PNOC
The Energy Company

Rising Up To the **Challenge**

06
ANNUAL REPORT

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PNOC Vision

To be a world-class Philippine energy enterprise.

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 Core Values

Professional integrity
Professional excellence
Company loyalty
Belongingness/Teamwork

RAPHAEL P. M. LOTILLA
Secretary, Department of Energy

PEDRO A. AQUINO, JR.
President and Chief Executive Officer
Officer-in-Charge

Dear Shareholders,

The Philippine National Oil Company does not rest on its laurels. After hurdling through transitions and initiating changes in the energy industry, PNOC was once again thrown in the loop with new challenges that tested the company's mettle. Each year, we try to outdo ourselves and surpass the previous year's accomplishments. And despite seemingly insurmountable odds, we have always prevailed. Rise up to the challenge we did!

We are a dynamic entity. In an environment that is constantly changing and subject to the whims of the global market, we try to serve our stakeholders to the best of our ability. Foremost is to fulfill our mandate to increase self-sufficiency in oil and gas, and to ensure security of energy supplies. And this we try to do through the expertise of our subsidiaries and the dedication of our own people. Working closely with the Administration in terms of policy direction, PNOC strove to fulfill its mandate by providing energy sources for the country's consumption.

We diversify to expand options. The past thirty-three (33) years has seen the creation and dissolution of our subsidiaries, as their lives either begin, to support a new project, or meet an end, as they serve their purpose. The year 2006 marks such a time in PNOC's history as we venture into exploring for alternative sources of fuel. We welcomed to the PNOC family, the PNOC Alternative Fuels Corporation (PAFC), whose mandate is to explore the viability of alternative sources of fuels in the country, and develop them for utilization and commercialization purposes.

Only six months into the fray, PAFC has made significant progress in its study of jatropha's potential as a feasible alternative to oil. Aside from identifying possible jatropha plantation sites, conducting ocular surveys, assessing the best plant variety, and negotiating with potential partners, we have also looked into the economic and financial viability of putting up a jatropha biodiesel plant, to complement its production. And with the way things are moving, the promise that jatropha brings may well become a reality sooner than we expect.

We anticipate the country's needs. The price of world crude oil, which started at \$35/barrel at the beginning of 2005, jumped to around \$55/barrel at the start of 2006. With this rising trend, there is an urgency that we need to address – that of mitigating the increasing cost of oil by producing our own supply.

With this in mind, we, led by our exploration arm PNOC EC, signed the Terms of Service and Tripartite Agreement with the SC 38 Consortium for the Camago-Malampaya Oil Leg (CMOL) Project, together with the DOE. This project is for the development and production of oil reserves in the Malampaya field. There were eight (8) companies who signified their interest in developing the project, which might prove to be as successful as the Malampaya Project.

Report of the **Chairman** and **President**

We continue to produce oil and gas. The Malampaya Deepwater Gas-to-Power Project still provides the gas fuel requirements of Santa Rita (1000 MW), San Lorenzo (500 MW) and Ilijan (1,200 MW) Power Plants in Batangas, for a combined natural gas offtake of 105.45 billion cubic feet for the year. Our 3 MW San Antonio Gas and Power Plant in Isabela generated 16,672.3 megawatt hours (MWhr) of electricity, and produced 327.37 million standard cubic feet (mmscf) of gas. These figures are 70 percent more than what was generated and produced last year!

The search for oil continues, as does our search for partners. Representatives from PNOC EC, China National Offshore Oil Corporation (CNOOC) and Vietnam Oil and Gas Corporation (PETROVIETNAM), conducted a Palawan geologic fieldwork, as a continuation of the Joint Marine Seismic Undertaking (JMSU) with CNOOC and PETROVIETNAM. Ongoing is the Offshore Mindoro SC 47, which is in partnership with PETRONAS of Malaysia, and fieldwork for the Ragay Gulf Project. Even the government has shown continued support by granting Service Contracts for Calamian (SC 57), West Calamian (SC 58), West Balabac (SC 59), and East Sabina (SC 63).

We aim to be the first in the world. Second only to the United States as the world's largest producer of geothermal energy, we are trying to close the gap starting with the near completion of the Northern Negros Geothermal Project (NNGP). This 49 MW plant is almost 95 percent in overall physical accomplishment, and is scheduled for commissioning in February 2007. Recently turned over to us is the world's biggest binary power plant, the 118.5 MW Upper Mahiao Power Plant.

For 2006, we were able to displace an equivalent 11.14 million barrels of fuel oil, because of the total 6,681.16 GWh we generated, equivalent to a total foreign exchange savings of about US$686.37 million (at RP's average crude oil import cost of about $61.64/barrel).

We earn our keep. After years of preparing for PNOC EDC's privatization, the successful Initial Public Offering (IPO) of 5.22 billion shares or 35.73 percent of the company's outstanding capital, at ₱3.20 per share, pushed through on December 13, 2006. The second offering of 0.78 billion shares completed 6.0 billion shares sold to the public. The sale of primary and secondary shares grossed us with ₱19.2 billion, giving the government a hefty share of the loot.

In terms of royalty payments coming from nine power projects, we remitted ₱555.79 million to the DOE and Local Government Units (LGUs).

The PNOC Development and Management Corporation (PDMC) stepped up its collections this year, which resulted in a posted net income of ₱19.76 million. This is the highest net income earned in the company's history, an increase of almost 77 percent from last year's earnings.

We tap nature's inherent power. Phase I of the three-phase wind development program is underway, in the 30 MW Saoit Wind Power Project (Northern Luzon Wind Power Project 1), our first venture into commercial wind power. The NEDA Board endorsement of the project is expected in early 2007. In the pipeline is the 46 MW Nagsurot Wind Power Project, pending financing and further study by NEDA. There are ongoing wind assessments and feasibility studies in identified areas such as Dinagat Island, Camiguin, and Taytay, Palawan.

In our Solar Homes Systems (SHS) Distribution Project, we installed 3,336 units this year, bringing the total to 12,280 units installed or 81 percent of the targeted 15,100 units. And because of our commitment to the Rural Electrification Program, we have connected 131 barangays to an electricity source for commercial electrification, and provided them opportunities for socio-economic growth.

We share our resources, skills and expertise. It was in the spirit of giving back to the people that we devoted 25 hectares of land to the GMA Abot Kayang Pabahay at Palupa Project, for the benefit of 3,598 informal dwellers. We also donated land in Rosario, Cavite, as the site for a new public market, and for use of a public school and the Philippine National Police.

We recognize that in developing our projects, we directly and indirectly impact on the lives of people, the environment, and communities. As such, we have made it our responsibility to ensure that we lessen the burden of change by introducing programs to affected communities, which focus on livelihood, health and sanitation, education, and the environment. It is our way of involving the people in our projects by giving them a role in the development process, and instilling in them a sense of ownership so that they will better understand what is at stake.

We rise to the call of the people. Our vision to be a world-class energy enterprise may seem just that – a vision. But with visions come the creativeness, the tenacity, and the will to make it a reality. With the challenges thrown our way, it is sometimes a case of one step forward and two steps back. But we are not cowed because we do not lose sight of the fact that first and foremost, we serve the people and that what we are doing will benefit not just one family, or one community, or one province, but the entire country.

PEDRO A. AQUINO, JR.
President and Chief Executive Officer
Officer-in-Charge

RAPHAEL P. M. LOTILLA
Secretary, Department of Energy

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. The $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

Thirty-three years later, PNOC is still re-inventing itself to meet the country's demand for energy. This has led to the creation of a new 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.

Oil and **Gas** - Building a Strong Energy Foundation for the Future

As our exploration arm, PNOC EC continues to perform with dedication and perseverance. Despite setbacks in its bid to be privatized, PNOC EC is still fulfilling its mandate to be at the forefront of exploring oil and gas. Our success in this field is noteworthy.

The Malampaya Legacy

PNOC EC and the Department of Energy (DOE) signed the Terms of Service and Tripartite Agreement with the SC 38 Consortium for the Camago-Malampaya Oil Leg (CMOL) Project. This project was meant for the development and production of oil reserves in the Malampaya field in offshore Northwest Palawan, as a buffer against the erratic world crude oil prices. Various companies were invited to submit proposals for their participation in the re-appraisal, development, and production of crude oil found beneath the Malampaya gas cap, and a total of eight (8) companies responded and submitted their appraisal and development plans. PNOC EC is preparing the partner selection process under Executive Order No. 556.

The Malampaya Deepwater Gas-to-Power Project continues 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 year's total natural gas offtake of these power plants was approximately 105.45 billion cubic feet (bcf), a little lower than last year's 111.95 bcf production.

The condensate production of the Malampaya project of 4.9 million barrels was slightly lower than the target of 5.0 million barrels for the year, and compared to last year's yield of 5.6 million barrels. The condensate produced was shipped to buyers in Singapore, Thailand, and China.

Gassing It Up

The 3MW San Antonio Gas and Power Plant services around 10,000 households in certain municipalities in Isabela - Echague, Jones, San Agustin, and parts of Santiago City. The first gas-fired power plant in the country, the San Antonio Plant generated 16,672.3 megawatt hours (MWhr) of electricity, and 327.37 million standard cubic feet (mmscf) of gas produced. This is a considerable increase from last year's figures of 4,968.8 MWhr and 93.64 mmscf electricity and gas produced, respectively.

Partnering and Collaborating for Oil

The search for oil continues as we tie up with partners from China, Vietnam, and Malaysia for joint ventures. Collaborative efforts produced the Joint Marine Seismic Undertaking (JMSU) with China National Offshore Oil Corporation (CNOOC) and Vietnam Oil and Gas Corporation (PETROVIETNAM) in 2005, to assess petroleum resource potential areas in the South China Sea. This year, PNOC EC, CNOOC, and the Petrovietnam Investment and Development Company (PIDC) representatives have conducted Palawan geologic fieldwork. Ongoing is the joint partnership with PETRONAS of Malaysia for Offshore Mindoro SC 47, and necessary fieldwork for the Ragay Gulf Project.

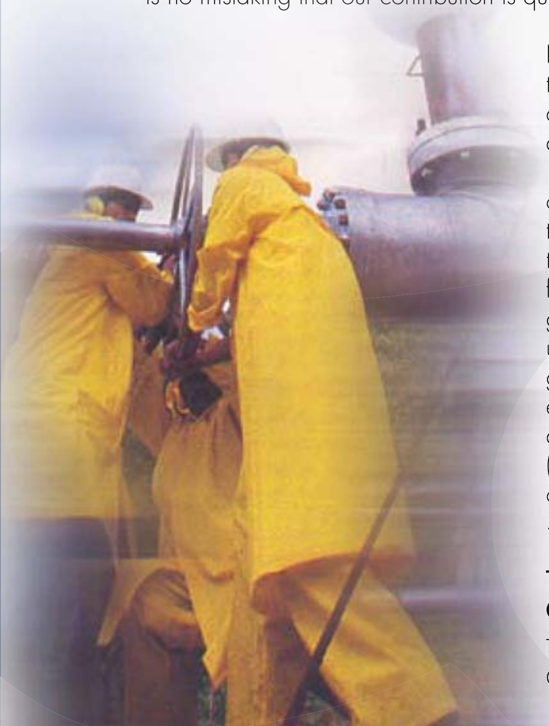
DOE granted PNOC EC Service Contracts for Northwest Palawan (Calamian – SC 57 and West Calamian – SC 58), West Balabac – SC 59, and East Sabina – SC 63. The government's continued support in our exploration activities ensures that we are able to exhaust all means to fulfill our mandate and serve the country at the same time.

Geothermal **Energy** - Nature is Our Partner in Development

We are proud to lay claim that the reason why the Philippines is the world's second largest producer of geothermal energy, next to the United States,is because of PNOC Energy Development Corporation (PNOC EDC).

Steam Generation for Energy Consumption

With an aggregate capacity of 1,148 MW from 9 (nine) geothermal projects across the country, we account for 60.3 percent of the total country installed geothermal capacity of 1,905.4 MW. For 2006, PNOC EDC accounted for 7.35 percent of the country's 15,619 MW installed power-generating capacity, and contributed 11.66 percent of the 56,148 gigawatt hours (GWh) total power generated for the year. Although this is slightly lower than last year's 12.9 percent power generated, there is no mistaking that our contribution is quite substantial.



In more concrete terms, the total amount generated at 6,681.16 GWh, displaced an equivalent 11.14 million barrels of fuel oil. This means that we did not have to buy that amount of fuel because we had geothermal energy to use in lieu of oil. This gave us a total foreign exchange savings of about US$686.37 million (at RP's average crude oil import cost of about $61.64/barrel).

The Power of Geothermal Plants

The Northern Negros Geothermal Project (NNGP), with a 49 MW capacity, is nearing completion, with overall physical accomplishment of almost 95 percent. With the transmission lines 99.35 percent complete, and the power plant 99.19 percent complete, the scheduled commissioning in February 2007, is a welcome reality. In June 2006, the 118.5 MW Upper Mahiao Power Plant, which is the biggest binary power plant in the world, was turned over to us.

In the area of steam field development, six (6) wells were worked over and acidized, while gas lifting was undertaken on three (3) wells. In March 2006, PNOC EDC's implementation strategy limited itself to steam field development, with power plant construction and operations offered to Independent Power Producers (IPPs). IPPs were invited to submit proposals for the purchase of geothermal steam from the project, after which a Geothermal Resource Sales Contract (GRSC) will be offered to the chosen IPP.

For in-house drilling, we drilled three (3) new wells, completed three (3) top holes, and worked over nine (9) wells in Leyte. As we are relentless in our bid to be better and more equipped to handle our activities, upgrading and improving our equipment is a primary concern.

Moving On

We successfully completed our Initial Public Offering (IPO) of 5.22 billion shares on December 13, 2006, at ₱3.20 per share, representing 35.73 percent of the PNOC EDC's outstanding capital. Another 0.78 billion shares were listed on December 18, 2006, bringing the number of shares sold to the public to 6.0 billion, or 40 percent of the company's outstanding capital. From the IPO, gross proceeds for PNOC and PNOC EDC reached ₱19.2 billion at ₱9.6 billion each from the sale of secondary and primary shares.

The privatization of PNOC EDC has been a work in progress, and is part of the national government's efforts to encourage private participation in the energy sector.


ISUZU

Coal - Mother Nature's Enduring Gift

Coal production remains a core business activity of PNOC, as we develop and maintain the production and supply of coal in the country. The demand is such that there is a need to locate and discover possible sources of coal, to be able to meet requirements. The production of coal however, involves issues pertaining to environment and its impact on the lives of people in affected areas.

Building Capital, Relationships and Partnerships

With this in mind, great care is given to consultation, focus group discussions, information and education, and requisite training, when an area is targeted for coal development. For a project to be successful, obtaining local acceptance is a must. The community must be involved and sold on the idea that the project will not only benefit them but the country as well.

The Integrated Coal Minemouth Power Project in Isabela showed promise as initial surveys were favorable. But despite numerous coordination meetings with the Regional Offices of the Department of Environment and Natural Resources (DENR) and Environmental Management Bureau (EMB), the National Commission on Indigenous People (NICP), and consultative meetings with barangay officials and the communities, PNOC EC decided to shelve the project effective July 13, 2006, because it continued to encounter significant opposition from the barangays to be affected by the project.

The Philippine Army (PA) recommended the suspension of the Surigao Coal Project because of the unfavorable peace and order situation in the project area. A one-year moratorium was granted by the Department of Energy (DOE) on October 12, 2006. In the meantime, PNOC EC is monitoring and providing monthly development reports on the site situation.

PNOC EC's exploration activities goes beyond country borders. Its relationship with Indonesia has produced the draft of a Memorandum of Agreement (MOA) between PNOC EC and PT Putra Asyano Mutiara Timur (PAMT) regarding the joint venture project for the Ampah coal concession in Central Kalimantan, Indonesia, was finalized in March. PNOC EC though, continued to evaluate other coal areas in Indonesia as alternative sources.

Providing Needs

This year's total coal production from Integrated Little Baguio (ILB), Lumbog, Shaft 3, and small-scale miners at 108.36 thousand metric tons (MT) is 20 percent lower than coal production last year. The production is 99.6 thousand MT lower than the target 208.0 thousand MT, because of the breakdown of Narita 220 KW hoist leading to an inefficient haulage system.

We continued to cater to the coal requirements of the cement industry and the Naga Power Plant in Cebu. Despite this, the direct coal sales were only 480.1 thousand MT, which was 55 percent lower than the 1,076.1 thousand MT target for 2006. Also, coal sales on a marketing fee basis were 26.3 thousand MT or 88 percent lower than 222.0 thousand MT target for the year. The reasons for the dismal showing are the cheaper prices of imported coal, the sluggish cement market, low local coal production, and decrease in delivery of coal.

Aside from our usual activities, we continue to offer integrated services consisting of discharging foreign and local coal shipments, stockpiling, screening, blending, and hauling of coal to cement plants in the country. The actual volume handled is 139.7 thousand MT, only 50 percent of the target 282.0 thousand MT, due to the competitiveness of Indonesian coal prices.

Renewable **Energy** / Barangay **Electrification**
- Seeking Alternatives to Meet Growing Demands

We are aware of our responsibility to bring the country to a certain level of energy self-sufficiency, by providing power, energy, and electricity, to areas that do not have access to them. The Government strongly believes in empowering the people through the provision of electric services, which will yield more opportunities for improved quality of life, greater access to basic services and better infrastructure for rural development.

Let There Be Light

Our commitment to accelerate the electrification of remote areas in the country continues, as we connected 131 barangays, located in Leyte (48), Negros (62), Cotabato (14), Bohol (5), and Cebu (2), to an electricity source for commercial electrification, under the Rural Electrification Program. Electricity is now available in far-flung areas, providing opportunities and socio-economic growth to marginalized sectors in un-electrified barangays of the country.

