875 |
| Purchase price adjustment | **809,757,306** | 809,757,306 |
| Long-term receivables | **261,234,909** | 3,923,863,855 |
| Collateral for bonds issued | **40,813,707** | 48,337,598 |
| Special deposits and funds | **12,133,116** | 39,642,998 |
| Cash - restricted | **10,000,000** | - |
| Claims receivable from GSIS | **8,353,405** | 8,938,070 |
| Guarantee fee – Miyazawa II | **-** | 351,708,984 |
| Deferred royalty fee | **-** | 896,949,151 |
| Others | **258,700,475** | 351,993,359 |
| | **2,368,418,246** | 6,692,728,196 |
| Allowance for doubtful accounts | **(306,825,192)** | (3,866,477,318) |
| | **2,061,593,054** | 2,826,250,878 |

Deposit for sinking fund represents PNOC EC's prepayment of its Citibank loan to the Parent Company, deposited to the special Dollar account with Land Bank of the Philippines. This is in compliance with the DOF'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.

The Purchase Price Adjustment (PPA) fund is a trust fund under the Stock Purchase Agreement executed by and between the Parent Company, 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 the Parent Company to Saudi Aramco and AOC arising out of representations and warranties of the Parent Company under the Stock Purchase Agreement.

Long-term receivables comprised mainly of long overdue trade accounts from various government agencies and private institution that have been outstanding for more than two years.

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.

Cash–restricted pertains to the balance of PNOC EC's trust fund placed in savings deposit with the Land Bank of the Philippines which is intended to cover indemnity benefits of directors and officers who are involved in any action or suit filed against the Company.

Claims receivables from Government Security Insurance System (GSIS) consist mainly of estimated claim on reported loss of various properties damaged by typhoon "Caloy" at Energy Supply Base in Batangas and typhoon "Paeng" at the San Antonio Gas Plant in Isabela.

Guarantee fee for 2006 refers to PNOC EDC's upfront fees for the Miyazawa II loans while deferred royalty fees pertains to fees due to Department of Energy (DOE) and Local Government Units (LGU's) (See Note 1).

Other deferred charges includes PAFC's biological assets pertaining to jatropha plants and seedlings (P115.96 million).

## 17. NON-CURRENT ASSETS HELD FOR SALE

This account includes the following:

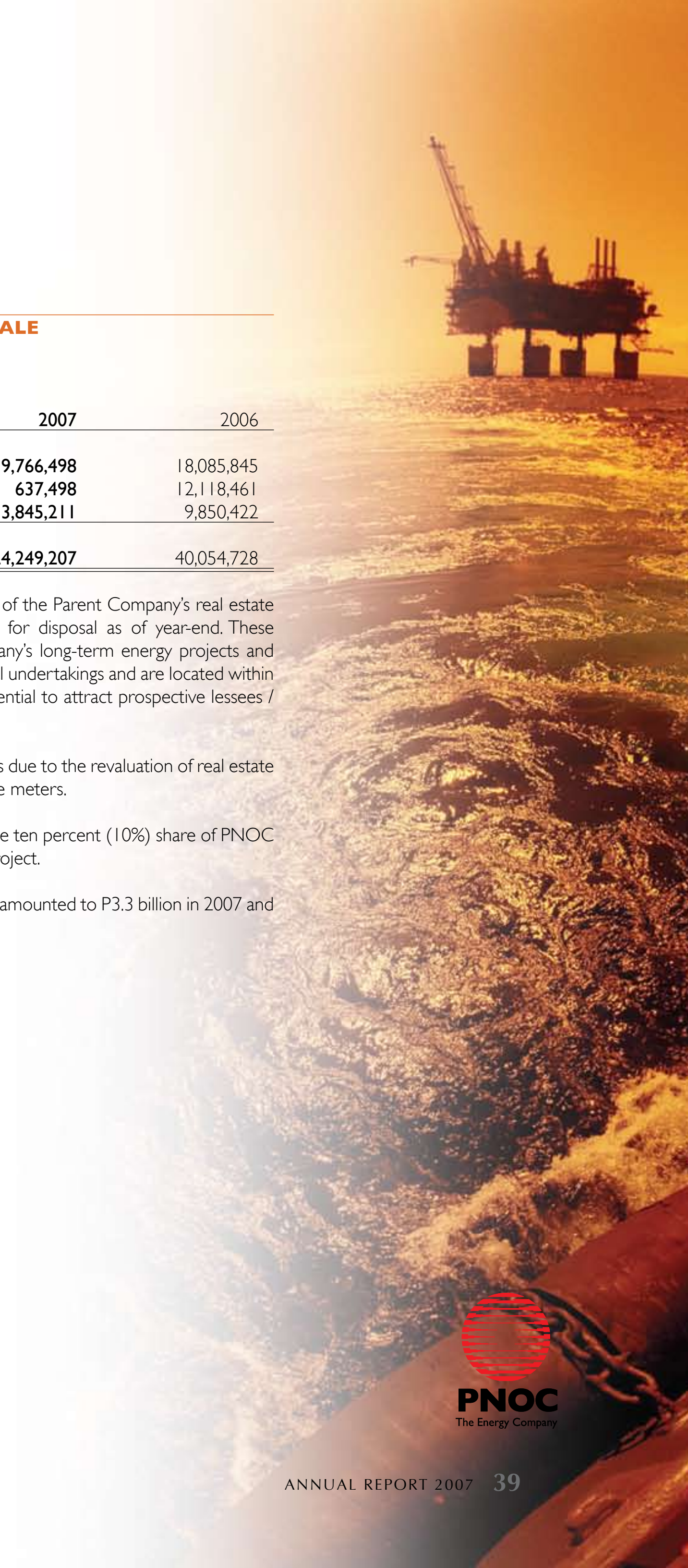
| | **2007** | 2006 |
|---|---:|---:|
| Property, Plant & Equipment | **419,766,498** | 18,085,845 |
| Materials and supplies inventory for disposal | **637,498** | 12,118,461 |
| Surplus property available for sale | **3,845,211** | 9,850,422 |
| | **424,249,207** | 40,054,728 |

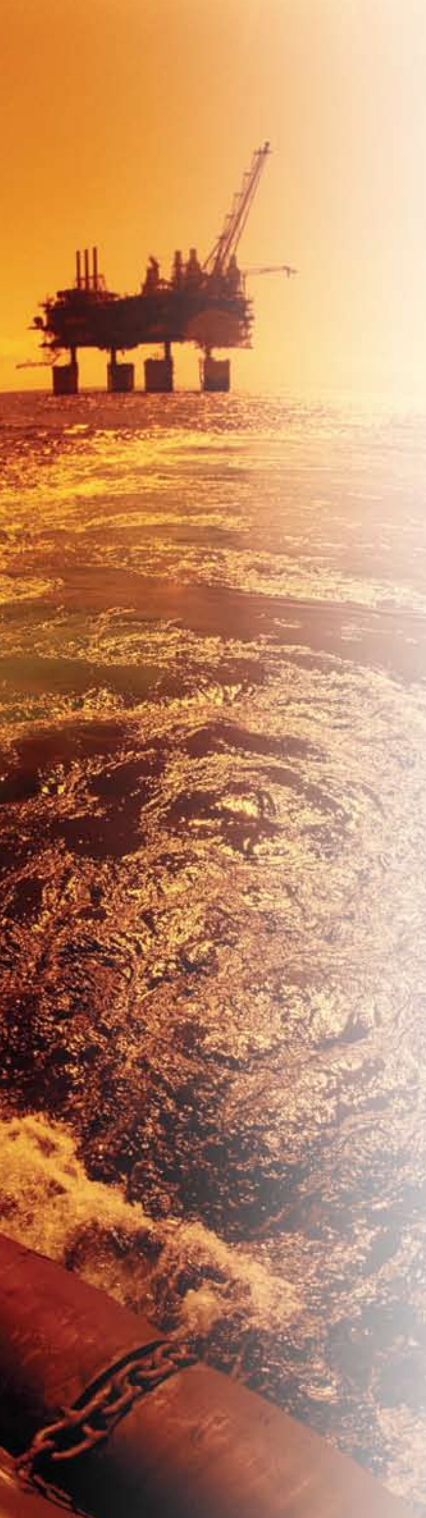
The property, plant and equipment consist mainly of the Parent Company's real estate properties that are made available for sale and for disposal as of year-end. These properties are not suitable for the Parent Company's long-term energy projects and other viable energy-allied industrial and commercial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

The increase in non-current assets held for sale was due to the revaluation of real estate properties with a total area of 2,166,491.32 square meters.

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

Depreciation and depletion charged to operations amounted to P3.3 billion in 2007 and P2.1 billion in 2006.





## 18. PROPERTY, PLANT & EQUIPMENT

The details of this account are as follows:

| | Land, Leases & Improvements | Buildings and Improvements | Wells, Platforms and other Facilities | Plant Facilities | Pier Facilities | Tankers | Machinery and Equipment | Transportation Equipment |
|---|---|---|---|---|---|---|---|---|
| **COST** | | | | | | | | |
| January 1, 2007 | 3,138,693,332 | 14,280,544,552 | 29,942,134,200 | 3,968,015,783 | 200,580,156 | 508,724,752 | 1,944,290,150 | 313,235,556 |
| Additions | | 5,333,796 | 65,446,416 | 10,270,117 | | 89,945,441 | 8,152,112 | 10,441,769 |
| Reclassifications | (9,684) | | | (7,132,228) | 8,994,290 | | (2,898,098) | (495,223) |
| Disposal of assets due to EDC's privatization | (1,727,641,708) | (13,997,696,549) | (18,524,437,444) | (3,670,775,022) | | | (1,814,203,249) | (268,057,139) |
| Disposals | (370,127,620) | (1,760,189) | | | | (55,256,353) | (6,560,749) | (2,211,481) |
| **December 31, 2007** | **1,040,914,320** | **286,421,610** | **11,483,143,172** | **300,378,650** | **209,574,446** | **543,413,840** | **128,780,166** | **52,913,482** |
| ACCUMULATED DEPRECIATION | | | | | | | | |
| January 1, 2007 | (2,767,292) | (5,305,803,908) | (8,529,038,088) | (1,495,426,114) | (133,025,691) | (144,713,103) | (1,384,280,658) | (278,930,663) |
| Provision | (186,055) | (10,865,076) | (555,599,658) | (19,752,409) | (13,818,291) | (33,464,476) | (4,243,887) | (6,610,487) |
| Reclassifications | | | | 5,032,586 | (5,069,680) | | 3,921,910 | 40,684 |
| Disposals | - | 704,076 | | | | 55,256,352 | 5,895,282 | 2,200,838 |
| Disposal of assets due to EDC's privatization | | 5,206,448,813 | 6,618,700,160 | 1,297,210,113 | | | 1,268,039,275 | 244,673,006 |
| **December 31, 2007** | **(2,953,347)** | **(109,516,095)** | **(2,465,937,586)** | **(212,935,824)** | **(151,913,662)** | **(122,921,227)** | **(110,668,078)** | **(38,626,622)** |
| NET CARRYING AMOUNT | | | | | | | | |
| **December 31, 2007** | **1,037,960,973** | **176,905,515** | **9,017,205,586** | **87,442,826** | **57,660,784** | **420,492,613** | **18,112,088** | **14,286,860** |

| | Land, Leases & Improvements | Buildings and Improvements | Wells, Platforms and other Facilities | Plant Facilities | Pier Facilities | Tankers | Machinery and Equipment | Transportation Equipment |
|---|---|---|---|---|---|---|---|---|
| **COST** | | | | | | | | |
| January 1, 2006 | 2,656,808,955 | 14,233,962,620 | 29,325,734,378 | 3,951,496,348 | 200,580,156 | 508,724,752 | 1,928,251,740 | 334,961,390 |
| Additions | 14,703,878 | 14 | 616,399,822 | 16,534,162 | | | 6,969,899 | 1,912,557 |
| Revaluations | 467,170,815 | | | | | | | |
| Reclassifications | 9,684 | 62,998,337 | | | | | 23,292,530 | 4,019,374 |
| Disposals | - | (16,416,419) | | (14,727) | | | (14,224,019) | (27,657,765) |
| **December 31, 2006** | **3,138,693,332** | **14,280,544,552** | **29,942,134,200** | **3,968,015,783** | **200,580,156** | **508,724,752** | **1,944,290,150** | **313,235,556** |
| ACCUMULATED DEPRECIATION | | | | | | | | |
| January 1, 2006 | (2,557,075) | (4,601,929,722) | (7,483,804,237) | (1,355,146,334) | (119,528,409) | (112,135,012) | (1,282,727,812) | (278,796,475) |
| Provision | (210,217) | (714,865,380) | (1,045,233,851) | (140,287,511) | (13,497,282) | (32,578,091) | (114,360,131) | (27,093,823) |
| Disposals | - | 10,991,194 | | 7,731 | | | 12,807,285 | 26,959,635 |
| **December 31, 2006** | **(2,767,292)** | **(5,305,803,908)** | **(8,529,038,088)** | **(1,495,426,114)** | **(133,025,691)** | **(144,713,103)** | **(1,384,280,658)** | **(278,930,663)** |
| **NET CARRYING AMOUNT** | | | | | | | | |
| **December 31, 2006** | **3,135, 926,040** | **8,974,740,644** | **21,413,096,112** | **2,472,589,669** | **67,554,465** | **364,011,649** | **560,009,492** | **34,304,893** |

