Petron Corporation 2005 Annual Report

Strategic Transformation

PETRON
Fuel Success.

Strategic Transformation

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Company Profile

Petron Corporation is the largest oil refining and marketing company in the Philippines. Supplying more than a third of the country's oil requirements, our world-class products and quality services fuel the lives of millions of Filipinos. We are dedicated and passionate about our vision to be the leading provider of total customer solutions in the energy sector and its derivative businesses.

We operate a refinery in Limay, Bataan, with a rated capacity of 180,000 barrels a day. Our ISO 14001 certified refinery processes crude oil into a full range of petroleum products including LPG, gasoline, diesel, jet fuel, kerosene, industrial fuel oil, and mixed xylene.

From the refinery, we move our products mainly by sea to 30 depots and terminals situated all over the country. Through this nationwide network, we supply fuel oil, diesel, and LPG to various industrial customers. The power sector is our largest customer.

We also supply jet fuel at key airports to international and domestic carriers.

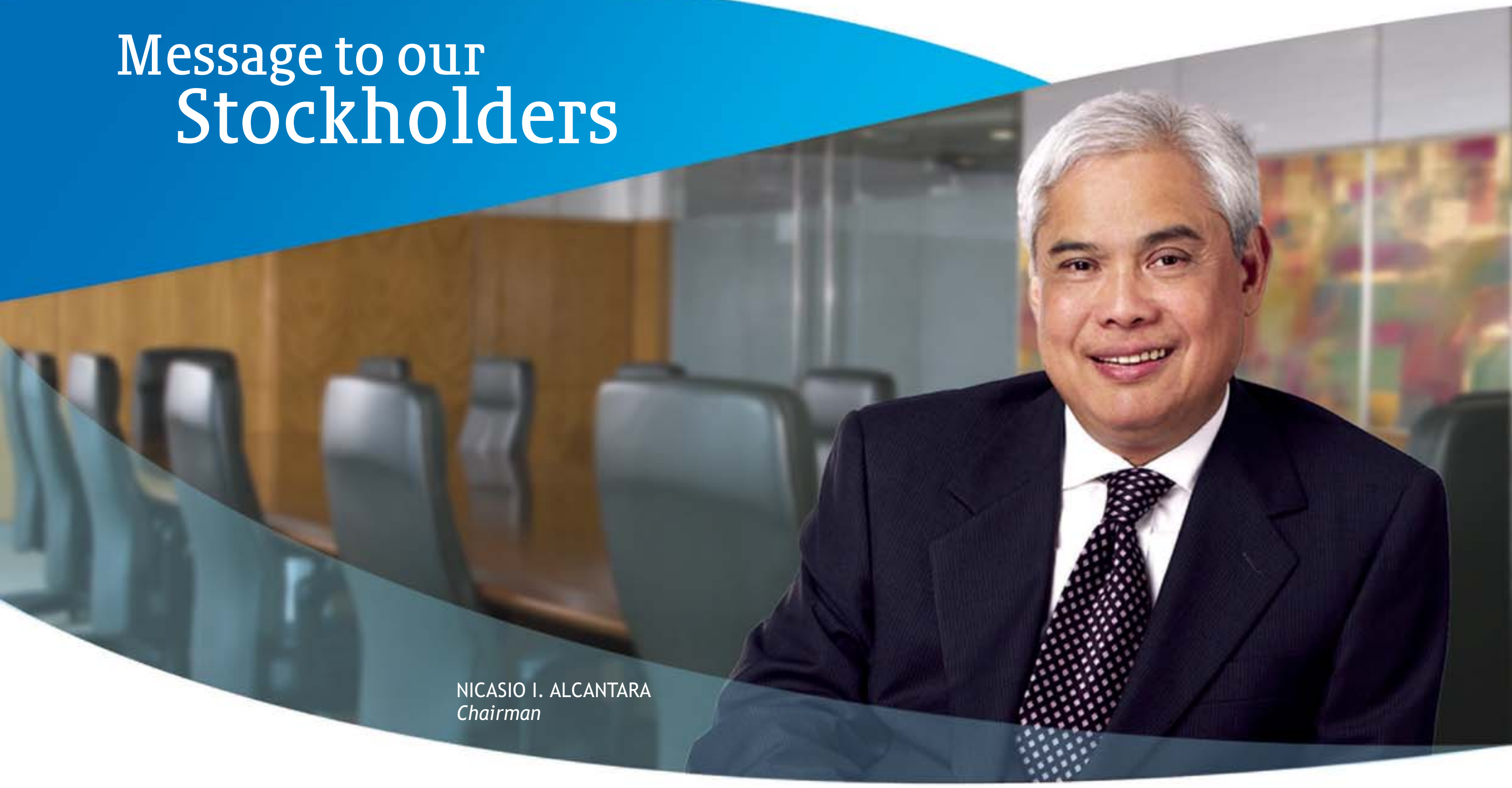
Through more than 1,200 service stations, we retail gasoline, diesel and kerosene to motorists and public transport operators. We also sell our LPG brand Gasul to households and other consumers through an extensive dealership network.

We operate a world-class lube oil blending plant at our Pandacan Terminal, where we manufacture lubes and greases. These are also sold through service stations and sales centers.

We are expanding our non-fuel businesses which include our convenience store brand "Treats." We have partnered with major fast-food chains, coffee shops, and other consumer services to give our customers a one-stop full service experience. We are also putting up additional company-owned and operated service stations in strategic locations.

We are publicly-listed. The Philippine National Oil Company and the Aramco Overseas Company B.V. each owns a 40% share of equity. The remaining 20% is held by close to 200,000 individual stockholders.

Message to our Stockholders



NICASIO I. ALCANTARA
Chairman

Fueling Growth Through Strategic Transformation

We are proud to report that your company's earnings in 2005 exceeded our most optimistic expectations. At ₱6.05 billion, Petron's 2005 net income is nearly 50% more than our 2004 income and is the highest that the company has ever seen in its entire history. This achievement is partly the result of favorable market prices—particularly for our exports—and partly due to our deliberate efforts to fuel growth.

We have maintained a tight vigilance over our costs, such that our 2005 operating expenses are 7% lower than the 2004 level. Our refinery investments have also reduced the cost of producing Clean Air Act compliant fuels, improving our margins on gasoline and diesel. But more than these, our achievement is strongly underpinned by our strategic business imperatives.

Last year, we presented a vision and mission for your company to be the leading provider of total customer solutions in the energy sector and its derivative businesses. This vision is supported by four strategic business imperatives, namely: 1) Protect our leadership in the oil business; 2) Expand non-fuel business; 3) Explore overseas market expansion; and 4) Diversify into other energy and petroleum businesses.

Our performance in 2005 reflects the level of our commitment to our vision.

Protecting Leadership

In a market that contracted by around 8%, we increased our overall share to 38.3% from 37.7% in 2004. Our lead over our nearest competitor widened to 6.5% compared to the previous year's 4.6%. Petron led in all the fuels market segments —Reseller, Industrial and LPG—increasing market share in each.

KHALID D. AL-FADDAGH
President and Chief Executive Officer

With our strategic business imperatives already in motion, our company is indeed poised for a strategic transformation.

In Lubes, we continued to sustain our growth over the past few years. Last year, our market share leaped by 4.4%, bringing us from third to second place among the three major players.

Retail and distribution network expansion, effective marketing and advertising campaigns, and a growing base of Petron fleet and credit card holders have helped secure our successes in the domestic oil market. Introduction of new products also provided a big boost to our sales. This was especially true with the launch of our high performance Xtra Unleaded gasoline, which even drew unsolicited, enthusiastic testimonials from motorists. We also re-launched our brand of automotive LPG under a new brand called Xtend to highlight its cost efficiency as an alternative to gasoline. At the end of 2005, several taxi operators had converted their fleets and were using Xtend.

Expansion of Non-fuel Business

We continued to increase the number of Treats convenience stores (C-stores) and other non-fuel businesses in our retail network. The opening of three new Treats outlets brought the number of our C-stores to 40. Quick-serve restaurants and service locators now number 67, from 58 in 2004. The revenue generated by these businesses reached ₱143.4 million in 2005, up by 70.3% from ₱84.2 million in 2004.

We continued to expand our company-owned, company-operated (COCO) service stations bringing our total count to 7 as of end 2005. We are committed to increase the number of our COCO stations since these allow us to capture revenue streams which include food and other consumer products and the direct franchising of complementary quick-service restaurants.

Overseas Markets Expansion

We continued to aggressively search for more markets for our traditional commodity export business. We have tapped niche products such as straight-run fuel oil, naphtha and diesel to further penetrate the overseas market.

Our initial efforts at exporting our brand to overseas markets have already met with success in the case of lubes. We signed a five-year agreement with a distributor based in Cambodia for the marketing, sales, and distribution of our lube products. By the end of 2005, we had made our first export shipment of lubes. After that, the volume of shipments quickly doubled, indicating a highly promising market. Our success in this could lead to further opportunities in other countries in the Southeast Asian region.

Apart from exporting our brand, we are also firming up our relationship with a globally-recognized producer of fuel additives to establish a regional supply and technology hub.

Business Diversification

Given that the domestic market for fuels remains small and shows few signs of growing significantly in the near future, diversification into other energy and petroleum businesses is a logical next step for Petron. In particular, we see petrochemicals as a viable platform for growth and the key to strategic transformation for the company.

Our initial venture into petrochemicals—made some years ago—has proved highly profitable. In 2005, our sales of mixed xylene increased almost 30% in terms of volume compared to 2004. Our income from this business came to almost ₱1.0 billion and contributed 16% of our net earnings.

The need to address the problem of obsolescence for our refinery's conversion unit (used to upgrade products from black to white) has presented us with an opportunity to further venture into petrochemical production. By adopting the

latest cracking technology—a Petro Fluidized Catalytic Cracker (Petro FCC)—and setting up a Propylene Recovery Unit, we will not only increase our white product yield but will also be able to produce petrochemical grade propylene, which can be sold either locally or exported. The domestic market alone is practically assured, with the existence of two polypropylene plants in the country and no local producer of propylene feedstock.

We also plan to invest in a benzene, toluene and expanded mixed xylene extraction facility. Like the Petro FCC, this will leverage existing refinery processes to produce higher-value petrochemicals.

Margins on petrochemicals are significantly higher than those for the refinery streams from which they are extracted. Furthermore, worldwide demand for them is robust and expected to exceed global GDP growth. Thus, when our projects go on stream in 2008, we expect Petron's income to enter a new growth trajectory, reaching ₱10 billion plus in 2010.

The potential for further integration of petrochemical processing with our existing refining operations provides a rich source of possibilities for Petron's future growth, and we continued to update our Refinery Masterplan to maximize this synergy.

With our strategic business imperatives already in motion, your company is indeed poised for a strategic transformation. We aim to go beyond being the dominant player in the local oil industry to a company that provides total customer solutions in the energy sector and its derivative businesses.

KHALID D. AL-FADDAGH
President and Chief Executive Officer

NICASIO I. ALCANTARA
Chairman

Fueling Leadership

Our sustained leadership in the industry is a product of our commitment to excellence. It extends across various segments of the downstream oil sector, enabling us to serve more than one-third of the total market.

2005 marks the year of strategic transformation for Petron Corporation. Guided by our vision and driven by our strategic business imperatives, we built on existing programs and implemented new ones to secure a brighter and more profitable future for the company. This is the story of our journey towards that goal.

Fueling Leadership

Our marketing and network expansion efforts continued to make us the brand of choice as we increased our overall market share versus our competitors. In a market that contracted by around 8%, we increased our share to 38.3% while other oil majors lost market share.

In the fiercely contested Reseller Trade, which is the largest segment of the market, we further widened our lead over our closest rival by 1.3%—bringing our share of this vital sector to 34.0%. This was partly due to our revitalized service station program wherein we added 37 new stations and brought our total count to 1,242 stations nationwide at the end of 2005—the largest retail network in the country.

To capture additional streams while allowing us to quickly introduce marketing innovations, we added two more company-owned, company-operated (COCO) service stations for a total count of seven. Our COCO stations combined with our 43 Treats convenience stores and other food and business locators generated nearly ₱1.2 billion in revenues.

Underscoring our quality products and services at the service station level, we were once again chosen by consumers as a Superbrand in the Best Gas Station category for the fifth straight year. This award inspires us to serve our customers better.

In the Industrial sector, Petron's sales were the least affected by industry contraction because of the acquisition of new accounts, particularly in the aviation sector. We continued to dominate this sector with 46.3% of the market equivalent to a 1% increase compared to 2004. This is 13.1 percentage points higher than our nearest competitor. We acquired a majority of the National Power Corporation's requirements for industrial fuel oil and diesel, equivalent to 64.4% of its total consumption.

"Gasul" continued to be the LPG brand most preferred by consumers. Despite tougher competition, we increased our share to 27.3% in 2005 versus 26.5% the previous year. Through our dealers, we established 50 branch stores to bring

our Gasul products closer to Filipino households. To further protect consumers, we continued our campaign to raise awareness of the dangers of using unsafe, illegally-refilled LPG cylinders.

In support of the government's calls to introduce more environment-friendly alternative fuels, we re-launched our AutoLPG product under the brand, "Xtend." Aptly named, Xtend is a cost-efficient and cleaner fuel for vehicles. At the end of the year, more than 200 vehicles were using Xtend as a transport fuel.

Highlighting the popularity of our lubricant brands such as Ultron and Rev-X, our Lube Trade emerged a strong second as sales improved by 6% despite an industry average decline of 7.7%. We also raised brand awareness by increasing our presence in non-traditional markets, which include auto supply outlets and hardware stores.

Another notable development in this trade was the signing of a five-year agreement with a local distributor for the sales and distribution of Petron lubricants in Cambodia. This marked our very first lubes export.

We continued to look for synergies with a leading fuels technology company. This is with the aim of establishing an innovation center for fuels technology in Asia with a supply hub for toll blending for additives and a technology hub that will provide service support to customers.

Bel-Aire Square Station. Company-owned, company-operated stations (COCO) continue to provide additional revenue streams coming from non-fuels businesses.

The latest result of our continuing research and development program was the launch of two new products namely the Petron Farm Trac Oil, single-grade motor oil for farm equipment, and Petron Marine HD Oil, a marine oil formulated as crankcase oil for in-board engines of small fishing boats.

Our successful sales performance in Marketing was supported by our Cards business. The advantages and privileges of using the Petron Fleet Card—the first fleet card powered by microchip technology—and the Petron-BPI MasterCard were enjoyed by more than 60,000 cardholders.

Amid high gasoline prices, we launched Xtra Unleaded—a high performance, environment-friendly gasoline that gives consumers power for extra miles. We conducted a test run based on actual road and traffic conditions, and with just one full tank of Xtra gasoline, two Honda Jazz hatchbacks traveled 1,114 kilometers from Pagudpud, Ilocos Norte to Sorsogon.

We also launched our text promos namely the "Ultron/Rev-X Oil for a Million" and "Gasul Gen-U-Win Da Repeat" which helped boost the sales of these products.

To further increase customer satisfaction, several initiatives were implemented including the Customer Satisfaction Index measurement, a feedback system using SMS, and the Mystery Shopper program wherein employees anonymously visit Petron stations to check if service standards set by the company are being maintained.

Treats. Petron's customers enjoy full-service convenience from its own brand of C-stores.

Fueling Excellence

We continue to seek innovations to ensure cost-effective ways of delivering products to customers.

Fueling Operational Excellence

As part of our efforts to bring our products to our customers across the archipelago in a cost-effective manner, we continued to adopt innovative IT solutions to enhance supply chain efficiencies. We deployed the Distribution Planner/Optimizer in the last quarter of 2005 and immediately reaped benefits from its use.

The automated vessel scheduling has lowered transshipment costs by generating vessel schedules in a shorter time and at the least cost. It also enables our programmers to respond more effectively to order changes and emergency situations. Another benefit is better inventory management through increased inventory visibility throughout the supply chain, resulting in reduced risk of product run-outs.

In our continuous pursuit of service quality, we completed the ISO 9001:2000 certification of all our depots and terminals last year. This means that the quality management systems at our facilities are at par with international standards.

We also initiated the necessary training needed in preparation for the ISO 14001 certification of our facilities. The ISO 14001 is an environmental management system certification given to facilities that have effective frameworks for consistently addressing environmental concerns.

We strengthened the security of all our facilities by complying with the International Ships and Ports Facility Security (ISPS) standards. Going further, we worked for the certification of other locations that are without piers but are also vulnerable to terrorist attacks. As of end 2005, several of our facilities had obtained the distinction of being the only domestic ports ISPS-certified by the Department of Transportation and Communications-Office of Transport Security (DOTC-OTS). In fact, our terminals in Mandaue and Zamboanga have been used as models by the DOTC in conducting trainings.

Also affirming our efforts to maintain operational excellence, our depots and terminals have reached nearly 10 million man-hours without lost time incident. Our Pandacan Terminal led the way with 2.7 million man-hours.

Fueling Progress

We also continued to aim for making our refinery "Best-in-Class" by means of programs that would enable us to match or even surpass operational efficiencies of similar refineries in the region.

Fueling Progress

Our 180,000 barrel per day, ISO 14001-certified Bataan refinery processed 131,900 barrels of crude oil daily or a utilization rate of 73% in 2005. This is a 10% increase in utilization rate from 2004.

In May of last year, we commissioned our $100 million Clean Air facilities, namely the 22,000 barrel-per-day Gas Oil Hydrotreater 3 and the 10,000 barrel-per-day Isomerization unit. With these facilities, Petron became the only local oil company capable of producing fuels to meet its requirements without resorting to product importations. The operation of these units helped to boost our net income last year.

Underscoring our commitment to environmental stewardship, we once again passed a grueling environmental audit at our refinery, maintaining our ISO 14001 certification. We also began preparations to upgrade our current ISO environmental certification.

We also continued to work to make the refinery "Best-in-Class" by means of programs that would enable the refinery to match or even surpass operational efficiencies of similar refineries in the region.

For instance, we completed the installation of Custody Flow Meters (CFM) in our loading lines to facilitate accurate product metering. The installation of the CFM has reduced our unidentified losses and has an additional benefit resulting in the speedy loading and release of product vessels.

To further improve operational availability, we installed a new transformer that allows the refinery to draw more power from the National Power Corporation. This also insulates the facility from external power fluctuations thus improving plant reliability.