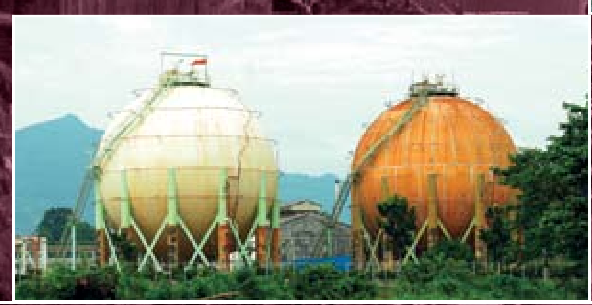
The Solar Home Systems (SHS) Distribution Project involves the sale and distribution of 15,100 solar home systems to the Cordillera Autonomous Region, Ilocos, Cagayan Valley, Central Luzon, Southern Tagalog, Bicol, Western Visayas, and Central Visayas.

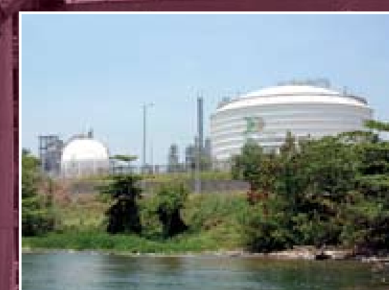
We installed 3,336 units for 2006, bringing the total number of units installed to 12,280, since the project's inception in 2001.

Let the Winds Blow

The 30 MW Saoit Wind Power Project (Northern Luzon Wind Power Project 1), is our first commercial wind power project. Aside from installing Wind Turbine Generators, we will construct a 42-km transmission line and switchyard that will interconnect to the nearest NPC substation. This is Phase I of a three-phase wind development program. Bid submission for the project is set for the first quarter of 2007.

On hold is the 46 MW Nagsurot Wind Power Project. Although the project was ready for implementation in March 2006, with financing from KfW, the National Economic Development Authority (NEDA) Board remanded the project's feasibility study to NEDA Investment Coordinating Committee (ICC) for further study. The Philippine government decided not to avail of KfW financing for the project. Meantime, wind assessments and feasibility studies were completed in the areas of Bayog, Boracay, Nubenta, Tagkiling, Sta. Ana, and Dinagat Island.





Petrochemicals - Providing Services to Our Partners

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

Park Services

The Petrochem Park, under the Locators Agreement, continues to provide services, such as the provision of raw and fire water, power supply within the Park and other commercial areas, and jetty service, to our locators. Not only did we provide these services, we also implemented health, safety, security, and environment (HSSE) programs. Under these programs, we conducted emergency response seminars, first aid training, and organizational meetings of the Multi-Partite Monitoring Team. Preparations were made for the Comprehensive Land Use Plan (CLUP) and Zoning Plan of Limay and Mariveles, the amendment to the allocation of the Environmental Liability Guarantee Fund (EGLF) contributions per locator, and the Interim Guidebook. Water and ambient air quality monitoring is regularly conducted.

Social Work and Development

We do not forget about the people whose lives we affect with our daily operations. With this in mind, we provided livelihood programs to the Lamao Multi-Purpose Cooperative, and conducted groundworking and cooperative formation activities with the Lamao Bakers Association. To get to know our communities more, we coordinated with LGUs for the conduct of a community needs assessment, so we can focus our help to areas where it is really needed. As part of our safety measures, we conducted Safety Services Training Seminars in coordination with the Philippine National Red Cross (PNRC) Bataan Chapter, the PAFC Emergency Response Team (ERT), and Barangays Lamao and Batangas Dos.

The Dong In Tulay Rehabilitation Center helps needy children who are residents of Barangays Lamao and Batangas Dos. We donated ₱150,000 to augment their needs and coordinated with Rural Health Units in Mariveles, Bataan, for further assistance.


DR. JOSE P. RIZAL

Shipping and **Transport** - Moving With the Tides

The PNOC Shipping and Transport Corporation (PSTC) had a banner year in 2006 as it embarked into various efficiency measures that further enhanced its market position in the domestic tanker industry.

Fleet utilization was at its peak of 88 percent compared to only 80.3 percent in 2005. Compared to 143 voyages last year, 2006 had a total of 166 voyages, loaded with 519,647.45 metric tons of petroleum cargo, and navigated a total of 152,002.97 nautical miles, considerable higher than the 135,955.15 miles logged in 2005.

MT Gomburza continued its Time Charter arrangement in hauling crude from Philodrill Nido Oil Field in Palawan to Shell Tabangao Refinery, while providing tramper services to Petroleum Authority of Thailand (PTT) and new emerging oil players, for their black tonnage requirements. MT Gen. A. Luna was awarded with a four-year Consecutive Voyage Charter Party (CVCP) contract with Petron Corporation, while MT JP Rizal's Time Charter Party contract with Petron was renewed for a term of seven (7) years. The fleet is continuously monitored and retrofitted to conform with international and local safety standards.

Our overall financial standing for the year was laudable, as the Net Profit reached an all-time high of ₱65.8 million or 45 percent more than last year's showing of ₱36 million. Based on the 2006 profit, the government and PNOC stand to benefit from the cash dividend to be issued, as this is 100 percent more than what was declared and paid the previous year.

The company's robust performance is the result of measures adapted to ensure the effective utilization of vessels, coupled with various cost-saving devices in accordance with the Government's Austerity Measures or Administrative Order 103. And to strengthen employee competence and expertise, trainings and seminars are continuously being provided.

Our real estate arm, PNOC Development and Management Corporation (PDMC), has not slackened in surpassing last year's achievements. For 2006, we posted the highest net income in PDMC's history of ₱19.76 million, compared to ₱11.18 million earned in 2005, an increase of 76.67 percent! This was due to collections jumping by 39 percent, making 2006 the company's best performing year since it started operations.

Land to the Landless

It is a case of doing well while doing good. Our major achievement is the socialized housing scheme – 25 hectares devoted to the GMA Abot Kayang Pabahay at Palupa under Executive Order 59, which involves the subdivision, titling and distribution of parcels for the benefit of 3,598 informal dwellers. As of yearend 2006, 2,818 parcels have been distributed at socialized prices, with project funding being sourced internally.

We donated more than two hectares of our land in Barangay Tejeros Convention in Rosario, Cavite, to the Municipality of Rosario, Cavite, the Department of Education, and the Philippine National Police (PNP). 1.5 hectares was used exclusively as the site for the new public market, while the rest were donated for use of the Tejeros Elementary School and the PNP Special Weapons and Tactics (SWAT) headquarters.

Housing Opportunities

We entered into a Joint Venture Agreement (JVA) with Sta. Lucia Realty Development, Inc. (Sta. Lucia), for the development of our 32-hectare property located along Gen. Trias Drive, Rosario, Cavite. Known as the Costa Verde Residential and Commercial Estate Project, this venture promises a good return on investment for PNOC, once the upscale subdivision/commercial center is in full swing.


PNOC-EDC/LEYTE GEOTHERMAL PRODUCTION FIELD
CALENERGY International ORMAT LEYTE OPERATIONS
NPC-LGPP & the LOCAL GOVERNMENT UNIT OF KANANGA, LEYTE
joins the Whole World in the Celebration of WORLD EARTH DAY 2006 through
PLANTING OF INDIGENOUS TREE SPECIES
APRIL 25, 2006 TONGONAN, KANANGA, LEYTE


Balik-Biyaya

Social **Responsibility**

- Building Social Capital by Investing in People and Communities

As corporations and organizations evolve, they are becoming more socially aware of their responsibilities to give back to the people. We continue to empower the Filipino people through our Corporate Social Responsibility (CSR) programs.

Giving Back

We regularly remit royalty payments to the national and local government, while providing sources of livelihood for host communities, and promoting environmental protection. These royalty payments help to subsidize power rates and finance development projects in communities where there are geothermal power projects. In 2006, actual royalty payments made to the DOE and Local Government Units (LGUs) came to a staggering Php555.79 million, coming from nine power projects.

We even participated in the government's Accelerated Barangay Electrification Program, while energizing an additional 131 barangays and sitios through the O-llaw Project.

Lending a Helping Hand

When nature unleashes its power and calamities are declared, we are on hand to provide assistance to victims and their families. We facilitated rescue and relief operations when landslides, mudslides and floods hit Southern Leyte and Bicol, and fires ravaged Tacloban and Ormoc. We also helped with the Energy Housing Village Project in Southern Leyte. And because of these efforts, President Gloria Arroyo gave us a citation for "bravery and courage in the face of grave dangers and countless risks", a small price to pay for helping those in need.

Making Differences in Lives

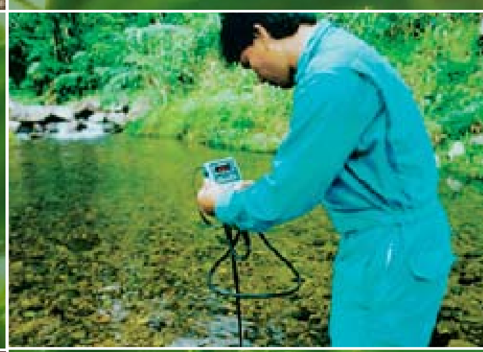
Perceptive to the needs of communities affected by and surrounding our project sites, we maintain livelihood programs, which are focused on wealth creation. 43 barangays, involving 16,900 households, located within the social fence of project sites, are the target beneficiaries of the programs. Activities include 1) strengthening farmers and community associations by organizing core groups and providing training; 2) improving the economic viability of existing and new projects by replicating profitable projects (e.g. plantations of abaca, banana, coffee, mangrove), establishing integrated projects like egg layer and goat dairy production, and awarding small-scale contracting projects to associations; 3) exploring large-scale/high return projects; and, 4) enhancing planning and monitoring systems such as conducting household surveys for profiling of households and developing a database system.

Another way of giving back to host communities, is through the Balik-Biyaya Program, which focuses on four major fronts – health and sanitation (balik-kalusugan), education (balik-galing), livelihood (balik-kabuhayan), and environment (balik-kalikasan).

All these are efforts to give back to communities whose lives were inadvertently affected by our projects. As we gain and benefit from our projects, so too should the people who are within the vicinity of project sites. The reason for involving them is two-fold – not only do we have the chance to share our expertise and skills, but the people, because of a better understanding of what our projects can do, begin to develop a sense of ownership for the projects, thus ensuring the success of their operations.

Recognizing Our Worth

Our humble attempts to improve the company and its services have not gone unnoticed. In 2006, we received the Anvil Award of Merit for the 2005 Energy Camp Program, the Golden Quill Awards of Merit from the International Association of Business Communications (IABC) for the 2005 Sulyap Calendar and 2005 Energy Camp Program, and the Enercon Award from the DOE for having conducted a widespread lighting retrofit in our buildings.



Environment - Taking Our Stewardship Seriously

Caring for the environment is imperative because here is where we source our energy. Nature is our supplier, and we are stewards and caretakers of what has been given to us. As we take from the land, then so should we give back.

Re-populating the Forest

And give back we did. In 2006, we produced and maintained a total of 292,087 seedlings, while 21,401 seedlings were dispersed in the different nurseries within the geothermal projects. We established 129 hectares of land for nurseries and plantations. To maintain 1,600 hectares of land, we contracted the labor to communities within the projects sites, to provide alternative livelihood to upland farmers. In giving them work, there is the chance that kaingin-making/illegal tree-cutting activities will be minimized, if not altogether eliminated.

Concurrent to these activities, we undertook forestry law enforcement activities within the geothermal reservation, through forest patrols, apprehensions and confiscation of illegally cut logs, and filing of cases against the violators. Our efforts produced considerable results preventing further damage to the environment.

Guarding Our Source of Wealth

We regularly conduct monitoring activities of river/effluent quality and air/noise quality in our five (5) geothermal projects, such as taking and analyzing water samples, and measuring noise levels. As always, we comply with government standards. Aside from this, there is a multi-sectoral team organized per site, which performs quarterly monitoring of our compliance with DENR and government standards, in addition to the annual audit conducted by the DOE. The check and balance is a guarantee that we do not become remiss in complying.

Alternative **Fuels**
- The Key to a Sustainable Future

The year 2006 saw the birth of PNOC's newest addition to the family – the PNOC Alternative Fuels Corporation or PAFC. Formerly the PNOC Petrochemical Development Corporation (PPDC), PAFC's primary mandate is to explore, develop, and accelerate the utilization and commercialization of alternative fuels in the country. There is now a need to source alternative fuels instead of just relying on the basic oil and gas, which are subject to the whims of the global market. The government wants us to have the options of providing fuel without being too dependent on our usual sources.

Jatropha's Promise

Our major focus is the in-depth study of jatropha or tuba-tuba, a drought-resistant perennial shrub, which can be found throughout the country, as a source of fuel. The plant has seeds that yield a high concentration of oil that can run diesel-powered motor vehicles or burn as fuel for home stoves. If developed to its full potential, this can help augment the country's domestic demand of seven billion liters of fuel a year. The development of jatropha falls under the government's Bio-diesel Program.

In developing jatropha's potential, we conducted ocular surveys of potential sites for mega-nurseries and plantations, identified possible sources of planting materials, assessed and identified the best variety of seeds/seedlings to gain maximum oil yield, and negotiated with potential partners on jatropha plantations.

Simultaneous to the above activities, we have also assessed several areas for possible locations for the Jatropha Biodiesel Refinery. The entire biodiesel project entails the construction of oil extraction, biodiesel refinery and transesterification. We have also conducted a feasibility study to establish the economic and financial viability of putting-up an integrated jatropha biodiesel project in the country, with several simulations being done to determine the sensitivity of the project on various economic and financial conditions. The viability of the project was determined using various economic and financial parameters.

Other **Business**

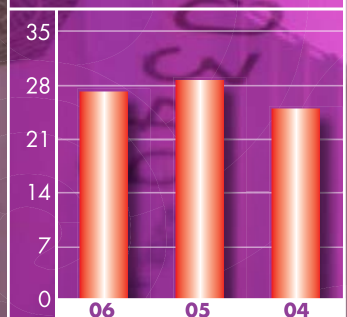
Our Energy Supply Base (ESB) in Mabini, Batangas, continued to serve the energy industry and commercial clients by providing docking, warehousing and other related services. PNOC and its subsidiaries occupy ESB facilities for the upkeep of equipment. To increase our energy-related clients though, marketing efforts are currently being intensified. The year 2006 saw 185 domestic vessels and 36 foreign vessels berth at ESB's port.

3 - Year **Financial Highlights**

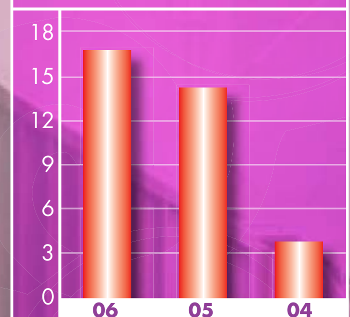
(In Million Pesos)

	2004	2005	2006
Sales	25,573	28,754	27,669
Net Income	4,352	13,992	16,329
Operating Expenses	2,807	2,485	2,362
Income (Loss from Operations)	8,781	12,750	13,010
Total Assets	108,696	103,956	112,333
Total Liabilities	94,908	75,204	61,687
Total Equity	13,788	28,752	50,646

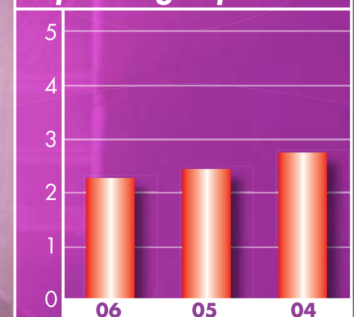
Sales



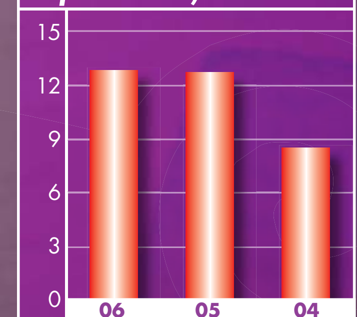
Net Income



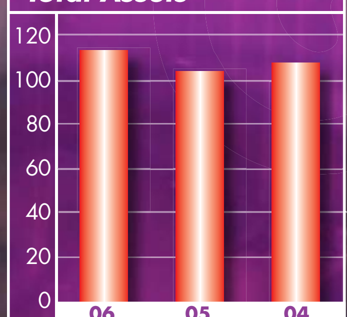
Operating Expenses



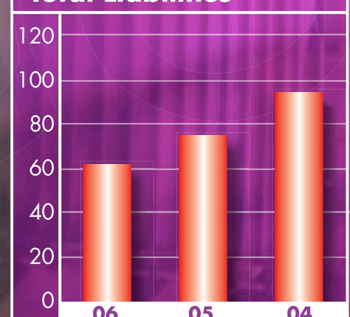
Income (Loss from Operations)



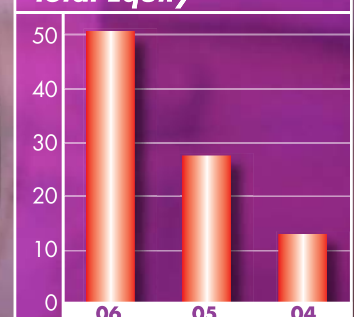
Total Assets



Total Liabilities



Total Equity



Financial **Ratios**

	2004	2005	2006
1. Profitability Ratios (%)			
Gross Profit Margin	45	52	55.6
Return on Assets	4	13	14.6
Return on Equity	32	49	32.3
2. Liquidity Ratios			
Current Ratio	1.31	1.28	2.24
Quick Ratio	1.19	1.17	1.79
3. Leverage Ratios			
Debt Ratio	0.87	0.75	0.55
Debt - to- Equity Ratio	6.88	2.93	1.22

FINANCIAL POSITION

In 2006, the company's total Consolidated Net Income was ₱16.33 billion, a sizable 17% or ₱2.34 billion increase from last year's level of ₱13.99 billion. This increase can be attributed to gains made from PNOC-EDC's Initial Public Offering in December 2006, falling under the company's Other Income.

The year's total Consolidated Net Sales amounted to ₱27.67 billion, a 4% or ₱1.08 billion decrease from last year's level of ₱28.75 billion. The decline in PNOC-EDC's Electricity Sales amounting to ₱727.59 million, from ₱16.46 billion in 2005 to ₱15.73 billion in 2006 was the main reason for the decrease in total sales. This in turn was due to electricity selling prices being largely affected by the appreciation of the Philippine peso versus the US dollar, from USD1=₱53.062 in 2005 to USD1=₱49.045 in 2006, the foreign exchange rate being one of the price inflators.