| Furniture, Fixtures & Equipment | Construction in Progress | Others | Total |
|---|---|---|---|
| 427,321,872 | 3,514,520,439 | 55,113,107 | 58,293,173,899 |
| 19,616,209 | 17,171,815 | (3,098) | 226,374,577 |
| (3,328,729) | | | (4,869,672) |
| (280,000,006) | (3,455,412,035) | (15,208,989) | (43,753,432,141) |
| (1,261,647) | | (182,300) | (437,360,339) |
| **162,347,699** | **76,280,219** | **39,718,720** | **14,323,886,324** |
| (318,812,027) | | (5,395,714) | (17,598,193,258) |
| (16,839,968) | | (1,801,527) | (663,181,834) |
| 108,197 | | | 4,033,697 |
| 1,604,109 | | 181,000 | 65,841,657 |
| 244,582,291 | | | 14,879,653,658 |
| **(89,357,398)** | **-** | **(7,016,241)** | **(3,311,846,080)** |
| **72,990,301** | **76,280,219** | **32,702,479** | **11,012,040,244** |

| Furniture, Fixtures & Equipment | Construction in Progress | Others | Total |
|---|---|---|---|
| 379,758,861 | 650,384,972 | 59,801,945 | 54,230,466,117 |
| 41,217,124 | 3,400,077,472 | 1,691,110 | 4,099,506,038 |
| | | | 467,170,815 |
| 28,079,258 | (535,942,005) | (6,013,997) | (423,556,819) |
| (21,733,371) | | (365,951) | (80,412,252) |
| **427,321,872** | **3,514,520,439** | **55,113,107** | **58,293,173,899** |
| (300,364,557) | | (5,586,536) | (15,542,576,169) |
| (40,072,745) | | (170,329) | (2,128,369,360) |
| 21,625,275 | | 361,151 | 72,752,271 |
| **(318,812,027)** | **-** | **(5,395,714)** | **(17,598,193,258)** |
| **108,509,845** | **3,514,520,439** | **49,717,393** | **40,694,980,641** |

## 19. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Accounts Payable and accrued expenses | **767,495,058** | 3,237,900,194 |
| Accrued interest | **151,006,006** | 1,170,451,288 |
| Royalty fee payable | **-** | 524,644,631 |
| Other current liabilities | **492,354,065** | 853,441,820 |
| | **1,410,855,129** | 5,786,437,933 |

## 20. INCOME TAX PAYABLE

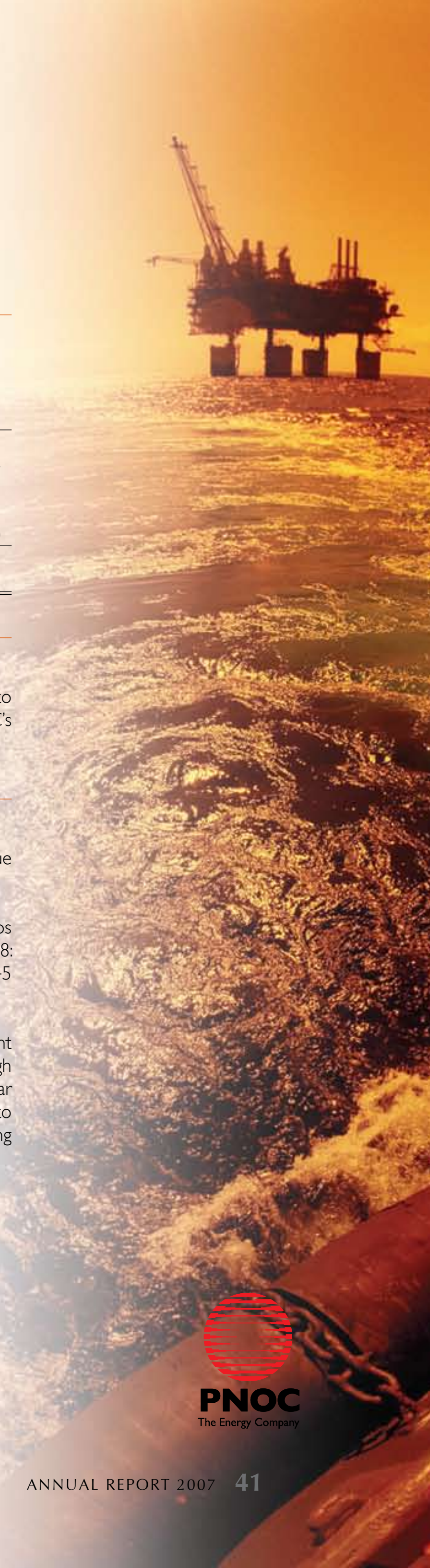
This account pertains to the income tax liability of PNOC EC and PDMC amounting to P19,185,921 and P31,187,494, respectively. In 2006, this account includes PNOC EDC's income tax liability of P507,932,215 (See Note 1).

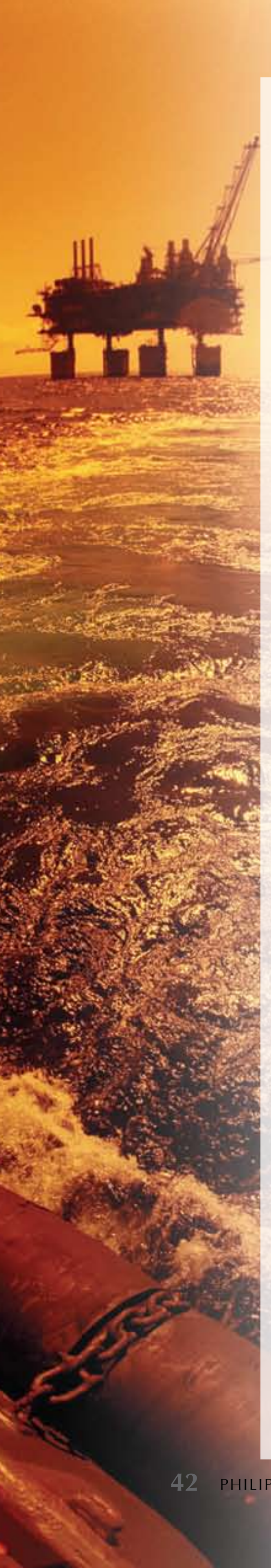
## 21. BOT LEASE OBLIGATIONS

This account pertains to the liability of PNOC EDC in 2006 set up for the present value of the stream of future cash payments for the BOT Power plants (See Note 1).

Outstanding balances of these foreign obligations were restated into Philippine pesos based on the prevailing foreign exchange rates at year-end (USD1=JPY113.688: USD1=PHP41.411 on December 31, 2007 and USD1=JPY 118.934: USD1=PHP49.045 on December 31, 2006).

A substantial portion of these obligations are guaranteed by the Philippine Government in consideration for surety given to creditor banks, the Philippine Government, through 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.





## 22. LONG-TERM LOANS

Long-term loans are summarized as follows:

| Creditor/Project Name | | Maturities | Interest Rate | 2007 | 2006 |
|---|---|---|---|---|---|
| **International Bank for Reconstruction and Development** | | | | | |
| 2969 PH Bacon Manito Geothermal Power Project | | | | | |
| - US$41.0 million | PNOC EDC | 1994 to 2008 | 1/2 of 1% over cost of qualified borrowings | **213,917,488** | 464,006,909 |
| 3164 PH Energy Sector Project | | | | | |
| - US$150.0 million | PNOC and PNOC EDC | 1995 to 2010 | 1/2 of 1% over cost of qualified borrowings | **1,567,944,501** | 2,381,795,853 |
| 3702 PH Geothermal Exploration Project | | | | | |
| - US$64.0 million | PNOC EDC | 1999 to 2013 | 1/2 of 1% over cost of qualified borrowings | **1,194,375,196** | 1,516,373,173 |
| 3747 PH Geothermal Exploration Project | | | | | |
| - US$114.0 million | PNOC EDC | 1999 to 2014 | 1/2 of 1% over cost of qualified borrowings | **1,353,629,820** | 1,701,179,610 |
| - JPY 12.4 billion | | 1999 to 2014 | | **971,506,792** | 1,270,302,115 |
| **Overseas Economic Cooperation Fund (OECF)** | | | | | |
| 8th Yen Tongonan I Geothermal Power Project | | | | | |
| - JPY 5.8 billion | PNOC EDC | 1990 to 2010 | 3% | - | 411,272,172 |
| - JPY 1.5 billion (restructured) | | | 3.2% | - | 163,260,896 |
| 9th Yen Palipinom I Geothermal Power Project | | | | | |
| - JPY 10.8 billion | PNOC EDC | 1991 to 2011 | 3% | - | 770,899,585 |
| 15th Yen Palinpinon II Geothermal Power Project | | | | | |
| - JPY 4.0 billion | PNOC EDC | 1999 to 2019 | 5.7 % | **650,141,912** | 800,031,045 |
| 18th Yen Palinpinon II Geothermal Power Project | | | | | |
| - JPY 77.4 billion | PNOC EDC | 2003 to 2023 | 3% | - | 25,681,845 |
| 19th Yen Mt. Labo Geothermal Power Project | | | | | |
| - JPY 10.8 billion | PNOC EDC | 2004 to 2024 | 4.9% | - | 115,897,514 |
| 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% | - | 4,299,364,022 |
| **MIYAZAWA INITIATIVE I** | | | | | |
| - JPY 5.2 billion | PNOC EDC | June 1, 2009 | Tranche A = 3.78 % | - | 2,127,831,057 |
| - JPY 6.8 billion | | | Tranche B - LIBOR + 1.60 % | - | 2,820,613,262 |
| **MIYAZAWA INITIATIVE II** | | | | | |
| - JPY 22.0 billion | PNOC EDC | June 26, 2010 | 2.37% | - | 9,072,147,920 |
| **Citibank Syndicated Loan** | | | | | |
| - US$175 million Malampaya Deepwater-Gas-to-Power Project | PNOC-EC | 2010 | LIBOR plus .85% | **1,946,317,000** | 4,414,050,000 |
| **Landbank of the Philippines** | | | | | |
| - PHP 1.5 billion | PNOC EDC | June 29, 2008 | Average 91 day T-bills + 2.5% | - | 882,954,546 |
| | PSTC | 2005 to 2013 | | **254,752,928** | 299,057,786 |
| **Standard Chartered** | | | | | |
| - US$ 75 million | PNOC EDC | August 4, 2009 | 2.22% + LIBOR | - | 3,678,375,000 |
| **US$90 Million Five Years Guaranteed Loan Facility** | | | | | |
| - US$45.7 million | PNOC EDC | February 21, 2008 | Tranche 1 = 3.7 % + 6 mos. LIBOR | - | 1,807,602,533 |
| - US$44.3 million | | | Tranche 2 = 3.39 % + 6 mos. LIBOR | - | 1,736,716,159 |
| **National Government** | | | | | |
| Principal Collaterized Interest Reduction Bonds (PCIR) | PNOC and PNOC EDC | 1992 to 2017 | Year 1 4 1/4 %<br>Year 2 5 1/4 %<br>Year 3 5 3/4 %<br>Year 4 - 5 6 1/4 %<br>Year 6 - 25 6 1/2 % | **180,717,605** | 214,032,380 |
| Interest Reduction Bonds (IRB) | PNOC | 1992 to 2008 | Year 1-2 4 %<br>Year 3-5 5 %<br>Year 6 6 %<br>Year 7 - 15 LIBOR plus 13/16 of 1% | - | 888,583 |
| Philippine New Money Bonds | PNOC | 1992 to 2010 | LIBOR plus 13/16 of 1% | **8,494,224** | 15,090,165 |
| TOTAL | | | | **8,341,797,466** | 40,989,424,130 |
| Less: Current portion | | | | **1,312,712,048** | 3,264,561,183 |
| | | | | **7,029,085,418** | 37,724,862,947 |

## 23. OTHER LONG-TERM LIABILITIES

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Liability for future abandonment costs | **57,672,418** | 51,289,619 |
| Retirement benefit obligations | **-** | 869,569,338 |
| Others | **4,976,573** | 261,409,419 |
| | **62,648,991** | 1,182,268,376 |

The liability for future abandonment costs pertains to the accumulated amount out of the estimated US$3.00 million PNOC EC's share in the future abandonment costs of SC 38 Malampaya Project. Using the accrued liability method in accounting for this transaction, the liability for future abandonment costs expensed amounted to P6.38 million in 2007 and P5.81 million in 2006.

Retirement benefit obligations for 2006 refers to PNOC EDC's accrued vacation and sick leave cumulative balances as of balance sheet date.

## 24. ROYALTY FEE PAYABLE

The Royalty Fee Payable of PNOC EDC in 2006 consists of account due to DOE and LGU's (See Note 1).