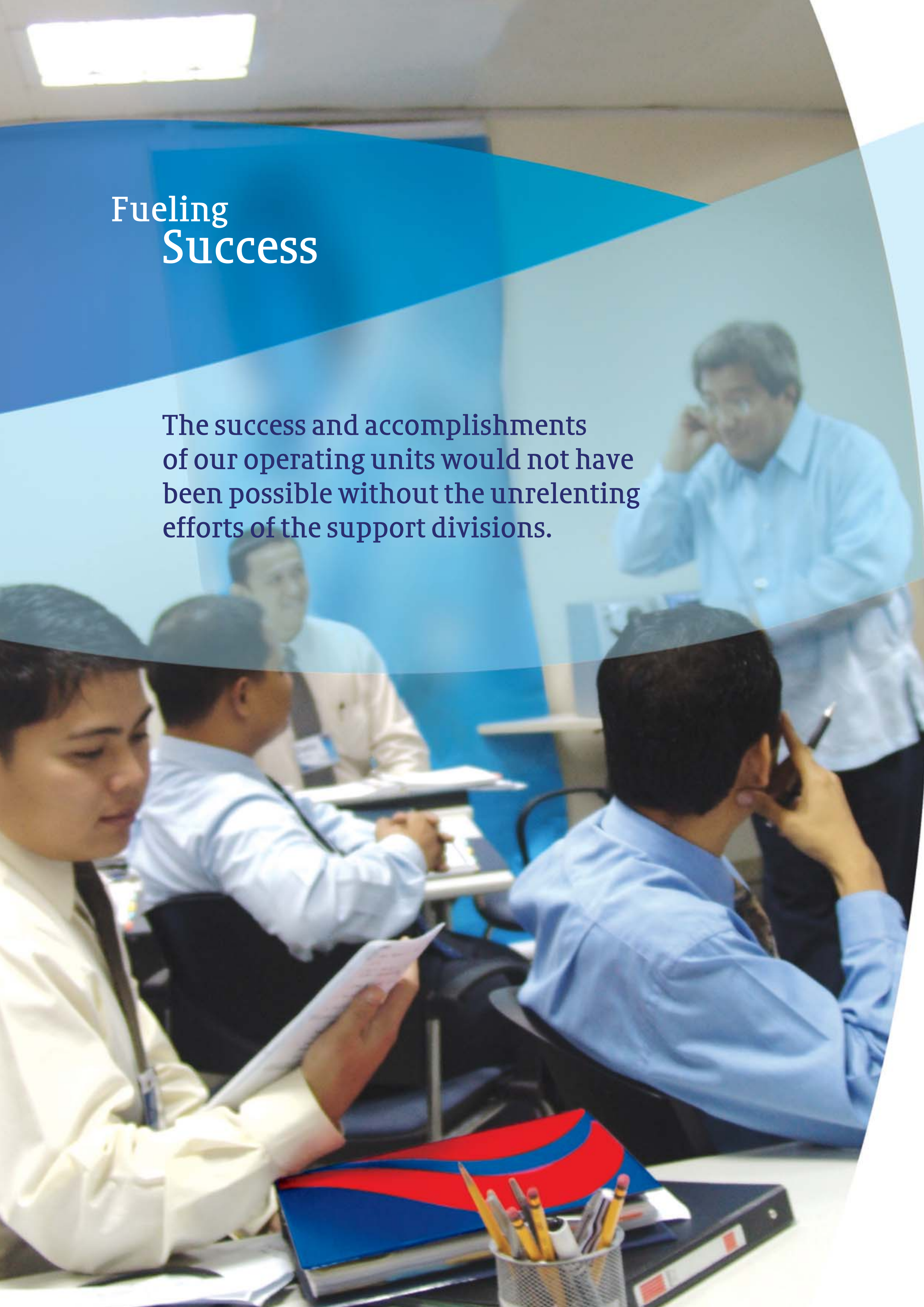
These programs were driven by the Continuous Improvement and Productivity (CIP) Program which empowered employees to set forth ideas to improve work processes at the refinery. Since its inception in 2003, implemented CIP projects are estimated to have saved the company roughly ₱260 million. To raise the bar of excellence, recognition was given to individual personnel displaying Best-in-Class performance.

Last year also marked the beginning of our $300 million Refinery Master Plan wherein we will construct additional refinery units that will allow us to double our existing mixed xylene capacity and extract high-value petrochemical streams, namely propylene, benzene, and toluene. These investments will likewise optimize refinery operations through higher white product yields.

The new refinery units, which will come on stream by mid-2008, are expected to boost our income significantly. The market for petrochemicals is expected to remain robust. In 2005, our mixed xylene exports grew by almost 30% in terms of volume and contributed 16% of our net income.

Fueling Success

The success and accomplishments of our operating units would not have been possible without the unrelenting efforts of the support divisions.



Fueling Success

The success and accomplishments of our operating units would not have been possible without the unrelenting efforts of the support divisions.

Finance and Subsidiaries continued to manage our financing costs through selective hedging strategies aided by the Value-at-Risk tool. As a result, actual financing costs for 2005 were lower than the projected amount.

While property insurance premiums increased by 20% in the global insurance markets, our well-managed safety programs and continuing efforts to negotiate for lower insurance rates softened the impact of this development.

We also generated ₱69 million from the sale of idle assets or 82% more than in 2004. Asset management activities through the active leasing of office spaces and building facilities yielded an additional ₱17.2 million in rental income.

Through negotiations for better prices, tolling arrangement, direct sourcing and e-bidding, we were able to realize savings on purchases of materials and services amounting to ₱173 million last year.

We continued to roll-out point-of-sale (POS) systems, covering 31 Petron service stations in 2005. The POS system is linked to the Petron Makati head office back-end application thru an IT and Communication infrastructure. The POS provides our customers with consistent and efficient customer service since it automates various processes at the service station level.

We also managed the PR aspects of successive price increases amid record-high crude prices by touching base with the government, media, NGOs and the public to inform them of the external factors driving local pump prices.

Underscoring our efforts to improve our corporate governance practices, Petron was cited by the Institute of Corporate Directors (ICD) as one of the Best Governed Listed Companies in the Philippines. The ICD, an international organization that promotes corporate governance practices in line with global standards, applied several criteria including disclosure, transparency and board responsibility.

To a large degree, our achievements throughout the years have been built on our human development and wellness programs.

We had regular assemblies to increase employee awareness of Petron's strategic business goals, performance and challenges. Vision-Mission-Values and Branding cascade sessions were organized for the workforce. In an effort to instill a customer-focused culture, Fuel Service Excellence workshops were given to frontliners in various locations to initiate and practice behaviors that would delight customers.

We also organized rewards programs for the different groups to recognize commendable performances in line with the company's vision.

Fueling Commitment

Petron's stewardship extends beyond the business sphere. Our commitment to our business inspires a similiar commitment to the country's future.

Fueling Commitment

Beyond working to improve the company's bottom line, we aimed to promote the best interests of our stakeholders by conducting our business in a safe manner while caring for the community and environment.

We held various Health, Safety and Environment (HSE) trainings for our employees such as Basic Occupational Safety and Health, First Aid/Basic Life Support and Defensive Driving courses to equip them with the skills necessary to prevent and respond to mishaps in the workplace.

We also conducted numerous safety and risk assessment audits at our various facilities to ensure that our stringent HSE standards are maintained. For example, we worked for the speedy accreditation of our facilities' Oil Spill Contingency Plan (OSCP) with the Philippine Coast Guard (PCG). Last year, we secured OSCP accreditation for our Zamboanga depot—making it the first facility in the oil industry to receive this.

We also encouraged our business partners to adopt our HSE practices. We conducted our Contractor Safety Management program which establishes guidelines on the minimum HSE requirements that our partners should comply with prior to any work activity within our facilities. Oil Spill and Fire Control trainings were conducted for various industrial accounts.

Petron School. Petron is fervent in its commitment to take part in uplifting the lives of Filipino people through education.

In 2005, we defined what we stood for socially as we integrated social responsibility into our core activities. With a focus on poverty alleviation and with education as our primary tool, we launched Project H.O.P.E. or Helping Filipino Children and Youth Overcome Poverty through Education.

Under Project H.O.P.E., we expanded our Tulong Aral ng Petron program and supported nearly 4,000 scholars in more than 80 public elementary schools in Metro Manila and Mindanao. Tulong Aral is complemented by literacy programs for our scholars and livelihood opportunities for their parents.

Apart from giving out numerous scholarships and the launching of partner programs, we have already built 13 Petron Schools by 2005 to give children access to education in areas where the need is greatest.

Beyond basic education, we introduced an entrepreneurship program for the youth to bridge the gap between what is being taught in our schools and the skills needed for students to be able to successfully enter the workforce. We started this program initially at the Muntinlupa Business High School with a focus on technology and livelihood education for its students.

Health, safety and environment. Safety practices remain an integral part of our business.

Meanwhile, we continued to pursue our environmental stewardship programs.

We have remained actively involved in the Bataan Integrated Coastal Management Program (BICMP), a comprehensive and long-term plan to manage coastal and marine resources in the province. One milestone of the BICMP is its institutionalization as an office of the Bataan Provincial government.

In our other facilities, our Supply and Operations group conducted coastal clean-ups, tree and mangrove planting, and other ecology-friendly initiatives.

We also supported the rehabilitation of the La Mesa Watershed, the last remaining forest in Metro Manila. We inaugurated the Petron Fitness and Nature Trail and the 2,500-seater Petron Amphitheater at the La Mesa Eco-park.

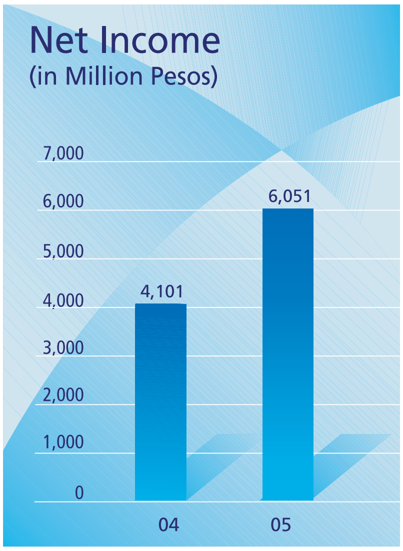
Our social responsibility programs have been successfully implemented through the active participation of Petron employees. Over the years, we have seen the unwavering involvement of our employees, contributing their time, talent and resources to every CSR activity.

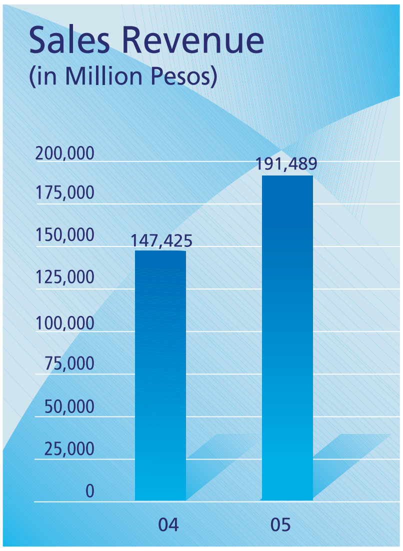
We publish a separate report that details all of our HSE and Petron Foundation activities.

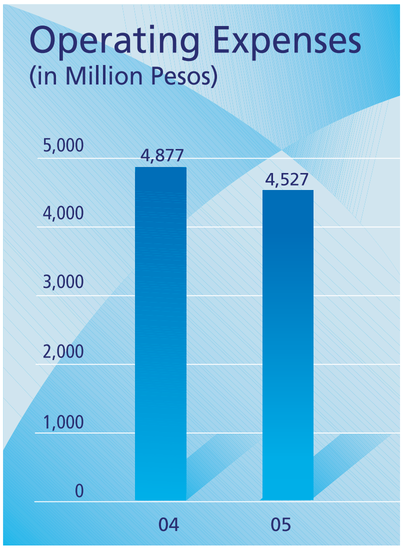
Mangrove planting and coastal clean-up. Environmental protection is one of the core projects of Petron Foundation.

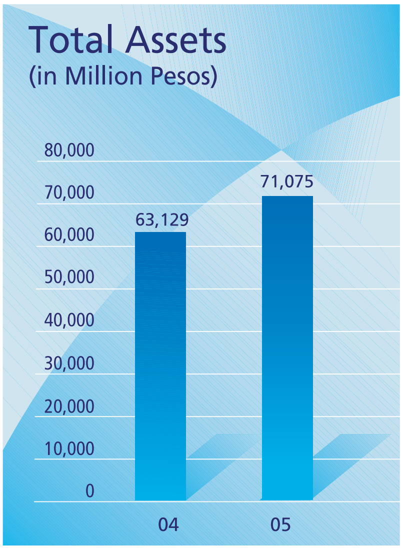
Financial Highlights

(In Million Pesos, Except Per Share Amount)	2005	2004
SALES	**191,489**	147,425
NET INCOME (LOSS)	**6,051**	4,101
OPERATING EXPENSES	**4,527**	4,877
INCOME (LOSS) FROM OPERATIONS	**10,002**	7,111
PLANT, PROPERTY & EQUIPMENT	**22,570**	22,446
TOTAL ASSETS	**71,075**	63,129
TOTAL EQUITY	**27,615**	22,323
(In Pesos Per Share)		
EARNINGS PER SHARE	**0.64**	0.44
CASH DIVIDEND DECLARED	**0.10**	0.20









Financial Highlights

Net earnings of ₱6 billion

Your Company posted a net income of ₱6.05 billion during the year, up 48% from restated earnings of ₱4.10 billion in 2004.

Net income attributable to shareholders amounted to ₱6.04 billion, arrived at after deducting ₱7 million of earnings attributable to minority interests. Restated 2004 net income attributable to shareholders was ₱4.09 billion. Consequently, Petron's 2005 earnings per share reached 64 centavos, up 45% from the prior year's 44 centavos.

2004 upward profit restatement

The net income for 2004 was restated to ₱4.10 billion from the earlier reported value of ₱3.43 billion. This was due to accounting changes arising from Petron's first-time adoption of Philippine Financial Reporting Standards (PFRS). PFRS aligned the country's accounting principles and procedures with those of International Accounting Standards and International Financial Reporting Standards. The Securities and Exchange Commission has mandated the implementation of PFRS by Philippine corporations for the financial reporting period beginning January 1, 2005.

The major effect on the 2004 income statement of this change in accounting policies is to decrease the cost of goods sold by ₱1.01 billion, thereby increasing net income. This restatement was due to the Company's adoption of the first-in-first-out (FIFO) method for accounting of petroleum product inventory. The Company formerly used the last-in-first-out (LIFO) method but this has been disallowed under PFRS. In a period of rising prices, a firm would generally report a lower cost of goods if it uses FIFO rather than LIFO for inventory accounting.

Sales revenue up 30%

Petron achieved a 30% year-on-year (YoY) increase in sales revenue to ₱191.49 billion. This was mainly due to increases in selling prices in an effort to cover the increasing cost of crude oil imports.

On the other hand, sales volume slid 2% YoY to 51.70 million barrels. This was on account of a 7% decline in domestic sales to 43.71 million barrels. However, Petron's domestic sales performance was still better than the 8% contraction of the total domestic market, as reported by the Department of Energy.

Meanwhile, Petron's export sales improved 45% YoY to 7.96 million barrels, partly compensating for the decline in domestic volumes.

But cost of goods sold increased 31%

The cost of goods sold reached ₱176.96 billion in 2005, up 31% YoY, higher than revenue growth of 30%. Accordingly, the gross margin rate decreased 0.54%-points to 7.59% from 8.13% in 2004.

As a result, growth in gross earnings slowed to 21% YoY from the 30% rate at the sales revenue line. Gross profit amounted to ₱14.53 billion in 2005.

Better expense performance

Petron's selling and administrative expenses declined 7% YoY to ₱4.53 billion, which can be traced primarily to lower employee costs. This, in turn, relates to the early adoption by the Company of accounting standards on employee benefits that allow actuarial gains and losses to be directly recognized under equity.

Meanwhile, net interest expense and other charges grew 10% to ₱1.86 billion due to increased short-term borrowings to fund higher-priced crude oil imports.

The year-on-year reduction in selling and administrative expenses, coupled with the slower growth in net interest expense and other charges relative to gross profit growth, boosted pre-tax income by 50% to ₱8.14 billion.

Higher tax provision

The provision for income tax was 58% higher YoY to ₱2.09 billion. Petron's income tax provision relative to pre-tax income increased to 26% from 24% in 2004 due mainly to the increase in the corporate income tax rate to 35% from 32% effective November 1, 2005.

Petron's income tax holiday for its mixed xylene sales remained the main contributor to an effective tax rate lower than the statutory rate. On May 10, 2005, the Board of Investments approved a one-year extension of this income tax holiday to December 4, 2006 from December 5, 2005.

Financial Highlights

Record-high earnings

Petron's key profit drivers during the year were the 30% YoY growth in sales revenue, the 7% reduction in selling and administrative expenses and the relatively moderate 10% increase in net interest expense and other charges. On the other hand, the improvement in profitability was tempered by a gross margin rate thinner by 0.54%-points, as well as by a higher effective tax rate. Still, the Company's net profit margin for 2005 reached 3.16%, higher than the 2.78% achieved in 2004.

Thus, net profit margin expansion leveraged on strong sales revenue growth resulted to a 48% YoY surge in your Company's earnings to a historic high of ₱6.05 billion.

A sturdier balance sheet

Your Company emerged from 2005 with a stronger balance sheet. Petron's debt-to-equity profile moved to a less-leveraged position of 60/40 at end 2005 from 64/36 at end 2004. Current asset cover of current liabilities likewise improved to 129% from 124% at the prior year. Debt service coverage also improved to 1.8x from 1.6x.

Total assets increased by ₱7.95 billion during the year to ₱71.08 billion. The bulk of this increase – ₱6.90 billion – was in inventory and receivables and mainly due to the increase in unit cost of crude oil and petroleum products.

On the liability side, suppliers' credit and short-term debt increased in response to the higher level of working capital. However, these two accounts grew by only ₱4.71 billion during the year, less than the increase in inventory and receivable balances. Meanwhile, ₱1.89 billion of long-term debt was repaid during the year.

Total liabilities increased by ₱2.65 billion. This increase funded a third of the ₱7.95 billion increase in assets. The balance was funded by a ₱5.29 billion improvement in stockholders' equity on the back of the year's ₱6.05 billion net income.

And better net operating cash flow

Your Company likewise achieved better cash flow performance in 2005. Net cash inflow from operations improved to ₱1.96 billion for the year from just ₱191 million in 2004. This was due to higher cash earnings of ₱8.29 billion, up 32% YoY, as well as a minimal 4% increase in incremental cash requirements for working capital to ₱6.33 billion.

There was also a large reduction in net investing cash outflow – ₱2.50 billion compared to ₱5.42 billion in 2004 – on the back of lower capital expenditures. The bulk of the US$100 million expenditure for the Isomerization and Gasoil Hydrotreater projects at the Bataan Refinery occurred in 2004 and the Company had no other project of similar scale in 2005.

Consequently, there was less need for new debt financing in 2005 compared to 2004. Loan availment net of repayment amounted to ₱1.37 billion during the year, lower than the ₱7.91 billion in 2004. Furthermore, the ₱847 million cash outflow for dividends in 2005 was half the ₱1.74 billion paid out in the preceding year.