The Cost of Sales was reduced by ₱1.18 billion or 9%, from ₱13.49 billion in 2005 to ₱12.31 billion in 2006. This was due primarily to the reduction in PNOC-EDC's BOT fees or energy conversion costs with the completion of the 10-year BOT cooperation period for the Upper Mahiao Power Plant and its turnover by CE Cebu to PNOC-EDC on June 25, 2006.

Likewise, as a government corporation, the company strictly adhered to the provisions of Administrative Order (AO) No. 103, "Directing the Adoption of Austerity Measures in the Government". Hence, through PDMC's Manpower Reduction Program, the company was able to cut Operating Expenses by ₱122.41 million or 5%, from ₱2.48 billion in 2005 to ₱2.36 billion in 2006.

Finally, the company was able to significantly strengthen its cash position to ₱15.10 billion in 2006, almost triple the ₱5.56 billion figure in 2005. This was a substantial increase of 172% or ₱9.54 billion, and was due largely to the net proceeds from PNOC-EDC's Initial Public Offering in 2006 amounting to ₱18.55 billion.

FINANCIAL CONDITION

The company's Total Consolidated Assets reached ₱112.33 billion at the end of 2006, an 8% or ₱8.38 billion increase from last year's level of ₱103.96 billion. This was due mainly to the increase in the Cash and Cash Equivalents as a result of the PNOC-EDC IPO proceeds.

Conscious of the PGMA Administration's directive to reduce Contingent Liabilities and contain the Consolidated Public Sector Deficit, the company strongly adhered to its policy of paying off long-term loans. So in 2006, Total Consolidated Liabilities was 18% or ₱13.52 billion lower at ₱61.69 billion, compared to ₱75.20 billion in 2005. This reduction in Liabilities was due mostly to the increasing principal repayments for loans contracted with the International Bank for Reconstruction and Development (IBRD) and Japan's Oversees Economic Cooperation Fund (OECF).

Finally, the company's Total Equity was at ₱50.65 billion, a hefty 76% or ₱21.89 billion increase from the ₱28.75 billion in 2005. This was mainly due to the Net Income earned in 2006, which amounted to ₱16.33 billion, and the inclusion of PNOC-EDC's minority interest of ₱12.28 billion in the company's Retained Earnings.

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

State Auditor's Report

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

We have audited the accompanying consolidated financial statements of the Philippine National Oil Company (a Corporation wholly owned by the Republic of the Philippines) and Subsidiaries which comprise the consolidated balance sheet as of December 31, 2006 and the consolidated income statement, consolidated statement of changes in equity and consolidated cash flow statement for the year 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 consolidated 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 consolidated 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. Our 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, 2006, and its financial performance and cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

COMMISSION ON AUDIT

LITA E. DIEZ
Director III
Officer-in-Charge

November 5, 2007

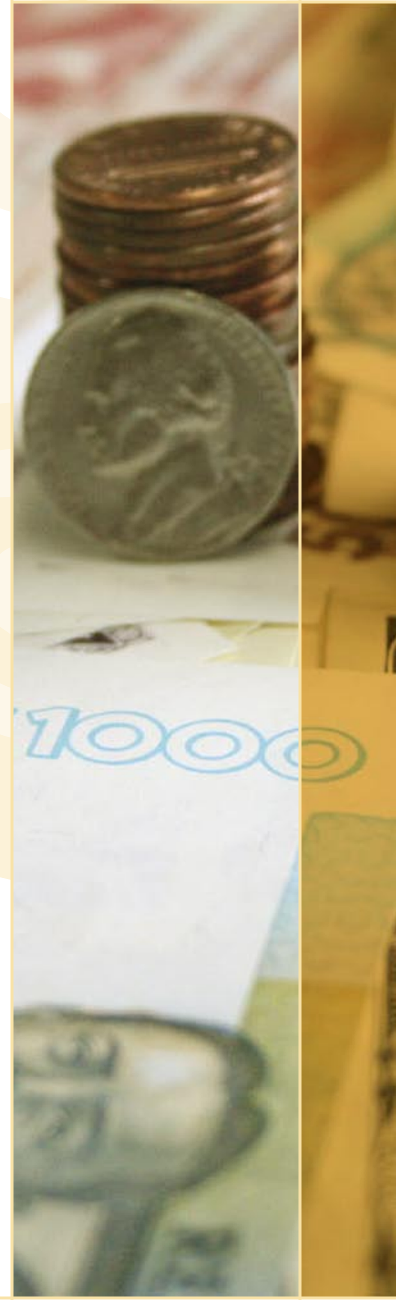
PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Consolidated **Balance Sheet**

(With comparative figures for 2005)
In Philippine Peso

	Notes	2006	2005 (as restated)
ASSETS			
Current Assets			
Cash and cash equivalents	4	15,099,024,934	5,561,619,510
Cash-restricted	5	33,212,957	-
Short-term investments	6	5,253,238,040	4,367,761,755
Accounts and notes receivable - net	7	5,475,774,745	6,955,830,322
Inventories - net	8	2,141,565,936	1,921,586,782
Investments in available-for-sale securities	9	1,278,631,449	2,726,590,586
Prepaid expenses and other current assets	10	3,189,025,045	1,837,739,363
Total Current Assets		32,470,473,106	23,371,128,318
Non-Current Assets			
Long-term receivables	11	1,140,017,684	1,553,860,771
Investments in available-for-sale securities	9	2,452,976,187	2,007,733,274
Investments	12	5,333,959,391	5,223,634,443
Property, plant and equipment - net	13	40,694,980,641	36,659,252,181
BOT power plants - net	14	17,637,817,500	20,870,005,021
Exploratory and development costs	15	5,866,232,902	5,206,028,067
Investment property	16	977,360,704	979,158,916
Deferred tax asset	35	2,892,882,404	4,717,344,215
Deferred charges and other assets	17	2,826,250,879	3,334,666,328
Total Non-Current Assets		79,822,478,292	80,551,683,216
Non-current Assets Held for Sale	18	40,054,728	32,907,628
TOTAL ASSETS		112,333,006,126	103,955,719,162
LIABILITIES AND EQUITY			
LIABILITIES			
Current Liabilities			
Accounts payable and accrued expenses	19	5,786,102,130	6,126,094,605
Income tax payable	34	517,837,260	2,098,234,868
Dividends payable	27	2,195,314,331	302,411,743
Current portion of long-term loans	22	3,264,561,183	4,720,728,397
Current portion of BOT lease obligations	21	2,766,401,494	5,058,280,501
Total Current Liabilities		14,530,216,398	18,305,750,114
Non-Current Liabilities			
Long-term loans-net of current portion	22	37,724,862,947	44,910,780,759
BOT lease obligations-net of current portion	21	413,180,565	2,777,311,576
Royalty fee payable - net of current portion	20	1,816,945,624	1,529,978,668
Other credits	23	6,019,876,438	6,490,125,154
Other long-term liabilities	24	1,182,268,376	1,190,264,409
Total Non-Current Liabilities		47,157,133,950	56,898,460,566
TOTAL LIABILITIES		61,687,350,348	75,204,210,680
EQUITY		50,645,655,778	28,751,508,482
TOTAL LIABILITIES AND EQUITY		112,333,006,126	103,955,719,162

See accompanying Notes to Financial Statements.



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

Consolidated **Statements of Income**

(With comparative figures for 2005)
In Philippine Peso

	Notes	2006	2005 (as restated)
NET SALES	30	27,669,028,731	28,753,944,988
COST OF SALES	31	12,309,307,274	13,485,275,902
GROSS MARGIN		15,359,721,457	15,268,669,086
UNREALIZED GROSS PROFIT FROM INSTALLMENT SALES		21,505,387	56,433,663
REALIZED GROSS PROFIT		15,338,216,070	15,212,235,423
REALIZED GROSS PROFIT FROM PREVIOUS YEAR'S INSTALLMENT SALES		33,837,592	22,550,569
TOTAL REALIZED GROSS PROFIT		15,372,053,662	15,234,785,992
OPERATING EXPENSES	32	2,362,097,151	2,484,507,072
INCOME FROM OPERATIONS		13,009,956,511	12,750,278,920
OTHER INCOME (CHARGES) - NET	33	7,871,316,950	5,421,274,084
INCOME BEFORE INCOME TAX		20,881,273,461	18,171,553,004
PROVISION FOR INCOME TAX	34		
CURRENT		(2,577,405,930)	(2,027,231,277)
DEFERRED		(1,828,290,800)	(2,145,649,872)
NET INCOME BEFORE MINORITY INTEREST		16,475,576,731	13,998,671,855
MINORITY INTEREST		(146,976,270)	(6,804,256)
NET INCOME		16,328,600,461	13,991,867,599

See accompanying Notes to Financial Statements.

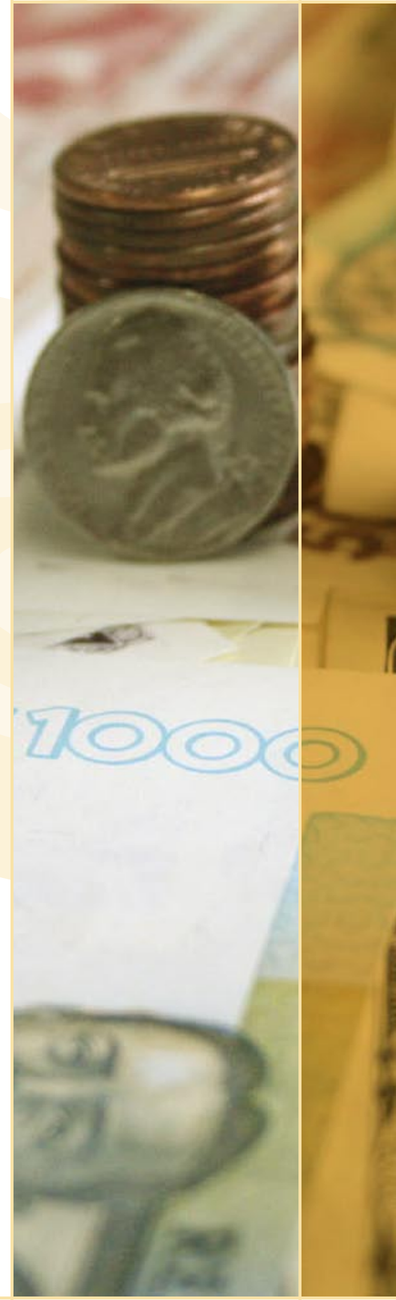
PHILIPPINE NATIONAL OIL COMPANY
(A Corporation Wholly Owned by the Government of the Republic of the Philippines)
AND SUBSIDIARIES

Consolidated **Cash Flow Statement**

(With comparative figures for 2005)
In Philippine Peso

	2006	2005 (as restated)
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers	28,348,732,120	27,756,775,666
Cash paid to suppliers and employees	(14,026,354,721)	(10,780,630,014)
Interest income received	997,084,305	944,226,019
Interest expenses paid	(3,078,128,841)	(3,928,999,387)
Income taxes paid	(3,581,752,465)	(368,736,504)
Net cash provided by operating activities	8,659,580,398	13,622,635,780
CASH FLOWS FROM INVESTING ACTIVITIES		
Net proceeds from PNOC-EDC's Initial Public Offering	18,549,279,055	-
Investment in Available-for-Sale Securities	839,213,678	(856,529,340)
Cash dividends received	395,801,336	376,680,800
Short-term investment	161,191,494	(87,751,486)
Proceeds from disposal of assets	33,723,500	31,554,889
Share of National Government in Initial Public Offering	(4,568,017,027)	-
Capital expenditures	(3,021,002,592)	(598,352,232)
Exploratory & development costs	(621,355,222)	(415,701,860)
Investments	(153,401,483)	(181,585,485)
Net cash provided by (used in) investing activities	11,615,432,739	(1,731,684,714)
CASH FLOWS FROM FINANCING ACTIVITIES		
Additional loan drawdowns	2,725,632,762	2,437,307,488
Short-term loans proceeds	1,150,000,000	346,334,000
Payment of BOT lease obligations	(5,042,087,781)	(5,789,262,776)
Repayment of long-term debt	(8,009,722,119)	(4,534,742,003)
Repayment of short-term loans	(1,166,300,000)	(159,834,000)
Payment of cash dividends	(372,813,664)	(614,083,284)
Net cash used in financing activities	(10,715,290,802)	(8,314,280,575)
NET INCREASE IN CASH AND CASH EQUIVALENTS	9,559,722,335	3,576,670,491
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND AND CASH EQUIVALENTS	(22,316,911)	(3,855,501)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	5,561,619,510	1,988,804,520
CASH AND CASH EQUIVALENTS AT END OF YEAR	15,099,024,934	5,561,619,510

See accompanying Notes to Financial Statements.



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

Consolidated **Statements of Changes in Equity**

(With comparative figures for 2005)
In Philippine Peso

	Capital Stock (Note 25)	Donated Capital (Note 26)	Retained Earnings (Note 27)	Revaluation Surplus (Note 28)	Fair Value and other reserves (Note 29)	Total	Minority Interest	Total Equity
Balance at January 1, 2005 as previously reported	3,114,595,519	130,289,284	10,537,048,723			13,781,933,526	6,025,006	13,787,958,532
Net income for 2005			13,626,770,952			13,626,770,952	6,035,940	13,632,806,892
Cash dividends			(303,494,978)			(303,494,978)		(303,494,978)
Realignment of Deferred Tax assets @ 35% Income Tax rate			(13,210,425)			(13,210,425)		(13,210,425)
Deferred tax benefit			13,304,601			13,304,601		13,304,601
Prior-period adjustments			(5,339,895)			(5,339,895)		(5,339,895)
Revaluation of land				467,170,815		467,170,815		467,170,815
Unrealized Holding Gain on Investments in Available-for-Sale Securities					110,309,139	110,309,139		110,309,139
Balance at December 31, 2005 as previously reported	3,114,595,519	130,289,284	23,855,078,978	467,170,815	110,309,139	27,677,443,735	12,060,946	27,689,504,681
Prior-period adjustments		(34,568,394)	(113,655,075)			(148,223,469)	(81,250)	(148,304,719)
Change in accounting policy			192,423,275			192,423,275	404,939	192,828,214
Increase in PNOC-ECs' net income for 2005			365,096,647			365,096,647	768,316	365,864,963
Allowance for decline in value of shares of stocks			651,615,343			651,615,343		651,615,343
Balance at December 31, 2005 as restated	3,114,595,519	95,720,890	24,950,559,168	467,170,815	110,309,139	28,738,355,531	13,152,951	28,751,508,482
Balance at January 1, 2006	3,114,595,519	95,720,890	24,950,559,168	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 of National Government from PNOC-EDC's Initial Public Offering			(4,568,017,027)			(4,568,017,027)		(4,568,017,027)
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 Investments 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	34,398,114,975	467,598,815	131,462,811	38,207,493,010	12,438,162,768	50,645,655,778

See accompanying Not es to Financial Statements.

Notes to Consolidated **Financial Statements**

1. CORPORATE HISTORICAL BACKGROUND

The Philippine National Oil Company (PNOC) was created under Presidential Decree No. 334 on November 9, 1973, to provide and maintain an adequate and stable supply of oil in the country. Its charter was amended to include energy exploration and development. The Philippines is now the world's largest user of wet steam technology in geothermal operations. It ranked second to the United States in terms of total megawatts generated from geothermal energy. Thirty-three years since its creation, PNOC 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 PNOC to get more involved in new and renewable energy activities and projects. It has ventured into several projects carried out by the following subsidiaries:

a) PNOC Energy Development Corporation (PNOC-EDC) was established in 1976 to undertake exploration and development of geothermal energy sources in the country. At present, it operates nine (9) geothermal steamfields with an aggregate capacity of 1,145 megawatts, accounting for about 60% of the country's total installed geothermal capacity. It also operates six (6) power plants, which were built through the Build-Operate-Transfer scheme.

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

   In November 2005, PNOC-EDC undertook a re-validation study and recommended a revised implementation plan for the Northern Luzon Wind Power Project, approved by the PNOC-EDC Board on April 24, 2006 and endorsed by the NEDA-ICC on November 10, 2006. The revised implementation plan includes the design and construction of a wind farm and a proposed reduction of the wind capacity requirement from 40MW to 30MW and a reduced transmission line from 230 kV to 115 kV of a single circuit.

   PNOC-EDC successfully completed its initial Public Offering (IPO) on December 13, 2006 with the sale of 5.22 billion shares at P3.20/share, generating net proceeds of P9.14 billion for PNOC and National Government. PNOC then holds 60% interest as of December 31, 2006.

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

   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%) interest in SC 38 Malampaya Deepwater Gas-to-Power Project, producing gas and condensate that fuel the Ilijan, Sta. Rita and San Lorenzo power plants in Batangas. PNOC-EC gas production from the San Antonio gas field fuels a small power plant in Isabela. In June 2002, PNOC-EC assumed the operations of coal trading and integrated services from PNOC Coal Corporation.

c) PNOC Alternative Fuels Corporation (PAFC), formerly 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 thereto to enhance the energy security and promote sustainable energy development; to develop projects for implementation of alternative fuel sources which shall include, but not limited, to bio-fuels, bio-diesel, bio-mass, bio-gas and such other energy systems that support environmental sustainability and energy consumption efficiency.

   PAFC has retained its secondary purpose, its mandate to manage, operate and develop some 530 hectares of land in Bataan as a petrochemical industrial estate, known as Petrochemical Park. PAFC initially developed about 85 hectares of the park for the midstream plants.

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

e) PNOC Development and Management Corporation (PDMC) is engaged in industrial estate development and management. Its assets consist mainly of landholdings in Cavite. PDMC develops its real estate properties. About twenty-five (25) hectares were disposed 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 and 32 hectares were developed onto a mixed residential/commercial subdivision.