## 25. OTHER CREDITS

This account consists mainly of PNOC EC's unearned revenue for the net entitlements from the undelivered gas of the "take-or-pay" transactions of the SC 38 Malampaya Project where customers are obliged to pay the contracted volume or quantity even if there is no delivery or consumption of the produced gas during the period.

It also includes the cost of land and building owned by PNOC EDC at Fort Bonifacio, Taguig City which will be transferred to Parent Company.

## 26. CAPITAL STOCK

The Parent 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 P50 a share. From 1975 to 1988, an additional 6,029,191 shares were subscribed by the Republic of the Philippines at P500 per share.

## 27. DONATED CAPITAL

In 1998, PNOC EDC donated to PNOC EC the Kremco Model trailer-mounted drilling rig and a Digitran RS-300 drilling rig simulator.

In 2005, the Drilling Rig Stimulator, together with its housing building, was transferred back to PNOC EDC and the corresponding adjustment was effected in 2007.

## 28. RESERVES

This account in 2006 pertains to PNOC EDC's gain on the realignment of investments in bonds and stocks classified as available-for-sale securities (See Note 1).

## 29. REVALUATION SURPLUS

This account consist mainly of the appraisal of the Parent Company's real estate properties classified as investment properties, idle properties and those held for disposal with a total land area of 5,719,411.93 square meters. These properties were evaluated by Binswanger Philippines, Cuervo Appraiser Inc., Evalue Philippines, Asia Appraisal and Royal Asia Appraisal Corporation in various dates in 2006 and 2007.

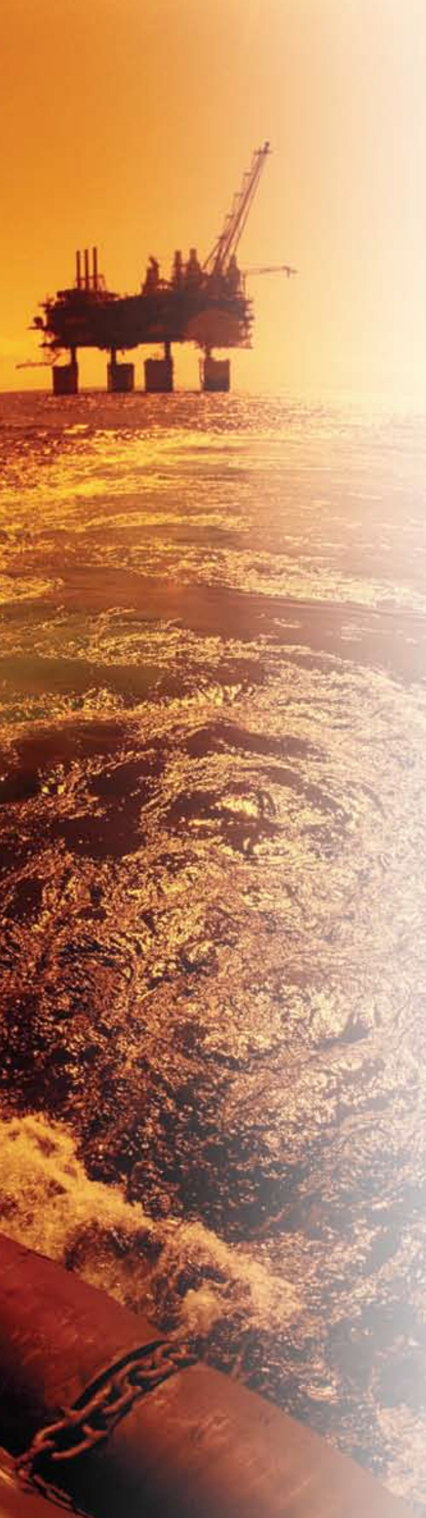
It includes the appraisal value of 588,967 square meters of PDMC's land area located in Rosario, Noveleta and Gen. Trias, Cavite amounting to P468,715,398 which was carried in the PDMC's Property, Plant and Equipment (PPE) account. The appraisal was conducted by Valencia Appraisal Corp. in May 2005. It also includes appraisal increase of P398,000 recognized by PSTC on the two (2) vehicles donated by the Parent Company based on the appraisal reports of Royal Asia Appraisal Corporation.

## 30. RETAINED EARNINGS

As of December 31, 2007, a total of P9.9 billion was appropriated for investment projects and capital requirements of the Parent Company (P6.75 billion), PNOC EC (P3.0 billion), PSTC (P150 million). In 2007, the Board of Directors of PNOC EC approved the appropriation of P3.0 billion to meet the company's cash requirements for capital expenditures and exploration projects in the next three (3) years, while PSTC appropriated additional P62 million intended solely for equity participation on the acquisition of future tankers and Light Cargo Tankers.

Pursuant to Republic Act No 7656, the Parent Company declared to the National Government a total cash dividend of P1,306,326,754 for its 2007 net earnings. This includes the cash dividend declared and remitted directly to the Bureau of Treasury by the subsidiaries, namely, PNOC EDC (P445.5 million), PNOC EC (P49.89 million) and PSTC (P18.0 million).

The Parent Company remitted to the Bureau of Treasury the total amount of P62,169,358,565 representing the share of the National Government (NG) in the net proceeds from the Secondary and Final Offerings of PNOC EDC.



## 31. NET SALES

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Oil and gas production | **4,369,144,346** | 4,885,901,280 |
| Coal operations | **1,846,883,815** | 1,216,459,848 |
| Shipping | **265,162,075** | 386,866,666 |
| Energy supply base | **226,339,742** | 114,702,535 |
| Socialized housing | **161,690,595** | 35,746,375 |
| Lease income | **21,420,839** | - |
| Water | **12,049,102** | 8,516,150 |
| Thruput | **11,617,125** | 9,023,109 |
| Right of way | **3,166,665** | 2,878,787 |
| Electricity | **-** | 15,727,908,745 |
| Steam | **-** | 5,019,529,299 |
| Drilling | **-** | 261,449,987 |
| Others | **256,714** | 45,950 |
| | **6,917,731,018** | 27,669,028,731 |

Revenues from Oil and Gas Production pertains to PNOC EC's 10% participating interest in Service Contract 38 (SC38) called the Malampaya Project which is involved in the exploration and development of the contract area in the offshore Northwest Palawan, Philippines. The Project supplies fuel to three power plants in Batangas, the Ilijan, Sta. Rita and San Lorenzo power plants, and one gas plant in Tabangao. The Malampaya Project also produced condensate, which is shipped to buyers in Singapore, Thailand and China. For 2007, the Malampaya Project produced total natural gas of 126.03 billion cubic feet (BCF) and 105.45 BCF gas offtake in 2006. Total condensate production, on the other hand reached 5.75 million barrels in 2007 and 5.04 million barrels in 2006.

Coal operations came from PNOC EC's own mining operations from one of its coal operating contract (COC), known as the Zamboanga Sibugay Project or COC-41, within the Malangas Coal Reservation, and its engagement in coal trading activities. It operates three coal terminals where coal shipments, sourced from third parties, are stored before delivery to customers. For the year 2007, total coal sales were 776.83 thousand metric tons (MT) while in 2006, sales volume was at 480.1 thousand MT.

Lease income pertains to PAFC's rental income from land of approximately 910,935 meters, which is leased out to Orica Explosives Philippines, Inc. The lease income was originally classified as other income in 2006 and reclassified as operating revenue in 2007.

## 32. COST OF SALES

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Coal purchases and landed costs | **1,425,453,773** | 999,461,242 |
| Depreciation and amortization charges | **624,128,217** | 2,734,818,391 |
| Oil and gas production costs | **583,901,151** | 489,971,141 |
| Fuel, oil, and TBA | **200,348,271** | 67,876,697 |
| Coal marketing and selling | **141,613,466** | 62,118,080 |
| Employee costs | **78,402,505** | 949,348,005 |
| Purchased services and utilities | **42,428,443** | 5,075,960,499 |
| Maintenance and repairs | **41,056,761** | 347,438,318 |
| Rental, insurance and taxes | **36,309,795** | 325,223,409 |
| Shipping and delivery | **12,776,899** | 82,996,031 |
| Business and other expenses | **9,933,475** | 36,817,465 |
| Materials and supplies | **7,015,998** | 369,822,500 |
| Technical support charges | **-** | 296,167,148 |
| Royalty fee | **-** | 470,394,682 |
| Miscellaneous expenses | **1,661,255** | 893,666 |
| | **3,205,030,009** | 12,309,307,274 |

## 33. OPERATING EXPENSES

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Employee costs | **234,447,768** | 547,797,681 |
| Purchased services and utilities | **214,097,806** | 275,171,628 |
| Rental/insurance/taxes | **117,118,238** | 266,477,372 |
| Business expenses | **98,082,301** | 74,003,493 |
| Depreciation/amortization | **34,207,053** | 109,652,464 |
| Materials and supplie | **18,364,897** | 61,396,957 |
| Maintenance and repairs | **12,375,459** | 21,518,421 |
| Provision for doubtful accounts | **7,081,337** | 314,512,641 |
| Administrative and allocated charges | **-** | 662,147,642 |
| Others | **70,032,927** | 29,438,852 |
| | **805,807,786** | 2,362,117,151 |

## 34. OTHER INCOME (CHARGES)

This account consists of the following:

| | 2007 | 2006 |
|---|---|---|
| Gain from PNOC-EDC privatization | **63,025,771,366** | 6,136,034,055 |
| Dividend income | **1,266,750,971** | 376,734,178 |
| Interest income - net of final tax | **850,418,974** | 1,031,652,128 |
| Gain on disposal of assets | **684,777,986** | - |
| Lease income | **160,520,426** | 178,019,274 |
| Gain from initial recognition of biological assets | **111,370,787** | - |
| Interest expense | **(328,775,124)** | (2,765,228,436) |
| Impairment loss | **(48,229,203)** | (165,356,407) |
| Guarantee fee | **(33,527,094)** | (48,135,368) |
| Foreign exchange gain/(loss) | **(3,455,955)** | 2,995,943,823 |
| Inflation adjustment on prior year's electricity and steam sales | **-** | 63,035,787 |
| Mineral exploration | **-** | (18,998,648) |
| Other income (charges) | **(339,994,775)** | 87,636,564 |
| | **65,345,628,359** | 7,871,336,950 |

## 35. INCOME TAX

Components of income tax expense are as follows:

| | 2007 | 2006 |
|---|---|---|
| Current tax | **1,216,027,204** | 2,577,405,930 |
| Deferred tax | **112,159,489** | 1,828,290,800 |
| | **1,328,186,693** | 4,405,696,730 |

This account comprised mainly of PNOC EC's current tax of P1.17 billion and deferred tax of P80.2 million.

## 36. DEFERRED INCOME TAX

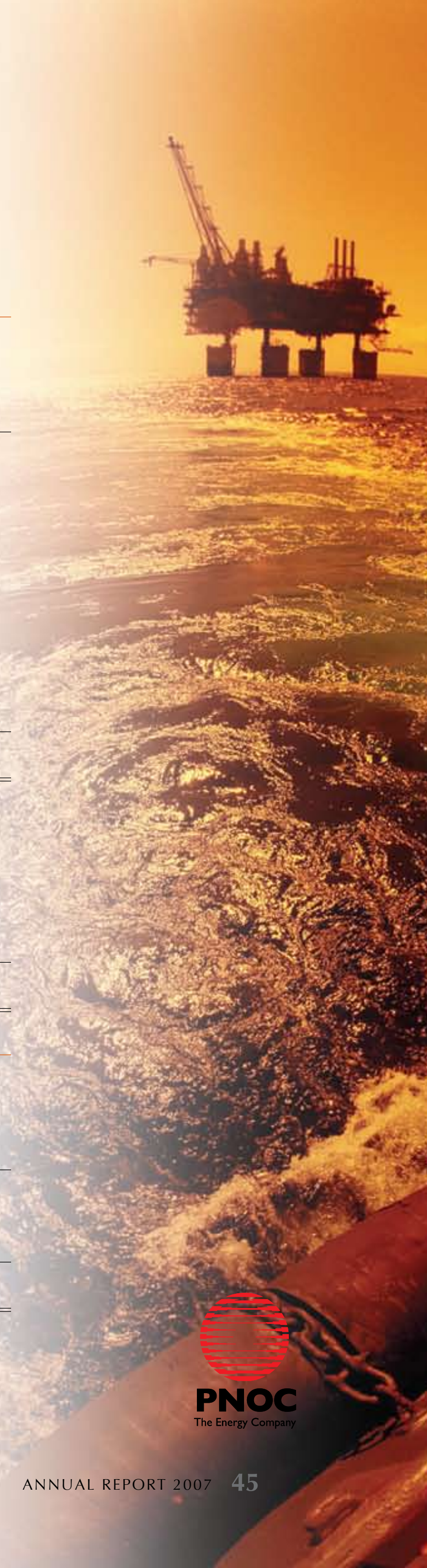
The analysis of deferred income tax for financial reporting purposes follows:

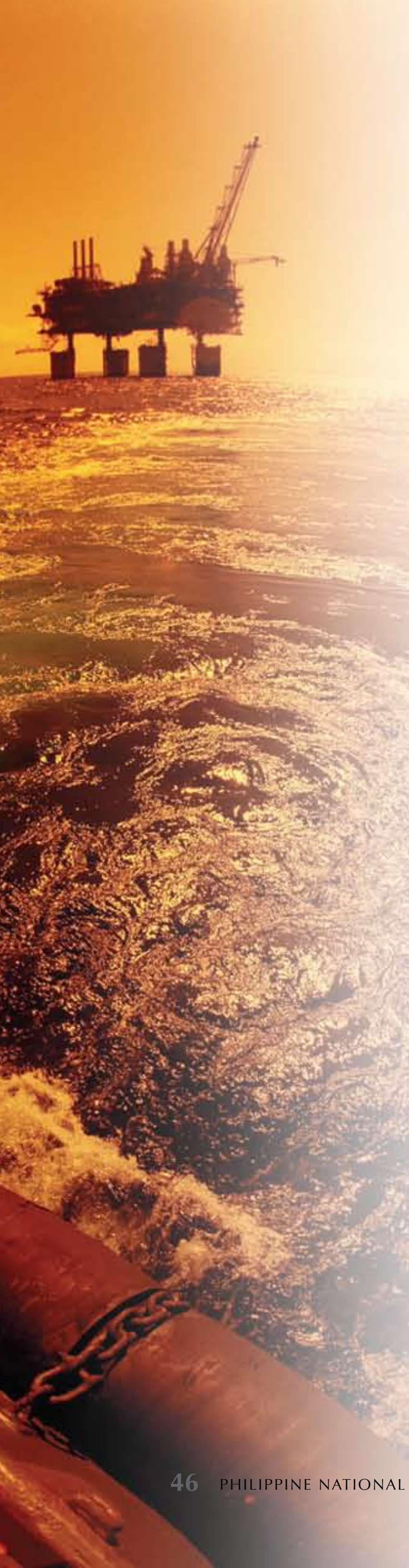
| | 2007 | 2006 |
|---|---|---|
| Deferred tax assets: | | |
| Foreign exchange losses (gains) – BOT Power Plants | **-** | 5,361,920,902 |
| Unrealized foreign exchange losses (gains) | **61,824,627** | 1,500,793,666 |
| Allowance for doubtful accounts | **152,203,819** | 1,215,065,416 |
| Allowance for decline in value of investments | **193,343,334** | 193,343,334 |
| Carry forward of unused tax credits | **141,009,496** | 229,282,874 |
| Net operating loss carry over (NOLCO) | **106,288,102** | 106,288,102 |
| Minimum corporate income tax (MCIT) | **43,705,362** | 28,155,243 |
| Others | **-** | 50,087,326 |
| Total deferred tax assets | **698,374,740** | 8,684,936,863 |
| Deferred tax liability: | | |
| Increase in fair value applied as deemed Cost | **344,950,978** | 2,191,567,286 |
| Rental | **392,263** | - |
| Others | **1,441,720** | - |
| Deductible expenses per PD 1442 | **-** | 3,600,281,418 |
| Unrealized foreign exchange gains/ losses | **-** | 205,755 |
| Total deferred tax liability | **346,784,961** | 5,792,054,459 |

## 37. EARNINGS PER SHARE

Basic earnings per share amounts are computed as follows:

| | 2007 | 2006 |
|---|---|---|
| Net income (after tax) attributable to equity holders | **66,897,374,030** | 16,328,600,461 |
| Number of shares | **8,029,191** | 8,029,191 |
| Basic earnings per share | **8,332** | 2,034 |





## 38. RATIONALIZATION/PRIVATIZATION

PNOC

The Parent Company is presently exploring several avenues by which it can achieve its goal of focusing and streamlining its operations. An option that is being considered is the Rationalization Program of the Government, as embodied in Executive Order 366, which aims to conduct a strategic review of the operations and organizations of the Executive Branch and the rationalization of its functions and agencies.

The Parent Company's Rationalization Program continues to undergo fine-tuning to be relevant to the current thrust of the government and the management. Although efforts were afoot to finish the rationalization Plan in 2007, changes in thrust of the management as well as the privatization of it's major subsidiary, PNOC EDC and the planned activation of the PNOC Renewables Corporation requires further changes in the Rationalization Plan.

With this new thrust of the Parent Company, the Rationalization Plan may be put in place by the end of 2008.

PNOC EC

In February 2007, the Boards of Directors of PNOC EC and the Parent Company approved a plan to privatize PNOC EC through an Additional Public Offering of its authorized capital stock. In this connection, the PNOC EC Privatization Committee (PRIVACOM) was also formed and authorized by the Boards of Directors of the Parent Company and PNOC EC to coordinate the process of selecting the Financial Advisor for the privatization of PNOC EC.

The mandate for the financial advisory/underwriting/global coordinating services was awarded by the PRIVACOM in September 2007.

## 39. SIGNIFICANT AGREEMENTS

### Service Contracts

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

Accordingly, the Parent Company thru its subsidiaries, entered into service contracts with the 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 are what remain 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 Parent 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%).

### Oil and Gas Exploration and Production

Malampaya Project (SC 38)

PNOC EC owns ten percent (10%) participating interest in Service Contract (SC) 38 called the Malampaya Project which is involved in the exploration and development of the contract area in offshore Northwest Palawan, Philippines. Commercial gas production commenced on January 1, 2002. The project supplies fuel to three power plants in Batangas, the Ilijan, Sta. Rita and San Lorenzo power plants, and one gas plant in Tabangao. In 2007, the Project produced total gas of 3.56 million cubic meters (126.03 billion cubic feet) and 5.78 million barrels (.092 million cubic meters) of condensate.

San Antonio Gas Project (SAGP) (SC 37)

PNOC EC owns and operates the San Antonio Gas Project which consist of a Gas Field and 3 MW Gas Power Plant located in the province of Isabela. Gas from Well SA-1 continues to fuel the power plant which delivers electricity to the Isabela-I Electric Cooperative, Inc. (ISELCO-I) and supplies electricity to the municipalities of Echague, Jones, San Agustin and Santiago City. In 2007, the Gas Field produced 324.8 million standard cubic feet (mmsfc) of gas which was used for power generation and supply to compressed Natural Gas Station, while the Gas Power Plant generated electricity of 14.7 megawatt hours (MWHr).

The gas field is expected to fuel the power plant only until February or March of 2008 because of the depleting gas reserves. After which, the PNOC EC will decommission the power plant and will supply gas to Adsorb Natural Gas transport project.

### Other Pre-operating Projects

Natural Gas Infrastructure Projects

In view of perceived uncertainties in the commercial aspects of the Batangas to Manila Natural Gas Pipeline Project (BATMAN-1), PNOC EC management and the DOE decided to put the project on hold. PNOC EC, however, continues its efforts for the development of the Bataan LNG terminal project and the associated Bataan to Manila (BATMAN-2) gas pipeline project.

Meetings with parties interested to participate in PNOC EC's downstream natural gas development projects are continuing. These parties include potential partners, contractors, engineering firms, trading houses, financing arrangers, etc.

Ragay Gulf (SC 43)

The PNOC EC has a 15% participating interest in SC-43 which was granted by the DOE on January 14, 2004, covering 10,880 sq. km. in the Ragay Gulf, in offshore Bicol, and partly in Bondoc Peninsula. Its partners in SC 43 are PearlOil (Ragay) Philippines ("Pearl") and Premier Oil Philippines BV ("Premier") which, has 64% and 21% participating interests, respectively. Pearl replaces Premier Oil as operator of SC-43 upon acquiring 21.5% from the latter's original 42.5% participating interest. The SC-43 consortium acquired 152 kms. of 2D seismic data in July 2005 which was used to identify and evaluate prospects in the area. One of these prospects is Monte Cristo which is scheduled to be drilled in early 2008, the first one in SC 43. Another 325 kms. of 2D seismic data was acquired in November 2007 to identify and evaluate deeper targets in SC 43 similar to known oil and gas reservoirs in offshore Palawan.

Offshore Mindoro (SC47)

The PNOC EC has a 19.4% participating interest in SC-47 which was awarded by the DOE on January 10, 2005 covering 14,667 sq. km. in offshore Mindoro. Its joint venture partner, Petronas Carigali Overseas Sdn Bhd ("Petronas Carigali"), holds 80% participating interest and is the SC operator. The PNOC EC also represents the participating interest of PetroEnergy Resources Corporation (0.4%) and Basic Energy Corporation (0.2%) in SC 47. Sea bed logging, a relatively new remote sensing technique that detects resistivity variations in the subsurface that can be associated with the presence of hydrocarbons, was conducted for the first time in the country in June 2006 to further confirm the potential of SC 47 drilling targets. The results were encouraging and in August-September 2007, Petronas drilled Kamia-1 well which encountered minor oil and gas quantities. The well satisfied the drilling commitment of the 1st subphase of SC 47. Petronas, however, has advised the consortium that it will not enter into the 2nd subphase which will result in the block's operatorship reverting back to PNOC EC.

Calamian (SC 57)

The PNOC EC has a 100% participating interest in SC-57 when the DOE granted it on September 15, 2005. SC 57 covers 7,200 sq. km. in offshore Northwest Palawan, west of the Calamian Islands and north east of the Malampaya Gas Field. The PNOC EC subsequently entered into joint venture arrangements for the exploration of SC-57 in 2006 with China National Offshore Oil Corporation (CNOOC) acquiring 51% participating interests and operatorship of the block and Mitra Energy Inc. ("Mitra Energy") getting 21%, leaving the PNOC EC with the remaining 28%. Under the said arrangement, the PNOC EC will be carried up to the drilling of the first well. However, the DOE has yet to approve the transfer of participating interests of the PNOC EC to CNOOC and Mitra Energy. Approximately 2,268 km. of new 2D seismic data was acquired in August-September 2006 which satisfies the first sub-phase of the consortium's work obligations with the DOE. A number of targets have been identified for prospect evaluation based on the processing and interpretation of the existing and newly acquired data in SC 57. Plans for the drilling of the first well will be firmed up once DOE grants its approval of the PNOC EC's joint venture partners.

West Calamian

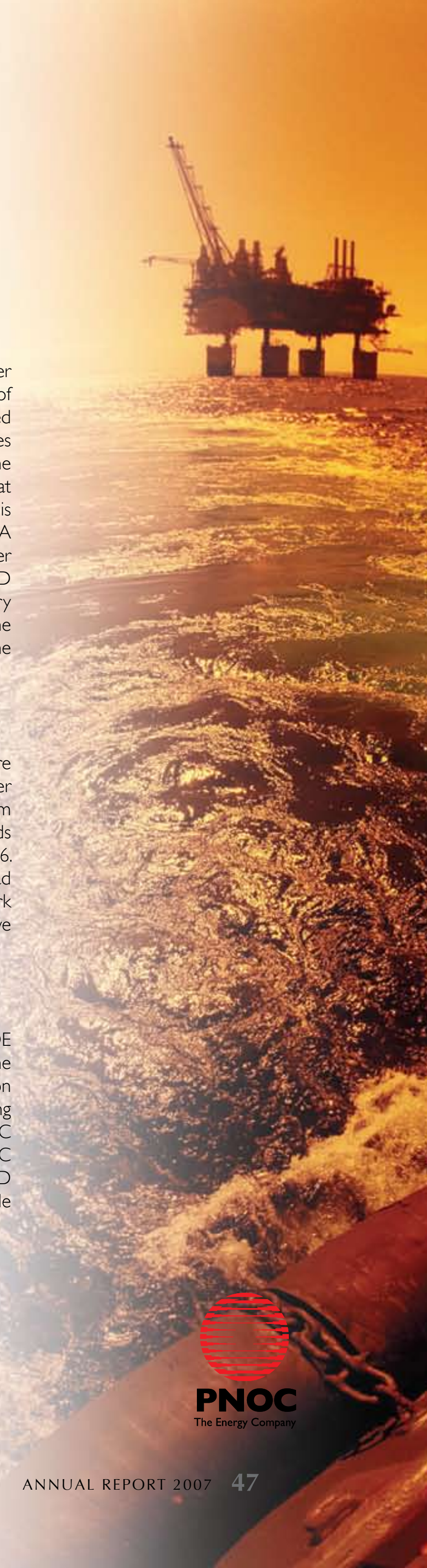
The PNOC EC entered into SC-58 with the DOE for 13,440 sq. km. of deep water acreage in offshore Northwest Palawan on January 12, 2006. SC-58 is located west of SC-57 and adjacent to the Malampaya Gas Field. The PNOC EC subsequently entered into joint venture arrangement for exploration with Nido Petroleum Philippines Pty. Ltd. ("Nido Petroleum") in July 2006 for a 50% participating interest. Under the arrangement, Nido Petroleum will be the operator and undertake a work program that includes 2D and 3D seismic surveys and the drilling of the first well. The PNOC EC is carried up to the drilling of the first well and will regain the operatorship thereafter. A total of 3,184 km. of regional 2D data was acquired in SC 58 in September-October 2006. A follow-up seismic survey to acquire about 5,000 kms of 2D and recon 3D seismic data was started in November 2007 and expected to be completed by January 2008. A total of 3,590.175 kms. was already acquired by end December 2007. The processing and interpretation of the new data in 2008 will enable the selection of the target for the first exploration drilling in SC 58 in early 2009.