Statement of Management's Responsibility for Financial Statements

The management of Petron Corporation is responsible for all information and representations contained in the consolidated balance sheets as of December 31, 2005 and 2004, and the related consolidated statements of income, recognized income and expense and cash flows for the years ended December 31, 2005 and 2004. The financial statements have been prepared in conformity with generally accepted accounting principles in the Philippines and reflect amounts that are based on the best estimates and informed judgment of management with an appropriate consideration to materiality.

In this regard, management maintains a system of accounting and reporting which provides for the necessary internal controls to ensure that transactions are properly authorized and recorded, assets are safeguarded against unauthorized use or disposition and liabilities are recognized. The management likewise discloses to the company's audit committee and to its external auditor: (i) all significant deficiencies in the design or operation of internal controls that could adversely affect its ability to record, process, and report financial data; (ii) material weaknesses in the internal controls, and (iii) any fraud that involves management or other employees who exercise significant roles in internal controls.

The Board of Directors reviews the financial statements before such statements are approved and submitted to the stockholders of the Company.

SyCip Gorres Velayo & Co., the independent auditors appointed by the stockholders, have examined the financial statements of the Company in accordance with generally accepted auditing standards in the Philippines and have expressed their opinion on the fairness of presentation upon completion of such examination, in their report to the Board of Directors and stockholders.

MA. CONCEPCION F. DE CLARO
Controller

NICASIO I. ALCANTARA
Chairman

Report of Independent Auditors

SGV & Co

SyCip Gorres Velayo & Co.
6760 Ayala Avenue
1226 Makati City
Philippines

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The Stockholders and the Board of Directors
Petron Corporation
Petron MegaPlaza
358 Sen. Gil Puyat Avenue
Makati City

We have audited the accompanying consolidated balance sheets of Petron Corporation and Subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, recognized income and expense and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Petron Corporation and Subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for the years then ended in conformity with the accounting principles generally accepted in the Philippines.

SYCIP GORRES VELAYO & CO.

Wilson P. Tan

Wilson P. Tan
Partner
CPA Certificate No. 76737
SEC Accreditation No. 0100-A
Tax Identification No. 102-098-469
PTR No. 4181277, January 2, 2006, Makati City

April 4, 2006

Consolidated Balance Sheets
(Amounts in Millions)

	December 31	
	2005	2004 (As restated- Note 3)
ASSETS		
Current Assets		
Cash and cash equivalents (Note 6)	**₱4,071**	₱4,104
Financial assets at fair value through profit or loss (Notes 7, 9 and 12)	**144**	–
Available-for-sale investments (Notes 8 and 12)	**259**	–
Short-term investments (Notes 7 and 9)	**-**	63
Receivables (Note 10)	**14,055**	11,758
Inventories (Notes 11, 25 and 28)	**27,018**	22,414
Other current assets (Note 32)	**1,297**	790
Total Current Assets	**46,844**	39,129
Noncurrent Assets		
Property, plant and equipment (Note 13)	**22,570**	22,446
Investment properties (Note 14)	**207**	202
Available-for-sale investments (Notes 8 and 12)	**196**	–
Other noncurrent assets (Notes 7, 8, 12, 15 and 27)	**1,258**	1,352
Total Noncurrent Assets	**24,231**	24,000
	₱71,075	₱63,129
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term loans (Note 16)	**₱21,407**	₱18,477
Liabilities for crude oil and petroleum product importation (Note 25)	**7,911**	6,128
Accounts payable and accrued expenses (Notes 17 and 32)	**4,818**	5,085
Current portion of long-term debt (Notes 18 and 32)	**1,906**	1,595
Income tax payable	**183**	278
Total Current Liabilities	**36,225**	31,563
Noncurrent Liabilities		
Long-term debt - net of current portion (Note 18)	**5,025**	7,227
Deferred income tax liabilities (Note 24)	**1,513**	1,349
Other noncurrent liabilities (Note 19)	**697**	667
Total Noncurrent Liabilities	**7,235**	9,243
Stockholders' Equity Attributable to Equity Holders of the Parent (Note 20)		
Capital stock	**9,375**	9,375
Retained earnings:		
Appropriated	**11,652**	6,906
Unappropriated	**6,352**	5,623
Other reserves	**128**	309
Stockholders' Equity Attributable to Equity Holders of the Parent	**27,507**	22,213
Minority Interest (Note 20)	**108**	110
Total Stockholders' Equity	**27,615**	22,323
	₱71,075	₱63,129

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Income

(Amounts in Millions, Except Per Share Amounts)

	Years Ended December 31	
	2005	2004 (As restated- Note 3)
SALES (Notes 28 and 34)	**₱191,489**	₱147,425
COST OF GOODS SOLD (Notes 21, 25 and 28)	**176,960**	135,437
GROSS PROFIT	**14,529**	11,988
SELLING AND ADMINISTRATIVE EXPENSES (Notes 22, 26 and 27)	**(4,527)**	(4,877)
INTEREST EXPENSE (Notes 16, 18 and 23)	**(2,091)**	(1,675)
INTEREST INCOME (Note 23)	**317**	344
OTHERS (Note 23)	**(86)**	(356)
INCOME BEFORE INCOME TAX	**8,142**	5,424
PROVISION FOR (BENEFIT FROM) INCOME TAX (Notes 24 and 33)		
Current	**2,057**	1,339
Deferred	**34**	(16)
	2,091	1,323
NET INCOME	**₱6,051**	₱4,101
Attributable to:		
Equity holders of the parent	**₱6,044**	₱4,094
Minority interest	**7**	7
	₱6,051	₱4,101
EARNINGS PER SHARE ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT (Note 29)	**₱0.64**	₱0.44

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Recognized Income and Expense

(Amounts in Millions)(Note 2)

	Years Ended December 31	
	2005	2004
Actuarial gains on defined pension plan (Note 27)	**₱356**	₱286
Tax effect	**(133)**	(92)
Net actuarial gains on defined pension plan	**223**	194
Less actuarial losses (gains) due to limit on recognized plan asset [net of tax effect of ₱212 and ₱53 in 2005 and 2004, respectively (Notes 20 and 27)]	**(408)**	115
	(185)	309
Unrealized fair value gain on available-for-sale investments [net of tax effect of ₱4 and effect of change in accounting policy - PAS 39 of ₱2 (Notes 3 and 8)]	**4**	-
NET INCOME (LOSS) RECOGNIZED DIRECTLY IN STOCKHOLDERS' EQUITY	**(181)**	309
NET INCOME FOR THE YEAR (Note 20)	**6,051**	4,101
TOTAL RECOGNIZED INCOME AND EXPENSE FOR THE YEAR	**₱5,870**	₱4,410
Attributable to:		
Equity holders of the parent	**₱5,863**	₱4,403
Minority interest	**7**	7
	₱5,870	₱4,410

See accompanying Notes to Consolidated Financial Statements.

Consolidated
Statements of Cash Flows
(Amounts in Millions)

	Years Ended December 31	
	2005	2004 (As restated-Note 3)
CASH FLOWS FROM OPERATING ACTIVITIES		
Income before income tax	**₱8,142**	₱5,424
Adjustments for:		
Depreciation and amortization	**2,335**	1,856
Interest expense	**2,091**	1,675
Interest income	**(317)**	(344)
Net unrealized foreign exchange loss (gain)	**(270)**	48
Others	**(111)**	–
Operating income before working capital changes	**11,870**	8,659
Changes in operating assets and liabilities (Note 30)	**(6,326)**	(6,093)
Interest paid	**(2,047)**	(1,643)
Income taxes paid	**(1,850)**	(1,075)
Interest received	**316**	343
Net cash provided by operating activities	**1,963**	191
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to:		
Property, plant and equipment	**(2,313)**	(5,463)
Investment properties	**(16)**	–
Decrease (increase) in:		
Other receivables	**9**	209
Other noncurrent assets	**(67)**	(182)
Reductions from (additions to):		
Financial assets at fair value through profit or loss	**2**	–
Available-for-sale investments	**(118)**	–
Short-term investments	**-**	19
Net cash used in investing activities	**(2,503)**	(5,417)
CASH FLOWS FROM FINANCING ACTIVITIES		
Availments of loans	**78,246**	80,854
Payments of:		
Loans	**(76,879)**	(72,949)
Cash dividends	**(925)**	(1,846)
Others	**78**	101
Net cash provided by financing activities	**520**	6,160
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	**(13)**	(28)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	**(33)**	906
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	**4,104**	3,198
CASH AND CASH EQUIVALENTS AT END OF YEAR (Note 6)	**₱4,071**	₱4,104

See accompanying Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

1. Corporate Information

Petron Corporation (the Parent Company or Petron) was incorporated on December 15, 1966 under the laws of the Republic of the Philippines. Petron is the Philippines' largest oil refining and marketing company, supplying more than one-third of the country's oil requirements. Its 180,000 barrel per day refinery located in Limay, Bataan processes crude oil into a full range of petroleum products, including liquefied petroleum gas (LPG), gasoline, diesel, jet fuel, kerosene, industrial fuel oil, lubes and greases, asphalts and mixed xylene (a high value petrochemical product). From its refinery, Petron moves its products mainly by sea, using tankers and barges to distribute products to a nationwide network of depots and terminals. Through this network, it sells fuel oil, diesel and LPG to industrial customers.

Petron also retails gasoline, diesel and kerosene to motorists, public transport operators and households through more than a thousand service stations - the largest network in the country. Petron also sells its LPG brand "Gasul" to consumers through a dealership network.

Petron is also expanding its non-fuels business which includes its convenience store "Treats" to add other revenue streams to its core business.

In line with its efforts to increase its presence in the regional market and take advantage of favorable prices abroad, Petron exports various petroleum products to other Asian countries such as Cambodia, Korea, China and Australia.

The principal activities of the subsidiaries are described in Note 2 under "Basis of Consolidation."

The registered office address of Petron and its Philippine-based subsidiaries is Petron MegaPlaza, 358 Sen. Gil Puyat Avenue, Makati City.

The consolidated financial statements for the years ended December 31, 2005 and 2004 were approved and authorized for issue by the Board of Directors (BOD) on April 4, 2006.

2. Basis of Preparation

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

The Company prepared its consolidated financial statements until December 31, 2004 in conformity with previous Statements of Financial Accounting Standards (SFAS) and Statements of Financial Accounting Standards/International Accounting Standards (SFAS/IAS) issued by the PASC.

The Company applied PFRS 1, "First-time Adoption of Philippine Financial Reporting Standards," in preparing the consolidated financial statements, with January 1, 2004 as the date of transition. The Company applied the accounting policies set forth in Note 3 to all the years presented, except those relating to financial instruments. An explanation of how the transition to PFRS has affected the reported financial position, financial performance and cash flows of the Company is also discussed in Note 3.

The consolidated financial statements of the Company have been prepared on the historical cost basis, except for financial assets at fair value through profit or loss (FVPL), available-for-sale (AFS) investments and derivative financial instruments, which are measured at fair value.

The consolidated financial statements are presented in Philippine pesos, which is the Company's functional and presentation currency under PFRS, and all amounts are rounded to the nearest millions (₱000,000), except when otherwise indicated.

Basis of Consolidation

The consolidated financial statements comprise the financial statements of Petron and its subsidiaries as of December 31 of each year. The financial statements of the subsidiaries are prepared for the same reporting year as the Parent Company.

The purchase method of accounting is used for acquired businesses. Subsidiaries are consolidated from the date on which control is transferred to the Company and cease to be consolidated from the date on which control is transferred out of the Company.

The consolidated subsidiaries include:

Subsidiaries	Percentage of Ownership	Country of Incorporation
Overseas Ventures Insurance Corporation (Ovincor)	100.00	Bermuda
Petrogen Insurance Corporation (Petrogen)	100.00	Philippines
Petron Freeport Corporation (PFC)	100.00	Philippines
Petron Marketing Corporation (PMC)	100.00	Philippines
New Ventures Realty Corporation and Subsidiary (NVRC)	79.95	Philippines

In the past, Petron, being partly foreign-owned, was not allowed by the Retail Trade Law to engage in direct retailing. Upon enactment of the Retail Trade Liberalization Act (RTLA) in 2000, the Philippine Board of Investments (BOI) has approved Petron's application to establish a retail enterprise, paving the way for the establishment of a direct-retailing subsidiary, PMC, on January 27, 2004. PMC operates company-owned, company-operated (COCO) service stations. The COCO stations will play a major part in launching market initiatives to strengthen the "Petron" brand and will give the Company the opportunity to quickly introduce innovations beyond the present services that are available in its stations.

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

The primary purpose of PFC and PMC is to, among others, sell on wholesale or retail, and operate service stations, retail outlets, restaurants, convenience stores and the like. NVRC and its subsidiary's primary purpose is to acquire real estate and derive income from its sale or lease.

Petrogen and Ovincor are engaged in the business of non-life insurance and re-insurance.

The consolidated financial statements are prepared using uniform accounting policies for like transactions and other events in similar circumstances. Intercompany balances and transactions, including intercompany profits and unrealized profits and losses are eliminated.

Minority interest represents the portion of net income and net assets of NVRC, not held by the Company and are presented separately in the consolidated statements of recognized revenue and expense, consolidated statements of income and within equity in the consolidated balance sheets, separately from Parent stockholders' equity.

In prior years, the Company presented separate statements of changes in stockholders' equity. Starting 2005 and in compliance with its early adoption of Amendments to PAS 19, "Employee Benefits - Actuarial Gains and Losses, Group Plans and Disclosures," the Company presents comparative consolidated statements of recognized income and expense, which show changes in stockholders' equity attributable to total income and expense, including gains and losses, whether recognized in the consolidated statements of income or directly as changes in stockholders' equity, generated by the Company's activities for the years ended December 31, 2005 and 2004. Changes resulting from transactions with equity holders of the parent and minority interest holders acting in their capacity as equity holders (such as equity contributions, re-acquisitions of the Company's own equity instruments and dividends) and transaction costs directly related to such transactions, are disclosed in Note 20 - Other Changes in Stockholders' Equity.

3. Changes in Accounting Policies

Explanation of Transition to PFRS

The transition to PFRS resulted in certain changes to the Company's previous accounting policies [referred to in the following tables and explanations as "previous Generally Accepted Accounting Principles (GAAP)"]. The comparative figures for the 2004 consolidated financial statements were restated to reflect the changes in accounting policies, except those relating to financial instruments. The Company availed of the exemption under PFRS 1 and applied PAS 32, "Financial Instruments: Disclosure and Presentation" and PAS 39, "Financial Instruments: Recognition and Measurement" effective January 1, 2005.

An explanation of the effects of the transition to PFRS is set forth in the following tables and notes.

Reconciliation of Accounts at January 1, 2004 and December 31, 2004

		At January 1, 2004 (date of transition)			At December 31, 2004 (end of last period presented under previous GAAP)		
	Notes	Previous GAAP	Effect of transition to PFRS	PFRS	Previous GAAP	Effect of transition to PFRS	PFRS
ASSETS							
Current Assets							
Cash and cash equivalents		₱3,198	₱-	₱3,198	₱4,104	₱-	₱4,104
Short-term investments		69	-	69	63	-	63
Receivables		9,468	-	9,468	11,758	-	11,758
Inventories	a	15,674	2,424	18,098	19,235	3,179	22,414
Other current assets		753	-	753	790	-	790
Total Current Assets		29,162	2,424	31,586	35,950	3,179	39,129
Noncurrent Assets							
Property, plant and equipment	b, d, f, g	₱21,497	(₱2,657)	₱18,840	₱24,862	(₱2,416)	₱22,446
Investment properties	f	-	199	199	-	202	202
Other noncurrent assets	c, f, g	542	480	1,022	605	747	1,352
Total Noncurrent Assets		22,039	(1,978)	20,061	25,467	(1,467)	24,000
		₱51,201	₱446	₱51,647	₱61,417	₱1,712	₱63,129

	Notes	At January 1, 2004 (date of transition) Previous GAAP	Effect of transition to PFRS	PFRS	At December 31, 2004 (end of last period presented under previous GAAP) Previous GAAP	Effect of transition to PFRS	PFRS
LIABILITIES AND STOCKHOLDERS' EQUITY							
Current Liabilities							
Short-term loans		₱15,385	₱–	₱15,385	₱18,477	₱–	₱18,477
Liabilities for crude oil and petroleum product importation		6,560	–	6,560	6,128	–	6,128
Accounts payable and accrued expenses		3,872	–	3,872	5,085	–	5,085
Income tax payable		14	–	14	278	–	278
Current portion of long-term debt		712	–	712	1,595	–	1,595
Total Current Liabilities		26,543	–	26,543	31,563	–	31,563
Noncurrent Liabilities							
Long-term debt - net of current portion		3,288	–	3,288	7,227	–	7,227
Deferred income tax liabilities	g, i	1,207	91	1,298	882	467	1,349
Other noncurrent liabilities	b	390	225	615	411	256	667
Total Noncurrent Liabilities		4,885	316	5,201	8,520	723	9,243
Stockholders' Equity Attributable to Equity Holders of the Parent							
Capital stock		9,375	–	9,375	9,375	–	9,375
Retained earnings:							
Appropriated		5,551	–	5,551	6,906	–	6,906
Unappropriated	h	4,663	211	4,874	4,858	765	5,623
Other reserves	c, d	81	(81)	–	85	224	309
Stockholders' Equity Attributable to Equity Holders of the Parent		19,670	130	19,800	21,224	989	22,213
Minority Interest		103	–	103	110	–	110
Total Stockholders' Equity		19,773	130	19,903	21,334	989	22,323
		₱51,201	₱446	₱51,647	₱61,417	₱1,712	₱63,129

Reconciliation of Income for the Year Ended December 31, 2004

	Notes	Previous GAAP	Effect of transition to PFRS	PFRS
Sales		₱147,425	₱–	₱147,425
Cost of goods sold	a, d	136,444	(1,007)	135,437
Gross profit		10,981	1,007	11,988
Selling and administrative expenses	b, c	(4,866)	(11)	(4,877)
Interest income		344	–	344
Interest expense	b	(1,647)	(28)	(1,675)
Others	d, g	(366)	10	(356)
Income before income tax		4,446	978	5,424
Provision for income tax	a, b, c, d	1,014	309	1,323
Net income		₱3,432	₱669	₱4,101
Attributable to:				
Equity holders of the parent		₱3,425	₱669	₱4,094
Minority interest		7	–	7
		₱3,432	₱669	₱4,101
Earnings per share attributable to equity holders of the parent		₱0.37	₱0.07	₱0.44

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

Notes to the Reconciliation of Equity at January 1 and December 31, 2004 and Income for 2004

a. PAS 2, "Inventories." PFRS reduces the alternatives for measurement of inventories. It does not permit the use of the last-in, first-out (LIFO) formula to measure the cost of inventories. In 2005, the Parent Company changed its inventory costing method for petroleum products (except for lubes and greases, waxes and solvents) from LIFO to first-in, first-out (FIFO) method. The impact of this change increased retained earnings by ₱1,648 (net of tax effect of ₱776) as of January 1, 2004 and ₱2,162 (net of tax effect of ₱1,017) as of December 31, 2004 and increased inventories by ₱2,424 as of January 1, 2004 and ₱3,179 as of December 31, 2004. This accounting change also decreased cost of goods sold by ₱755 for 2004.

b. PAS 16, "Property, Plant and Equipment." Property, plant and equipment under PFRS include the estimated costs of dismantling or removing structures used in operation for which the Company is liable. Under previous GAAP, dismantling or removal costs were recognized when incurred.