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

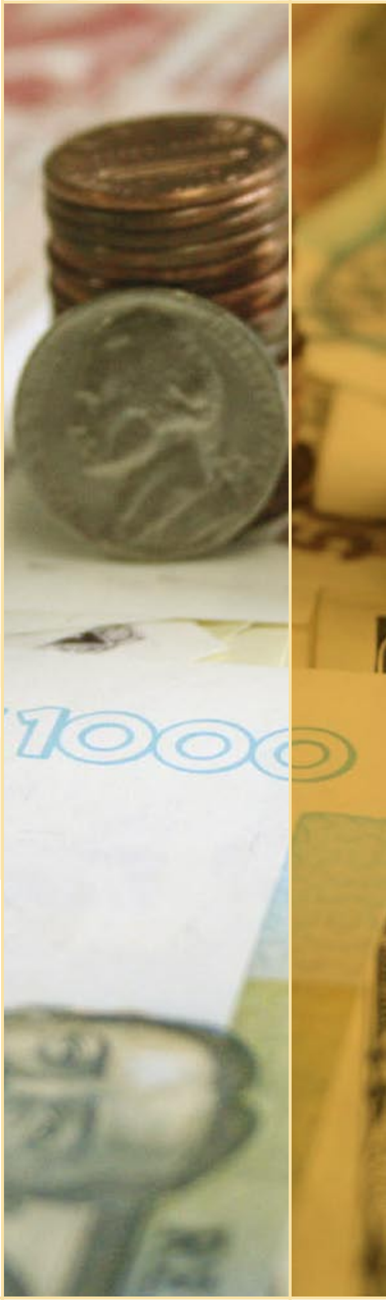
   Effective May 31, 2002, PCC ceased to operate and its coal trading activities were absorbed by PNOC-EC. PCC still on its winding-up process administered by PNOC, being the Trustee-Receiver.

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

h) Tanker Companies namely, PNOC Tankers, Petron Tankers, Petrophil Tankers and PNOC Oil Carriers, Inc. ceased operating in 1995 due to continued losses suffered. Final audit reports of the tanker companies were issued by the Commission on Audit for the period ended June 1996. In 2003, the Securities and Exchange Commission has issued a certificate for the revocation of registration of these four (4) tanker companies. Likewise, the Bureau of Internal Revenue 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.

2. BASIS OF FINANCIAL STATEMENT PREPARATION

The consolidated financial statements of PNOC and subsidiaries have been prepared in compliance with accounting principles generally accepted in the Philippines as set forth in Philippine Financial Reporting Standards (PFRS) and Philippine Accounting Standards (PAS), including interpretations issued by the Accounting Standards Council (ASC).



Basis of Consolidation

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

The subsidiaries included in the consolidation are the following:

1. PNOC Energy Development Corporation (PNOC-EDC)
2. PNOC Exploration Corporation (PNOC-EC)
3. PNOC Alternative Fuels Corporation (PAFC)
4. PNOC Shipping and Transport Corporation (PSTC)
5. PNOC Development and Management Corporation (PDMC)
6. PNOC Coal Corporation (PCC)
7. PNOC Dockyard and Engineering Corporation (PDEC)
8. PNOC Tanker Companies

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

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) Cash and Cash Equivalents

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.

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.

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

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, plant 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 PNOC. 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 PNOC 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. Major spare part is 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. In 2006, PNOC-EC changed its accounting policy from full-cost method to successful-efforts method of accounting for its oil and gas productions. The carrying value is 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 value exceeds the estimated recoverable amount, the asset or cash-generating unit is written down to its 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, depreciation, depletion, and amortization of SC 38 Project-related other facilities and equipment are computed using the straight-line method based on the estimated useful life of 21 years.

Production Wells

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

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

i) <u>Exploratory and Development Costs</u>

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

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

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

Upon commercial operation of a plant, all drilling costs, including related costs of wells hooked to the FCRS and those wells that are to be utilized either for recycling for waste disposal, are transferred to Production Wells account and amortized over the estimated useful life of the properties.

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

j) <u>Impairment of Assets</u>

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

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

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

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

k) <u>Non-current Assets Held for Sale</u>

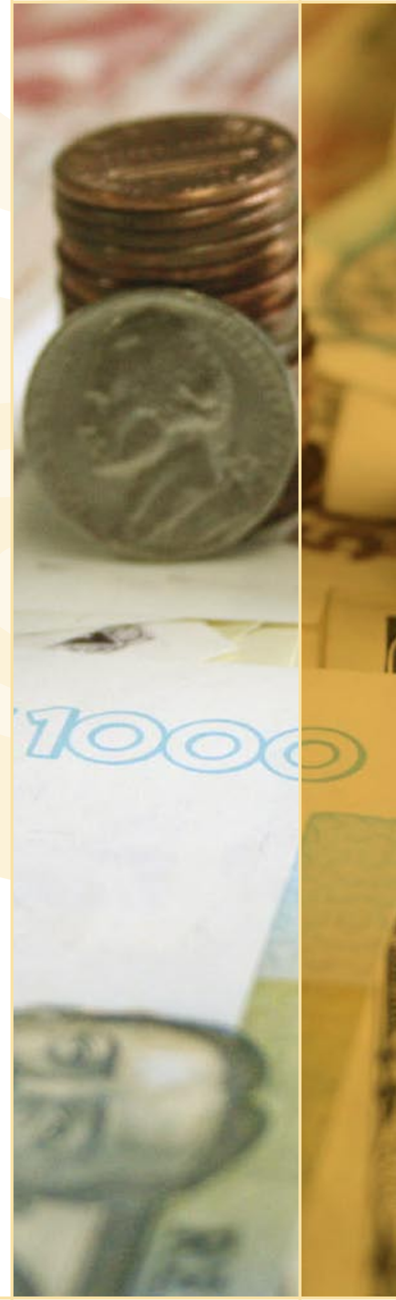
Non-current assets are classified as held for sale if their carrying amounts will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset is available for immediate sale in its present condition. 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.

l) <u>Revenue Recognition</u>

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

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



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

Revenue from sale of gas, condensate and oil is recognized upon delivery in accordance with the provisions of SC No. 38 Gas Sales and Purchase 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.

m) <u>Leases</u>

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

The Company as Lessor

Amounts due from lessees under finance leases are recorded as receivables at the amount of the PNOC'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 PNOC's net investment outstanding in respect of the leases.

The Company as Lessee

Assets held under finance leases are recognized as assets of the PNOC 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 PNOC's general policy on borrowing costs.

n) <u>Build-Operate-Transfer (BOT) Projects</u>

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

o) <u>Borrowing Costs</u>

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.

p) <u>Foreign Currency Transactions</u>

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

q) <u>Retirement Benefit Costs</u>

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.

r) <u>Income Taxes</u>

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. PNOC'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 is 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:

	2006	2005
Cash in bank	73,293,709	587,221,279
Petty cash	4,836,892	6,344,365
Marketable securities	15,020,894,333	4,968,053,866
	15,099,024,934	5,561,619,510

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

5. CASH-RESTRICTED

The cash-restricted in 2006 represents the 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 (JCIB) der the 21st Yen Loan.

6. SHORT-TERM INVESTMENTS

This account 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 RECEIVABLE

This account consists of:

	2006	2005
Trade receivables	5,036,039,210	6,472,711,031
Others	553,530,858	627,507,150
	5,589,570,068	7,100,218,181
Allowance for doubtful accounts	(113,795,323)	(144,387,859)
	5,475,774,745	6,955,830,322

Trade receivables pertain mainly to PNOC-EDC's billings to the National Power Corporation (₱4.21 billion) for the sale of electricity and steam production supplied to the latter's power plants.

The account also includes PNOC-EC's 10% share in the SC 38 Consortium's receivables on gas and condensate sales (₱436.20 million), receivables on Coal project which consist of coal sales and integrated services, receivables from Energy Supply Base which refers to rentals, pier services, supply of fuel as well as other fees for the usage of EC's facilities and equipments by customers from the energy and commercial sectors and PSTC's receivables from hauling or transporting of refined petroleum products to local oil companies.

Other receivables consist mainly of 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:

	2006	2005
Parts and supplies	1,309,410,980	1,148,090,114
Land	761,868,204	761,570,431
Condensate	70,510,935	16,044,779
Coal	23,493,317	19,598,958
	2,165,283,436	1,945,304,282
Allowance for obsolescence	(23,717,500)	(23,717,500)
	2,141,565,936	1,921,586,782

Parts and supplies inventories consist mainly of PNOC-EDC's landed inventories (₱1.16 billion), net of uninstalled inventory of major spare parts for the fluid collection and re-injection system (FCRS). It also includes PNOC-EC's 10% share in the inventory of SC 38 Consortium (₱70.74 million).

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 mixed residential and commercial housing. It also includes PAFC's saleable land in Bataan.

Condensate inventory pertains to the undelivered stock of SC 38 Malampaya Project as stored in its offshore Concrete Gravity Structure in offshore Palawan with a volume of 22,308.96 bbls, while the coal inventory represents PNOC-EC's undelivered stock from various Coal Terminals with a total volume of 13,052.031 metric tons.

9. INVESTMENTS IN AVAILABLE-FOR-SALE SECURITIES

This account pertains to investments in peso and dollar-denominated government debt securities. The current portion pertains to PNOC-EDC's investments. The fair values of these securities are based on quoted market prices as at balance sheet date. Accumulated unrealized holding gain on bonds and other investments is presented under equity and amounts to ₱131.46 million and ₱110.31 million for the years ended December 31, 2006 and 2005, respectively. The non-current portion consists substantially of PNOC's investments in treasury bonds with maturities of up to five (5) years in the amount of ₱2.24 billion in 2006 and ₱1.80 billion in 2005.

10. PREPAID EXPENSES AND OTHER CURRENT ASSETS

This account consists of the following:

	2006	2005
Advances to contractors	1,053,172,238	510,664,066
Special deposits	765,471,945	733,047,489
Prepaid expenses	301,626,829	260,295,212
Other prepaid and deferred charges	1,068,754,033	333,732,596
	3,189,025,045	1,837,739,363

Advances to contractors pertain to PNOC-EDC's 25% advance payment to Kanematsu Corporation for the Northern Negros Geothermal Power Plant Project.

The increase in 2006 was mainly brought about by the reclassification of the advance payment to Kanematsu Corporation from the Deferred charges and Other Assets - Prepaid Expense account.

Other prepaid and other charges in 2006 pertain mainly to PNOC-EDC's VAT receivable from BIR in the amount of ₱811.22 million.

11. LONG-TERM RECEIVABLES

This account consists of PNOC-EC's 10% share in receivables including interest in the SC 38 Malampaya projects "take or pay" annual deficiency for the years 2002 to 2005 under the GSPA. It also includes PDMC's mortgage receivables from contracts generated by the socialized housing and mixed residential and commercial housing project in Rosario, Cavite, to be collected within long periods ranging from two (2) to twenty-five (25) years.

	2006	2005
National Power Corporation	780,914,527	770,416,032
First Gas Power Corporation	155,651,017	443,407,101
FGP Corporation	44,487,595	181,991,137
Socialized housing	113,268,451	116,935,643
Costa Verde Subdivision	45,696,094	65,417,625
	1,140,017,684	1,578,167,538
Allowance for doubtful accounts	-	(24,306,767)
	1,140,017,684	1,553,860,771

12. INVESTMENTS

This account consists of investments in the following:

	2006	2005
Petron Corporation	4,448,444,187	4,448,444,187
National Development Corporation-7% Preferred shares (NDC)	369,151,000	369,151,000
Investment in Joint Ventures	268,080,898	156,755,950
Petrochemicals Corporation of Asia Pacific (Petrocorp)	-	245,967,752
Goodyear Philippines, Inc.	96,453,350	96,453,350
Gulf Oil Philippines, Inc.	54,978,000	54,978,000
Others	96,851,956	96,851,956
	5,333,959,391	5,468,602,195
Allowance for unrealized loss	-	(244,967,752)
	5,333,959,391	5,223,634,443

The wells, platform and other facilities pertains to PNOC-EDC's production wells and to the ten percent (10%) share of PNOC-EC in the aggregate assets of SC 38 Malampaya Project amounting to ₱11.90 billion and ₱9.50 billion, respectively, 2006 and ₱11.95 billion and ₱9.86 billion, respectively in 2005 .

Depreciation and depletion charged to operations amounted to ₱2.1 billion in 2006 and ₱3.2 billion in 2005.

The PNOC-EC adjusted the prior year's cost of wells, platforms and other facilities and its related accumulated depreciation in the amount of ₱5.82 billion and ₱801.72 million, respectively, as a result of change in policy from full-cost method to successful efforts method of accounting for its oil and gas operations. The adjustment pertains to the estimated future development cost which was capitalized in prior years consistent with the full-cost method of accounting.

13. PROPERTY, PLANT & EQUIPMENT

The details of this account are as follows:

	Land, Leases & Improvements	Buildings and Improvements	Wells, Platform and other Facilities	Plant Facilities	Pier Facilities	Tankers	Machinery and Equipment	Transportation Equipment	Furniture, Fixtures & Equipment	Construction in Progress	Others	Total
COST												
January 1, 2006	2,656,808,955	14,233,962,620	29,363,837,548	3,953,636,051	200,580,156	508,724,752	1,928,251,740	334,961,390	384,215,043	643,789,087	21,698,776	54,230,466,118
Additions	14,703,878	14	616,399,822	30,910,878			6,969,899	1,912,557	54,920,755	3,371,997,124	1,691,110	4,099,506,037
Revaluation	467,170,815											467,170,815
Reclassifications	9,684	62,998,337					23,292,530	4,019,374	28,079,258	(535,942,005)	(6,013,997)	(423,556,819)
Disposals		(16,416,419)		(14,727)			(14,224,019)	(27,657,765)	(21,733,371)		(365,951)	(80,412,252)
December 31, 2006	3,138,693,332	14,280,544,552	29,980,237,370	3,984,532,202	200,580,156	508,724,752	1,944,290,150	313,235,556	445,481,685	3,479,844,206	17,009,938	58,293,173,899
ACCUMULATED DEPRECIATION												
January 1, 2006	(2,557,075)	(4,601,929,722)	(7,487,547,176)	(1,355,146,334)	(119,528,409)	(112,135,012)	(1,282,727,812)	(278,796,475)	(300,364,557)		(1,843,597)	(15,542,576,169)
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)	(40,072,745)		(170,329)	(2,128,369,360)
Disposals		10,991,194		7,731			12,807,285	26,959,635	21,625,275		361,151	72,752,271
December 31, 2006	(2,767,292)	(5,305,803,908)	(8,532,781,027)	(1,495,426,114)	(133,025,691)	(144,713,103)	(1,384,280,658)	(278,930,663)	(318,812,027)	-	(1,652,775)	(17,598,193,258)
NET CARRYING AMOUNT												
December 31, 2006	3,135,926,040	8,974,740,644	21,447,456,343	2,489,106,088	67,554,465	364,011,649	560,009,492	34,304,893	126,669,658	3,479,844,206	15,357,163	40,694,980,641
NET CARRYING AMOUNT												
December 31, 2005	3,121,422,695	9,632,032,898	21,876,290,372	102,681,135	81,051,747	396,589,740	645,523,929	56,164,916	83,850,480	643,789,088	19,855,181	36,659,252,181

14. BOT POWER PLANTS

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

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

	Malitbog	Mahanagdong	Upper Mahiao	Mindanao I	Mindanao II	Tongonan I Optimization	Total
COST							
January 1, 2006	12,287,865,264	7,853,473,973	3,670,775,022	2,186,029,391	2,798,177,959	470,881,120	29,267,202,729
Additions	170,161,059	-	-	-	-	-	170,161,059
Reclassifications	-	-	(3,670,775,022)	(1,214,473)	-	-	(3,671,989,495)
December 31, 2006	12,458,026,323	7,853,474,973	-	2,184,814,918	2,798,177,959	470,881,120	25,765,374,293
ACCUMULATED DEPRECIATION							
January 1, 2006	(3,602,961,628)	(2,228,238,322)	(1,174,966,440)	(644,687,190)	(615,543,816)	(130,800,310)	(8,397,197,706)
Provision	(411,003,453)	(261,504,545)	(101,869,738)	(72,819,971)	(93,208,576)	(15,696,037)	(956,102,320)
Adjustment	(52,466,326)						(52,466,326)
Reclassification	-	-	1,276,836,178	1,373,381	-	-	1,278,209,559
December 31, 2006	(4,066,431,407)	(2,489,742,867)	-	(716,133,780)	(708,752,392)	(146,496,347)	(8,127,556,793)
Carrying Amount **December 31, 2006**	**8,931,594,916**	**5,363,731,106**	-	**1,468,681,138**	**2,089,425,567**	**324,384,773**	**17,637,817,500**
Carrying Amount December 31, 2005	8,684,903,635	5,625,235,651	2,495,808,581	1,541,342,201	2,182,634,143	340,080,810	20,870,005,021

Depreciation expenses amounted to ₱956.1 million in 2006 and ₱975.4 million in 2005.

The corresponding liability account set up for BOT Power Plants is presented under the BOT lease obligations account.

15. EXPLORATORY AND DEVELOPMENT COSTS

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

The increase in exploratory and development costs was mainly due to the additional development and drilling costs in the geothermal projects mainly in Northern Negros, Malitbog and Upper Mahiao in Leyte and Cabalian, So. Leyte.

In 2006, certain projects evaluated as impaired aggregating to ₱165.10 million were written off in the books of PNOC-EC. Prior year's capitalized costs in the amount of ₱37.06 million were expensed and charged to retained earnings.

16. INVESTMENT PROPERTY

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

It also includes PNOC-EDC's land and building and PAFC's land totaling approximately 910,935 square meters and is presently leased to Orica Explosives Philippines, Inc., for a period of three years from March 1, 2001 to February 28, 2004. A new contract has been signed extending the lease for another five-year term from March 1, 2004 to February 28, 2009, excluding a one-year clear-up period from March 1, 2009 to February 28, 2010.