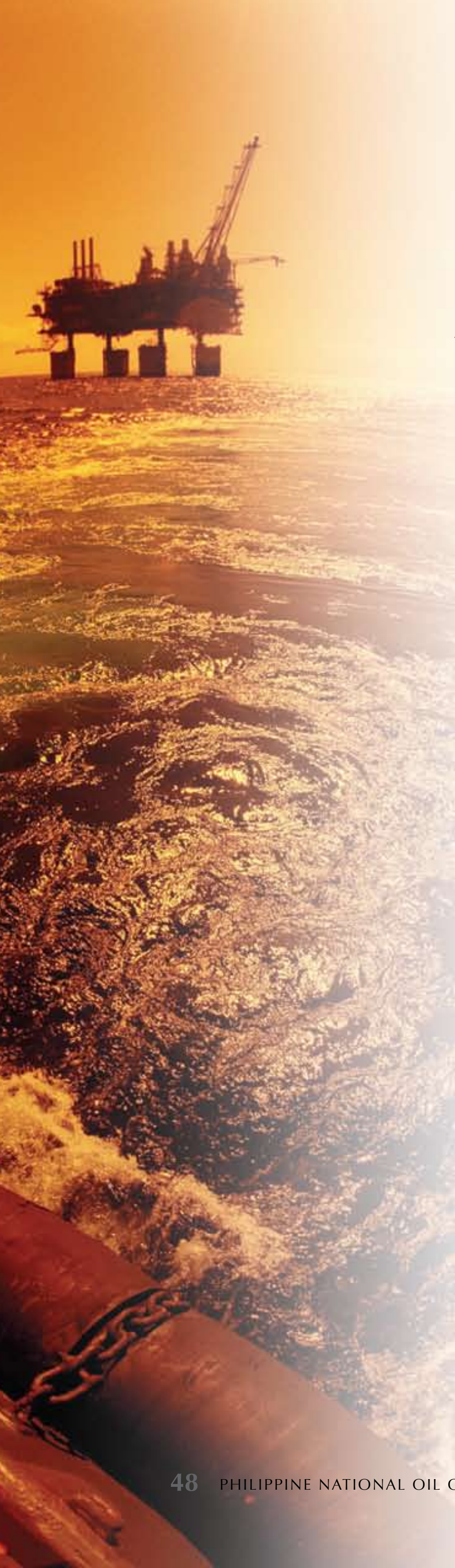
West Balabac

The PNOC EC entered into SC-59 with the DOE for 14,760 sq. km. in offshore Southwest Palawan, on January 13, 2006. SC-59 is located north of recent deepwater petroleum discoveries in offshore Malaysia and may share a common petroleum system with it. The PNOC EC currently has a 100% participating interest in SC-59 but intends to involve joint venture partners into the block through a bidding process per E.O. 556. The PNOC EC completed a 2,056-km. seismic program in November 2006 and had satisfied its obligations with the DOE for the first two sub-phases of the SC-59 work program. In the ongoing prospect evaluation of the block, a number of structures have been identified which are potential targets for future exploration drilling.

East Sabina (SC 63)

The PNOC EC, as operator, and Nido petroleum entered into SC-63 with the DOE for 10,560 sq. km. in offshore Southwest Palawan on November 24, 2006. Each of the company has 50% participating interests in SC-63 and shall equally share the exploration costs. The block is located south of the oil and gas fields in offshore Palawan including Malampaya. A gas discovery well, the Abo-abo A-1X, was previously drilled within SC 63 and was reported to produce 50 mmscf of gas per day during test. The PNOC EC has accelerated the seismic program for SC 63 acquiring about 3,254 km. of new 2D seismic data in October-December 2007 providing a regional coverage of the whole block including additional lines to define the Abo-abo structure.





Joint Marine Seismic Undertaking (JMSU)

The PNOC EC has signed a tripartite agreement for the JMSU project with CNOOC and PetroVietnam on March 14, 2005 covering 142,886 sq. km. in the South China Sea, west of Palawan. It is considered a big step towards transforming a previous area of conflict into an area for possible cooperation and mutual benefit. The agreement is for an initial three-year period aimed at assessing the petroleum potential of the area without affecting territorial claims of the respective participating countries. The expenses are equally shared by the three national oil companies. A large database had been generated by the project with the acquisition of approximately 11,000 km. of regional 2D seismic data in 2005. The second phase of seismic acquisition started in October 2007 involving about 11,800 km. of 2D seismic data. As of end December 2007, only 4,531.65 kms have been acquired due to delays brought by survey vessel and equipment problems. Seismic processing and interpretation of the new data will be conducted in 2008.

## Coal Operating Contracts (COC)

Surigao Coal Exploration – COC No. 140

The COC No. 140 was awarded to PNOC EC by DOE on July 5, 2005. The coal contract area with at total of 3,000 hectares is located in the Municipality of Tago, Surigao del Sur. The COC will allow PNOC EC two (2) years to conduct exploration activities within the area, which has an estimated 2.8 million tons of in-situ proven reserves (BED 1984).

The project was twice placed under moratorium due to heightened insurgency and subsequent military alert in the area since 2006. The DOE approved two proposed moratoria; the first October 12, 2006 valid until July 5, 2007; and the second on June 19, 2007, valid until July 5, 2008.

Despite the approved moratorium, PNOC EC, in cooperation with the National Commission on Indigenous Peoples, (NCIP), CARAGA Regional Office conducted the Free and Prior Informed Consent Activities in December 2007. A Memorandum of Agreement (MOA) between PNOC EC and the Manobo People residing in Barangays Layog and Caras-an, Municipality of Tago, Surigao del Sur was signed on December 24, 2007. The MOA signifies the Manobo People's approval of the project and PNOC EC's firm commitment to pursue exploration activities.

Isabela Coal Exploration – COC No. 122 and 141

PNOC EC is the holder of COC-122 which straddles portions of Cauayan City and the municipalities of Naguillian and Benito Soliven in Isabela. The US$ 95 million project involves putting up a 57.5-MW power plant that will utilize the low-rank coal in the province.

The project was shelved in July 2006. Coal Development sought a moratorium from the Department of Energy (DOE) which was granted in June 2007 and effective retroactive to April 2007. Efforts to renew field activities were initiated in July 2007, starting with coordination meetings with the newly elected/incumbent government officials at the municipal and provincial levels. Barangay level reconnaissance was started as early as November 2007, to reassess the conditions at the grassroots level in preparation fro a full swing implementation of work programs in 2008.

For COC 141, with the expiration of the Exploration COC on July 5, 2007, the DOE granted a two (2) year exploration COC extension valid until July 4, 2009.

Indonesian Coal Projects

PNOC EC intends to establish strategic alliance and venture into coal mining business in Indonesia in order to ensure a stable and competitive supply of coal for the Philippine market.

Definitive agreements between PNOC EC and Putra Asyano Mutiara Timur (PAMT) were pursued in the Year 2007. PNOC EC is awaiting the following documents by PAMT: KP for Exploration and Legal & Financial documents before a final agreement is forged. While this is on going, PNOC EC continued to identify and evaluate five (5) additional coal concession areas in various stages of development. Preliminary assessment was completed in September 2007. The short listed concession areas include: PT Berkat Banua Inti, PT Senajaya Energimas Mulia, PT Antang Gunung Meratus, PT Bangaun Banua Persada and PT Satui Bara Tama.

In August 2007, a Memorandum of Agreement (MOA) was signed between PNOC EC and PT Berkat Banaua Inti for a possible joint venture agreement after the completion of a due diligence.

Malangas Coal Project – COC No. 41

PNOC EC operates Coal Operating Contract (COC) 41 within the Malangas Coal Reservation in Zamboanga Sibugay straddling portions of the municipalities of Malangas, Diplahan and Imelda. As holder of the COC, PNOC EC oversees the operations of a large-scale coal mine within the contract area known as the integrated Little Baguio (ILB) colliery, in joint venture with Taiwan Overseas Mining Co., Phil., (TOMC). The ILB Colliery is the largest semi-mechanized underground coalmine in the country. Another joint venture agreement is under negotiation with Filsystem Inc. (FSI) as of the end of December 2007 for the Lalat Colliery. PNOC EC also supervises mining operations of various small-scale coal miners.

On 28 August 2007 the project acquired the Environmental Compliance (ECC) Certificate from the Department of Environment and Natural Resources covering the entire COC No.41 excluding those areas previously with existing ECC, particularly the ILB and Lalat Colliery.

The project completed rehabilitation of the Malangas Coal Stockyard retaining wall, MCP Field office perimeter fence and construction of the mooring dolphin at the loading terminal.

The project also started extensive exploration and drilling activities in Lumbong, Shaft 3 and Malongon areas on the last quarter of 2007 in preparation for the opening of new mines.

Energy Supply Base (ESB)

PNOC EC operates the Energy Supply Base in Mabini, Batangas which provides docking, storage and warehousing facilities of various oil and energy-related companies. Although initially set up to provide logistics support to the energy industry, the ESB services now extend to other commercial clients with the granting by the Philippine Ports Authority (PPA) of a 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) which will expire on May 3, 2021. The Parent Company intends to further expand ESB operations to serve the increasing needs of oil and energy related companies as well as other businesses.

PNOC Solar Home Systems (SHS) Distribution Project

The Parent Company's Solar Home Systems (SHS) Distribution Project supports the rural electrification objectives and social reform agenda of the Philippine government and involves the sale, distribution and installation of 15,100 SHS in unelectrified rural households in Regions 1-7, the Cordillera Administrative Region and the whole of the Mindanao Regions. A five-year bilateral agreement (2002-2007) was entered into by and between the government of the Philippines and the Netherlands. The Netherlands government, through its MILIEV Program, provides a 60% grant (EUR 5,591,026) on the total equipment cost. The balance of 40% (EUR 3,727,350.74) plus all other project management and operational costs are initially shouldered by the Parent Company and later passed on to the beneficiaries through affordable and manageable payment schemes. The project is implemented by the Parent Company in cooperation with the DOE who bears the costs of taxes and duties of the SHS units. Shell Solar Philippines Corporation (SSPC) is the appointed technical contractor for the Project.

The Parent Company has installed 2,820 units of solar home systems from January to December 2007 completing its target of 15,100 SHS within a period of five years. About 66% or 1,859 units of these solar installations were in Mindanao with 862 units in Tawi-tawi under the Parent Company and DOE barangay electrification cooperation in the area.

## 40. COMMITMENTS

Prior to Petron's privatization in 1994, majority of its landholdings amounting to P153 million was transferred to the Parent Company 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 the Parent Company was executed for a period of 25 years from September 1, 1993 to August 31, 2018 subject to renewal. Annual leasehold rental has reached P137.3 million in 2007 and P134.4 million in 2006.

## 41. 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. Keppel Philippines Shipyard, Inc. vs. PNOC/PDEC
   CA-GR CV No. 86830
   Court of Appeals

   For: Specific Performance

4. Tirso B. Savellano vs. BIR, PNOC and PNB
   G.R. No. 180004
   Supreme Court

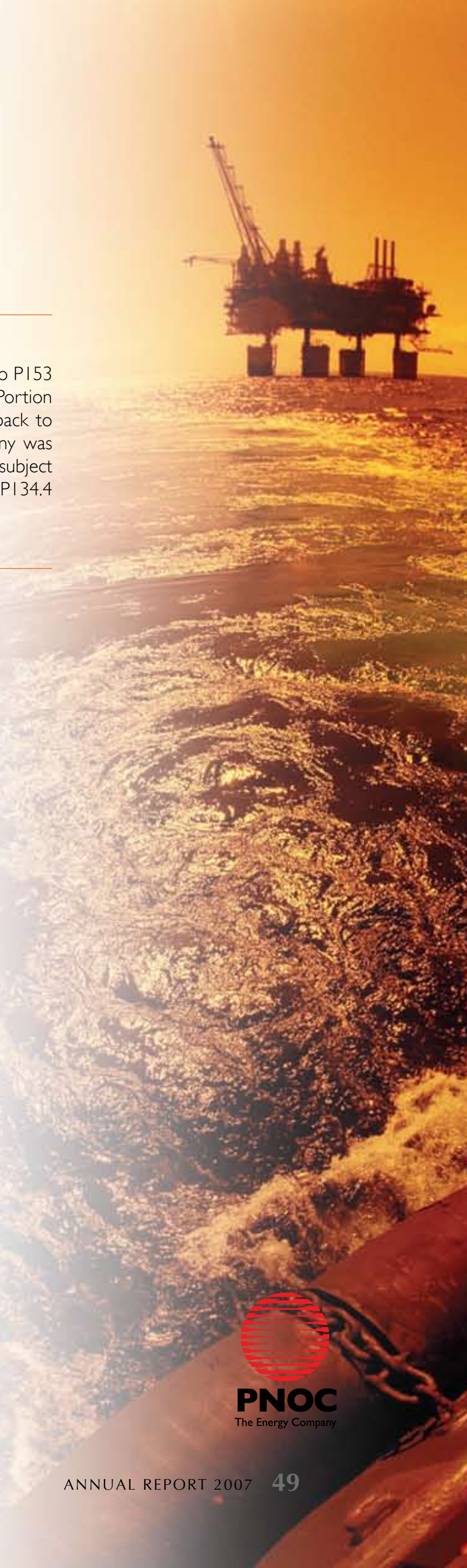
   For: Petition for Review on Certiorari