Adoption of this standard increased (decreased) the following accounts:

	At January 1, 2004			At December 31, 2004		
	Gross	Tax Effect	Net	Gross	Tax Effect	Net
Property, plant and equipment	₱54	₱–	₱54	₱53	₱–	₱53
Other noncurrent liabilities	225	–	225	256	–	256
Retained earnings	(171)	55	(116)	(204)	65	(139)

This also increased selling and administrative expenses by ₱4 and interest expense by ₱28 for 2004.

c. PAS 19, "Employee Benefits." Adoption of PAS 19 requires recognition of defined benefit liability or net pension asset in the consolidated balance sheets. This resulted to the recognition of transition pension asset under the Company's defined benefit plan which increased retained earnings by ₱343 (net of tax effect of ₱162) as of January 1, 2004 and ₱338 (net of tax effect of ₱160) as of January 1, 2005. The adoption also resulted to an increase in other noncurrent assets by ₱505 and ₱783 as of January 1, 2004 and December 31, 2004 respectively and also increase in selling and administrative expenses by ₱7 for 2004.

The Company also early adopted the Amendments to PAS 19, "Employee Benefits - Actuarial Gains and Losses, Group Plans and Disclosures." The standard permits the recognition of actuarial gains and losses outside profit and loss and instead present a statement of recognized income and expense. Actuarially computed gains amounted to ₱309 (net of tax effect of ₱145) for the year ended December 31, 2004 and actuarial losses due to limit in plan assets to be recognized amounted to ₱115 (net of tax effect of ₱53) for the year ended December 31, 2004. The latter is recognized immediately in retained earnings (see Note 20).

d. PAS 21, "The Effects of Changes in Foreign Exchange Rates." Under PFRS, capitalization of foreign exchange losses is prohibited. Any undepreciated capitalized foreign exchange losses allowed under previous GAAP was adjusted against January 1, 2004 retained earnings and prior years' consolidated financial statements presented were restated. The effect is a reduction in retained earnings of ₱1,784 (net of tax effect of ₱627) as of January 1, 2004 and ₱1,612 (net of tax effect of ₱570) as of December 31, 2004. This also reduced property, plant and equipment by ₱2,411 as of January 1, 2004 and ₱2,182 as of December 31, 2004. Cost of sales also decreased by ₱252 for 2004.

PAS 21 also requires each individual entity to determine its functional currency and evaluate whether the activities of its foreign operations are carried out as an extension of the Parent Company. Ovincor was assessed to be an extension of the Parent Company and, as a result, the cumulative translation adjustment of ₱81 (net of tax effect of ₱38) and ₱85 (net of tax effect of ₱40) in prior years were reversed against retained earnings as of January 1, 2004 and December 31, 2004, respectively, while other income increased by ₱6 for 2004.

e. PAS 32, "Financial Instruments: Disclosure and Presentation" and PAS 39, "Financial Instruments: Recognition and Measurement." Under PFRS, financial assets at FVPL, AFS investments and derivative financial instruments (including embedded derivatives) are recognized as assets or liabilities and measured at fair value. Moreover, PFRS requires more stringent impairment assessment for financial assets. Under previous GAAP, investments in marketable equity securities and investments in shares of stock were measured at the lower of aggregate cost or market.

The Company availed of the exemption under PFRS 1 and account for PAS 32 and PAS 39 starting January 1, 2005. The cumulative effect of adopting this accounting standard was adjusted to January 1, 2005 stockholders' equity.

Due to the adoption of PAS 32 and PAS 39, Petrogen classified its investments in government securities as AFS investments. As such, Petrogen recorded these investments at fair value resulting in the recognition of cumulative translation adjustments amounting to ₱2 (net of tax effect of ₱0.7) as of January 1, 2005. Petrogen also changed its method of amortizing bond premiums and discounts from straight-line method to effective interest method resulting in a decrease in retained earnings and investments as of January 1, 2005 by ₱0.4 and ₱0.6, respectively.

Adoption of this standard has increased (decreased) the following accounts in the January 1, 2005 consolidated balance sheet:

	Amount
Receivables	(₱39)
Other current assets	1
Accounts payable and accrued expenses	(10)
Other current liabilities	32
Deferred income tax liabilities	(6)
Other noncurrent liabilities	(6)
Retained earnings	(39)
Minority interest	(9)

f. PAS 40, "Investment Property." The Company's investment properties amounting to ₱183 as of January 1, 2004 and ₱171 as of December 31, 2004 were reclassified from "Building and related facilities" and "Land and leasehold improvements" accounts to "Investment properties" account in the consolidated balance sheets. Idle properties and properties purchased awaiting transfer of titles amounting to ₱16 as of January 1, 2004 and ₱31 as of December 31, 2004, previously presented as "Other noncurrent assets," were also reclassified to investment properties. The Company opted to carry its investment properties using the cost model (see Note 4).

g. PFRS 3, "Business Combination." Under previous GAAP, goodwill was amortized over 20 years. Under PFRS, the Company ceased annual goodwill amortization and commenced testing for impairment annually from January 1, 2004. The adoption of PFRS 3 has resulted in the reversal of a business combination previously accounted for under the purchase method. Since the acquisition does not qualify as business acquisition but a purchase of an asset, the resulting goodwill and subsequent amortization were reversed. The effect is an addition to retained earnings and reduction of other noncurrent assets by ₱9 as of January 1, 2004 and ₱5 as of December 31, 2004 and reduction of property, plant and equipment by ₱117 as of January 1, 2004 and December 31, 2004. The adoption of this standard also reduced deferred income tax liabilities by ₱126 in 2004, while other expenses was reduced by ₱4 for 2004.

h. The above adjustments increased (decreased) retained earnings at January 1, 2004 and December 31, 2004 as follows:

	January 1, 2004	December 31, 2004
Inventories (see Note a)	₱2,424	₱3,179
Property, plant and equipment (see Notes b and d)	(2,357)	(2,129)
Other noncurrent assets (see Notes c and g)	505	479
Other noncurrent liabilities (see Note b)	(225)	(256)
Other reserves (see Note d)	81	85
Increase in deferred income tax liabilities (see Notes a, b, c, d and g)	(217)	(593)
	₱211	₱765

i. The above changes decreased (increased) the deferred income tax liabilities as follows:

	January 1, 2004	December 31, 2004
Inventories (see Note a)	(₱776)	(₱1,017)
Property, plant and equipment (see Notes b and d)	610	554
Other noncurrent assets (see Note c)	(161)	(251)
Other noncurrent liabilities (see Note b)	72	81
Other reserves (see Note d)	38	40
	(₱217)	(₱593)

Effect on the Consolidated Cash Flows Statement for 2004

There are no material differences between the consolidated statement of cash flows prepared under PFRS and under previous GAAP.

Other Adopted PFRS

The Company has also adopted the following other PFRSs. Comparative presentation and disclosures have been amended as required by the standards. Adoption of these standards has no effect on stockholders' equity at January 1 and December 31, 2004.

- PAS 1, "Presentation of Financial Statements";
- PAS 8, "Accounting Policies, Changes in Accounting Estimates and Errors";
- PAS 10, "Events after the Balance Sheet Date";
- PAS 17, "Leases";
- PAS 24, "Related Party Disclosures";
- PAS 33, "Earnings per Share";
- PAS 36, "Impairment of Assets";
- PAS 38, "Intangible Assets";
- PFRS 2, "Share-based Payments";
- PFRS 4, "Insurance Contracts"; and
- PFRS 5, "Noncurrent Assets Held for Sale and Discontinued Operations."

Standards Not Yet Effective

The Company did not early adopt the following standards that have been approved but are not yet effective:

- PFRS 6, "Exploration for and Evaluation of Mineral Resources," effective 2006 — This standard is not relevant to the Company's business operations.
- PFRS 7, "Financial Instruments - Disclosures" — Additional disclosure requirements will be included when this standard takes effect in 2007.

4. Summary of Significant Accounting Policies

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 dates of acquisition and that are subject to an insignificant risk of change in value.

Financial Assets and Liabilities

Accounting Policies Effective January 1, 2005

Financial assets and liabilities are recognized initially at fair value. Transaction costs are included in the initial measurement of all financial assets and liabilities, except for financial instruments measured at FVPL.

The Company recognizes a financial asset or liability in the consolidated balance sheet when it becomes a party to the contractual provisions of the instrument. A financial liability (or a part of a financial liability) is derecognized when the obligation is extinguished. In the case of a regular way purchase or sale of financial assets, recognition and derecognition, as applicable, is done using settlement date accounting.

Financial instruments are classified as liabilities or equity in accordance with the substance of the contractual arrangement. Interest, dividends, gains and losses relating to a financial instrument or a component that is a financial liability, are reported as expense or income. Distributions to holders of financial instruments classified as stockholders' equity are charged directly to equity net of any related income tax benefits. Financial instruments are offset when there is a legally enforceable right to offset and intention to settle either on a net basis or to realize the asset and settle the liability simultaneously.

Financial assets are classified into the following categories: financial asset at FVPL, loans and receivables, held-to-maturity (HTM) investments, and AFS investments. The Company determines the classification at initial recognition and, where allowed and appropriate, re-evaluates this designation at every reporting date.

a. Financial Asset at FVPL

A financial asset is classified in this category if acquired principally for the purpose of selling or repurchasing in the near term or upon initial recognition, it is designated by the management as FVPL. Derivatives are also categorized as held at FVPL, except those derivatives designated and considered as effective hedging instruments. Assets classified under this category are carried at fair value in the consolidated balance sheet. Changes in the fair value of such assets are accounted for in earnings. Financial instruments held at FVPL are classified as current if they are expected to be realized within 12 months from the balance sheet date.

Classified as financial assets at FVPL are the Company's investments in marketable equity securities and proprietary membership shares (see Note 7).

b. Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments and are not quoted in an active market. Such assets are carried at cost or amortized cost in the consolidated balance sheet. Amortization is determined using the effective interest method. Loans and receivables are included in current assets if maturity is within 12 months from the balance sheet date. Otherwise, these are classified as noncurrent assets.

Classified as loans and receivables are the Company's trade and other receivables (see Note 10).

c. HTM Investments

HTM investments are quoted non-derivative financial assets with fixed or determinable payments and fixed maturities wherein the Company has the positive intention and ability to hold to maturity. HTM investments assets are carried at cost or amortized cost in the consolidated balance sheet. Amortization is determined by using the effective interest method. Assets under this category are classified as current assets if maturity is within 12 months from the balance sheet date and as noncurrent assets if maturity date is more than a year from the balance sheet date.

The Company has no HTM investments as of December 31, 2005.

d. AFS Investments

AFS investments are those nonderivative financial assets that are designated as AFS or are not classified in any of the three preceding categories. After initial recognition, AFS sale financial assets are measured at fair value with gains or losses being recognized as a separate component of stockholders' equity until the investment is derecognized or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the consolidated statement of income.

Classified as AFS investments are Petrogen's investments in government securities (see Note 8).

The fair value of investments that are actively traded in organized financial markets is determined by reference to quoted market bid prices at the close of business on the balance sheet date. For investments where there is no active market, fair value is determined using valuation techniques. Such techniques include using recent arm's length market transactions; reference to the current market value of another instrument, which is substantially the same; discounted cash flow analysis and option pricing models.

e. Derivative Financial Instruments

The Company uses commodity price swaps to protect its margin on industrial fuel from potential price volatility of crude oil and industrial fuel oil. It also enters into short-term forward currency contracts to hedge its currency exposure on crude oil importations. In addition, the Company has identified and bifurcated embedded foreign currency derivatives from certain non-financial contracts.

Derivative instruments are initially recognized at fair value on the date in which a derivative transaction is entered into or bifurcated, and are subsequently re-measured at fair value. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative. The Company has opted not to designate its derivative transactions under hedge accounting. Consequently, gains and losses from changes in fair value of these derivatives are recognized immediately in the consolidated statements of income.

The fair values of freestanding and bifurcated forward currency transactions are calculated by reference to current forward exchange rates for contracts with similar maturity profiles. The fair values of commodity swaps are determined based on quotes obtained from counterparty banks.

Accounting Policies Prior to January 1, 2005

a. Investments in Marketable Equity Securities

Investments in marketable equity securities, shown under "Short-term investments" account in the 2004 consolidated balance sheet, were stated at the lower of aggregate cost or market value determined as of balance sheet date. The amount by which the aggregate cost exceeds market value was accounted for as a valuation allowance and changes in the valuation allowance are included in the consolidated statements of income. Realized gains or losses from the sales of current marketable equity securities were included in the consolidated statement of income. The cost of marketable equity securities used for determining the gain or loss on the sales of such securities was computed using the average method.

b. Investments in Shares of Stock

These investments in proprietary membership shares were carried at cost. An allowance was provided for any substantial and presumably permanent decline in the carrying values of these investments.

c. Derivative Financial Instruments

Gains or losses on derivative instruments, including premium amortization, were recognized in current operations simultaneous with the gains or losses on the underlying hedged transactions. No accounting recognition was given to embedded derivatives.

<u>Interest-Bearing Loans and Borrowings</u>
All loans and borrowings are initially recognized at the fair value of the consideration received less directly attributable transaction costs.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortized cost using the effective interest method. Amortized cost is calculated by taking into account any related issue costs, discount or premium.

Gains and losses are recognized in net profit or loss when the liabilities are derecognized as well as through the amortization process.

<u>Impairment of Financial Assets</u>
The Company assesses at each balance sheet date whether a financial asset or group of financial assets is impaired.

Loans and Receivables. If there is objective evidence that an impairment loss on loans and receivables carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in the consolidated statement of income.

The Company first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed. Any subsequent reversal of an impairment loss is recognized in the consolidated statement of income, to the extent that the carrying value of the asset does not exceed its amortized cost at the reversal date.

AFS Investments. If an AFS asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortization) and its current fair value, less any impairment loss previously recognized in consolidated statements of income, is transferred from stockholders' equity to the consolidated statement of income. Reversals in respect of equity instruments classified as AFS are not recognized in consolidated statement of income. Reversals of impairment losses on debt instruments are reversed through the consolidated statement of income, if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognized in the consolidated statement of income.

<u>Derecognition of Financial Assets and Liabilities</u>

Effective January 1, 2005

Financial Assets. A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognized when:

- the rights to receive cash flows from the asset have expired;
- the Company retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass-through' arrangement; or
- the Company has transferred its rights to receive cash flows from the asset and either (a) has transferred

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substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Financial Liabilities. A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognized in the consolidated statement of income.

Receivables
Trade receivables are recognized and carried at original invoice amount less an allowance for any uncollectible amount. Provision is made when there is objective evidence that the Company will not be able to collect the debts. Bad debts are written off when identified.

Inventories
Inventories are carried at the lower of cost or net realizable value. For petroleum products, crude oil and tires, batteries and accessories (TBA), the net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion, marketing and distribution. For materials and supplies, net realizable value is the current replacement cost.

For financial reporting purposes, Petron uses the FIFO method in costing petroleum products (except lubes and greases, waxes and solvents), crude oil and other products.

Cost is determined using the moving-average method in costing lubes and greases, waxes and solvents, TBA and materials and supplies inventories.

For income tax reporting purposes, cost of all inventories is determined using the moving-average method.

For financial reporting purposes, duties and taxes related to the acquisition of inventories are capitalized as part of inventory cost. For income tax reporting purposes, such duties and taxes are treated as deductible expenses in the period these charges are incurred.

Interest in a Joint Venture
The Company's 33.33% joint venture interest in Pandacan Depot Services Inc. (PDSI) (see Note 12), incorporated on September 29, 2004 under the laws of the Republic of the Philippines, is accounted for under equity method of accounting. The interest in joint venture is carried in the consolidated balance sheets at cost plus post-acquisition changes in the Company's share of net assets of the joint venture, less any impairment in value. The consolidated statements of income reflect the Company's share in the results of operations of the joint venture.

Property, Plant and Equipment
Property, plant and equipment, except land, are stated at cost less accumulated depreciation, amortization and any impairment in value. Land owned by NVRC and its subsidiary, is stated at cost less any impairment in value.

The initial cost of property, plant and equipment comprises its purchase price, including import duties and taxes and any directly attributable costs of bringing the assets to their working condition and location for their intended use. Cost also includes any related asset retirement obligation and interest incurred during the construction period on funds borrowed to finance the construction of the projects. Expenditures incurred after the property, plant and equipment have been put into operation, such as repairs, maintenance and overhaul costs, are normally charged to income in the period the costs are incurred. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard of performance, the expenditures are capitalized as additional costs of property, plant and equipment. When assets are retired or otherwise disposed of, the cost and the related accumulated depreciation, amortization and impairment loss, if any, are removed from the accounts and any resulting gain or loss is credited or charged to current operations.

When each major inspection is performed, its cost is recognized in the carrying amount of the property, plant and equipment as a replacement if the recognition criteria are satisfied.

For financial reporting purposes, depreciation and amortization are computed using the straight-line method over the following estimated useful lives of the assets:

Buildings and related facilities	20-25 years
Refinery and plant equipment	10-16 years
Service stations and other equipment	4-10 years
Computers, office and motor equipment	2-6 years
Leasehold improvements	10 years or the term of the lease, whichever is shorter

The useful lives and depreciation and amortization method are reviewed periodically to ensure that the periods and method of depreciation and amortization are consistent with the expected pattern of economic benefits from the items of property, plant and equipment. The residual value, if any, is also reviewed and adjusted if appropriate, at each year end.

For income tax reporting purposes, depreciation and amortization are computed using the double-declining balance method.

For financial reporting purposes, duties and taxes related to the acquisition of property, plant and equipment are capitalized. For income tax reporting purposes, such duties and taxes are treated as deductible expenses in the period these charges are incurred.

Construction-in-progress represents plant and properties under construction and is stated at cost. This includes cost of construction, plant and equipment, interest and other direct costs. Construction-in-progress is not depreciated until such time as the relevant assets are completed and available for operational use.

Investment Properties

Investment properties, except land, are stated at cost less accumulated depreciation and any impairment in value. Cost includes transaction costs. The carrying amount includes the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met; and excludes the costs of day-to-day servicing of an investment property. Land is carried at cost less any impairment in value.