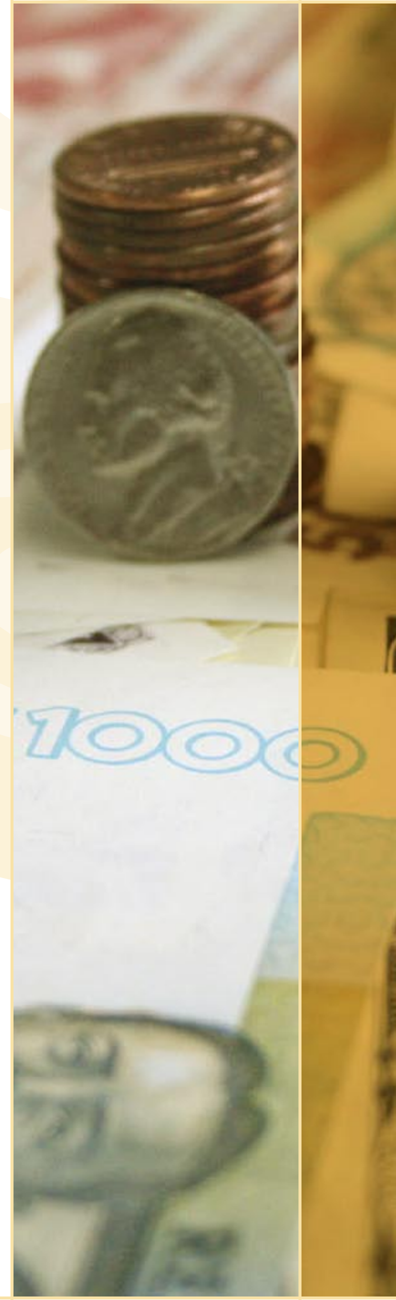
17. DEFERRED CHARGES AND OTHER ASSETS

This account includes the following:

	2006	2005
Long-term receivables	1,990,279,652	1,917,934,604
Claims receivable from BIR	1,894,719,994	2,707,006,565
Deferred royalty fee	896,949,151	697,795,289
Petron's purchase price adjustment Fund	809,757,306	809,757,306
Guarantee fee – Miyazawa II	351,708,984	452,552,486
Prepaid expenses	-	457,486,009
Deposit for sinking fund	261,536,875	282,805,498
Collateral for bonds issued	48,337,598	52,296,658
Special deposits and funds	39,642,998	34,653,721
Investment in available-for-sale Securities	22,776,381	21,740,587
Others	377,019,258	170,875,909
	6,692,728,197	7,604,904,632
Allowance for doubtful accounts	(3,866,477,318)	(4,270,238,304)
	2,826,250,879	3,334,666,328

Long-term receivables comprised mainly of long-overdue trade accounts from NPC for PNOC-EDC's steam sales.

Claims receivables from BIR pertain to PNOC-EDC's refund of input VAT on BOT fees, which were initially denied by the BIR regional level on July 2, 2002. Subsequently, PNOC-EDC submitted a letter of reconsideration on September 2, 2002. The request for reconsideration was endorsed by RDO 50 to the BIR Head Office legal department and the review of the claims is still on going. The decrease in 2006 pertains mainly to the reclassification to Other Current Assets portion of the VAT receivable which a Tax Credit Certificate was already issued by BIR on January 31, 2006 amounting to ₱811.22 million.



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

Guarantee fee on Miyazawa II pertains to the upfront fees subject to amortization starting on the 6th year towards the end of the 10-year loan period.

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

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

The decrease in prepaid expenses was mainly due to the reclassification to other current assets of the 25% advance payment to Kanematsu Corporation for the construction of Northern Negros Geothermal Power Plant Project.

Other accounts mainly consist of PNOC-EDC's ₱121 million input VAT on the purchase of good and services which will be claimed for refund from the Bureau of Internal Revenue and ₱118 million typhoon-related claims from insurance.

18. NON-CURRENT ASSETS HELD FOR SALE

This account includes the following:

	2006	2005
Property, plant & equipment	18,085,845	17,725,313
Materials and supplies inventory for disposal	12,118,461	12,085,696
Surplus property available for sale	9,850,422	3,096,619
	40,054,728	32,907,628

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

19. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

This account consists of the following:

	2006	2005
Accounts payable - trade	2,904,877,767	3,629,784,625
Accrued interest	1,170,451,288	878,310,484
Royalty fee payable (Note 19)	524,644,631	613,194,967
Short-term loans payable	-	207,000,000
Other current liabilities	1,186,128,444	797,804,529
	5,786,102,130	6,126,094,605

Accounts payable - trade comprise mainly of PNOC-EDC's accrued capacity fees for BOT plants and other accrued expenses as of year end.

Short-term loans payable pertain to peso and dollar loans obtained from the Land Bank of the Philippines for the acquisition of PSTC's vessel, MT Dr. Jose Rizal, by PNOC Shipping & Transport Corporation. In January 2006, these loans were refinanced to an 8-year loan.

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

20. ROYALTY FEE PAYABLE

This account consists of the following:

	2006	2005
Due to DOE	2,016,945,624	1,729,978,669
Due to LGU's	324,644,631	413,194,966
	2,341,590,255	2,143,173,635
Less Current portion	524,644,631	613,194,967
Long-term portion	1,816,945,624	1,529,978,668

21. BOT LEASE OBLIGATIONS

This account consists of the following:

	Minimum Lease Payments		Present Value of Minimum Lease Payments	
	2006	2005	2006	2005
Amounts payable under finance leases:				
Within one year	2,904,781,721	5,538,025,533	2,766,401,494	5,058,280,501
In the second to fourth years inclusive	434,680,911	2,934,961,447	413,180,565	2,777,312,576
Less: Future finance charges	(159,880,573)	(637,394,903)	-	-
Present value of lease obligations	3,179,582,059	7,835,592,077	3,179,582,059	7,835,592,077
Less: Amount due for settlement within 12 months (shown under current liabilities)	(2,766,401,494)	(5,058,280,501)	(2,766,401,494)	(5,058,280,501)
Amount due for settlement after 12 months	413,180,565	2,777,311,576	413,180,565	2,777,311,576

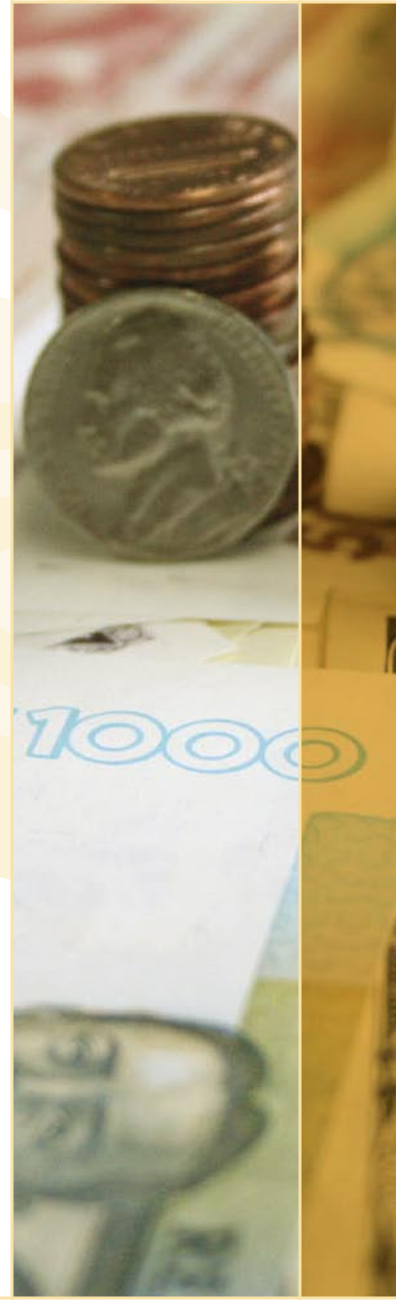
This account pertains to the liability set up for the present value of the stream of future cash payments [for capital cost recovery (CCR) fees] for the BOT power plants during the ten-year cooperation period discounted at the buy-out rate indicated in the BOT contracts. The BOT lease obligations are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

Outstanding balances of these foreign obligations were restated into Philippine pesos based on the prevailing foreign exchange rates at year-end (USD1=JPY118.934: USD1=PHP49.045 on December 31, 2006 and USD1=JPY 117.855: USD1=PHP53.062 on December 31, 2005).

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

22. Long-term debt are summarized as follows:

Creditor/Project Name		Maturities	Interest Rate	2006	2005
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	464,006,909	700,991,542
3164 PH Energy Sector Project					
- US$150.0 million	PNOC & EDC	1995 to 2010	1/2 of 1% over cost of qualified borrowings	2,381,795,853	3,086,281,742
3702 PH Geothermal Exploration Project					
- US$64.0 million	PNOC EDC	1999 to 2013	1/2 of 1% over cost of qualified borrowings	1,516,373,173	1,751,831,108
3747 PH Geothermal Exploration Project					
- US$114.0 million	PNOC EDC	1999 to 2014	1/2 of 1% over cost of qualified borrowings	1,701,179,610	1,950,460,737
- JPY 12.4 billion		1999 to 2014		1,270,302,115	1,573,036,407
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	577,411,044
- JPY 1.5 billion (restructured)			3.2%	163,260,896	210,575,227
9th Yen Palipinom I Geothermal Power Project					
- JPY 10.8 billion	PNOC EDC	1991 to 2011	3%	770,899,584	1,028,717,214
15th Yen Palinpinon II Geothermal Power Project					
- JPY 4.0 billion	PNOC EDC	1999 to 2019	5.7 %	800,031,045	943,362,515
18th Yen Palinpinon II Geothermal Power Project					
- JPY 77.4 billion	PNOC EDC	2003 to 2023	3%	25,681,845	29,739,136
19th Yen Mt. Labo Geothermal Power Project					
- JPY 10.8 billion	PNOC EDC	2004 to 2024	4.9%	115,897,514	133,568,251
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	2,056,852,409
MIYAZAWA INITIATIVE I					
- JPY 5.2 billion	PNOC EDC	June 1, 2009	Tranche A = 3.78 %	2,127,831,058	2,341,201,564
- JPY 6.8 billion			Tranche B - LIBOR + 1.60 %	2,820,613,262	3,061,571,276
MIYAZAWA INITIATIVE II					
- JPY 22.0 billion	PNOC EDC	June 26, 2010	2.37%	9,072,147,920	9,905,083,540
Citibank Syndicated Loan					
- US$175 million Malampaya Deepwater-Gas-to-Power Project	PNOC-EC	2008	LIBOR plus 3.5%	4,414,050,000	8,277,672,000
Landbank of the Philippines					
- PHP 1.5 billion	EDC	June 29, 2008	Average 91 day T-bills + 2%	882,954,546	1,387,500,000
	PNOC- PSTC	2005 to 2013		299,057,786	119,434,000
J P Morgan Chase Manhattan					
- US$ 110 million	PNOC EDC	October 19, 2006	3.85% + LIBOR (2.42375)	-	1,167,364,000
Bank of Tokyo Mitsubishi					
- US$ 30 million	PNOC EDC	December 14, 2006	3.85% + LIBOR (1.90875)	-	318,372,000
Standard Chartered					
- US$ 75 million	PNOC EDC	August 4, 2009	2.22% + LIBOR	3,678,375,000	3,979,650,000
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	2,424,933,400
- US$44.3 million			Tranche 2 = 3.39 % + 6 mos. LIBOR	1,736,716,159	2,350,646,600
National Government					
Principal Collaterized Interest Reduction Bonds (PCIR)	PNOC & EDC	1992 to 2017	Year 1 4 1/4 % Year 2 5 1/4 % Year 3 5 3/4 % Year 4 - 5 6 1/4 % Year 6 - 25 6 1/2 %	214,032,380	231,562,569
Interest Reduction Bonds (IRB)	PNOC	1992 to 2008	Year 1-2 4 % Year 3-5 5 % Year 6 6 % Year 7 - 15 LIBOR plus 13/16 of 1%	888,583	1,922,720
Philippine New Money Bonds	PNOC	1992 to 2010	LIBOR plus 13/16 of 1%	15,090,165	21,768,155
TOTAL				40,989,424,130	49,631,509,156
Less: Current portion				3,264,561,183	4,720,728,397
				37,724,862,947	44,910,780,759



23. OTHER CREDITS

This account consists mainly of PNOC-EC's net entitlements from the "Take-or-Pay" transactions of SC 38 Malampaya Project. Under the "Take-or-Pay" provision of the Gas Sales and Purchase Agreement, customers are obliged to pay the contracted volume and/or quantity even if there is no delivery to customers or consumption of the produced gas during the period. In turn, the SC 38 Consortium is bound to deliver the deficiency volumes in the future. The value of the undelivered volume is treated as unearned revenue until delivery is actually effected.

24. OTHER LONG-TERM LIABILITIES

This account consists of the following:

	2006	2005
Retirement benefit obligations	869,569,338	903,521,207
Liability for future abandonment costs	51,289,619	45,478,132
Others	261,409,419	241,265,070
	1,182,268,376	1,190,264,409

25. CAPITAL STOCK

PNOC'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 P50 per share. The remaining shares may be subscribed and paid for by the Republic of the Philippines or by government financial institutions at no less than ₱50 a share. From 1975 to 1988, additional 6,029,191 shares were subscribed by the Republic of the Philippines at P500 per share.

26. 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, which were donated to it by the Canadian International Development Agency (CIDA), through Petro-Canada, in 1993 and 1994, respectively.

The Gas Turbine, which was donated by the CIDA in 1995 million to PNOC-EC, was derecognized in 2006 and credited to retained earnings account. The asset was already disposed and replaced by a new gas turbine.

27. RETAINED EARNINGS

In compliance with Republic Act 7656, PNOC declared cash dividends to the National Government (NG) in the total amount of ₱2.227 billion out of PNOC's 2006 net earnings. In addition, PSTC and PNOC EC remitted to the Bureau of Treasury the amounts of ₱9.088 million and ₱9.978 million, respectively.

On December 22 and 29, 2006, PNOC remitted to the Bureau of Treasury the amount of ₱4.568 billion representing the share of the National Government in the net proceeds from the Initial Public Offering (IPO) of PNOC-EDC, which included the proceeds of the sale of its stocks declared as dividend.

28. REVALUATION SURPLUS

This account refers to the appraisal of PDMC's real property with a land area of 588,967 sq.m. located in Rosario, Noveleta and Gen. Trias, Cavite evaluated by Valencia Appraisal Corp. in May 2005. It also includes PSTC's appraisal increase of ₱428,000 recognized on the two (2) vehicles donated by PNOC based on the appraisal reports of Royal Asia Appraisal Corporation.

29. FAIR VALUE AND OTHER RESERVES

This account consists of PNOC-EDC's gains on the realignment of investments in bonds and stocks classified as available-for-sale securities.

30. NET SALES

This account consists of the following:

	2006	2005
Electricity	15,727,908,745	16,455,494,955
Oil and gas production	4,885,901,280	5,071,495,030
Steam	5,019,529,299	4,967,362,240
Coal operations	1,216,459,848	1,535,582,338
Shipping	386,866,666	398,523,662
Drilling	261,449,987	149,524,840
Energy supply base	114,702,535	89,108,098
Socialized housing	35,746,375	68,289,464
Water	8,516,150	8,450,444
Thruput	9,023,109	7,493,838
Right of way	2,878,787	2,617,079
Others	45,950	3,000
	27,669,028,731	28,753,944,988

31. COST OF SALES

This account consists of the following:

	2006	2005
Purchased services and utilities	5,075,960,499	5,965,968,863
Depreciation and amortization charges	2,734,818,391	2,902,045,920
Employee costs	949,348,005	987,840,050
Coal purchases and landed costs	999,461,242	1,145,312,080
Royalty fee	470,394,682	528,839,664
Oil and gas production costs	489,971,141	483,287,464
Materials and supplies	369,822,500	338,410,639
Maintenance and repairs	347,438,318	279,216,716
Rental, insurance and taxes	325,223,409	218,848,336
Fuel, oil, and TBA	67,876,697	166,630,858
Shipping and delivery	82,996,031	80,222,831
Technical support charges	296,167,148	280,933,242
Business and other expenses	36,817,465	26,640,996
Coal marketing and selling	62,118,080	79,867,783
Miscellaneous expenses	893,666	1,210,460
	12,309,307,274	13,485,275,902

32. OPERATING EXPENSES

This account consists of the following:

	2006	2005
Administrative and allocated charges	662,147,642	775,205,084
Employee costs	547,797,681	686,908,133
Provision for doubtful accounts	314,512,641	271,318,082
Purchased services and utilities	275,171,628	250,761,978
Rental/insurance/taxes	266,457,372	208,410,039
Depreciation/amortization	109,652,464	114,783,922
Business expenses	74,003,493	67,902,361
Materials and supplies	61,396,957	54,680,715
Maintenance and repairs	21,518,421	18,819,703
Others	29,438,852	35,717,055
	2,362,097,151	2,484,507,072

33. OTHER INCOME (CHARGES)

This account consists of the following:

	2006	2005
Profit/Loss in subsidiaries – Gain from PNOC-EDC IPO	6,136,034,055	-
Foreign exchange gains (losses)	2,995,943,823	6,814,281,702
Interest income - net of final tax	1,031,652,128	1,086,442,730
Dividend income	376,734,178	376,681,200
Lease income	177,999,274	164,661,303
Inflation adjustment on prior year's electricity and steam sales	63,035,787	290,586,245
Interest expense	(2,765,228,436)	(2,803,964,964)
Impairment loss	(165,356,407)	(331,074,704)
Mineral Exploration	(18,998,648)	(12,088,516)
Other income (charges)	39,501,196	(164,250,912)
	7,871,316,950	5,421,274,084

Foreign exchange gains (losses) refer to foreign exchange differential on repayment and realignment of foreign loans, money market placements in dollar denomination and cash in banks in US dollar and Japanese yen currencies. The 2006 foreign exchange gain was attributed to the realignment of foreign loans because of the appreciation of peso and depreciation of yen against the US dollar currency (USD1=JPY118.934: USD1=PHP49.045 on December 31, 2006 and USD1=JPY 117.855: USD1=PHP53.062 on December 31, 2005).

34. INCOME TAX

Components of income tax expense are as follows:

	2006	2005
Current tax	2,577,405,930	2,027,231,277
Deferred tax	1,828,290,800	2,145,649,872
	4,405,696,730	4,172,881,149

This account comprises mainly of PNOC-EDC's current tax of ₱1.70 billion and deferred tax of ₱1.86 billion in 2006 and ₱1.60 billion and ₱2.17 billion, respectively in 2005.