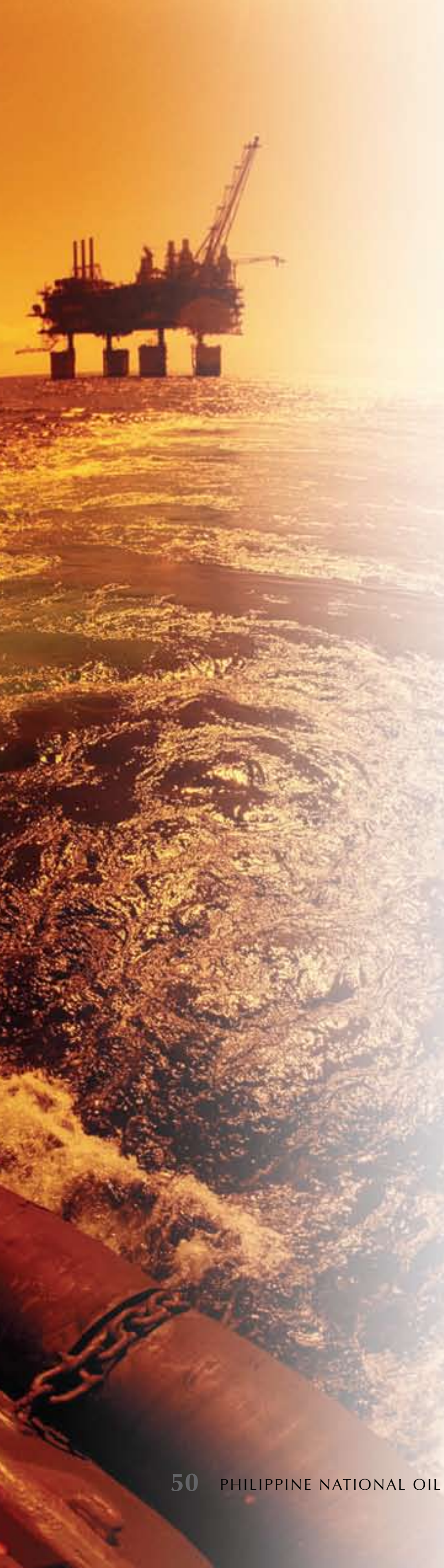
5. PNOC vs Petron, Opimio Abrahano, Jr. and Maria Soliven
   Civil Case No. 04-0009-D
   RTC Branch 41, Dagupan City

   For: Unlawful Detainer

6. Heirs of Maria Soliven represented by Barbara Abrahano vs. PNOC
   Civil Case No. 2007-0129-D
   RTC Branch 42, Dagupan City

   For: Declaration of Right of Way with Application for the Issuance of Restraining Order





7. PNOC vs. National College of Business Arts (NCBA)
Supreme Court
For: Appeal by Certiorari

8. Sun Gas, Inc. vs. Arnel Abela et. al.
Civil Case No. 07-29250
RTC Branch 23, Iloilo City
For: Petition for Contempt

9. Jamal Ashley Yahya Abbas vs. Nieves L. Osorio , Pedro A. Aquino Jr., Roland F. Rodriguez and PNOC
CA-G.R. SP No. 58128
Court of Appeals
For: Petition for Review at CA (illegal termination case)

10. PNOC vs. Sps. Jojo & Vilma Permejo et. al.
Civil Case No. 2006-64
RTC Branch 55, Lucena City
For: Accion Publiciana

11. PNOC vs Maria Nabong
Civil Case No. 16931
Municipal Trial Court in the City
Branch III, Cabanatuan City
For: Accion Publiciana

12. NAPOCOR vs Raul B. Saulog, Crown Radio Corp., PNOC et. al.
CA-G.R. CV No. 75321
Court of Appeals, Manila
For: Expropriation

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

15. Pablita Maputi et. al vs. NPC/PNOC/PNOC-EDC
CA GR No. 00975
Court of Appeals
For: Collection of Royalties with prayer fro accounting and injunction

PNOC-EC

1. PNOC-EC vs. Rafael G. Mangubat (Vehicle Acquisition Plan)
Case No. 02-47516
Quezon City RTC Branch 218
For: Awaiting decision on Motion for Issuance of Writ of Execution

2. PNOC-EC vs. Jose M. Asistio (Vehicle Acquisition Plan)
Case No. 69263
Pasig City RTC Branch 67
For: Company's motion to declare Mr. Asistio in default was granted and will present evidence exparte at the soonest time possible.

3. PNOC-EC vs. Bernardo F. Ople (Vehicle Acquisition Plan)
Case No. 02-48508
Quezon City RTC Branch 98
For: Hearing still to be set.

4. PNOC-EC vs. Pedro T. Santos (Vehicle Acquisition Plan)
Case No. 69262
Pasig City RTC Branch 67
For: Awaiting decision on defendant's Petition for Review filed with the Supreme Court.

5. PNOC-EC vs. Felimon Joson
Case No. 1901-1907
1st Municipal Trial Court (MCTC) of Mabini & Tingloy, Batangas
For: Evidence presented and is now for resolution by the court.

6. Province of Palawan vs. SC#38 Joint Venture Partners
CCN 4108
Palawan Regional Trial Court
For: Awaiting pre-trial order by the court.

7. Burgundy Global Exploration Corp. vs. PNOC- EC & Mitra Energy Ltd.
Case No. 06-450
Makati Regional trial Court Branch 59
For: Petioner filed for a Motion for Reconsideration.

8. **Taiwan Overseas Mining Co., Phils., Inc. vs. PNOC and PNOC- EC**
   Case No. 06-450
   Makati Regional trial Court Branch 59

   For: Pre-trial scheduled on January 15, 2008

<u>PNOC-PDMC</u>

1. **Filoil Development And Management Corp. vs. Adeling O. Abad, et. al.**
   Civil Case No. 546
   Municipal Trial Court of Rosario, Cavite

   For: Ejectment and Damages

2. **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

   For: Illegal Dismissal and non-payment of benefits

3. **Spouses Serafin and Carmen Abutin vs. PDMC/Filoil and PEZA**
   Civil Case No. N-7510
   Regional Trial Court Branch 88 Cavite City

   For: Specific Performance

4. **Marina A. Enage vs. PDMC, Wilfredo R. Bacareza, Jr.**
   Case No. 00-03-02106-06
   National Capital Region (NLRC-NCR)

   For: Money Claim/ Benefits

## 42. RESTATEMENT OF ACCOUNTS

The total assets in 2006 was restated from P112,333,006,126 to P118,125,396,388 due mainly to the disclosure of the deferred tax liability amounting to P5,792,054,459 which was previously presented as net of deferred tax asset.

## 43. EVENTS AFTER BALANCE SHEET DATE

<u>PSTC</u>

a. Acquisition of Two New Double Hull Tankers

   Two double hull tankers named M/T Lapu-Lapu and M/T Emilio Jacinto were delivered in the Philippines in January and February 2008, respectively.

b. 10 Year Time Charter Contract with Petron Corporation

   The Parent Company has started to carry out the ten (10) year Time Charter contract awarded by Petron for the Company's two (2) new double hull tankers. M/T Lapu-Lapu had its maiden voyage on March 18, 2008 while M/T Emilio Jacinto started its commercial operation on April 27, 2008.

c. Privatization

   In a special meeting held at Renaissance Hotel, Makati City on February 27, 2008, the Parent Company Board of Directors under Resolution No. 1737, Series of 2008 resolved to defer, indefinitely, the privatization of PSTC in view of the support of the Company to the energy infrastructure of DOE, Parent Company and its other subsidiaries.

<u>PAFC</u>

As of end-February, additional 218 accessions of jatropha curcas have been in the germplasm for further assessment of local jatropha varieties. Jatropha seed preservation techniques and pest control management have been initially established. This activity is a joint collaboration between the Parent Company and the PNOC AFC and the University of the Philippines at Los Banos (UPLB) for Tissue Culture and Integrated Germplasm. Likewise, under the same integrated project, preliminary data were gathered on soil nutrient management through compost and vermiculture, both derived from jatropha wastes.

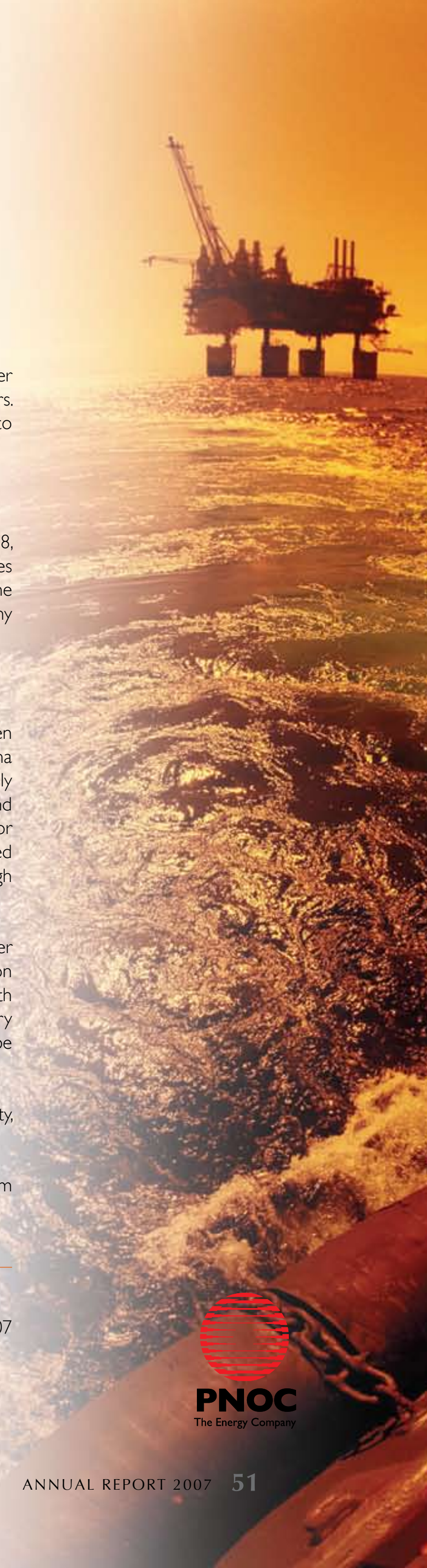
The Department of Science and Technology produced jatropha methyl ester (JME) funded by the Parent Company. Said JME was analyzed by the Petron Laboratory and test results indicated that the locally produced JME passed both the American and European biodiesel standards. It also passed rigid stationary engine performance test up to 20% blend (B20). However, such blend will still be subjected to further evaluation and analysis to establish additional parameters.

As early as January 2008, construction of the PAFC-DOST biofuel testing facility, which will house the first expeller and electrification equipment, is in full swing.

Correspondingly, the first semi-commercial scale expeller was procured from India and was expected to be delivered in April 2008.

## 44. AUTHORIZATION FOR ISSUE

The consolidated financial statements of the Company as of December 31,2007 were authorized for issuance by the management on October 3, 2008.



# Comments and Observations

## PNOC Alternative Fuels Corporation

1. **Expenses for various projects at the PNOC-AFC Industrial Park are still lodged in the Incomplete Construction account – P19.466 million**

   The Incomplete Construction account, which carried a balance of P19,466,495.28 as of December 31, 2007, included expenses related to the projects at the PAFC Industrial Park such as earthworks and slope protection works for the Naphtha Cracker Area; Shoreline perimeter fence and jetty gate improvements; tools and equipment for electrical power and lighting systems; tank 300 facilities and firewater system; modification of jetty firefighting facility. There were also temporary accounts for multiple TSP field lab/warehouse building/test production wells and for the cracker water system tank 200.

   However, we were able to verify that most of the projects have already been completed and should have been transferred to the appropriate Property, Plant & Equipment account.

   We recommended and management agreed to reclassify the completed projects to the appropriate Property, Plant & Equipment accounts and provide the appropriate provisions for accumulated depreciation.

2. **Provision of allowance for doubtful accounts was understated – P2.761 million**

   Our review of the Trade Receivables (Acct. 140) disclosed that out of the total balance of P134,365,487.16 as of December 31, 2007, an Allowance for Doubtful Accounts of P114,587,086.42 was provided by management.

   The Corporation's existing policy is to provide an allowance of 60% for accounts that have remained outstanding from 2 to 4 years, and 100% for those over 5 years or more.