Investment properties are derecognized when either they have been disposed of or when the investment property is permanently withdrawn from use and no future economic benefit is expected from its disposal. Any gains or losses on the retirement or disposal of an investment property are recognized in the consolidated statements of income in the year of retirement or disposal.

Transfers are made to investment property when, and only when, there is a change in use, evidenced by ending of owner-occupation, commencement of an operating lease to another party or ending of construction or development. Transfers are made from investment property when, and only when, there is a change in use, evidenced by commencement of owner-occupation or commencement of development with a view to sale. These transfers are recorded using the carrying amount of the investment property at the date of the change in use.

For financial reporting purposes, depreciation on office units is computed on a straight-line basis over the estimated useful lives of the assets of 20 years. For income tax reporting purposes, depreciation is computed using the double-declining balance method.

Asset Impairment

The carrying values of long-lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying values may not be recoverable. If any such indication exists and where the carrying values exceed the estimated recoverable amounts, the assets or cash-generating units are written down to their recoverable amounts. The recoverable amount of the asset is the greater of net selling price and value in use. The net selling price is the amount obtainable from the sale of an asset in an arm's-length transaction. 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 assessment of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the smallest cash-generating unit to which the asset belongs. Impairment losses are recognized in the consolidated statements of income.

A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the recoverable amount of an asset, however, not to an amount higher than the carrying amount that would have been determined (net of any depreciation and amortization) had no impairment loss been recognized for the asset in prior years. A reversal of an impairment loss is credited to current operations.

Pension Costs

The Company has a defined benefit pension plan covering all permanent, regular, full-time employees administered by a trustee bank. The cost of providing benefits under the defined benefit plans is determined using the projected unit credit actuarial valuation method. Actuarial gains and losses are recognized immediately in full in the consolidated statements of recognized income and expense. Any actuarial gains and losses and adjustments arising from the limits on asset ceiling test are taken directly to retained earnings.

The past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. If the benefits are already vested immediately following the introduction of, or changes to, a pension plan, past service cost is recognized immediately.

The defined benefit liability is the aggregate of the present value of the defined benefit obligation reduced by past service cost not yet recognized and the fair value of plan assets out of which the obligations are to be settled directly. If such aggregate is negative, the asset is measured at the lower of such aggregate or the aggregate of cumulative unrecognized net actuarial losses and past service cost and the present value of any economic benefits available in the form of refunds from the plan or reductions in the future contributions to the plan.

Borrowing Costs

Borrowing costs generally are expensed as incurred. For financial reporting purposes, interest on loans used to finance capital projects is capitalized as part of project costs (shown as part of "Construction in-progress" account in the consolidated balance sheets) during construction period. Capitalization of interest commences when the activities to prepare the asset are in progress and expenditures and interest are being incurred. Interest costs are capitalized until the assets are substantially ready for their intended use. If the carrying amount of the asset exceeds its recoverable amount, an impairment loss is recognized. For income tax reporting purposes, such interest is treated as deductible expense in the period the interest is incurred.

Cylinder Deposits

The LPG cylinders remain the property of the Company and are loaned in the concept of commodatum to dealers upon payment by the latter of an equivalent 100% of acquisition cost of cylinders.

The Company maintains the balance of cylinder deposits at an amount equivalent to three days worth of inventory of its biggest dealers, but in no case lower than ₱200 at any given time, to take care of possible returns by dealers.

Cylinder deposits, shown under "Other noncurrent liabilities" account in the consolidated balance sheets, are reduced for estimated non-returns. The reduction is credited directly to income.

Provisions
Provisions are recognized when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a credit adjusted pre-tax rate that reflects current market assessment of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as an interest expense.

The Company recognizes provisions arising from legal and/or constructive obligations associated with the cost of dismantling and removing an item of property, plant and equipment and restoring the site where it is located, the obligation for which the Company incurs either when the asset is acquired or as a consequence of having used the asset during a particular period for purposes other than to produce inventories during that period.

Revenue Recognition.
Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Company and revenue can be reliably measured. The following specific criteria must also be met before revenue is recognized:

Sale of goods. Revenue is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer.

Interest income. Revenue is recognized on a time proportion basis that reflects the effective yield on the assets.

Rental income. Rental income arising on investment properties is accounted for on a straight-line basis over the lease terms.

Operating Leases

Company as a Lessee. Operating lease payments are recognized as an expense in the consolidated statements of income on a straight-line basis over the lease terms.

Company as a Lessor. Leases where the Company retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Initial direct costs incurred in negotiating an operating lease are added to the carrying amount of the leased asset and recognized over the lease terms on the same bases as rental income. Operating lease payments are recognized as income in the consolidated statements of income on a straight-line basis over the lease terms.

Foreign Currency-Denominated Transactions and Translations
Transactions in foreign currencies are recorded using the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are restated using the spot exchange rate as of balance sheet date. Exchange gains or losses arising from foreign currency-denominated transactions are credited or charged to current operations.

The functional currency of Ovincor, a foreign subsidiary, is the Philippine peso.

Income Taxes

Current Tax. Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

Deferred Tax. Deferred income tax is provided in full, using the balance sheet liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, the deferred income tax is not recognized if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted at the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each balance sheet date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statements of income.

Deferred tax assets and deferred tax liabilities are offset only if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

Earnings Per Share Attributable to the Equity Holders of the Parent
Basic earnings per share is computed based on the weighted average number of outstanding shares after giving

retroactive effect to any stock split and stock dividends declared during the year. There are no dilutive potential common shares outstanding that would require disclosure of diluted earnings per share in the consolidated statements of income.

Segments
The Company's operating businesses are recognized and managed separately according to the nature of the products and invoices provided, with each segment representing a strategic business unit that offers different products and serves different markets. Financial information on business and geographical segments is presented in Note 34.

Contingencies
Contingent liabilities are not recognized in the consolidated financial statements. They are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent assets are not recognized in the consolidated financial statements but are disclosed when an inflow of economic benefits is probable.

Subsequent Events
Post-year-end events that provide additional information about the Company's position at the balance sheet date (adjusting events) are reflected in the consolidated financial statements. Post-year-end events that are not adjusting events are disclosed in the notes to the consolidated financial statements when material.

5. Significant Accounting Judgments and Estimates

The Company's financial statements prepared in accordance with PFRS require management to make judgments and estimates that affects amounts reported in the financial statements and related notes.

Judgments
In the process of applying the Company's accounting policies, management has made the following judgments, apart from those involving estimations, which have the most significant effect on the amounts recognized in the consolidated financial statements.

Operating Lease Commitments - Company as Lessor/Lessee. The Company has entered into commercial property leases on its investment property portfolio. The Company has determined that it retains all the significant risks and rewards of ownership of the properties leased out on operating leases while the significant risks and rewards for properties leased from third parties are retained by the lessors. Total lease income amounted to ₱280 and ₱274 in 2005 and in 2004, respectively (see Note 23), while lease expense amounted to ₱306 and ₱271 in 2005 and in 2004, respectively (see Note 22).

Estimation Uncertainty
The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustments to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Financial Assets and Liabilities. PFRS requires that certain financial assets and liabilities be carried at fair value, which requires the use of accounting estimates and judgments. While significant components of fair value measurement are determined using verifiable objective evidence (i.e., foreign exchange rates, interest rates, volatility rates), the timing and amount of changes in fair value would differ with the valuation methodology used. Any change in the fair value of these financial assets and liabilities would directly affect income and stockholders' equity.

The aggregate fair value of the financial assets carried at fair value amounted to ₱599 as of December 31, 2005 (see Notes 7 and 8).

Allowance for Doubtful Accounts. Allowance for doubtful accounts is maintained at a level considered adequate to provide for potentially uncollectible receivables. The level of allowance is based on past collection experience and other factors that may affect collectibility. An evaluation of the receivables, designed to identify potential charges to the allowance, is performed regularly throughout the year. Specifically, in coordination with Marketing Group, Credit Management evaluates customer's accounts in identifying customers who are unable to meet their financial obligations. In these cases, management uses sound judgment based on the best available facts and circumstances, including but not limited to, the length of relationship with the customers and their payment track record. The amounts of provisions differ for each period based on available objective evidence for which the Company may consider that it will probably not be able to collect some of its accounts. Bad debts are written off when identified to be worthless after exhausting all efforts to collect.

An increase in allowance for doubtful accounts would increase the Company's recorded selling and administrative expenses and decrease current assets. Provisions for doubtful accounts amounted to ₱106 in 2005 and ₱162 in 2004 (see Note 22). Receivables, net of allowance for doubtful accounts, amounted to ₱14,055 and ₱11,758 as of December 31, 2005 and 2004, respectively (see Note 10).

Allowance for Inventory Obsolescence. The allowance for obsolescence consists of collective and specific provisions. A collective provision is established as a certain percentage based on the age and movement of stocks. In case there is write-off or disposal of slow-moving items during the year, a reduction in the allowance for obsolescence is made.

Review of existing allowance is done every quarter, while a revised set-up or booking is posted at the end of the year based on evaluations or recommendations of proponents. The amount and timing of recorded expenses for any period would therefore differ based on the judgments or estimates made.

Inventories, net of allowance for obsolescence, amounted to ₱27,018 and ₱22,414 as of December 31, 2005 and 2004, respectively (see Note 11).

Estimated Useful Lives. The useful life of each of the Company's item of property, plant and equipment and investment properties is estimated based on the period over which the asset is expected to be available for use. Such estimation is based on a collective assessment of practices of similar businesses, internal technical evaluation and experience with similar assets. The estimated useful life of each asset is reviewed periodically and updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on the use of the asset. It is possible, however, that future results of operations could be materially affected by changes in the amounts and timing of recorded expenses brought about by changes in the factors mentioned above. A reduction in the estimated useful life of any item of property, plant and equipment would increase the recorded cost of goods sold, selling and administrative expenses and decrease noncurrent assets.

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Property, plant and equipment and investment properties, net of accumulated depreciation and amortization as of December 31, 2005 and 2004 amounted to ₱22,777 and ₱22,648, respectively (see Notes 13 and 14).

Asset Impairment. Except for intangible assets with indefinite useful lives, PFRS requires that an impairment review be performed when certain impairment indicators are present. For intangible assets with indefinite useful lives, impairment testing is performed on an annual basis. Determining the net recoverable value of assets requires the estimation of cash flows expected to be generated from the continued use and ultimate disposition of such assets. While it is believed that the assumptions used in the estimation of fair values reflected in the consolidated financial statements are appropriate and reasonable, significant changes in these assumptions may materially affect the assessment of recoverable values and any resulting impairment loss could have a material adverse impact on the results of operations.

No impairment loss was recognized in 2005 and 2004. The aggregate carrying amount of property, plant and equipment and investment properties, net of accumulated depreciation amounted to ₱22,777 and ₱22,648 as of December 31, 2005 and 2004, respectively (see Notes 13 and 14).

Pension Costs. The determination of the obligation and cost for pension and other retirement benefits is dependent on the selection of certain assumptions used by actuary in calculating such amounts. Those assumptions are described in Note 27 and include, among others, discount rate and rate of compensation increase. In accordance with PAS 19, as amended, the Company recognizes all actuarial gains and losses in the consolidated statements of recognized income and expense, and therefore generally affects the recorded obligation. While it is believed that the Company's assumptions are reasonable and appropriate, significant differences in actual experience or significant changes in assumptions may materially affect the Company's pension obligations.

Net pension plan assets amounted to ₱1,137 and ₱783 as of December 31, 2005 and 2004, respectively (see Note 27). Actuarial gains or losses as of December 31, 2005 and 2004, included under "Other reserves" account in the consolidated balance sheets, amounted to ₱185 and ₱309, respectively.

Deferred Income Tax Assets. Significant judgment is required in determining provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Company recognizes liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

Deferred income tax assets as of December 31, 2005 and 2004 amounted to ₱1,082 and ₱878, respectively (see Note 24).

Asset Retirement Obligation. Determining asset retirement obligation requires estimation of the costs of dismantling, installations and restoring leased properties to their original condition. The Company determined the amount of asset retirement obligation by obtaining estimates of dismantling costs from proponent who is responsible for the operation of the asset discounted at the Company's current borrowing rates ranging from 9.94% to 15.29% depending on the life of the capitalized costs. While it is believed that the assumptions used in the estimation of such costs are reasonable, significant changes in these assumptions may materially affect the recorded expense or obligation in future periods.

The Company has an asset retirement obligation arising from leased service stations and bulk plants. Such obligation is not expected to be settled for the foreseeable future and therefore a reasonable estimate of fair value cannot be determined. However, given the impact of discounting, any estimate of the asset retirement obligation may not likely be significant.

Asset retirement obligation as of December 31, 2005 and 2004 amounted to ₱298 and ₱256, respectively (see Note 19).

Contingencies. The Company currently has various tax assessments and legal claims. The Company develops estimate of the probable costs for the assessments and resolution of these claims in consultation with in-house as well as outside counsel handling the prosecution and defense of these cases and is based upon an analysis of potential results. The Company currently does not believe these tax assessments and legal claims will have a material adverse effect on its consolidated financial position and results of operations. It is possible, however, that future results of operations could be materially affected by changes in the estimates or in the effectiveness of strategies relating to these proceedings (see Note 35). No provision for contingencies was recognized in 2005 and 2004.

6. Cash and Cash Equivalents

	2005	2004
Cash on hand and in banks	**₱3,576**	₱3,430
Money market placements	**495**	674
	₱4,071	₱4,104

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

7. Financial Assets at FVPL

As of December 31, 2005, this account consists of:

Marketable equity securities	₱82
Proprietary membership shares	62
	₱144

In 2004, marketable equity securities are classified as short-term investments (see Note 9) and proprietary membership shares are classified as investments (see Note 12).

8. AFS Investments

This account consists of investments in government securities of Petrogen which are deposited with the Insurance Commission in accordance with the provisions of the Insurance Code, for the benefit and security of policyholders and creditors of Petrogen. These investments bear fixed interest rates ranging from 4.5% to 11.8%.

Following is the breakdown of investments in government securities by contractual maturity dates as of December 31, 2005:

Due in one year or less	₱259
Due after one year through five years	196
	₱455

In 2004, these are classified under "Investments" account (see Note 12).

9. Short-term Investments

As of December 31, 2004, this account consisted of:

Marketable equity securities	₱60
Short-term cash investments	3
	₱63

In 2005, the marketable equity securities are classified as financial assets at FVPL (see Note 7). In 2004, these securities are carried at the lower of aggregate cost or market value.

10. Receivables

	2005	2004
Trade	**₱11,890**	₱10,136
Others	**3,012**	2,327
	14,902	12,463
Less allowance for doubtful accounts	**847**	705
	₱14,055	₱11,758

Trade receivables are non-interest bearing and generally on 45-day term.

11. Inventories

	2005	2004 (As restated - see Note 3)
At cost:		
Petroleum	**₱14,624**	₱12,552
Crude oil and others	**11,947**	9,151
At net realizable value - TBA products, materials and supplies	**447**	711
	₱27,018	₱22,414

Using the moving-average method, the cost of petroleum, crude oil and other products would have increased by ₱619 as of December 31, 2005 and ₱242 as of December 31, 2004.

Cost of TBA products, material and supplies amounted to ₱881 as of December 31, 2005 and ₱980 as of December 31, 2004.

12. Investments

This account, included under "Other noncurrent assets" account in 2004 (see Note 15), consists of the following:

Notes and bonds - at amortized cost (see Note 8)	₱330
Shares of stock - at lower of cost or market (see Note 7)	69
Joint venture interest in PDSI	4
Other investment (net of allowance for decline in value of ₱594 in 2005 and ₱580 in 2004)	–
	₱403

- Investments in notes and bonds pertain to Petrogen's investment in government securities, which are classified as AFS investments in 2005 (see Note 8).
- Investments in shares of stock comprise of proprietary membership shares. In 2005, these are classified as financial assets at FVPL (see Note 7).
- The Company has a 33.33% joint venture interest in PDSI, which is involved in receiving, storing and handling the out-loading of petroleum products of the three major oil companies to serve the fuel requirements of their respective customers. PDSI was incorporated on September 29, 2004. In 2005, this joint venture interest is included under "Other noncurrent assets" account.
- Other investment consists of redeemable preferred voting shares of an institution under a court-approved rehabilitation plan. The Company provided full allowance for the cost of investment. In 2005, this is included under "Other noncurrent assets" account.

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

13. Property, Plant and Equipment

	Buildings and Related Facilities	Refinery and Plant Equipment	Service Stations and Other Equipment	Computers Office and Motor Equipment	Land and Leasehold Improvements	Construction-in-Progress	Total
Net carrying amount, at January 1, 2005, as restated (Note 3)	₱5,510	₱9,358	₱540	₱433	₱917	₱5,688	₱22,446
Additions	195	–	168	1,861	368	2,448	
Transfers	288	3,687	328	150	61	(4,514)	–
Depreciation and amortization for the year	(408)	(1,476)	(177)	(146)	(117)	–	(2,324)
Net carrying amount, at December 31, 2005	₱5,585	₱11,569	₱707	₱445	₱2,722	₱1,542	₱22,570
At January 1, 2005, as restated (Note 3)							
Cost	₱7,601	₱18,423	₱2,698	₱1,656	₱1,749	₱5,688	₱37,815
Accumulated depreciation and amortization	(2,091)	(9,065)	(2,158)	(1,223)	(832)	–	(15,369)
Net carrying amount	₱5,510	₱9,358	₱540	₱433	₱917	₱5,688	₱22,446
At December 31, 2005							
Cost	₱8,081	₱22,105	₱3,037	₱1,796	₱3,667	₱1,542	₱40,228
Accumulated depreciation and amortization	(2,496)	(10,536)	(2,330)	(1,351)	(945)	–	(17,658)
Net carrying amount	₱5,585	₱11,569	₱707	₱445	₱2,722	₱1,542	₱22,570

The Company has asset retirement obligation arising from leased service stations and bulk plants. Such obligation is not expected to be settled for the foreseeable future and therefore a reasonable estimate of fair value cannot be determined. However, given the impact of discounting, any estimate of the asset retirement obligation may not likely be significant.

Interest capitalized in 2005 amounted to ₱46 using a capitalization rate of 6.94% for peso loans. Interest capitalized in 2004 amounted to ₱98 using a capitalization rate of 8.24% for peso loans and 3.16% for dollar loans.

14. Investment Properties

	Land	Office Units	Total
Net carrying amount, at January 1, 2005, as restated	₱32	₱170	₱202
Additions	16	–	16
Depreciation and amortization for the year	–	(11)	(11)
Net carrying amount, at December 31, 2005	₱48	₱159	₱207
At January 1, 2005, as restated:			
Cost	₱32	₱235	₱267
Accumulated depreciation and amortization	–	(65)	(65)
Net carrying amount	₱32	₱170	₱202

	Land	Office Units	Total
At December 31, 2005:			
Cost	₱48	₱235	₱283
Accumulated depreciation and amortization	–	(76)	(76)
Net carrying amount	₱48	₱159	₱207

There are no available fair values for office units located in Petron Megaplaza and for the parcels of land in various locations intended for service stations.