35. DEFERRED INCOME TAX

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

	2006	2005
Deferred tax assets:		
Foreign exchange losses (gains) – BOT Power Plants	5,361,920,902	5,607,478,024
Unrealized foreign exchange losses (gains)	1,500,793,666	2,860,649,190
Allowance for doubtful accounts	1,215,065,416	1,363,043,562
Allowance for decline in value of investments	193,343,334	228,320,643
Carry forward of unused tax credits	229,282,874	204,201,380
Net operating loss carry over (NOLCO)	106,288,102	41,453,756
Minimum corporate income tax (MCIT)	28,155,243	15,948,721
Others	50,087,326	112,659,489
Total deferred tax assets	8,684,936,863	10,433,754,765
Deferred tax liability:		
Increase in fair value applied as deemed Cost	2,191,567,286	2,232,093,578
Deductible expenses per PD 1442	3,600,281,418	3,484,237,437
Unrealized foreign exchange gains losses	205,755	79,535
Total deferred tax liability	5,792,054,459	5,716,410,550
Net Deferred Tax Assets	2,892,882,404	4,717,344,215

36. RATIONALIZATION/MANPOWER REDUCTION PROGRAM (MRP)

PNOC

PNOC 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.

As part of the Rationalization Program, which aims to ensure that overlaps and duplications are eliminated, the PNOC sees itself offering separation programs for affected employees who may opt to be separated or retired from the Government Service. If implemented, this will affect about 50 plantilla positions bringing the total manpower of PNOC from 211 to 178.

PNOC continues to work forward to arrive at a rationalization program that would be suited to its mandate and operations. The rationalization program continues to undergo changes as Management revisits its relationships with other government agencies and its own subsidiaries. Efforts at arriving at a definite plan by the end of FY 2005 were not successful due to further refinement of corporate objectives.

A review of PNOC's plans, programs and projects is currently being undertaken to finally incorporate the needed change and is expected to be finished by mid-2007. Expected implementation of the plan will be in the last half of the year, subject to the approval of the PNOC Board and the DBM-CSC Rationalization Program Committee.

PDMC

PDMC implemented a Manpower Reduction Program (MRP) bringing down the number of regular employees from 52 to 19. The Board of Directors, in its Board Resolution No. 28, Series of 2005 dated August 1, 2005, has approved the new Table of Organization, while Board Resolution No. 31, Series of 2005 dated August 11, 2005, approved the MRP and its Implementing Guidelines. Separation pay was given in January 16, 2006. The total cost of the program was ₱10,400,206 .

37. SIGNIFICANT AGREEMENTS

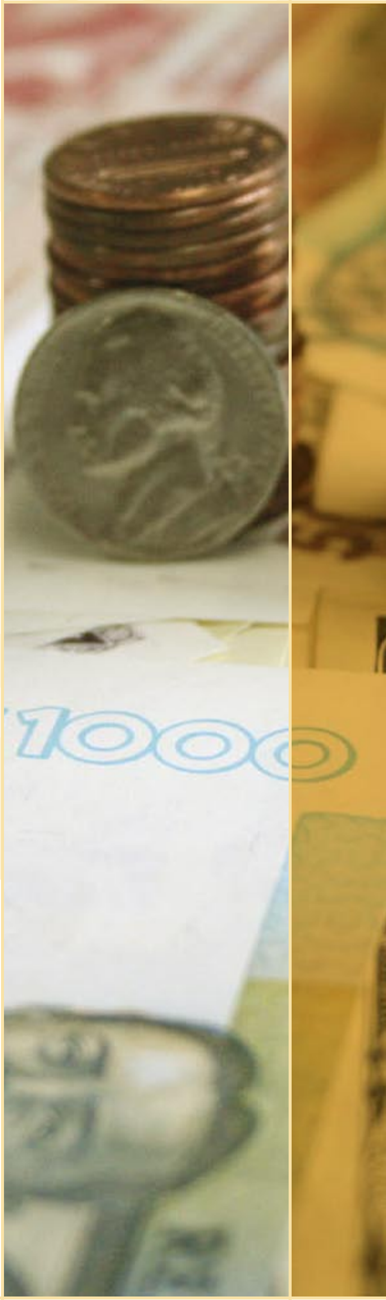
Service Contracts

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

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

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

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



Geothermal Steam Sales Contracts

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

Tongonan I

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

Palinpinon I

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

Palinpinon II

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

Bacon-Manito I

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

Bacon-Manito II

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

Build-Operate-Transfer (BOT) Contracts

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

Leyte

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

Except for the capital cost recovery portions, the fees are subject to inflation adjustments. The contracts are for a period of ten years commencing July 1996 for the Upper Mahiao Agreement, July 1997 for the Malitbog and Mahanagdong Agreements and September 1997 for the Optimization Agreement. The ownership of the Upper Mahiao Power Plant was transferred to PNOC-EDC on June 25, 2006.

Mindanao

Under the terms and conditions of the ECA with Oxbow Power Corporation and Marubeni Corporation, PNOC-EDC shall pay the BOT Contractor monthly energy efficiency fees and capacity fees, which include capital and fixed operating costs recovery fees and service fees, to be computed on a per kilowatt nominated capacity basis and excess energy fees which are payment for the share of BOT Contractor for the revenues from surplus energy generation on top of the nominated energy. Except for energy efficiency payments and capital cost recovery portion of capacity fees, the fees are subject to inflation adjustments. The contract is for a period of ten years commencing in March 1997 for Mindanao I (47 MW) and June 1999 for Mindanao II (48.25 MW). An amendment to the Mindanao I ECA was signed on November 17, 2006 extending the contract period to June 2009 with corresponding restructuring BOT fees.

Natural Gas Development and Production

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

PNOC Exploration Corporation entered into a Farm-in Agreement in December 1999 with Shell Philippines Exploration B.V. (SPEX) for the acquisition of 10% participating interest in Service Contract 38 (SC 38) for the exploration and development of the contract area in offshore Northwest Palawan, Philippines called the Malampaya Project. The SC 38 Consortium consists of partners Chevron Texaco, Shell Philippines LLC, SPEX (the operator of the project) and PNOC-EC, with participating interests at 45%, 25%, 20% and 10%, respectively. Commercial gas production commenced on January 1, 2002 that supply fuel to Ilijan, Sta. Rita and San Lorenzo power plants in Batangas. SC 38 Malampaya Project produced total gas of 2.98 million cubic meters (105.48 billion cubic feet) and 4.898 million barrels (0.78 million cubic meters) of condensate in 2006. The Malampaya production facilities were shut down from November 22 – December 16, 2006 for the conduct of regular maintenance.

San Antonio Gas Project (SAGP) (SC 37)

PNOC-EC owns and operates the San Antonio Gas Project (Gas Field and Power Plant). The San Antonio natural gas field was discovered and developed under Service Contract #37. Gas from Well SA-1 continues to fuel the power plant located in the project area which provides electricity to the Isabela Electric Cooperative I, Inc. (ISELCO-I). In 2006, the Gas Field generated electricity of 16.67 megawatt hours (MWhr), while the Gas Plant produced 327.69 million standard cubic feet (mmscf) for power generation and supply to compressed Natural Gas Station.

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.

Petroleum Exploration

Ragay Gulf (SC 43)

The members of the consortium are Premier Oil – the operator, PEARL Energy and PNOC-EC, holding 42.5%, 42.5% and 15% interest, respectively. A 133-km seismic survey was completed in August 2005, which is part of the work obligation entered into by the Consortium. The Consortium has decided to enter into the 2nd sub-phase of exploration and drill the Monte Cristo Prospect. Plans are underway for the drilling of the Monte Cristo-1 well, which is expected to start sometime in July 2007. It was also agreed upon that the well will be deviated so that the prospect can be acquired in 2007. In December 2006, Premier Oil notified PNOC-EC and Pearl Energy of its intent to reduce its interest to 21.5%.

Offshore Mindoro (SC47)

The DOE awarded Service Contract 47 on January 10, 2005 to PNOC-EC and Petronas Carigali, with participating interests of 20% and 80%, respectively. In the first quarter of 2006, the well was supposed to have been drilled to test the Kamia prospect but no rig was available. The drilling program has been moved to second quarter of 2007 and the necessary activities prior to drilling are being done. Consequently, a six-month extension was requested in order to fulfill this work commitment, which was granted by the DOE. Additional exploration work, a sea bed logging survey, was completed over the Kamia and Molave Prospects in June 2006.

Calamian (SC 57)

The DOE awarded Service Contract 57 on September 15, 2005 to PNOC-EC. China National Offshore Oil Corporation (CNOOC) and Mitra Energy have 51% and 21% participating interest in the project, respectively. The final terms of their respective offers were finally accepted and their farm-in approved. PNOC-EC will carry up the drilling of the first well. The operatorship of the block was transferred to CNOOC and awaiting DOE's approval. Around 2,000 kms of 2D seismic data were acquired between August and September 2006. The processing of this newly-acquired data and reprocessing of around 3,000 kms of old data have also been completed. The work obligation for the 1st sub-phase has been completed.

West Calamian (SC 58)

Service Contract 58 was awarded by the DOE to PNOC-EC on January 12, 2006. Nido Petroleum expressed interest in the area and farmed-in on July 17, 2006. It acquired 50% interest in exchange for carrying PNOC-EC up to drilling of the first well. The operatorship of the area was transferred to Nido and awaiting DOE's approval. Around 3,000 kms of 2D seismic were acquired between September and October 2006 and processing of these data is ongoing. This has fulfilled the work commitment entered into with the DOE for the 1st sub-phase of exploration.

West Balabac (SC 59)

Service Contract 59 was awarded by the DOE to PNOC-EC on January 13, 2006. A 200-km seismic program was designed, which was completed in November 2006. With the completion of the seismic program, the 1st sub-phase of exploration has been fulfilled. PNOC-EC is farming out the area to interested parties.

East Sabina (SC 63)

Service Contract 63 was awarded to PNOC-EC and Nido Petroleum on November 24, 2006, each having a 50% participating interest. It was a successful joint application by PNOC-EC and Nido for the Area 1 located in offshore SW Palawan offered under the Philippine Energy Contracting Round (PECR) 2005 of the Department of Energy. PNOC-EC is the operator of the block.

Joint Marine Seismic Undertaking (JMSU)

The Joint Marine Seismic Undertaking was signed by CNOOC (China), Petro-Vietnam Investment and Development Corporation (PIDC) and PNOC-EC (Philippines) on March 14, 2005. These National Oil Companies have agreed to jointly evaluate the petroleum potential of certain areas of the South China Sea. The expenses will be equally shared by these companies. Processing of the 11,000 kms 2D seismic data acquired in 2005 and reprocessing of 3,000 kms of old data have been completed in November 2006. The proposed Phase 2 of the JMSU work program and budget involving the acquisition of 10,000 kms 2D seismic data was finalized. This will be presented to the joint Operating Committee for approval.

Coal Operating Contracts (COC)

Surigao Coal Exploration – COC No. 140

The DOE granted PNOC-EC the Coal Operating Contract (COC) No. 140 on July 5, 2005 for the two (2)-year exploration of Coal Blocks CBS 38 38-L-126, 127 and 167, covering an area of approximately 3,000 hectares within the Barangays of Layog and Carra-an, both located in the Municipality of Tago, within the province of Surigao Del Sur, in Eastern Mindanao. Due to deteriorating peace and order conditions, PNOC-EC requested for a moratorium from the DOE. A one (1)-year moratorium on the implementation of project activities would thus remain in effect until July 2007.

Isabela Coal Exploration – COC No. 141

The DOE granted PNOC-EC the Coal Operating Contract (COC) No. 141 on July 5, 2005 for the exploration of Coal Blocks CBS 14-G-77, 78 and 79, covering an area of approximately 3,000 hectares in the Municipalities of Naguilian and Benito Soliven, all within the province of Isabela, in the Cagayan Valley of Northern Luzon. The three (3) coal blocks under COC 141 are located North and adjacent to the coal blocks of PNOC's COC 122. Due to the mounting opposition to the project, PNOC-EC's management temporarily suspended the project. In this regard, all activities in COC 141 have been deferred.

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

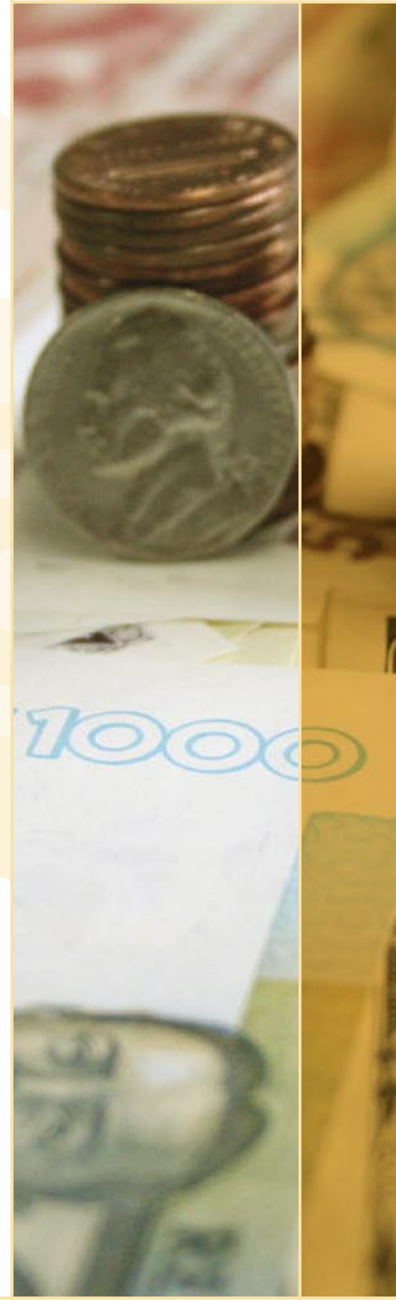
PNOC-EC continued to implement its extensive Information Education and Communication (IEC) campaigns at the affected cities/municipalities in Isabela, namely, the Municipalities of Benito Soliven and Naguilian and the City of Cauayan.

A Certificate of Precondition was acquired from the National Commission on Indigenous Peoples (NCIP) in August 2006 following the completion of a Field Based Investigation (FBI) in March 2006, consistent with the NCIP process. A topographic survey was partially completed on the proposed open pit mines due to opposition. The organized opposition to the project escalated leading to the decision to suspend the project in July 2006.

Indonesian Coal Projects

PNOC-EC started looking for possible coal suppliers in Indonesia in 2003 but decided to look instead for joint venture partners in coal mining. Bunyu coal mine was one of the shortlisted areas considered because of its abundant coal resource and proximity to the Philippines. However, due to very high moisture content, PNOC-EC did not pursue the marketing of Bunyu coal.

In 2006, a reconnaissance survey and geologic mapping was conducted by PNOC-EC on the 300 hectares of Ampah offered by PT Putra Asyano Mutiara Timur (PAMT). Logistics validations such as hauling from proposed mine to the jetty, barge capacity, possible location of screening plants and other options were also evaluated. The preliminary evaluation was encouraging leading to a recommendation for drilling, topographic survey and preparation of feasibility study. However, the execution of these activities was temporarily suspended because of the issuance of E.O. 556.



Malangas Coal Project – COC No. 41

PNOC-EC continues to explore and develop the six (6) coal projects under COC 41 located within the Malangas Coal Reservation. The project area of approximately 6,000 hectares straddles in the Municipalities of Imelda, Diplahan and Malangas, all in the Province of Zamboanga Sibugay. PNOC-EC currently has existing Joint Venture Agreements with Taiwan Overseas Mining Co., Phils., Inc. (TOMC) and Filipinas Systems Inc. (Filsystems) and several Small Scale Coal Mining Permittees. On April 27, 2006, PNOC-EC engaged SK PHILKOR Corporation under a Joint Coal Development and Production Agreement (JCPDA) for Lumbong and Shaft 3 Coal Projects. Total coal production for COC 41 as of December 31, 2006 is 108,356 MT.

In February 2006, PNOC-EC commenced the processing of the Environmental Impact Assessment (EIA) covering the entire COC 41 excluding those who have an existing ECC. GEOSHPERE Technologies Inc. (GTI) was engaged to conduct an intensive study of the area as prescribed under DAO 2003-30 of the DENR-EMB.

Malangas Coal Project (COC 41) was granted renewal for another term of three (3) years starting August 15, 2006. An extensive exploration program is underway to develop and produce the coal resources. PNOC-EC also started conducting exploration and drilling activities in the Alegria and Malongon areas by the last quarter of 2006.

Energy Supply Base (ESB)

PNOC-EC continues to serve the docking, storage and warehousing needs of various oil and energy-related companies in Batangas. Although initially set up to cater to logistic support needs of the energy industry, ESB's services now extend to other commercial clients with the granting by the Philippine Ports Authority of a permit to operate as a private commercial port under Certificate of Registration No. 291 on October 8, 1996. The permit is co-terminus with the 25-year foreshore lease agreement of ESB with the Department of Environment and Natural Resources (DENR) effective May 3, 1996, which will expire on May 3, 2021.

PNOC-EC has negotiated with Petron Corporation for the shared use of the ESB land and facilities covered by the long-term lease contracts between Petron Corporation and Philippine National Oil Company (PNOC). In relation to this, PNOC-EC negotiated with PNOC for direct long-term lease for ESB land. The lease agreement started on January 1, 2005 and will end on December 31, 2029.

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

PNOC Solar Home Systems (SHS) Distribution Project

The PNOC 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 PNOC and later passed on to the beneficiaries through affordable and manageable payment schemes. The project is implemented by PNOC in cooperation with the Department of Energy 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.

38. POWER PURCHASE AGREEMENTS

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

Leyte-Cebu, Leyte-Luzon

The PPA provides, among others, that NPC shall pay PNOC-EDC a base price per kilowatt-hour of electricity delivered subject to inflation adjustments. The PPA stipulates a contracted annual energy of 1,370 GWH for Leyte-Cebu and 3,000 GWH for Leyte-Luzon throughout the cooperation period. It also stipulates a nominated energy of not lower than 90% of the contracted annual energy. On November 12, 1999, NPC agreed to accept from PNOC-EDC a combined average annual nominated energy of 4,455 GWH for the period July 25, 1999 to July 25, 2000 for both Leyte-Cebu and Leyte-Luzon PPA. The combined annual nominated energy starting July 25, 2000 is currently under negotiation with NPC. The contracts are for a period of twenty-five years commencing in July 1996 for Leyte-Cebu and July 1997 for Leyte-Luzon.