   However, we determined that the provision was understated by P2,761,281.22, thereby also understating Bad Debts expense by the same amount. Among the causes for the discrepancy we noted are the following:

   a. An allowance was not provided for PRII uncollected Administrative Dues for CYs 2005 and 2006 amounting to P2,719,993.60. A provision of P297,245.16 or 60% thereof should have been provided.

   b. An understatement of P2,464,036.06 of the provision for the BPC account for water consumption, interest on delayed payment, and lot rental incurred from CYs 1999 to 2006.

   We recommended and management agreed that the necessary journal entries be made to record the additional allowance for doubtful accounts in accordance with the Corporation's policy.

3. **Deficiencies observed in the disbursement of funds for the TRICAP 10 Jatropha Project**

   The Corporation entered into a Memorandum of Agreement (MOA) with Tribal Communities Association of the Philippines, Inc. (Tricap 10) for the establishment of the Jatropha Model Plantation Project through a production-sharing agreement. The MOA provides that Tricap 10 shall provide the land to be utilized for the project while the Corporation shall shoulder all costs for the nursery and plantation project. By virtue of said Agreement, Pesos: Thirteen million two hundred thirty two thousand seven hundred nine and 47/100 only (P13,232,709.47) was released and transferred to the account of Tricap 10. Disbursements for expenses must comply with the guidelines on the disbursement of funds and procurement of goods and services.

   Our audit of disbursement vouchers submitted pertaining to the transactions of the Jatropha project revealed the following:

   (a) Several expenses were charged against the fund by TRICAP 10 even before the transfer of the P13.232 million cash on June 22, 2007.

   (b) Payments for gasoline/diesel were not supported by approved trip tickets or resemblance that expenses defrayed were authorized.

   (c) Some TRICAP 10 personnel were given transportation allowance without any document as an evidence of travel such as travel authority, itinerary of travel and bus tickets.

   (d) Some purchases lack supporting documents, e.g., purchase requisition, canvass summary, delivery receipt, etc.

   (e) Salaries were alleged to have been drawn by 97 laborers/workers but no corresponding signatures were affixed opposite their names in the payrolls.

   (f) No payrolls were attached to support the claims on several vouchers.

   (g) No memorandum receipt was issued to the personnel/end-user of office equipment to establish accountability.

   Expenses totaling P3,004,406.28 was set up by PAFC as a receivable from Tricap 10. This was a result of disallowed expenses worth P2,408,719.62 and unaccounted disbursements amounting to P595,686.66. In addition, we validated expenses amounting to P19,749.25 that should also be disallowed.

   We recommended and management agreed that the following measures be taken:

   (a) The provisions of the Guidelines on the Disbursement of Funds and Procurement of Goods and Services be strictly followed.

   (b) Charge the P19,749.25 in disallowed expenses as a receivable from Tricap 10.

4. **Detailed personnel from the Office of the President of the Philippines were directly paid honorarium and representation & transportation allowance (RATA)**

Our examination of the Professional and Technical Fees account disclosed that the Corporation directly paid honoraria and RATA to three (3) employees from the Presidential Management Staff (PMS) who were detailed at PAFC. This is in accordance with Board Resolution No. 039, series of 2006, which authorized the grant of P5,000.00 monthly honorarium effective September 01, 2006.

We would like to invite attention to the pertinent provisions of COA Circular No. 76-25 as amended by COA Circular No. 76-25-B on the policies on the payment of additional compensation, such as allowances, honoraria, incentive fees, service fees, etc., from GOCC funds. Said Circular requires that extra or additional compensations shall be remitted by the paying office to the collecting officer of the bureau or office of the recipient official or employee. The recipient is also allowed to collect the allowances provided he/she is not collecting a similar compensation from his/her mother agency.

Further, we also noted that there appears to be no Memorandum of Agreement between the PAFC and the PMS to cover the detail of the recipients of additional compensation.

We recommended and management agreed that the payment of honorarium and RATA be paid to their mother agencies and not directly to the detailed personnel, and that the detail of PMS personnel be covered by a written agreement between the PAFC and PMS.

## PNOC Exploration Corporation

5. **Deferred tax asset amounting to P143,181,995 was recognized despite a history of continuous tax losses.**

Philippine Accounting Standard (PAS) 12 – Income Taxes – states that:

*Par. 24 "A deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized..".*

*Par. 34 "A deferred tax asset shall be recognized for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized."*

Records show that the Corporation incurred tax losses from 2002 to 2007. Because of said tax losses, only the 2% Minimum Corporate Income Tax (MCIT) has been paid for the past several years. Details of the tax losses and MCIT paid are as follows:

| | Tax loss | MCIT |
|---|---|---|
| 2002 | 876,422,151.12 | |
| 2003 | 35,246,191.19 | |
| 2004 | 292,601,045.17 | |
| 2005 | 208,317,462.97 | 5,408,452 |
| 2006 | 95,607,015.11 | 7,315,328 |
| 2007 | 31,272,988.47 | 9,901,855 |

Notwithstanding the above Standard and tax loss data, PNOC EC recognized deferred tax asset in the total amount of P143,181,995 for all deductible temporary differences and carryforward of unused tax losses and unused tax credits, to wit:

| | Amount | Deferred tax asset |
|---|---|---|
| Taxable temporary differences | 10,956,286 | 3,834,700 |
| Carryforward of unused tax losses | 333,490,455 | 116,721,660 |
| Minimum Corporate Income Tax (MCIT) | 22,625,635 | 22,625,635 |
| | | 143,181,995 |

Considering the Company's history of consecutive tax losses, we believe there is no encouraging indication of taxable profit in the immediate future. Thus, a sound basis for the recognition of deferred tax asset is not present. Since the recognition of the deferred tax asset is not in conformity with the provisions of PAS 12, we recommended the reversal of the deferred tax asset amounting to P143,181,995.

According to PNOC EC management, the basis for recognizing the deferred tax asset are as follows: (a) the remarkable improvement in the Company's operating losses for tax purposes from P876.42 million in 2002 down to P31.27 million in 2007, (b) the operational improvement brought about by the 58% increase in coal sales volume or 52% improvement in coal revenue of the 2007 coal operations, (c) the projected 20% increase in the 2008 coal revenue, and (d) its aggressive plans for its coal operations. Management further asserts that the operating loss for CY 2007 would have been a taxable income of P78.40 million were it not for the P120.50 million prior year's capitalized exploration costs that were charged to current year's expenses as a result of the shift from the Full Cost Method to the Successful Efforts Method of accounting for oil and gas.

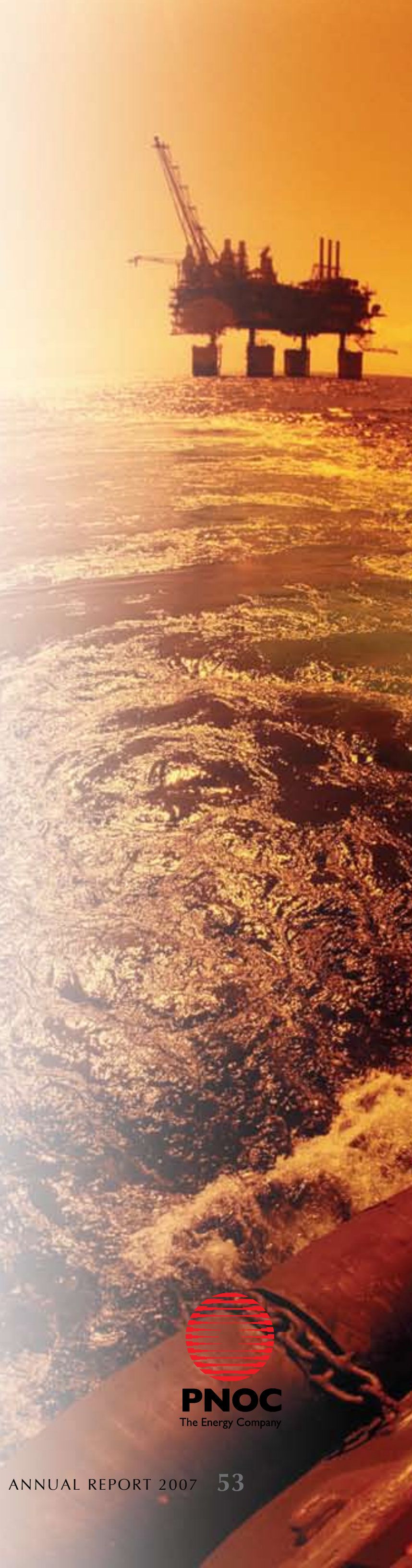
While we agree that there were marked decreases in the tax loss figures for the past three years, we maintain that these are not conclusive benchmarks that will translate to future taxable profit. As presented in the preceding paragraph, a substantial increase of 52% in coal revenues for 2007 was attained but this did not result in taxable profit.

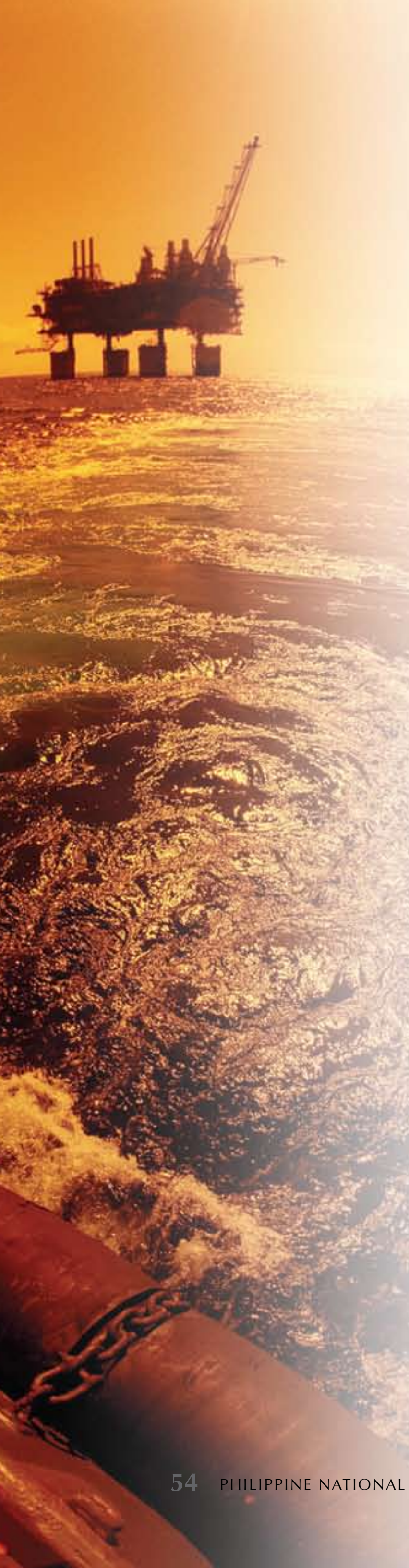
Furthermore, a disclosure on how the deferred tax asset was computed was not included in the Notes to Financial Statements.

## PNOC Development and Management Corporation

6. **Expenditures classified as Business Expenses paid out to members of the Board of Directors were not duly supported by official receipts – P1.87 million**

Section 30 of the Corporation Code of the Philippines states that "In no case shall the total yearly compensation of directors, as such directors, exceed ten (10%) percent of the net income before income tax of the corporation during the preceding year."





Since the Corporation reported a net income before tax of P19,714,667.00 for CY 2006, the total compensation for CY 2007 to the board members should not exceed P1,971,466.70. However, data contained in the Report of Salaries, Allowances/ Fringe Benefits Received by Principal Officers and Members of the Governing Board showed that compensation to board members totaled P3,841,813.57, or an excess of P1,870,346.87 from the authorized limit set by the Corporation Code.

According to Management, their Accounting Department inadvertently included the P1.87 million in representation expenses under Board Compensation, when in fact, these expenses should be classified under Business Expenses of the Corporation. Adjusting entries have been made to correct the error.

Taking the comment into consideration that the payments were not commutable allowances to Board Members, the representation expenses should then have been duly supported with official receipts as required by COA Circular No. 2006-001 dated January 3, 2006.

We recommended that the provisions of COA Circular No. 2006-001 be strictly complied with.

## PNOC Shipping and Transport Corporation

7. **Net variance in the confirmation of Trade Accounts Receivable – P2,780,794.87**

Our confirmation of Trade Accounts Receivable (TAR) revealed a net variance of P2,780,794.87, details of which are as follows:

(a) Petron Corporation:

| | | Amount |
|---|---|---|
| Per books, 12.31.07, Pre-closing | P | 20,352,435.97 |
| Adjustments: | | |
| Accruals | | (11,236,121.04) |
| Off-hire | | 11,804,598.10 |
| Final closing JVs | | (2,154,964.04) |
| COA adjustment | | 144,991.71 |
| As adjusted | | 18,910,940.70 |
| Per confirmation | | 6,829,930.56 |
| Less: Invoice # 17903 | | (8,637,624.15) |
| Variance for reconciliation | **P** | **3,433,385.99** |

Accruals amounting to P11,236,121.04 were deducted from the book balance because they represent revenue earned as of December 31, 2007 but the invoices were received by Petron Corporation in January 2008.

The final closing journal vouchers are adjustments of disputed and aged demurrage billings that were no longer recognized by Petron Corporation in their books as per their confirmation.