Rental income earned from the investment properties amounted to ₱20 and ₱15 in 2005 and 2004, respectively.

There are no other direct selling and administration expense (i.e., repairs and maintenance) arising from investment properties that generated rental income in 2005 and in 2004.

15. Other Noncurrent Assets

	2005	2004 (As restated - see Note 3)
Net pension plan assets (see Note 27)	**₱1,137**	₱783
Others	**121**	569
	₱1,258	₱1352

In 2005, "Others" account includes joint venture interest in PDSI and other investments (see Note 12).

16. Short-term Loans

This account pertains to unsecured peso and dollar loans obtained from local banks at interest rates ranging from 5.5% to 8.3% for peso loans and 2.5% to 3.2% for dollar loans, intended to fund the importation of crude oil and petroleum products, capital expenditures and working capital requirements.

17. Accounts Payable and Accrued Expenses

	2005	2004
Accrued expenses	**₱1,406**	₱1,575
Accounts payable	**472**	1,208
Specific and other taxes payable	**336**	482
Derivative liabilities (see Note 32)	**5**	–
Others	**2,599**	1,820
	₱4,818	₱5,085

Terms and conditions of the above financial liabilities:

- Accounts payable are non-interest bearing and are normally settled on 30-day term.
- Accrual of unpaid interest, selling and administrative expenses which are normally settled within a year.
- Other payables include unearned income arising from trade related transactions.

18. Long-term Debt

	2005	2004
Syndicated dollar bank loan (net of debt issue costs amounting to ₱80 in 2005 and ₱100 in 2004)	**₱5,258**	₱5,534
Unsecured peso loans	**1,673**	3,288
	6,931	8,822
Less current portion (net of debt issue costs amounting to ₱21 in 2005 and ₱20 in 2004)	**1,906**	1,595
	₱5,025	₱7,227

The salient terms of the foregoing loans are summarized as follows:

Original Amount	NORD - LB US$100 million	Landbank - ₱2 billion	Citibank - ₱2 billion
Payment Terms	Six semi-annual installments starting on the 30th month from June 2004 up to June 2009	Eight equal quarterly installments starting December 2004 up to September 2006	13 equal quarterly installments starting April 2004 up to April 2007
Interest (2005)	4.2% to 5.9%	7.2% to 8.7%	7.8% to 9.7%
Security	None	None	None
Major Covenants	Maintenance of certain financial ratios	None	Maintenance of certain financial ratios

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

As of December 31, 2005, the Company is in compliance with its loan covenants. Loan maturities (gross of ₱80 debt issue costs) for the next 4 years are as follows:

Year	Amount
2006	₱1,927
2007	1,767
2008	2,122
2009	1,195
	₱7,011

19. Other Noncurrent Liabilities

	2005	2004 (As restated - see Note 3)
Asset retirement obligation	**₱298**	₱256
Cylinder deposits	**244**	274
Cash bonds	**119**	108
Others	**36**	29
	₱697	₱667

Movement of asset retirement obligation follows:

	2005	2004 (As restated - see Note 3)
Beginning balance	**₱256**	₱228
Additions for the year	**9**	–
Accretion	**33**	28
Ending balance	**₱298**	₱256

20. Other Changes in Stockholders' Equity

	Attributable to Equity Holders of the Parent			
		Retained Earnings		Minority
	Capital Stock	Appropriated	Unappropriated	Interest
Balance at December 31, 2004, as previously reported	₱9,375	₱6,906	₱4,858	₱110
Effect of changes in accounting policies (see Note 3)	–	–	765	–
Balance at December 31, 2004, as restated	9,375	6,906	5,623	110
Effect of change in accounting policy - PAS 39 (see Note 3)	–	–	(39)	(9)
Balance at January 1, 2005	9,375	6,906	5,584	101
Net income for the year	–	–	6,044	7
Actuarial gains due to limit on recognized plan asset - net of tax effect	–	–	408	–
Appropriated for capital projects	–	4,746	(4,746)	–
Cash dividends - ₱0.10 per share	–	–	(938)	–
Balance at December 31, 2005	₱9,375	₱11,652	₱6,352	₱108
Balance at December 31, 2003, as previously reported	₱9,375	₱5,551	₱4,663	₱103
Effect of changes in accounting policies (see Note 3)	–	–	211	–
Balance at December 31, 2003, as restated	9,375	5,551	4,874	103
Net income for the year	–	–	4,094	7
Actuarial losses due to limit on recognized plan asset - net of tax effect	–	–	(115)	–
Appropriated for capital projects	–	1,355	(1,355)	–
Cash dividends - ₱0.20 per share	–	–	(1,875)	–
Balance at December 31, 2004, as restated	₱9,375	₱6,906	₱5,623	₱110

a. Capital Stock

	Number of Shares	Amount
Authorized - ₱1.00 par value	10,000,000,000	₱10,000
Issued and outstanding	9,375,104,497	₱9,375

The issued and outstanding common shares have been adjusted for the fractional shares issued in prior years.

b. Retained Earnings

i. Declaration of Cash Dividends
In 2005, the Company declared a cash dividend of ₱0.10 per share amounting to ₱938 to all stockholders of record as of May 12, 2005. In 2004, a cash dividend of ₱0.20 per share amounting to ₱1,875 was declared to all stockholders of record as of May 19, 2004.

ii. Appropriation for Capital Projects
Petron appropriated ₱4,746 in 2005 and ₱1,355 in 2004 for future capital projects.

21. Cost of Goods Sold

	2005	2004 (As restated - see Note 3)
Direct materials	**₱173,539**	₱132,850
Depreciation and amortization	**1,459**	1,009
Employee costs	**390**	353
Others	**1,572**	1,225
	₱176,960	₱135,437

22. Selling and Administrative

	2005	2004 (As restated - see Note 3)
Employee costs (see Note 27)	**₱1,023**	₱1,225
Depreciation and amortization	**876**	847
Purchased services and utilities	**748**	734
Maintenance and repairs	**567**	629
Advertising	**398**	403
Rental (see Note 26)	**306**	271
Materials and office supplies	**281**	260
Provision for doubtful accounts/accounts receivable written-off	**106**	162
Taxes and licenses	**102**	177
Others	**120**	169
	₱4,527	₱4,877

23. Interest Expense, Interest Income and Others

	2005	2004 (As restated - see Note 3)
Interest expense:		
Loans	**(₱1,615)**	(₱1,326)
Product borrowings	**(57)**	(87)
Accretion on asset retirement obligation (see Note 19)	**(33)**	(28)
Amortization of debt issue costs (see Note 18)	**(20)**	(10)
Others	**(366)**	(224)
	(₱2,091)	(₱1,675)
Interest income:		
Money market placements	**₱249**	₱180
Trade receivables	**42**	124
Product loaning	**13**	28
Cash in banks	**9**	8
Investment bonds	**-**	2
Others	**4**	2
	₱317	₱344
Others:		
Rent income	**₱280**	₱274
Derivatives net fair value loss (see Note 32)	**(260)**	–
Foreign exchange gain (loss)	**56**	(259)
Reversal of allowance (provision) for decline in value of investments	**14**	(91)
Miscellaneous	**(176)**	(280)
	(₱86)	(₱356)

24. Income Taxes

The major components of income tax expense for the years ended December 31, 2005 and 2004 are:

	2005	2004 (As restated - see Note 3)
Current income tax -		
Current income tax charge	**₱2,057**	₱1,339
Deferred income tax:		
Relating to origination and reversal of temporary differences	**102**	(16)
Change in tax rate	**(68)**	–
	₱34	(₱16)

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

The significant components of deferred income tax assets and liabilities are as follows:

	2005	2004 (As restated - see Note 3)
Deferred tax assets:		
Inventory differential	**₱217**	₱77
Rental	**205**	195
Asset retirement obligation	**90**	77
Various allowances, accruals and others	**565**	529
Total (Carried Forward)	**₱1,077**	₱878
Deferred tax liabilities:		
Excess of double-declining over straight-line method of depreciation and amortization	**1,267**	1,098
Capitalized taxes and duties on inventories deducted in advance	**411**	431
Net pension plan asset	**341**	251
Capitalized interest, duties and taxes on property, plant and equipment deducted in advance and others	**571**	447
	2,590	2,227
	₱1,513	₱1,349

The reconciliation between the provision for income tax computed at the applicable statutory income tax rate and, using tax rates of 32% for the period starting January 1 to October 31 and 35% for the period starting from November 1 to December 31 in 2005 and 32% in 2004, provision for income tax as shown in the consolidated statements of income is summarized as follows:

	2005	2004 (As restated - see Note 3)
Income tax computed at statutory income tax rates	**₱2,646**	₱1,736
Additions (reductions) resulting from:		
Income subject to income tax holiday (see Note 33)	**(440)**	(410)
Provision (reversal of allowance) for decline in value of investments	**(5)**	29
Interest income subjected to lower final tax and others	**(110)**	(32)
Provision for income tax	**₱2,091**	₱1,323

Provision for income tax includes final withholding tax on interest income.

On May 24, 2005, the President of the Republic of the Philippines signed into law Republic Act No. 9337, which took effect on July 1, 2005. Introducing the following changes:

a. Regular corporate income tax (RCIT) rate for domestic corporations and resident and non-resident foreign corporations is increased to 35% (from 32%) beginning November 1, 2005 and the rate will be reduced to 30% beginning January 1, 2009. RCIT rate shall be applied on the amount computed by multiplying the number of months covered by the new rate within the fiscal year by the taxable income of the corporation for the period, divided by 12 months.

b. Power of the President upon the recommendation of the Secretary of Finance to increase the rate of value added tax (VAT) to 12% (from 10%), after any of the following conditions has been satisfied:

   i. VAT collection as a percentage of gross domestic product (GDP) of the previous year exceeds two and four-fifth percent (2 4/5%); or

   ii. National Government deficit as a percentage of GDP of the previous year exceeds one and one-half percent (1 1/2%).

   On January 31, 2006, a Revenue Memorandum Circular No. 7-2006 was issued approving the recommendation of the Secretary of Finance to increase VAT to 12% (from 10%) effective February 1, 2006.

c. Input VAT on completed/finished capital goods should be spread evenly over the useful life or 60 months, whichever is shorter, if the acquisition costs, excluding the VAT component thereof exceed ₱1. On the other hand, input tax on assembled or constructed capital goods shall be recognized at the time of payment to the independent constructors as it involved a sale of service.

d. Input VAT credit in every quarter shall not exceed 70% of the output VAT if the amount of input tax exceeds the total output tax. The excess input tax shall be carried over to the succeeding period/s and is not allowed to be written-off for income tax purposes.

25. Related Party Transactions

The significant transactions with related parties are as follows:

			2005	
Name of Company	Relationship	Nature of Transaction	Transaction Amount	Balance at end of Year
Saudi Arabian Oil Company (Saudi Aramco)	Ultimate parent of Aramco Overseas Company B.V. (Stockholder)	Crude purchases	**₱122,826**	**₱5,728**
Philippine National Oil Company (PNOC)	Stockholder	Leases	**145**	**-**

			2004	
Name of Company	Relationship	Nature of Transaction	Transaction Amount	Balance at end of Year
Saudi Aramco	Ultimate parent of Aramco Overseas Company B.V. (Stockholder)	Crude purchases	₱73,711	₱3,963
PNOC	Stockholder	Leases	142	–

- Petron and Saudi Aramco have a term contract to purchase and supply, respectively, 90% of Petron's monthly crude oil requirements over a 20-year period at Saudi Aramco's standard Far East selling prices. Outstanding liabilities of Petron for such purchases are shown as part of "Liabilities for crude oil and petroleum product importation" account in the consolidated balance sheets.

- Petron has long-term lease agreements with PNOC until August 2018 covering certain lots where its refinery and other facilities are located. Lease charges on refinery facilities escalate at 2% a year, subject to increase upon reappraisal (see Note 26).

Total compensation and benefits of key management personnel of the Company, amounting to ₱290 and ₱278 in 2005 and 2004, respectively, consist of:

	2005	2004
Salaries and other short-term employee benefits	**₱248**	₱232
Post-employment benefits	**42**	46
	₱290	₱278

26. Operating Lease Commitments

Company as Lessee

The Company entered into commercial leases on certain parcels of land. These leases have an average life of between 1 to 16 years with renewal options included in the contracts. There are no restrictions placed upon the Company by entering into these leases. The lease agreements include upward escalation adjustment of the annual rental rates.

Future minimum rental payable under the non-cancellable operating lease agreements as of December 31 follows:

	2005	2004
Within one year	**₱377**	₱382
After one year but not more than five years	**1,518**	1,508
After five years	**2,620**	3,102
	₱4,515	₱4,992

Company as Lessor

The Company has entered into lease agreements on its investment property portfolio, consisting of surplus office spaces and parcels of land. The non-cancellable leases have remaining terms of between three to five years. All leases include a clause to enable upward escalation adjustment of the annual rental rates.

Future minimum rental receivable under the non-cancellable operating lease agreements as of December 31 follows:

	2005	2004
Within one year	**₱168**	₱195
After one year but not more than five years	**175**	220
After five years	**141**	161
	₱484	₱576

27. Pension Plan

The following tables summarize the components of net pension costs recognized in the consolidated statements of income and the funded status and amounts recognized in the consolidated balance sheets for the pension plan.

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

Net Pension Costs (Recognized in Selling and Administrative Expenses)

	2005	2004 (As restated - see Note 3)
Current service cost	**₱101**	₱106
Interest cost on benefit obligation	**239**	206
Expected return on plan assets	**(338)**	(305)
Net pension costs	**₱2**	₱7
Actual return on plan assets	**₱437**	₱394

Actuarial Gain (Loss) Recognized Directly in Stockholders' Equity

	2005	2004 (As restated - see Note 3)
Actuarial gain (loss) for the year due to present value of obligation	**(₱363)**	₱364
Actuarial gain for the year	**99**	90
Actuarial gains (losses) due to limit on recognized plan assets	**620**	(168)
Net actuarial gain recognized	**₱356**	₱286

Net Pension Asset

	2005	2004 (As restated - see Note 3)
Defined benefit obligation	**₱2,330**	₱1,709
Fair value of plan assets	**3,737**	3,382
Pension asset	**1,407**	1,673
Less unrecognized assets due to limit	**270**	890
Net pension asset recognized (see Note 15)	**₱1,137**	₱783

Changes in the present value of the defined benefit obligation are as follows:

	2005	2004 (As restated - see Note 3)
Opening defined benefit obligation	**₱1,709**	₱1,821
Interest cost	**239**	206
Current service cost	**101**	106
Benefits paid	**(82)**	(60)
Actuarial loss (gain) on obligation	**363**	(364)
Closing defined benefit obligation	**₱2,330**	₱1,709

Change in the fair value of plan assets are as follows:

	2005	2004 (As restated - see Note 3)
Opening fair value of plan assets	**₱3,382**	₱3,047
Expected return	**338**	305
Contributions by employer	**-**	-
Benefits paid	**(82)**	(60)
Actuarial gains on plan assets	**99**	90
Closing fair value of plan assets	**₱3,737**	₱3,382

The Company does not expect to contribute to its defined benefit pension plan until 2010.

The major categories of plan assets as a percentage of the fair value of total plan assets are as follows:

	2005	2004
Cash	**5%**	–%
Government securities	**71**	76
Stocks	**15**	14
Real estate	**8**	9
Others	**1**	1
	100%	100%

The overall expected rate of return on assets is determined based on the market prices prevailing on that date, applicable to the period over which the obligation is to be settled. There has been a significant change in the expected rate of return on assets due to the improved stock market scenario.

The principal assumptions used in determining obligations for the Company's plans are shown below:

	2005	2004
Discount rate	**11%**	14%
Expected rate of return on assets	**10%**	10%
Future salary increases	**8.5%**	9%

28. Supplementary Information

a. Processing License Agreement

Petron has an agreement with Pennzoil-Quaker State International Corporation (Pennzoil) for the exclusive right to manufacture, sell and distribute in the Philippines certain Pennzoil products until December 31, 2008. The agreement also includes the license to use certain Pennzoil trademarks in exchange for the payment of royalty fee based on net sales value. Royalty expense amounting to ₱1.07 in 2005 and ₱1.20 in 2004 are included as part of cost of goods sold account in the consolidated statements of income.

b. Fuel Supply Contract with National Power Corporation (NPC)

The Company entered into various fuel supply contracts with NPC. Under the agreement, the Company supplies the bunker fuel and diesel fuel oil requirements to selected NPC plants and NPC-supplied Independent Power Plants.

In the bidding held last January 6, 2006 for NPC fuel requirements from January to April 2006, Petron won a total of 26,782 kilo-liters (KL) of diesel fuel and 199,617 KL of bunker fuel worth ₱772 and ₱4,066, respectively.

Sales from the above transactions amounted to ₱10,211 in 2005 and ₱11,453 in 2004.

29. Earnings Per Share Attributable to Equity Holders of the Parent

	2005	2004 (As restated - see Note 3)
Net income attributable to equity holders of the parent	**₱6,044**	₱4,094
Weighted average number of shares	**9,375,104,497**	9,375,104,497
Earnings per share	**₱0.64**	₱0.44

30. Supplemental Disclosures of Cash Flow Information

Changes in operating assets and liabilities:

	2005	2004 (As restated - see Note 3)
Increase in assets:		
Receivables	**(₱2,084)**	(₱2,503)
Inventories	**(4,769)**	(4,316)
Other current assets	**(1,796)**	(69)
Increase (decrease) in liabilities:		
Liabilities for crude oil and petroleum product importation	**1,814**	(445)
Accounts payable and accrued expenses	**158**	706
	(6,677)	(6,627)
Provisions for doubtful accounts, inventory obsolescence and others	**351**	534
	(₱6,326)	(₱6,093)

31. Financial Risk Management Objectives and Policies

The Company's principal financial instruments include bank loans, cash and short-term deposits and derivative instruments. The main purpose of bank loans is to finance working capital relating to the importation of crude and petroleum products, as well as to partly fund capital expenditures. The Company has other financial assets and liabilities such as trade receivables and trade payables and investments in debt and equity securities, which are generated directly from its operations.

It is the Company's policy not to enter into derivative transactions for speculative purposes. The Company uses commodity price swaps to protect its margin on industrial fuel from potential price volatility of crude oil and industrial fuel oil. It also enters into short-term forward currency contracts to hedge its currency exposure on crude oil importations.

The main risks arising from the Company's financial instruments are foreign exchange risk, interest rate risk, credit risk, liquidity risk and commodity price risk. The BOD regularly reviews and approves the policies for managing these financial risks, as summarized below:

Foreign Exchange Risk

Foreign exchange risk occurs due to currency differences in the Company's assets and liabilities. The Company's foreign currency-denominated assets and liabilities were predominantly in US dollars in 2005 and 2004.