47 MW Mindanao I

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

48.25 MW Mindanao II

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

39. COMMITMENTS

Prior to Petron's privatization in 1994, majority of its landholdings amounting to ₱153 million, was transferred to PNOC as property dividend in 1993. Portion of these properties, specifically bulk plants and service stations, were leased back to Petron and a leasehold agreement between Petron and PNOC was executed for a period of 25 years from September 1, 1993 to August 31, 2018 subject to renewal. Annual leasehold rental has reached ₱136 million in 2006 and ₱134.6 million in 2005.

40. PRIVATIZATION

PNOC Energy Development Corporation

In April 1997, the Committee on Privatization (COP) approved the proposed privatization plan recommending for the sale of approximately 30% to 40% of PNOC-EDC's shares through an initial public offering (IPO) and the remaining 20% to 30% of shareholdings to strategic investor through an auction process. The plan was approved by then President Fidel V. Ramos in July 1997. On November 5, 1997, the PNOC Board, upon recommendation of the privatization advisors, decided to postpone the privatization of PNOC-EDC, in view of the unfavorable equity markets conditions.

On November 23, 2004 and December 10, 2004, the Board of Directors of PNOC-EDC and PNOC (mother), respectively, approved the re-activation of plans to privatize PNOC-EDC. In February 2005, PNOC-EDC awarded the mandate for financial advisory/underwriting/global coordinating services to CLSA Exchange Capital Inc. The privatization plan of PNOC-EDC shall involve the (a) issuance and sale of 5 billion new PNOC-EDC's shares and (b) sale of 4 billion existing shares of PNOC in PNOC-EDC.

PNOC-EDC's approach to privatization involves the sale through public bidding of PNOC-EDC shares of stock after a pre-negotiated Steam Sales Agreement (SSA) between the Power Sector Assets and Liabilities Management Corporation (PSALM) and PNOC-EDC would be finalized. This was presented to and approved by the PNOC-EDC and PNOC Boards in October and November 2005, respectively.

In May 2006, a resolution was passed by the Joint Congressional Power Commission (JCPC) endorsing the proposed plan to sell as a package each geothermal plant combined with a specific long-term SSA between PNOC-EDC and Power Sector Assets and Liability Management (PSALM).

In June 2006, the Privatization Council (PrC) approved PNOC-EDC's privatization plan involving the following:

a. The sale through an Initial Public Offering (IPO) of approximately 30% to 40% of PNOC-EDC's outstanding capital stock (after subscribing to 1.76 to 2.5 billion shares of newly created 5.0 billion shares);

b. The break-up of IPO into approximately equal number of primary and secondary shares.

PNOC-EDC successfully completed its IPO of 5.22 billion shares last December 13, 2006 at ₱3.20 per share. These shares represent 35.73% of the PNOC-EDC's outstanding capital. Another 0.78 billion shares, representing the over-allotment option, were listed last December 18, 2006 when CLSA exercised its "greenshoe option". This brings to 6.0 billion the number of PNOC-EDC shares already sold to the public as of December 31, 2006, i.e., representing 40% of PNOC-EDC's outstanding capital.

From the IPO, PNOC and PNOC-EDC's gross proceeds reached P9.6 billion each from the sale of secondary and primary shares.

41. CONTINGENCIES

PNOC

a. Compromise Agreement: Paul Mata vs. Petron and PNOC

In 1983, Petron engaged the services of Mr. Paul Mata for collection of monies owed to Petron and Filoil by the Manila Yellow Taxicab Co. and the Monserrats: Felipe, Enrique Jr. and Rosario vda. de Monserrat. It was a "no collection, no fee" contract, with expenses to be shouldered by Mr. Mata, who would get 40% of whatever amount was collected. Mr. Mata was able to identify leviable properties of the Monserrats consisting of several parcels of land in V. Mapa St. in Sta. Mesa, Manila. However, these properties were heavily encumbered.

Mr. Mata then moved to have the various encumbrances cancelled. He continued the civil suit (#89462) initiated by Filoil Marketing (Petron's predecessor in interest) against Felipe Monserrat and filed a civil case against Enrique Monserrat (#7285). He obtained favorable decisions on these cases, and so proceeded to have the properties sold in execution of the decision. A public auction was held at which Petron emerged as the highest bidder at ₱4M. Through Mr. Mata's efforts, the properties were eventually registered in Petron's name.

For all his efforts, Mata was paid the sum of ₱200,000 or 5% of P4M. Efren Dimalanta, Petron's collection manager, wrote Mr. Mata, offering to pay the balance by way of a proportionate share in the V. Mapa properties. When Mata sought registration of his (35%) rights, Petron reneged, saying, among others, that Dimalanta was not authorized to assign any part of the property. A series of negotiations failed to resolve the issue, and so in 1993 Mata brought suit against Petron for enforcement of the collection services contract. In the same year, Petron transferred the properties to PNOC as property dividends prior to its privatization.

The properties involved are 7 parcels of land having a total area of 7,296 square meters. While the certificates of title are in the name of Petron, possession of said certificates as well as other pertinent documents, are with Mr. Mata and/or his attorney-in-fact, Mr. Peter Kairuz.

Following Board approval on September 05, 2001 of the proposal for PNOC to enter into a compromise settlement with Mr. Mata and Petron, the Compromise Agreement was signed on December 14, 2001. Parties subsequently moved for court approval of the compromise agreement.

On March 13, 2002, PNOC received notice from the Court of Appeals that the Compromise Agreement was approved and that the case was therefore DISMISSED.

Before the Compromise Agreement could be implemented, however, PNOC received notice of the decision of the Court of Appeals in CAGR 53466 affirming the decision of the Manila Regional Trial Court (RTC) declaring National College of Business Administration (NCBA) as the rightful owner of the properties and nullifying Petron's titles thereto. With this development, PNOC, Mr. Mata and Petron decided to defer implementation pending a Supreme Court ruling on the matter.

The Office of the Solicitor General (OSG) elevated the CA decision to the Supreme Court in behalf of PNOC. Sometime in April 2006, PNOC was notified that the Supreme Court had handed down a decision dated January 31, 2006 reversing the earlier CA decision. The Supreme Court declared Petron as the owner of the parcels of land. On December 04, 2006 the Supreme Court denied with finality NCBA's Motion for Reconsideration.

With this development, parties to the compromise agreement moved for implementation. The property was reappraised in February 2007, resulting in a Fair Market Value (FMV) of ₱178,767,000. Real estate taxes paid on the property as well as expenses to secure it since 1994, when PNOC gained possession of the same, were computed. A Deed of Assignment of 35% interest in the property in favor of Mr. Paul Mata is being prepared pursuant to the 2001 Compromise Agreement.

b. Contingent Liabilities

PNOC

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

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

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

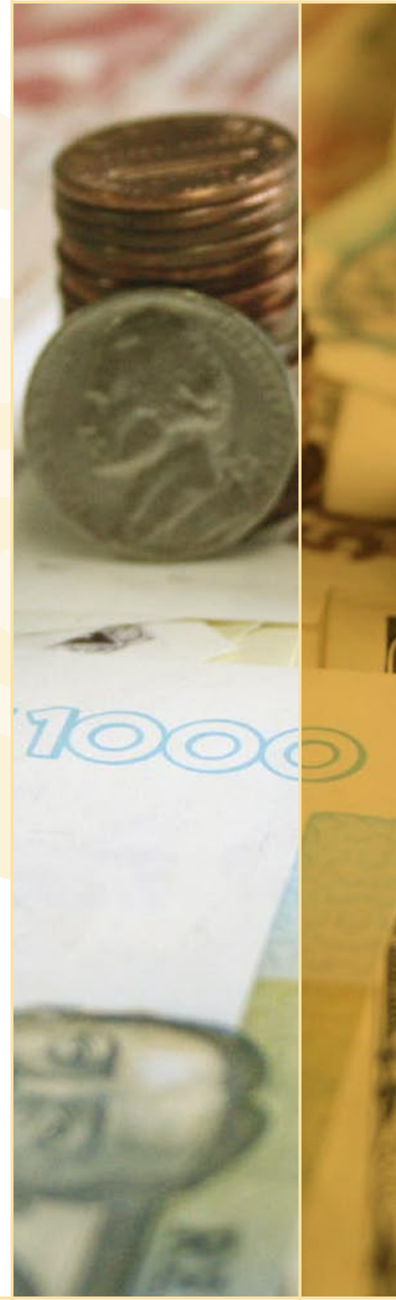
For: Specific Performance and Damages

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

For: Claim for Damages

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

For: Specific Performance



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

For: Expropriation

6. PNOC vs Petron, Opimio Abrahano, Jr. and Maria Soliven
Civil Case No. 04-0009-D
Remanded to MTC, Sta. Barbara, Pangasinan for Execution

For: Unlawful Detainer

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

For: Ejectment

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

For: Accion Publiciana

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

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

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

For: Petition for Issuance of New Owner's Copy of the TCT No. T-147729

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

For: Expropriation

12. In Re: Apprehension Case of ENVIRO 2000
Case No. 005-03-070
Office of the Secretary, Land Transportation Office (LTO)

For: Violation of R.A. 8506 (Banning the use of Right Hand Drive Vehicle)

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

For: Petition for Review on Certiorari

14. PNOC vs Sps Permejo et.al
Civil Case No. 2006-64
RTC Branch 55, Lucena City

For: Accion Publiciana

15. 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)

16. John Mark Conti vs. TIS Solutions, Inc. /Exceed Solutions, Inc./PNOC
NLRC Case No. 00-01-000151-2003
NLRC

For: Labor Case – Non-payment of wages and benefits

17. Mirant (Philippines) Energy, Inc. vs PNOC
Civil Case No. 06-998
MTC, Mariveles, Bataan

For: Forcible Entry

PNOC-EDC

As Petitioner

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

For: Breach of Contract and Damages Claim Against PNG

As Defendant

2. Frederick Ubag, et.al. vs. PNOC-EDC, et. al.
CA GR Sp. No. 81231
Court of Appeals, Cebu City

For: Illegal Dismissal

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

For: Injunction and Damages Claims Against PNOC-EDC

4. PNOC EDC vs. Province of Leyte and Loreto B. Ballais et. al
CC 2006-07-77 / CC 2006-05-49 / CC 2006-05-48
Eight Judicial Region, RTC Br. 8 and Br. 6, Tacloban City

For: Appeal on Denial of Franchise Tax Protest

5. PNOC-EDC vs Province of Leyte and Loreto B. Ballais and Atty. Rafael M. Iriarte
Local Board of Assessment Appeals, Province of Leyte

For: Petition on Cancellation of the assessment Notice entitled Real PropertyTax Order of Payment (RPTOP)

6. A. A. Buenviaje vs PNOC-EDC, et. al.
CA G.R. Sp. No. 94359
Court of Appeals, Manila

For: Illegal Dismissal

7. J. L. Estrella vs. PNOC-EDC, et. al.
NLRC CA No. 048768-06
NLRC, Quezon City

For: Illegal Dismissal

8. J. Fabico vs. PNOC-EDC, et. al.
NLRC CA No. 048840-06
NLRC, Quezon City

For: Illegal Dismissal

PDMC

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

For: Ejectment and Damages

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

For: Ejectment

4. In re: Application for Exemption Clearance Involving Parcels of Land with Total Area of 46.8953 hectares, more or less, located at Brgy. Ligtong, Rosario, Cavite
Dept. Of Agrarian Reform, Elliptical Road, Quezon City
Administrative Case No. A-999-131-00 dated 18 October 2002

For: Exemption from Coverage of CARP

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

For: Illegal Dismissal and non-payment of Benefits

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

For: Specific Performance

7. Marina A. Enage vs. PDMC, Wilfredo R. Bacareza, Jr.
National Labor Relations Commission – National Capital Region (NLRC-NCR)
NLRC-NCR Case No. 00-03-02106-06

For: Money Claim/Benefits

PNOC-EC

As Petitioner

1. PNOC-EC vs. Rafael G. Mangubat
02-47516
Quezon City Regional Trial Court, Branch 218

For: Collection of sum of money (₱665,294.70) plus interest

2. PNOC-EC vs. Jose M. Asistio
69263
Pasig City Regional Trial Court, Branch 67

For: Collection of sum of money (₱719,333.30) plus interest

3. PNOC-EC vs. Bernardo F. Ople
02-48508
Quezon City Regional Trial Court, Branch 98

For: Collection of sum of money (₱805,555.54) plus interest

4. PNOC-EC vs. Pedro T. Santos
69262
Pasig City Regional Trial Court, Branch 67

For: Collection of sum of money (₱697,666.60) plus interest

5. PNOC-EC vs. Aaltafil Corp.
CCN 124
1st Municipal Circuit Trial Court of Mabini & Tingloy, Batangas

For: Unlawful detainer plus back rentals

6. PNOC-EC vs. Felimon Joson
1901-1907

1st Municipal Circuit Trial Court of Mabini & Tingloy, Batangas

For: Criminal cases for bouncing checks in the total amount of ₱1.52 million

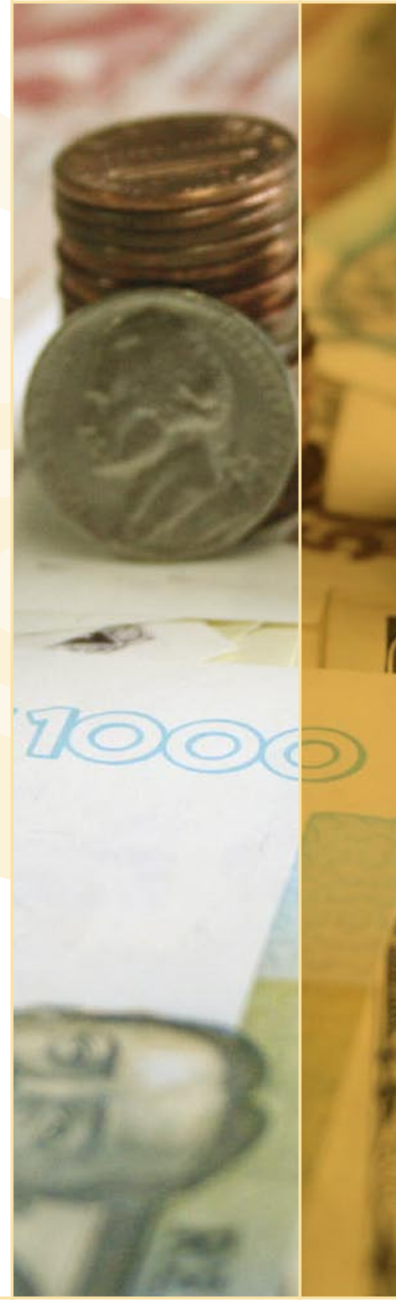
As Defendant

7. Province of Palawan vs. SC 38 Joint Venture Partners
CCN 4108
Palawan Regional Trial Court

For: Collection of real estate taxes for the years 2002 to 2005 against the SC 38 consortium totaling ₱265,259,194.28, 10% of which will be paid by PNOC-EC if the consortium will lose the case

8. Burgundy Global Exploration Corp. vs. PNOC-EC and Mitra Energy Ltd.
06-450
Makati City Regional Trial Court, Branch 59

For: Prohibition and mandamus



PAFC

1. Jaime Aripaza et al vs. Action Force Security & Allied Services, Inc.(AFSASI) and/or PPDC
   NLRC Case No. 01-3737
   National Labor Arbitration Commission
   Regional Arbitration Branch No. III, San Fernando, Pampanga

   For: Illegal Dismissal with Money Claims, Damages and Attorneys Fees

2. CLAIM OF ASIAKONSTRUCKT (Asia Construction and Development Corporation)

42. LEGAL PROCEEDINGS

As a member of the SC 38 Consortium, PNOC-EC is involved as a party defendant in a case filed by the Province of Palawan in a Regional Trial Court in Puerto Princessa City against the SC 38 Consortium for the collection of alleged delinquent real property taxes for the years 2002 – 2005 totaling ₱265,259,194.28, 10% of which shall be paid by PNOC-EC if the Consortium will lose the case. For its defense, the Consortium relies mainly on the provision of SC 38 granting exemption to the SC 38 Consortium from local and national taxes, except income tax. The pre-trial of the case was recently finished, except that the court has not yet issued a pre-trial order.

Other than the above case, PNOC-EC is not a party to, and its properties are not subject of, any material pending legal proceedings that could be expected to have a material adverse effect on the PNOC's financial position or results of operations.

43. EVENTS AFTER BALANCE SHEET DATE

PNOC

a. Subsidiary Loan Agreement

   On May 31, 2007, a subsidiary loan agreement was entered into by and between PNOC and PSTC, whereby PNOC shall make available to PSTC, a credit accommodation/facility in the amount not to exceed ₱900 million, exclusively for the purpose of financing its acquisition of two (2) petroleum tankers. The term of the loan will be for a period of nine (9) years including one (1) year grace period from the date of the first actual availment, payable in 32 equal quarterly amortization based on actual drawdown amount spread over a period of eight (8) years with quarterly interest on the outstanding loan balance at rates based on Philippine Dealing System Treasury Fixing (PDST-F) for nine (9)-year loans plus 1.50% margin to be fixed on the date of the first drawdown. The Subsidiary Loan Agreement was approved by the PNOC Board during its meeting on April 25, 2007, under PNOC Board Resolution NO.1677, series of 2007.

b. PNOC-EDC's secondary sale of 20% common stock

   Following the Initial Public Offering (IPO) of PNOC-EDC's 40% capital stock in December 2006, the National Government's (NG) objectives with respect to PNOC-EDC are: (1) to sell an additional 20% of PNOC-EDC common shares through a secondary sale, and (2) to have PNOC-EDC as majority private-owned following the secondary sale.

   Consistent with the NG's objective, the PNOC-EDC PrivaCom and the PNOC Board approved in April 2007 (a) the sale of 20% of PNOC-EDC common shares owned by PNOC through a secondary offering and (b) the issuance of new voting preferred shares.

   Immediately after its approval by the stockholders of PNOC-EDC in the June 14, 2007 annual stockholders meeting, PNOC-EDC filed with the Securities and Exchange Commission (SEC) on June 15, 2007, the increase in the authorized capital stock by way of 7.5 billion preferred shares. Both the Board of Directors of PNOC-EDC and PNOC, in their meetings in June 7 and 8, 2007, respectively, approved that the 60% of the preferred shares or 4.5 billion shares will be subscribed to by PNOC while the balance will be subscribed to by the PNOC-EDC Retirement Fund at a par value of ₱0.01 per share. The total consideration for PNOC's 60% preferred shares amounted to ₱45.0 million.