The COA adjustment amounting to P144,991.71 pertains to the double recording of 2% withholding tax on collections on time charter of GBB1 billed per Invoice No. 17890 dated September 2007 (JV-30-0902) but booked twice per JV-35-1202 and JV-46-P1202 dated December 2007.

Invoice No. 17903 (M/T Jose P. Rizal December 2007 charter hire bill) was inadvertently not included by Petron in their confirmation because the check was already prepared before December 31, 2007 but was not yet released to PSTC.

The variance of P3,433,385.99 is subject for reconciliation with Petron Corporation. These are accumulated demurrage/dispatch billings which were disputed and dropped by Petron in their books but are still outstanding in PSTC books.

(b) Delsan Transport Lines, Inc.

| | | Amount |
|---|---|---|
| Per books, 12.31.07 | P | 1,438,508.39 |
| Per confirmation | | |
| $50,749.97 @ P41.401 | | 2,101,099.51 |
| Variance | **P** | **(662,591.12)** |

Trade Receivables from Delsan are composed of outstanding accounts for 2006 amounting to P898,194.27 and current year's outstanding balance of P540,314.12. The balance confirmed by Delsan amounting to $50,749.97 represents the unpaid portion of October 2007 billing paid by Delsan in January 2008. The amount was translated to Peso using the exchange rate of the last business day of CY 2007 per Reference Exchange Bulletin, Treasury Department, BSP. Our verbal confirmation with Delsan management disclosed that their Company has already settled all liabilities with PSTC for 2006 and the confirmed amount pertained to 2007 transactions only.

The net variance resulting from the confirmation understated the recorded amount by P2,780,794.87 or 14% of the total account balance of P19,780,974.67 as of December 31, 2007.

We recommended and management agreed to reconcile balances per books with balances confirmed by Petron and Delsan and to investigate the discrepancies noted and furnish us with the written explanations on the details thereof together with supporting documents. We also recommended that an adjusting entry be prepared for the double recording of tax withheld on collections of receivables on time charter of GBB1.

8. **Long-term notes, accounts and other receivables totaling P3.90 million were not provided with allowance for doubtful accounts and CY 2003 expenses amounting to P2.30 million were still recorded as accrued expenses payable as of December 31, 2007.**

In 2003, PSTC chartered two tankers from Safeway Maritime Baulkers, Inc. (SMBI), M/T Agoncillo and M/T Bonifacio to service Petron Corporation. PSTC paid SMBI a fixed rate per day on charter hire of the vessels. In addition, PSTC paid for the bunker fuel used by the two vessels on their voyages. The bunker was initially recorded by PSTC as fuel inventory under Account 225–Materials and Supplies Inventory. After each voyage it recognized fuel expenses for the amount consumed by the vessels.

In the same year, PSTC had disagreements with SMBI that eventually resulted in SMBI's termination of contract and pulling-out of its vessels. The reasons are as follows:

(a) PSTC billed SMBI for the amount of bunker fuel left on board the vessels which SMBI refused to pay because they are claiming fuel savings on the under consumption of fuel versus guaranteed consumption. But PSTC contends that there was fuel savings only if the vessels were able to meet the guaranteed speed. During that time, the vessels were running below the guaranteed speed resulting to lower fuel consumption and lower turn-around which resulted in foregone revenues. With this scenario, SMBI insistently claimed fuel savings which PSTC disagreed to grant.

(b) Refusal by PSTC to grant the request of SMBI for an upward adjustment in the peso-dollar exchange rate used in the computation of charter hires. According to PSTC management, they did not grant the request because they have to abide by the terms and conditions of the signed contract wherein the rate per day is in US Dollars at a fixed foreign exchange rate. PSTC elevated the request of SMBI to Petron Corporation but Petron did not grant the request as well.

Analysis disclosed that receivable from SMBI amounting to P3,910,899.06 or 34% of the balance of Account 270 as of December 31, 2007 has not been provided with any allowance for uncollectible accounts, hence, it is not stated at net realizable value.

On the other hand, charter hire and fuel expenses remained under Account 640 – Accrued expenses payable despite having been outstanding for more than four years already.

We recommended and management agreed that an allowance be provided for the long outstanding receivables from SMBI and prepare necessary adjusting entries. Furthermore, we suggest that long outstanding payables to SMBI be reclassified to Other accounts payable (Account 588).

## PNOC Coal Corporation

9. Non-filing of the Amended Articles of Incorporation shortening the corporate term of the Corporation

The PNOC Board, through a resolution dated March 13, 2002, approved the dissolution of the PNOC Coal Corporation (PCC) by shortening its corporate term through an amendment of its articles of incorporation. It was further resolved that the operations of PCC such as coal trading, coal briquetting and coal mine-mouthing be absorbed by PNOC Exploration Corporation (PNOC-EC). The same resolution also authorized the PNOC President and Chief Executive Officer to create a Special Task Force Committee to implement the dissolution of PCC. The PCC Board, on the other hand, confirmed and approved the amendment to the articles of incorporation and the conversion of its operations into a division of PNOC-EC.

In view of the approved dissolution of PCC through the shortening of its corporate existence, a Memorandum of Agreement (MOA) was entered into by and between PNOC, PNOC-EC and PCC dated December 23, 2002. The MOA outlined in detail the responsibilities and respective undertakings of the parties to fully implement the dissolution, liquidation and winding-up of the affairs of PCC. An amendment to the MOA was executed on October 30, 2006 transferring the assets of PCC to PNOC and PNOC EC. Corollary to the amendment, a deed of assignment was also executed by PCC transferring its assets to PNOC and PNOC EC

Based on the foregoing, it is apparent that the intention to proceed with the dissolution of PCC is conclusive. However, it was noted that the requirement of filing the amended articles of incorporation shortening the corporate life of PCC with the Securities and Exchange Commission has not been complied with.

We recommended and management agreed that the amendment to the articles of incorporation shortening the corporate term of PCC be filed accordingly taking into consideration the following provisions/requirements of the Corporate Code of the Philippines and SEC, viz:

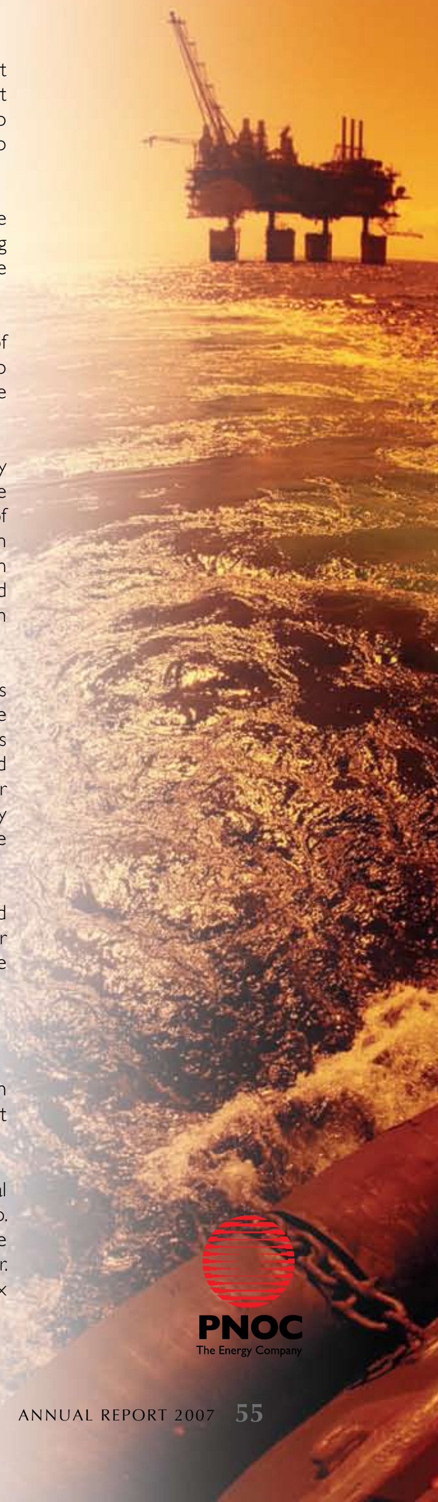
Sec. 120. ***Dissolution by shortening the corporate term.*** - A voluntary dissolution may be effected by amending the articles of incorporation to shorten the corporate term pursuant to the provisions of this Code. A copy of the amended articles of incorporation shall be submitted to the Securities and Exchange Commission in accordance to this Code. Upon approval of the amended articles of incorporation of the shortened term, as the case may be, the corporation shall be deemed dissolved without any further proceedings, subject to the provisions of this code on Liquidation.

Sec. 122 (par. 1). ***Corporate liquidation.*** - Every corporation whose charter expires by its own limitation or is annulled by forfeiture or otherwise, or whose corporate existence for other purposes is terminated in any other manner, shall nevertheless be continued as a body corporate for three (3) years after the time when it would have been dissolved, for the purpose of prosecuting and defending suits by or against it and enabling it to settle and close its affairs, to dispose of and convey its property and to distribute its assets, but not for the purpose of continuing the business for which it was established.

According to management, PNOC's Legal Department has already secured and signed the following corporate approvals and documentary requirements in preparation for the submission of the application for Amended Articles of Incorporation of the PNOC Coal Corporation shortening its corporate term viz:

a) Cover Sheet;
b) Amended Articles of Incorporation; and
c) Directors' Certificate re: approval of the amendment shortening its term by a majority of its Directors and by the stockholders representing at least 2/3 of the authorized capital stock.

Further, the Corporation is still awaiting the issuance of the Bureau of Internal Revenue (BIR) Tax Clearance which has been filed with the Revenue District No. 50-South Makati in July 2006 and re-filed on March 22, 2007. The BIR was unable to act on the request due to the loss of the records by the BIR Receiving Officer. Subsequent representations with said Revenue District disclosed that the Tax Clearance Certificate (TCC) is expected to be issued in June 2008.



# Board of Directors

**ANTONIO M. CAILAO**
President & CEO

**ANGELO T. REYES**
Chairman

**LEOPOLDO E. PETILLA**
Director

**EMIL P. JURADO**
Director

**DANTE B. CANLAS**
Director

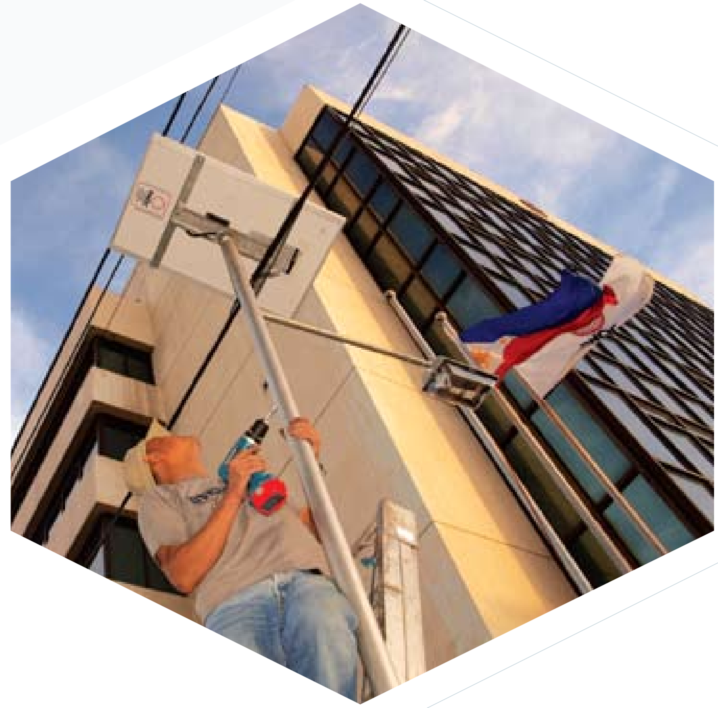
**EDGARDO M. DEL FONSO**
Director

**BOB D. GOTHONG**
Director

**RAYMOND DEMOCRITO C. MENDOZA**
Director

**RAMON B. MITRA**
Director

# Business Address



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## PNOC ALTERNATIVE FUELS CORPORATION
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## PNOC SHIPPING AND TRANSPORT CORPORATION
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Telephone No.: 525-9271

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## PNOC RENEWABLES CORPORATION
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# PNOC **Project** List

## 1. OIL AND GAS

1. Malampaya Deep Water Gas-to-Power Project (SC 38)
2. San Antonio Gas Power Plant (SC 37)
3. Calamian (SC 57)
4. West Calamian (SC 47)
5. West Balabac (SC 59)
6. Offshore Mindoro (SC 47)
7. Ragay Gulf (SC 43)
8. Tripartite Agreement Area (South China Sea)

## 2. COAL

9. Zamboanga-Sibugay Coal Project (COC 41)

## 3. RENEWABLE ENERGY

10. Solar Home Systems Distribution Project

## 4. ENERGY ALLIED ACTIVITIES

11. Energy Supply Base, Mabini, Batangas
12. Petrochemical Park, Limay & Mariveles, Bataan

## 5. REAL ESTATE DEVELOPMENT

13. Socialized Housing Project

PNOC
The Energy Company

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