This is a major structural risk for the Company since crude and product imports, which comprise the bulk of its inputs to operations, are US dollar-denominated. On the other hand, the Company receives peso-denominated revenue for the majority of its product sales.

The Company pursues a policy of hedging foreign exchange risk by purchasing currency forwards or by substituting US dollar-denominated liabilities with peso-based debt. The natural hedge provided by dollar-denominated assets is also factored in hedging decisions. As a matter of policy, currency hedging is limited to the extent of 100% of the underlying exposure.

The Company is allowed to engage in active risk management strategies for a portion of its foreign exchange risk exposure. Loss limits are in place, monitored daily and regularly reviewed by management.

Interest Rate Risk

The Company's exposure to interest rate risk is mainly related to its long-term debt instruments which are all on a floating rate basis as of December 31, 2005.

In the future, the Company may enter into hedging arrangements to fix the interest rate for all or part of the long-term debt. Hedging decisions would be guided by an assessment of the over-all interest rate risk profile of the Company's balance sheets and the net effect on this of possible interest rate movements.

Credit Risk

In effectively managing credit risk, Petron regulates and extends credit only to qualified and credit-worthy customers in consonance with established Company credit policies and guidelines and credit verification procedures. Requests for credit lines from trade customers undergo stages of review between the Marketing and Finance Groups while approvals, which are based on amounts of credit lines requested, are vested among line managers and top management that include the President and the Chairman. To the extent practicable, Petron also requires collateral as security for a credit facility to mitigate risk of customer's default.

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

In monitoring trade accounts receivable and credit lines, Petron maintains up-to-date records where daily sales and collection transactions of all customers are recorded in real-time, and month-end statements of accounts are forwarded to customers as collection medium. In close coordination with Petron's Marketing Group which is primarily tasked with collecting customer's accounts through the account executives scattered nationwide, Credit Department regularly reports to management trade accounts receivable balances (monthly) and credit utilization (bi-annual) efficiency.

Liquidity Risk

The Company is exposed to the possibility that adverse changes in the business environment and/or its operations would result to substantially higher working capital requirements and the subsequent difficulty in financing additional working capital.

The Company manages liquidity risk by maintaining a pool of credit lines from financial institutions that exceeds expected financing requirements for working capital. The Company likewise regularly evaluates other financing instruments and arrangements to broaden the Company's range of financing sources.

Commodity Price Risk

To minimize the Company's risk of potential losses due to volatility of Dubai and Singapore's Mean of Platts (MOPS) prices, the Company implemented commodity hedging for hedgeable petroleum products. Hedging policy (including the use of commodity price swaps) developed by the Risk Management Committee is already in place. Decisions are guided by the conditions set and approved by the Company's management.

32. Financial Instruments

Derivative Instruments

The Parent Company's derivative transactions are intended as economic hedge of well-defined foreign currency and commodity price risks. The Parent Company opted to adopt non-hedge accounting treatment for all its derivative transactions (including embedded derivatives).

Freestanding Derivatives. The Parent Company uses IFO-Dubai crack spread swaps to protect its margin on export and domestic sales of industrial fuel oil products. The cost base of the Parent Company's industrial fuel is that of the crude oil, most of which is supplied by Saudi Aramco and is priced based on Dubai/Oman crude price. On the other hand, the selling price of the industrial fuel is based on MOPS. Under the crack spread swap, the Parent Company and its counterparties agree to a monthly exchange of cash settlements based on a specified reference price, depending on the commodity being hedged. For the IFO portion of the crack spread swap that hedges the price risks on industrial fuel oil products, the Company acts as the floating rate payer and the reference price index is the monthly MOPS for HSFO 180 CST. For the Dubai portion that hedges the price risks on crude oil, the Parent Company acts as the fixed rate payer and the reference price index is the monthly average for Platt's Dubai Crude. The swap agreements effectively hedge the Parent Company's margin on industrial fuel oil. As of December 31, 2005 and 2004, there are no outstanding commodity swaps.

The Parent Company also enters into deliverable and non-deliverable short-term currency forward contracts to hedge its foreign currency exposure on crude oil importations. As of December 31, 2005, the Parent Company has outstanding currency forward contracts with an aggregate notional amount of US$45, and weighted average contracted forward rate of ₱53.206 to US$1.00. The net fair value loss on these currency forward contracts as of December 31, 2005 amounted to ₱5. As of December 31, 2004, the Parent Company has no outstanding deliverable and non-deliverable short-term currency forward contracts.

Embedded Derivatives. Embedded foreign currency derivatives exist in certain of the Parent Company's US dollar-denominated sales and purchase contracts for various fuel products. Under the sales contracts, the Parent Company agrees to fix the peso equivalent of the invoice amount based on the average Philippine Dealing System (PDS) rate of the month of delivery. In the purchase contracts, the peso equivalent is determined using the average PDS rate of the month preceding the month of delivery. The net fair value gain on these transactions as of December 31, 2005 amounted to ₱60.

Fair Value Changes on Derivatives

The net movements in fair value changes of all derivative transactions in 2005 are as follows:

	MTM Loss (Gain)
Fair values at January 1, 2005, as restated (see Note 3e)	₱31
Net changes in fair value during the year (see Note 23)	260
Less fair value of settled instruments	346
Balance at December 31, 2005 - net	(₱55)

Included in the consolidated balance sheets as:

Derivative assets (included under "Other current assets" account)	₱60
Derivative liabilities (see Note 17)	(5)
Net	₱55

Interest Rate Risk

The following table sets out the carrying amount, by maturity, of the Company's financial instruments that are exposed to interest rate risk:

	Interest Rates	Within 1 Year	1-2 years	2-3 Years	3-4 years	4-5 Years	More than 5 Years	Total
2005 Fixed Rate:								
Short-term debt (PHP)	7.0%	₱21,407	–	–	–	–	–	₱21,407
2005 Floating Rate:								
Long-term loan (Landbank)	7.2%	₱750	–	–	–	–	–	₱750
Long-term loan (Citibank)	8.0%	₱615	₱308	–	–	–	–	₱923
Long-term loan (NORD)	5.8%	$10	$28	–	$62	–	–	$100
2004 Fixed Rate:								
Short-term debt (USD)	2.8%	$30	–	–	–	–	–	$30
Short-term debt (PHP)	7.2%	₱16,787	–	–	–	–	–	₱16,787
2004 Floating Rate:								
Long-term loan (Landbank)	10.0%	₱1,000	₱750	–	–	–	–	₱1,750
Long-term loan (Citibank)	10.0%	₱615	₱615	₱308	–	–	–	₱1,538
Long-term loan (NORD)	3.7%	–	$10	$28	–	$62	–	$100

Interest on financial instruments classified as floating rate was repriced quarterly for the peso loans and quarterly or semi-annually for the US dollar-denominated loans. Interest on financial instruments classified as fixed rate was fixed until the maturity of the instrument. Other financial liabilities of the Company that were not included in the above tables were non-interest-bearing and were therefore not subject to interest rate risk.

The Company has interest-bearing assets of ₱4,526 as of December 31, 2005 and ₱4,437 as of December 31, 2004, of which ₱4,330 and ₱4,174, respectively, have maturities within 1 year (see Notes 6, 8, 9 and 12). Financial assets at FVPL are non-interest bearing investments and are therefore not subject to interest rate volatility.

The following table sets forth the carrying values and estimated fair values of the Company's financial assets and liabilities recognized as of December 31, 2005.

	Carrying Value	Fair Value
Current financial assets:		
Cash and cash equivalents	₱4,071	₱4,071
Financial assets at FVPL	144	144
AFS investments	259	259
Receivables	14,055	14,055
Derivative assets (included under "Other current assets" account)	60	60
Total current financial assets	18,589	18,589
Noncurrent financial assets -		
AFS investments	196	196
Total financial assets	₱18,785	₱18,785
Current financial liabilities:		
Short-term loans	₱21,407	₱21,407
Liabilities for crude oil and petroleum product importation	7,911	7,911
Accounts payable and accrued expenses (including derivative liabilities)	2,219	2,219
Total current financial liabilities	31,537	31,537
Noncurrent financial liabilities:		
Cash bonds (included under "Other noncurrent liabilities" account)	119	98
Long-term debt (including current portion)	6,931	7,032
Total financial liabilities	₱38,587	₱38,667

The following method and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate such value.

FVPL and AFS Investments. Market values have been used to determine the fair values of traded government securities and equity shares.

Derivative Assets and Liabilities. The fair values of freestanding and bifurcated forward currency transactions are calculated by reference to current forward exchange rates for contracts with similar maturity profiles.

Cash Bonds. Fair value is estimated as the present value of all future cash flows discounted using the applicable rates for similar types of instruments. Discount rate used is 9.97%.

Long-term Debt - Floating Rate. For variable rate loans that reprice every three months, the carrying value approximates the fair value because of recent and regular repricing based on current market rates. For variable rate loans that reprice every six months, the fair value is determined by discounting the principal amount plus the next interest payment using the prevailing market rate for the period up to the next repricing date. Average discount rate used is 4.41%.

Other Financial Assets and Liabilities. Due to the short-term nature of the transactions, the fair value of cash and cash equivalents, receivables, short-term loans, liabilities for crude oil and petroleum product importation, and accounts payable and accrued expenses approximate the carrying amounts as of balance sheet dates.

33. Registration with the BOI

Petron is registered with the BOI under the New Omnibus Investments Code of 1987 (Executive Order 226) as a pioneer, new producer status of Mixed Xylene. Under the terms of its registration, Petron is subject to certain requirements principally that of producing required metric tons of Mixed Xylene every year.

As a registered enterprise, Petron is entitled to the following benefits on its Mixed Xylene operations:

a. Income Tax Holiday (ITH) for six years from actual start of Mixed Xylene commercial operations (December 1999) until 2005. On May 10, 2005, the BOI approved Petron's application under Certificate of Registration No. DP98-148, for the one year extension of its ITH incentive. The approved bonus year is for the period December 5, 2005 to December 4, 2006;

b. Tax credits for taxes on duties on raw materials and supplies used for its export products and forming parts thereof; and,

c. Simplified custom procedures and others.

In October 2003, the BOI approved Petron's application under Republic Act 8479, otherwise known as the Downstream Oil Industry Deregulation Act (RA 8479), for new investments at its Bataan Refinery for an Isomerization Unit and a Gas Oil Hydrotreater (Project). The BOI is extending the following major incentives:

a. ITH for five years without extension or bonus year from January 2005 or actual start of commercial operations, whichever is earlier;

b. Duty of three percent and value added tax (VAT) on imported capital equipment and accompanying spare parts;

c. Exemption from real property tax on production equipment or machinery; and,

d. Exemption from contractor's tax.

Petron has availed of ITH credits amounting to ₱440 in 2005 and ₱410 in 2004.

On October 20, 2005, Petron registered with the BOI under the Omnibus Investments Code of 1987 (Executive Order 226) as (1) a non-pioneer, new export producer status of Mixed Xylene (2) a pioneer, new export producer status of Benzene and Toluene and (3) a pioneer, new domestic producer status of Propylene. Under the terms of its registration, Petron is subject to certain requirements principally that of producing required metric tons of the mentioned petrochemical products every year.

As a registered enterprise, Petron is entitled to the following benefits on its Petrochemical Products (Mixed Xylene, Benzene and Toluene, and Propylene) operations:

a. ITH (1) for four years from May 2008 or actual start of commercial operations, whichever is earlier, but in no case earlier than the date of registration for Mixed Xylene; (2) for six years from May 2008 or actual start of commercial operations, whichever is earlier, but in no case earlier than the date of registration for Benzene and Toluene; and (3) for six years from December 2007 or actual start of commercial operations, whichever is earlier, but in no case earlier than the date of registration for Propylene;

b. Tax credit equivalent to the national internal revenue taxes and duties paid on raw materials and supplies and semi-manufactured products used in producing its export product and forming parts thereof for ten years from start of commercial operations; and,

c. Simplification of custom procedures and others.

On October 21, 2005, the BOI approved Petron's application under RA 8479 for new investment at its Bataan Refinery for a Petro Fluidized Catalytic Cracking Unit. Subject to Petron's compliance with the terms and conditions of registration, the BOI is extending the following major incentives:

a. ITH for five years without extension or bonus year from December 2007 or actual start of commercial operations whichever is earlier, but in no case earlier than the date of registration subject to a 22% ITH rate of exemption;

b. Minimum duty of three percent and VAT on imported capital equipment and accompanying spare parts;

c. Exemption from real property tax on production equipment or machinery; and,

d. Exemption from contractor's tax.

In December 2005, the BOI approved Petron's application under RA 8479 as an Existing Industry Participant with New Investment in Modernization of the firm's Grease Manufacturing Plant in Pandacan, Manila. The BOI is extending the following major incentives:

a. ITH for a period of five years without extension or bonus year from March 2006 or actual start of commercial operations whichever is earlier, but in no case earlier than the date of registration subject to base figure of 845 metric tons of grease product representing the firm's highest attained sales volume prior to rehabilitation;

b. Minimum duty of three percent and VAT on imported capital equipment, machinery and accompanying spare parts;

c. Tax credit on domestic capital equipment on locally fabricated capital equipment which is equivalent to the difference between the tariff rate and the three percent duty imposed on the imported counterpart;

d. Exemption from taxes and duties on imported spare parts for consigned equipment with bonded manufacturing warehouse;

e. Exemption from real property tax on production equipment or machinery; and,

f. Exemption from contractor's tax.

34. Segment Information

The Company's operating businesses are organized and managed according to the nature of the products marketed, with each segment representing a strategic business unit that offers different products and serves different markets.

The Company's major sources of revenues are as follows:

a. Sales from petroleum and other related products which include gasoline, diesel and kerosene offered to motorists and public transport operators through its service station network around the country;

b. Insurance premiums from the business and operation of all kinds of insurance and reinsurance, on sea as well as on land, of properties, goods and merchandise, of transportation or conveyance, against fire, earthquake, marine perils, accidents and all other forms and lines of insurance authorized by law, except life insurance;

c. Lease of acquired real estate properties for petroleum, refining, storage and distribution facilities, gasoline service stations and other related structures;

d. Sales on wholesale or retail, and operation of service stations, retail outlets, restaurants, convenience stores and the like; and,

e. Export sales of various petroleum products to other Asian countries such as Cambodia, Korea, China and Australia.

(Amounts in Millions, Except Par Value, Share and Per Share Amounts, Exchange Rates and Commodity Volumes)

The following tables present revenue and income information and certain asset and liability information regarding the business segments for the years ended December 31, 2005 and 2004. Segment assets and liabilities exclude deferred income tax assets and liabilities.

	Petroleum	Insurance	Leasing	Marketing	Elimination	Total
Year Ended December 31, 2005						
Revenue:						
Total revenue	**₱191,228**	**₱539**	**₱316**	**₱2,026**	**(₱2,620)**	**₱191,489**
Segment results	**9,436**	**512**	**303**	**21**	**(270)**	**10,002**
Net income	**5,765**	**166**	**34**	**29**	**57**	**6,051**
Assets and liabilities:						
Segment assets	**69,403**	**1,369**	**2,347**	**587**	**(2,631)**	**71,075**
Segment liabilities	**41,711**	**150**	**1,800**	**205**	**(1,919)**	**41,947**
Other segment information:						
Property, plant and equipment	**19,871**	**1**	**1**	**429**	**2,268**	**22,570**
Depreciation and amortization	**2,315**	**-**	**-**	**20**	**-**	**2,335**
Year Ended December 31, 2004 (As restated - see Note 3)						
Revenue:						
Total revenue	₱147,356	₱531	₱249	₱663	(₱1,374)	₱147,425
Segment results	6,588	505	229	–	(211)	7,111
Net income	3,887	158	35	13	8	4,101
Assets and liabilities:						
Segment assets	61,561	1,222	2,231	419	(2,304)	63,129
Segment liabilities	39,285	137	1,674	81	(1,720)	39,457
Other segment information:						
Property, plant and equipment	20,029	2	–	163	2,252	22,446
Depreciation and amortization	1,848	–	–	8	–	1,856

The following tables present additional information on the petroleum business segment of the Company for 2005 and 2004:

	Retail	Lube	Gasul	Industrial	Marketing	Total
Year Ended December 31, 2005:						
Revenue	**₱82,621**	**₱1,406**	**₱8,351**	**₱68,776**	**₱30,074**	**₱191,228**
Property, plant and equipment	**4,450**	**603**	**195**	**52**	**14,497**	**19,797**
Capital expenditures	**327**	**-**	**30**	**-**	**1,058**	**1,415**
Year Ended December 31, 2004 (As restated - see Note 3):						
Revenue	₱65,075	₱1,107	₱7,650	₱54,594	₱18,930	₱147,356
Property, plant and equipment	4,608	12	206	65	15,255	20,146
Capital expenditures	577	2	37	21	4,996	5,633

Geographical Segments

The following tables present revenue and expenditure and certain asset information regarding the geographical segments of the Company for the years ended December 31, 2005 and 2004:

	Petroleum	Insurance	Leasing	Marketing	Elimination/ Others	Total
Year Ended December 31, 2005						
Revenue:						
Local	**₱167,703**	**₱464**	**₱316**	**₱2,026**	**(₱2,619)**	**₱167,890**
Export/International	**23,525**	**74**	**-**	**-**	**-**	**23,599**
Year Ended December 31, 2004 (As restated - see Note 3)						
Revenue:						
Local	₱134,275	₱463	₱249	₱663	(₱1,374)	₱134,276
Export/International	13,081	68	–	–	–	13,149

35. Other Matters

a. In 1998, the Company contested before the Court of Tax Appeals (CTA) the collection by the Bureau of Internal Revenue (BIR) of deficiency excise taxes amounting to ₱1,108 representing back taxes, surcharge and interest arising from the Company's acceptance and use of Tax Credit Certificates (TCCs) worth ₱659 from 1993 to 1997. In July 1999, the CTA ruled that, as a fuel supplier of BOI-registered companies, the Company was a qualified transferee for the TCCs. The CTA ruled that the collection by the BIR of the alleged deficiency excise taxes was contrary to law. The BIR appealed the ruling to the CTA where the case is still pending.

In November 1999, the Department of Finance (DOF) Center ExCom cancelled Tax Debit Memos (TDMs) worth ₱475, the related TCCs and their assignments. The BIR implemented this with a letter of assessment worth ₱651 deficiency taxes (inclusive of interest and charges) for the years 1995 to 1997, as a result of the cancellation. The Company contested on the grounds that the assessment has no factual and legal basis and that the cancellation of the TDMs was void. The Company elevated this protest to the CTA on July 10, 2000 where the case is still pending.

In January 2002, the BIR issued another assessment worth ₱739 deficiency taxes (inclusive of interest and charges) for the years 1995 to 1998, as a result of the cancellation of TCCs and TDMs by the DOF Center ExCom. The Company protested this assessment on the same legal grounds used against the tax assessment issued by the BIR in 1999. The Company elevated the protest to the CTA where the case is pending.