44. RESTATEMENT

Certain accounts in the 2005 financial statements were restated to conform with the 2006 financial statements presentation.

In 2006, PNOC-EC adjusted the prior year's capitalized exploration and development costs and the cost of wells, platforms and other facilities and its related accumulated depreciation as a result of change in policy from full-cost method to successful efforts method of accounting for its oil and gas operations. See Note 13.

In addition, the provision for income tax of PNOC-EC was restated due to recognition of deferred tax asset amounting to ₱77,140,867.

45. AUTHORIZATION FOR ISSUE

The management approved and authorized for issue the consolidated financial statements of PNOC and Subsidiaries as of December 31, 2006 on August 24, 2007.

Comments and **Observations**

1. Capitalization of allocated non-operating cost - ₱1.603 billion

It is PNOC Energy Development Corporation's (PNOC-EDC) policy to accumulate and defer costs associated with drilled wells that have commercial steam quantity and good steam quality to the account Exploration and Development cost. These costs include the following:

1) costs of drilling exploratory and exploratory-type stratigraphic test wells, pending determination of whether the well can produce proved reserves and those wells which do not produce proved reserves but will be utilized as re-injection wells or waste disposal wells;

2) allocated costs from Management Service Groups and Geothermal Division during the project development state;

3) costs of local administration, finance, general and security services, surface facilities and other local costs in preparing for and supporting the drilling activities, etc. incurred during the development drilling activities of production, re-injection or waste disposal wells;

4) cost incurred in the construction and commissioning of the Fluid Collection and Re-injection System (FCRS); and

5) borrowing costs on loans utilized for the project.

Upon commercial operation of a plant, all costs of wells hooked to the FCRS and of those wells that are to be utilized for waste recyling are capitalized and presented as part of asset account Production Wells and depreciated over the estimated useful life of the property.

Under paragraph 19 of International Accounting Standards/Philippine Accounting Standards (IAS/PAS) 16, Property, Plant and Equipment, the following are examples of costs that are not costs of an item of property, plant and equipment:

1) costs of opening a new facility;

2) costs of introducing a new product or service (including costs of advertising and promotional activities);

3) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

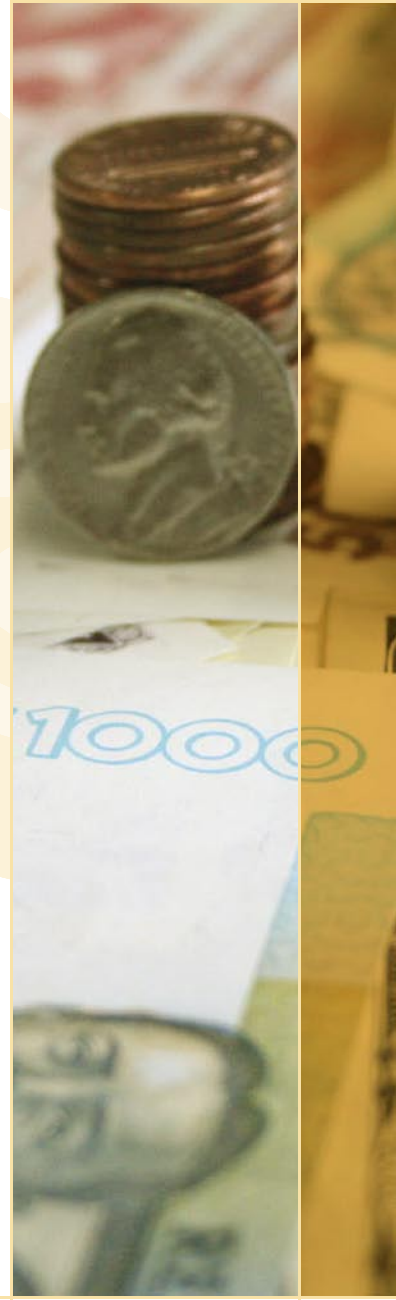
4) administration and other general overhead costs. (emphasis ours)

Our review of Account 330 or Exploration and Development Cost disclosed that of the total accumulated cost of ₱5.524 billion as of December 31, 2006, ₱1.603 billion or 29% pertained to the allocated costs of head office divisions such as General Management Services, Finance Division, Geothermal Division, Environmental Management Division and Geosciences/Reservoir. Table 1.0 shows the detail of the transferred costs from head office covering the period 1997 to 2006.

Table 1.0
Capitalized non-operating costs from head office

Year	Location	Amount
1997	30	19,521,952.42
	60	5,412,952.14
		24,934,904.56
2000	60	524,201.40
2002	31	40,644,211.51
2003	50	9,464,875.73
2004	41	22,311,293.34
	42	33,128,952.40
	43	99,398,897.44
	44	16,772,595.03
	55	78,601.96
	60	83,064,296.83
		254,754,637.00
2005	31	2,451,725.38
	42	79,146,517.31
	43	24,863,463.94
	44	20,304,485.69
	50	23,138,778.07
	60	958,138,463.96
	82	16,079,363.59
	95	3,131,634.06
		1,127,254,432.00
2006	31	106,944.13
	60	144,540,945.73
	95	482,825.43
		145,130,715.29
TOTAL		1,602,707,977.49

The capitalization of allocated head office cost is not in conformity with the provisions of paragraph 19 of PAS 16 and overstates the Exploration and Development Costs account and eventually the Property, Plant and Equipment account. It also understates the expenses and overstates the income and retained earnings account by ₱1.603 billion.



We recommended that PNOC-EDC Management review and revise the company policy capitalizing the costs associated with well drilling and development and consider the provisions of paragraph 19 of PAS 16. Also, the necessary adjusting entries should be made to record these allocated costs as expense of the period.

PNOC-EDC Management welcomed the audit recommendation to review their existing policy. Nonetheless, it is their position that the present policy of capitalizing overhead cost does not understate expenses nor overstate the Company's retained earnings. Their basis is the second item of Paragraph 3 of IAS/PAS 16 which states that the standard does not apply to **"mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources."**

In general, the geothermal industry is classified under the extractive industries which include the oil and gas industries as well as the coal mining industry, among others. However, due to the sustainable character of the geothermal resource, the geothermal industry cannot be totally classified under the extractive industries, which are depletable or non-regenerative in nature and are subject of the Philippine Financial Reporting Standards (PFRS) 6, Exploration for and Evaluation of Mineral Resources.

We maintain our position that the allocated costs from head office should not be capitalized as part of the cost of drilled wells. For purposes of clarification as to whether or not PAS 16 is applicable to well development cost, we quote hereunder the complete provisions of paragraph 3 of PAS 16, to wit:

"This standard does not apply to:

(a) property, plant and equipment classified as held for sale in accordance with IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations;

(b) biological assets related to agricultural activity (see IAS 41 Agriculture); or

(c) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b) and (c)." (emphasis supplied)

Hence, what is scoped out of PAS 16 is the mineral rights and mineral resources but not the items of property, plant and equipment used to develop or maintain the mineral resources. As earlier discussed, the allocated costs deferred and capitalized will be reclassified and presented as part of the cost of the production wells that is to be depreciated over the estimated useful life of the property. Hence, we maintain that the provisions of paragraph 19 of IAS/PAS 16 applies.

2. **Uncollected redemption price of NDC's 7% cumulative and redeemable preferred shares which expired in 2005 - ₱369.151 million**

The Philippine National Oil Company (PNOC) owns 369,151 preferred shares of the National Development Corporation (NDC) with a par value of ₱1,000 and recorded in the books as investment in the amount of ₱369,151,000. These shares were issued by NDC in payment of the outstanding obligation of the Philippine National Construction Corporation (PNCC), formerly Construction and Development Corporation of the Philippines, to PNOC when PNCC acquired from PNOC all its shares of stocks in Luzon Stevedoring Corporation (Lusteveco) [Executive Order No.671 dated March 19, 1981 required NDC to acquire Lusteveco]. The following are the features of the NDC preferred shares:

a. entitled to an annual preferential dividend equivalent to 7% per annum, payable annually and dividends shall be cumulative;

b. redeemable every first day of the year for a period of five years in five (5) equal annual installments in the amount of ₱73.83 million commencing on January 1, 2001.

These preferred shares of stocks were issued in payment of the obligation of NDC to PNOC with the intent of redeeming them in accordance with the agreed redemption schedule which commenced on January 1, 2001 with the last redemption date on January 1, 2005. The preferred shares provided for a mandatory redemption at a specified date and price. Hence, NDC should have redeemed all the shares at the specified date and price.

Records, however, showed that no redemption has been made from 2001 to date. Neither did the PNOC receive any dividend from the date of the acquisition of the preferred shares. Hence, PNOC has receivables from NDC in the aggregate amount of ₱911.80 million consisting of:

Dividends in arrears (1984-2005)	₱ 542,651,970
Redemption Price of Preferred Shares	369,151,000
Total Receivable from NDC	₱ 911,802,970

As early as 2002, PNOC Management, formalized its willingness to accept real properties situated in Manila as payment for the redemption price considering that circumstances indicated that NDC is not financially capable to pay in cash. Management averred that the real estate property of NDC situated at the Pandacan Oil Depot and leased out to Caltex Philippines has been identified as a suitable payment since it is contiguous to the real estate property of PNOC located in the same area and leased out to Petron.

It is recommended and PNOC Management committed to pursue the negotiation for the immediate settlement of the redemption price through dacion en pago. In case the proposed land swap is not feasible, Management should immediately identify other possible options that would facilitate settlement.

3. **Revenue recognized from a non-operating plant - ₱239.5 million**

Review of PNOC-EDC's receivable account disclosed that receivables totaling ₱239.5 million representing billings to the National Power Corporation (NPC) for the period August 26, 2005 to December 31, 2006 for the Bacman II – Cawayan Plant remain outstanding as of audit date as shown in Table 3.0.

Table 3.0
Outstanding Account of NPC for Bacman II – Cawayan Plant

Billing Period	Invoice No.	Actual Generation	Amount Billed	Amount Paid
2006				
Dec- Jan	BV0002	-	16,290,564.48	-
Jan- Feb	BV0010	-	16,024,599.36	-
Feb- Mar	BV0031	-	14,341,743.36	-
Mar- Apr	BV0040	-	16,049,508.48	-
Apr- May	BV0044	-	15,859,929.60	-
May- June	BV0048	-	16,499,479.68	-
June- July	BV0052	-	15,731,625.60	-
July- Aug	BV0056	-	16,124,235.84	-
Aug- Sept	BV0070	-	15,782,739.84	-
Sept- Oct	BV0073	-	15,244,070.40	-
Oct- Nov	BV0085	-	15,639,713.28	-
			173,588,209.92	
2005				
Aug-Sept	B00225	612,675.00	17,103,726.72	-
Sept - Oct	B00226		16,344,374.40	-
Oct – Nov	B00327		16,602,330.24	-
Nov - Dec	B00347		15,906,585.60	-
			65,957,016.96	
			239,545,226.88	

Plant visit conducted on January 29, 2007 disclosed that Bacman II-Cawayan Modular Plant had ceased operation since August 26, 2005 due to a lightning that hit the Tiwi-Daraga 230 KV line resulting to a line fault that caused extensive damage to the NPC's Bacman II – Cawayan Modular Plant.

Records showed that NPC refused to pay the billed amounts. Interview with PNOC-EDC Management, however, disclosed that receivables from NPC and income were recognized from the Bacman II – Cawayan Plant during the period that the plant is not operational because of the Addendum Agreement executed by the parties in February 5, 2007 pertaining to the Geothermal Resources Sales Contract (Bacon-Manito Geothermal Power Plant II) which states, inter alia, that:

Par 1. NPC shall pay the Guaranteed Monthly Remuneration (GMR) at 75% Plant Factor for the Billing Period starting August 25, 2005 until December 31, 2007 or until the Rehabilitation Completion Date (When Cawayan unit achieves its rated Capacity)

xxx

Par 3. The GMR paid by NPC starting August 25, 2005 until December 31, 2007 or until the Rehabilitation Completion Date, shall be treated as stored energy already paid for by NPC and shall be lifted starting December 25, 2007 or until the Rehabilitation Completion from the annual (Bacman 1) and semi-annual (Bacman II) Surplus Generation Billings under the total GMR has been completely recovered by NPC.

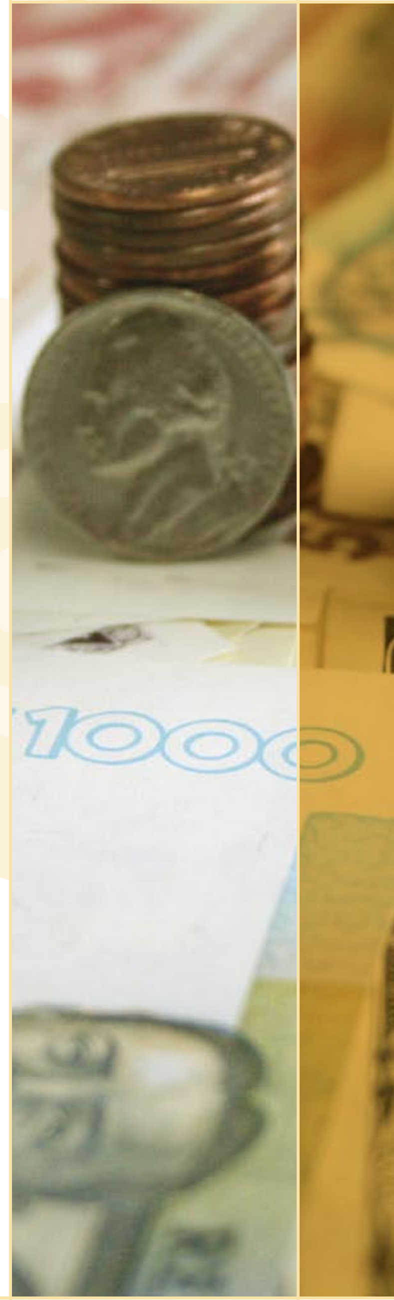
In the Addendum Agreement, NPC bound itself to pay GMR at 75% Plant Factor for the period starting August 25, 2005 until December 31, 2007 or until the Rehabilitation Completion Date. However, the payment pertaining thereto is to be treated as stored energy to be lifted when the plant is operational. Thus, payments received from NPC covering the period August 25, 2005 to December 31, 2006 or until the Rehabilitation Completion date are considered as advance payments. Therefore, there is no inflow of economic benefits that would warrant the recognition of income in the amounts of ₱173,588,209.92 in 2006 and ₱65,957,016.96 in 2005.

We recommended that adjusting journal entries be prepared to reverse the entries made recognizing sales revenue from August 26, 2005 to December 31 2006 and the corresponding receivable accounts from NPC and to record as deferred credits the payment to be received from NPC for the computed stored energy based on the 75% Plant Factor during the period that the plant is non-operational. This account should be reduced periodically by the amount of generated surplus recognized for the period.

PNOC-EDC Management explained that the recognition of revenues for the Cawayan Module of Bacman II from August 25, 2005 to December 31, 2006 was anchored in the Bacman II Geothermal Resources Steam Sales Agreement. PNOC-EDC's consent to the Addendum Agreement is a practical concession to NPC in order to collect payment as soon as possible since it has incurred costs for maintaining the Cawayan II steam field as faithful compliance with the geothermal resources steam sales agreement. Further, paragraph 1 of the Addendum Agreement provides that "NPC shall pay the Guaranteed Monthly Remuneration (GMR) at 75% Plant Factor for the Billing Period starting August 25, 2005 until December 31, 2007 or until the Rehabilitation Completion Date (when Cawayan unit achieves its rated capacity)" which is a tacit recognition of its monthly liability equivalent to the monthly take or pay provision of the main contract. According to Management, this is still applicable even during this period of the rehabilitation of the Cawayan Module power plant.

Management deemed it proper to recognize the billed period as revenues following the take-or-pay provision of the main contract and to recognize as volume discount the value of the future lifting of the stored energy when it occurs.

We maintain our position that payment to be made by NPC for the period that the plant is not operational, that is August 25, 2005 to December 31, 2007 or the Rehabilitation Completion Date should be considered as advance payment. Hence, recognition of income should be deferred until the lifting of the stored energy. The Addendum Agreement entered into by the parties as a result of the Bacman II – Cawayan outage amended the provision of the original agreement on take or pay during the period August 25, 2005 to the Rehabilitation Completion Date. Paragraph 3 specifically stated that the GMR paid from August 25, 2005 to December 31, 2007 shall be treated as stored energy. Further, paragraph 4 provides that the lifting of the stored energy is binding to the successor-in-interest of NPC to enable NPC to recover the whole amount paid to PNOC-EDC. The provision in the Addendum Agreement granting a right to NPC to fully recover the amount paid to PNOC-EDC in case the sale of generating facilities to a private entity is implemented implies that the payment to be made is an advance payment and not a discount; therefore, the same should not be recognized as revenue for the period. The execution of the Addendum Agreement in February 2007 is a subsequent event that requires adjustment of the financial statements.



Board of **Directors**

from left to right:

RAPHAEL PERPETUO M. LOTILLA
CHAIRMAN

PEDRO A. AQUINO, JR.
OIC PRESIDENT/CEO

EDUARDO V. MAÑALAC
PRESIDENT/CEO
(up to November 10, 2006)

LEOPOLDO E. PETILLA
DIRECTOR

RAMON B. MITRA
DIRECTOR

EMIL P. JURADO
DIRECTOR

DANTE B. CANLAS
DIRECTOR

EDGARDO M. DEL FONSO
DIRECTOR

BOB D. GOTHONG
DIRECTOR

RAYMUNDO DEMOCRITO C. MENDOZA
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PNOC Project List

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

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

III. COAL
14. Zamboanga-Sibugay Coal Project (COC 41)

IV. RENEWABLE ENERGY
15. Solar Home Systems Distribution Project

V. ENERGY ALLIED ACTIVITIES
16. Energy Supply Base, Mabini, Batangas
17. Petrochemicals in Limay and Mariveles, Bataan

VI. REAL ESTATE
18. Socialized Housing Project

Concept, Design and Printing by: MODE MATRIX MANILA, INC.

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