In the TCC-related criminal cases, two of which have been filed by the Office of the Ombudsman with the Sandiganbayan and four are currently with the Ombudsman on Preliminary Investigation, Petron officials are uniformly charged or accused of having conspired with former officials of DOF One-Stop-Shop Center, BIR and the Bureau of Customs (BOC) and with private individuals to defraud the government by accepting fraudulently issued TCCs and thereafter, by using these TCCs in payment of taxes. The Petron officers had acted on or signed the Deeds of Assignment in official capacities. The Company continues to express its full confidence in the integrity of its officers and employees, former and current. The Company, therefore, expects that the charges against these Petron officers and employees will be dismissed.

The Company maintains that it has not been involved in the issuance of these TCCs and that it had relied on the approval by the DOF and the BIR with respect to the issuance, the assignment and the use of these TCCs. The Company and its officers maintain that they have not gained any undue advantage in any of the TCC transaction and for each TCC that was duly assigned and accepted, the Company issued an equivalent credit note that was used to pay for fuel products of the Company.

Petron officers who were already arraigned in the first Sandiganbayan case went up to the SC after the Sandiganbayan reversed an earlier ruling dismissing the case for failure on the part of the Ombudsman to prosecute.

b. Petron has unused letters of credit totaling approximately ₱30 as of December 31, 2005 and ₱12 as of December 31, 2004.

c. Implementation of RA No. 8749, "Philippine Clean Air Act of 1999"

Petron has been fully complying with the Clean Air Act (CAA) since the law was implemented. It introduced its low-sulfur "Diesel Max" to the market three months ahead of the CAA-mandated schedule. Under the CAA law, oil firms are mandated to lower the sulfur content of Automotive Diesel Oil to 0.05% by January 1, 2004 nationwide.

Beyond CAA compliance, Petron is the only oil company that has invested substantial resources to upgrade its production capabilities to meet CAA specifications. In January 2005, it commissioned its Isomerization Unit that will enable the Company to produce isomerates for blending with gasoline to meet current specifications. The unit is part of the US$100 million refinery project that also includes a Gas Oil Hydrotreater that was commissioned in April 2005. With these two units, Petron is the only domestic oil firm that can serve the local market's demand for CAA-compliant fuels entirely from local production.

d. Pandacan Terminal Operations

The City Council of Manila (City Council), citing concerns of safety, security and health, passed City Ordinance No. 8027 reclassifying the areas occupied by the Oil Terminals of Petron, Shell and Caltex from Industrial to Commercial, making the operation of the terminals therein unlawful.

In an effort to address the concerns of the City Council, the oil companies implemented a Scale Down Program to reduce tankage capacities, create buffer zones and consolidate operation of their facilities. The Petron Linear Park was inaugurated on December 17, 2003. This serves as additional safety and security buffer zone, further enhancing the safety of the facility.

Of the 28 tanks that were committed to be dismantled under the Memorandum of Understanding signed between the three oil companies, the Department of Energy and the City of Manila, 26 have been decommissioned/ dismantled. The dismantling of the remaining two tanks is contingent upon full integration of the Pandacan Operations.

To date, the first phase of the engineering, procurement and construction is already more than 98% complete. On the other hand, the second phase of the engineering, procurement and construction is 40% complete.

The Joint Venture (PDSI) took over the operations of the "scaled-down" facility on November 1, 2004 after the City of Manila issued the business permit applied for.

Simultaneous with the Scale Down Program, Petron filed a petition with the Regional Trial Court (RTC) to annul the City Ordinance and enjoin the City Council of Manila, as well as the Mayor of Manila, from implementing the same. The RTC issued a status quo order which prevents the respondents from enforcing the Ordinance until further orders of the Court or termination of the case. The case has been referred to and is undergoing mediation before the Philippine Mediation Center.

e. Navotas Business Tax

In the case of Petron vs. Mayor Tobias Tiangco concerning the imposition of business tax for the sale of diesel at the Navotas Bulk Plant, the Temporary Restraining Order issued by the SC is still in effect and will prevent the closure of the Bulk Plant until the case is decided by the SC.

f. Ownership of LPG Cylinders in the Market

Liquefied Petroleum Gas Marketers Association (LPGMA), a group of independent refillers of LPG claims to have acquired ownership of LPG cylinders of Petron, Pilipinas Shell and Total Philippines in good faith. LPGMA claims it can exercise all rights of ownership over the cylinders, praying judgment from the RTC of Pasig City authorizing its members to repaint/obliterate the marks on the oil companies' LPG cylinders and all LPG cylinders which now or in the future may come into their possession; or to compel the parties to enter into a swapping arrangement and/or compelling the oil companies to buy back the cylinders.

On July 18, 2005, the RTC dismissed the petition for non-exhaustion of administrative remedies. LPGMA's Motion for Reconsideration is pending resolution by the RTC. On March 1, 2006, the RTC denied LPGMA's Motion for Reconsideration.

List of Banks and Financial Institutions

Allied Banking Corporation
Banco de Oro
Bank of the Philippine Islands
BDO Private Bank
China Banking Corporation
Chinatrust (Phils.) Commercial Bank Corporation
Development Bank of the Philippines
Equitable PCI Bank
Land Bank of the Philippines
Metropolitan Bank and Trust Company
PCI Capital Corporation
Philippine National Bank
Rizal Commercial Banking Corporation
Security Bank Corporation
Union Bank of the Philippines
United Coconut Planters Bank

ABN Amro Bank
Australia and New Zealand Banking Group, Ltd.
Bank of Butterfield
BNP Paribas
Calyon Corporate and Investment Bank
Citibank, N. A.
Deutsche Bank
ING Bank, N. V.
JP Morgan Chase Bank
Mizuho Corporate Bank
Schroders (Bermuda), Ltd.
Societe Generale
The Bank of Tokyo-Mitsubishi UFJ, Ltd. (Manila Branch)
The Hongkong and Shanghai Banking Corporation, Ltd.

Arab Petroleum Investment Corporation
Bank of China
Banque Saudi Fransi
Bumiputra Commerce Bank
Cathay United
Chiao Tung Bank
Chinatrust Commercial Bank
Citibank International Limited
International Commercial Bank of China
Norddeutsche Landesbank Girozentrale, Singapore
Saudi American Bank
The Saudi Investment Bank

Board of Directors

1. Nicasio I. Alcantara
Chairman

Nicasio I. Alcantara, 63, has been a Director and the Chairman of Petron since July 2001. Prior to joining Petron, he was Chairman / President of various corporations of the Alcantara Group of Companies.

2. Khalid D. Al-Faddagh
President & Chief Executive Officer

Khalid D. Al-Faddagh, 50, has been a Director since July 2001 and the President of the Company since July 2003. He has over 20 years experience in various professional and management positions in Saudi Aramco.

3. Bernardino R. Abes
Director

Bernardino R. Abes, 75, has been a Director of the Company since July 2001. He is currently the Chairman of the Government Service Insurance System.

4. Douhan H. Al-Douhan
Director

Douhan H. Al-Douhan, 70, has been an independent Director of the Company since July 2001. He has been the Managing Director of Randa Trading & Construction in Saudi Arabia since 2004.

5. Khalid G. Al-Buainain
Director

Khalid G. Al-Buainain, 46, has been a Director of the Company since July 2003. Currently, he serves as the Vice President for Refining of Saudi Aramco, the Chairman of Luberef and a member of the Saudi Aramco Executive Advisory Committee.

6. Herminio S. Aquino
Director

Herminio S. Aquino, 56, has been a Director of the Company since November 2004. He is the Chairman of Trackworks, Inc., Interconsult (Asia Pacific), Inc. and 7-Series, Inc.

7. Basil A. Abul-Hamayel
Director

Basil A. Abul-Hamayel, 41, has been a Director of the Company since July 2004. Mr. Abul-Hamayel has 24 years of service with Saudi Aramco and is now the Manager for Corporate Finance, Insurance and Asset Management Department in Saudi Aramco.

8. Alberto A. Pedrosa
Director

Alberto A. Pedrosa, 73, was elected Director of the Company in March 2005. He is currently the Chairman and Publisher of Republika, a news magazine focused on the 42,000 barangays in the country.

9. Jose Luis U. Yulo, Jr.
Director

Jose Luis U. Yulo, 58, has been an independent Director since July 2001. He is currently the Chairman of Insurance of the Philippine Islands Co., Inc., President of Metro Cebu Public Savings Bank and President of Centrex Corporation.

10. Ahmad O. Al-Khowaiter
Director

Ahmad O. Al-Khowaiter, 39, was elected as Director in July 2005. He is at present, the Manager of Facility Planning of Saudi Aramco.

Seated from Left to Right: *Nicasio I. Alcantara, Khalid D. Al-Faddagh, Bernardino R. Abes, Douhan H. Al-Douhan*

Standing from Left to Right: *Khalid G. Al-Buainain, Herminio S. Aquino, Basil A. Abul-Hamayel, Alberto A. Pedrosa, Jose Luis U. Yulo, Jr., Ahmad O. Al-Khowaiter*

Management Committee

Nicasio I. Alcantara
Chairman

Khalid D. Al-Faddagh
President and Chief Executive Officer

Jose K. Campos, Jr.
Vice President for Marketing

Alfred A. Trio
Vice President for Refining

Sulaiman M. Ababtain
Vice President for Corporate Planning

Antonio G. Pelayo
Vice President for Finance and Subsidiaries

Jose Jesus G. Laurel
Vice President for Legal and External Affairs

Felimon E. Antiporta
Officer-in-Charge for Supply and Operations

Rosario R. Eijansantos
Treasurer

Luis A. Maglaya
Corporate Secretary

Ma. Concepcion F. de Claro
Controller

Left to Right: *Sulaiman M. Ababtain, Luis A. Maglaya, Nicasio I. Alcantara, Khalid D. Al-Faddagh, Alfred A. Trio, Felimon E. Antiporta, Rosario R. Eijansantos, Jose K. Campos, Jr., Ma. Concepcion F. de Claro, Antonio G. Pelayo, Jose Jesus G. Laurel*

Depots and Terminals

LUZON

APARRI
J.P. de Carreon St. Punta
Aparri, Cagayan
(078) 888-2456/888-2071

BATANGAS
Bo. Mainaga, Mabini, Batangas
(043) 487-0418/487-0377
(043) 487-0419 (Fax)

CALAPAN
Roxas St. Brgy. Ilaya
Calapan City, Oriental Mindoro
(043) 288-1779

LIMAY
Petron Bataan Refinery
Limay, Bataan
(02) 886-3187-96 loc. 390-394

NAVOTAS
PFDA Compound
Navotas, Metro Manila
(02) 281-4826/281-1297

PALAWAN
Parola, Brgy. Maunlad
Puerto Princesa City, Palawan
(048) 433-2682/433-3329

PASACAO
Brgy. Camangi
Pasacao, Camarines Sur
(054) 513-9258/513-9175
(054) 513-9175 (Fax)

PORO
Poro Pt.
San Fernando, La Union
(072) 242-6032 to 34

ROSARIO
Gen. Trias, Rosario, Cavite
(046) 438-2860/438-1996

SAN JOSE
1020 A. Mabini St.
San Jose, Occidental Mindoro
(043) 491-1938

VISAYAS

AMLAN
Tandayag, Amlan, Negros Oriental
(035) 527-0790/417-0793/417-0795

BACOLOD
Bo. San Patricio
Bacolod City, Negros Occidental
(034) 433-9690/433-9687 to 89

ILOILO
Lapuz, Iloilo City
(033) 337-6895/338-1893

ISABEL
Lide, Isabel, Leyte
(053) 556-0177/337-2289

MANDAUE
Looc, Mandaue City, Cebu
(032) 346-5135/344-7341 to 51

ORMOC
Bo. Linao
Ormoc City, Leyte
(053) 255-9070/561-1239

ROXAS
Arnaldo Blvd. Culasi, Roxas City
(036) 621-1992/621-0722

TACLOBAN
Anibong, Tacloban City
(053) 325-6432 to 33

TAGBILARAN
Graham Ave., Tagbilaran, Bohol
(038) 411-3397

MINDANAO

BAWING
Purok Cabu
Bawing, General Santos City
(083) 380-7725 to 26

DAVAO
Km. 9, Bo. Pampanga
Davao City
(082) 234-2185/233-0399

GENERAL SANTOS
P. Acharon Blvd.
Bula, Gen. Santos City
(083) 301-1988

ILIGAN
Bo. Tuminobo
Iligan City, Lanao del Norte
(063) 492-0653/351-6704/221-5264

JIMENEZ
Jimenez, Misamis Occidental
(088) 272-3230/272-3243

NASIPIT
Talisay, Nasipit, Agusan del Norte
(085) 283-3126/343-2218/19

TAGOLOAN
Tagoloan, Misamis Oriental
(08822) 740-072/740-263

ZAMBOANGA
Bgy Campo Islam
Lower Calarian, Zamboanga City
(062) 991-1245/991-1571/991-4352

PANDACAN
Jesus St. Pandacan, Manila
Order & Billing
(02) 563-8491 to 95

Dispatching
(02) 563-3047/563-8521 loc. 223

CALAMBA
Calamba, Laguna
(049) 545-6481

AIRPORT INSTALLATIONS

DAVAO
Davao Airport
(082) 234-2185/86/233-0399

ILOILO
Petron ITP Aviation
Brgy. Airport, Mandurriao, Iloilo City
(033)321-3183

LAOAG
Laoag Airport
c/o NAIA 833-7084

MACTAN
MEPZ, Lapu-lapu City
(032) 340-4620/340-4629

NAIA
JOCASP, CPD, NAIA, Pasay City
(02) 833-7084/831-5842

LPG OPERATIONS

GASUL-PASIG
Bo. Ugong, Pasig, Metro Manila
(02) 671-2687 (DL)/671-9817(TL)

GASUL-SAN FERNANDO
San Fernando, Pampanga
(045) 961-3564

LEGASPI
Lakandula Drive
Bgy. Bonot, Legaspi City

Products

FUELS

Automotive Fuels
Blaze
XCS Plus with Valvemaster™
Xtra Unleaded
Regular Unleaded
Diesel Max
Xtend Autogas

Industrial Fuels
Petron Fuel Oil
IF-1
LSFO
Intermediate Fuels
Special Fuel Oil
Industrial Diesel Fuel

Aviation Fuels
Aviation Gasoline
Jet A- I

Household Fuels
Gasul
Gaas

AUTOMOTIVE LUBRICATING OILS

Diesel Engine Oils
Rev-X All Terrain
Rev-X Trekker
Rev-X Hauler
Rev-X HD
Petron HDX
Petron XD3
Petron XD 2040
Petron 2040
Petron Railroad Extra

Gasoline Engine Oils
Ultron Race
Ultron Rallye
Ultron Touring
Ultron Extra
Petron MO

Motorcycle Oils
Petron Sprint 4T
2T Premium
2T Enviro
2T Autolube
2T Powerburn

Automotive Gear Oils
Petron GX
Petron GEP
Petron GST

Automotive Transmission Fluids
Petron ATF Premium
Petron TF 38
Petron TDH 50

INDUSTRIAL LUBRICATING OILS

Turbine, Hydraulic and Circulating Oils
Hydrotur AWX
Hydrotur AW
Hydrotur AW (GT)
Hydrotur EP 46
Hydrotur N 100
Hydrotur R
Hydrotur SX 32
Hydrotur SX 68
Hydrotur SX 220
Hydrotur T
Hydrotur TEP

Industrial Gear Oils
Hypex EP (Oil-Based)
Hypex EP (Asphalt-Based)
Milrol 5K
Gearfluid
Gearkote

Cutting Oils
Turnol
Petrokut 10
Petrokut 27

Refrigeration Oils
Zerflo 68
Suniso

Other Industrial Lubricating Oils
Petrocyl S
Petrocyl
Airlube
Spinol 15
Spinol 10E
Petrosine 68
Voltran 60

MARINE LUBRICATING OILS

Marine Cylinder Oils
Petromar DCL 7050
Petromar DCL 4000 Series

Marine Trunk Piston Engine Oils
Petromar XC 5540
Petromar XC 5040
Petromar XC 4040
Petromar XC 3000 Series
Petromar XC 2000 Series
Petromar XC 1500 Series
Petromar XC 1000 Series

Other Marine Lubricants
Petromar 65
Petromar HD Marine Series

GREASES

Regular Performance Greases
Petrogrease MP
Petrogrease XX

Premium Performance Greases
Molygrease EP2
Molygrease Premium
Petrogrease EP
Petrogrease Premium

High Temperature Greases
Molygrease EP 1P and EP 2P
Petrogrease EP 290 and EP 375
Petrogrease HT

Complex Greases
Petrogrease Aluminum Complex
Petrogrease Lithium Complex
Petrogrease Lithium Complex with Moly

Food Grade Greases
Petrogrease Food Grade

ASPHALTS

Penetration Asphalt
Petropen

Cutback Asphalt
Petropen CB

Emulsified Asphalt
Petromul CSS -1

Blown Asphalts
Asphaltseal
Asphalt Joint Sealer

SPECIAL PRODUCTS

Process Oils
Process Oils
Product 50 R
Printsol 600
Rubbex 130
Stemol
Jute Batching Oil
Aldro Oil

Heat Transfer Oil
Petrotherm 32

Cleaning Agent
Greasolve

Flushing Oil
STM

Sealing Lubricant
Dust Stop Oil

Protective Coatings
Petrokote 500
Petrokote 392
Marinekote
Marinekote SS
Autokote
Cablelube
Cablekote

Others
Petron Farm Trac Oil
Petron Marine HD Oil
Bull's Eye

AFTERMARKET SPECIALTIES

Petromate Specialties
Petromate Oil Saver
Petromate Oil Improver
Petromate Gas Saver
Petromate Diesel Power Booster
Petromate Engine Flush
Petromate Super Coolant
Petromate Clean N' Shine
Petromate Penetrating Oil
Petromate Greaseaway
Petromate Brake and Clutch Fluid

AVIATION LUBRICANTS

Braycote 622
Nyco Grease GN 22
Hydraunycoil FH 51
Royco 481
Aviation Oil EE
Invarol FJ 13
Exxon Turbo Oil 2389
Exxon Turbo Oil 2380
Univis J-13
Turbonycoil 35 M

Information and Assistance

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For questions or comments regarding dividend payments, change of address, account status, lost or damaged stock certificates, please get in touch with:

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Public Affairs Department
39/F Petron MegaPlaza
358 Sen. Gil Puyat Avenue
Makati City 1200 Philippines
Tel. No. (632) 886-3888
Fax No. (632) 886-3064

Or with our stock transfer agent:

Stock Transfer Service, Inc.
8/F Phinma Plaza
39 Plaza Drive, Rockwell Center
Makati City 1200 Philippines
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Fax No. (632) 898-7597

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