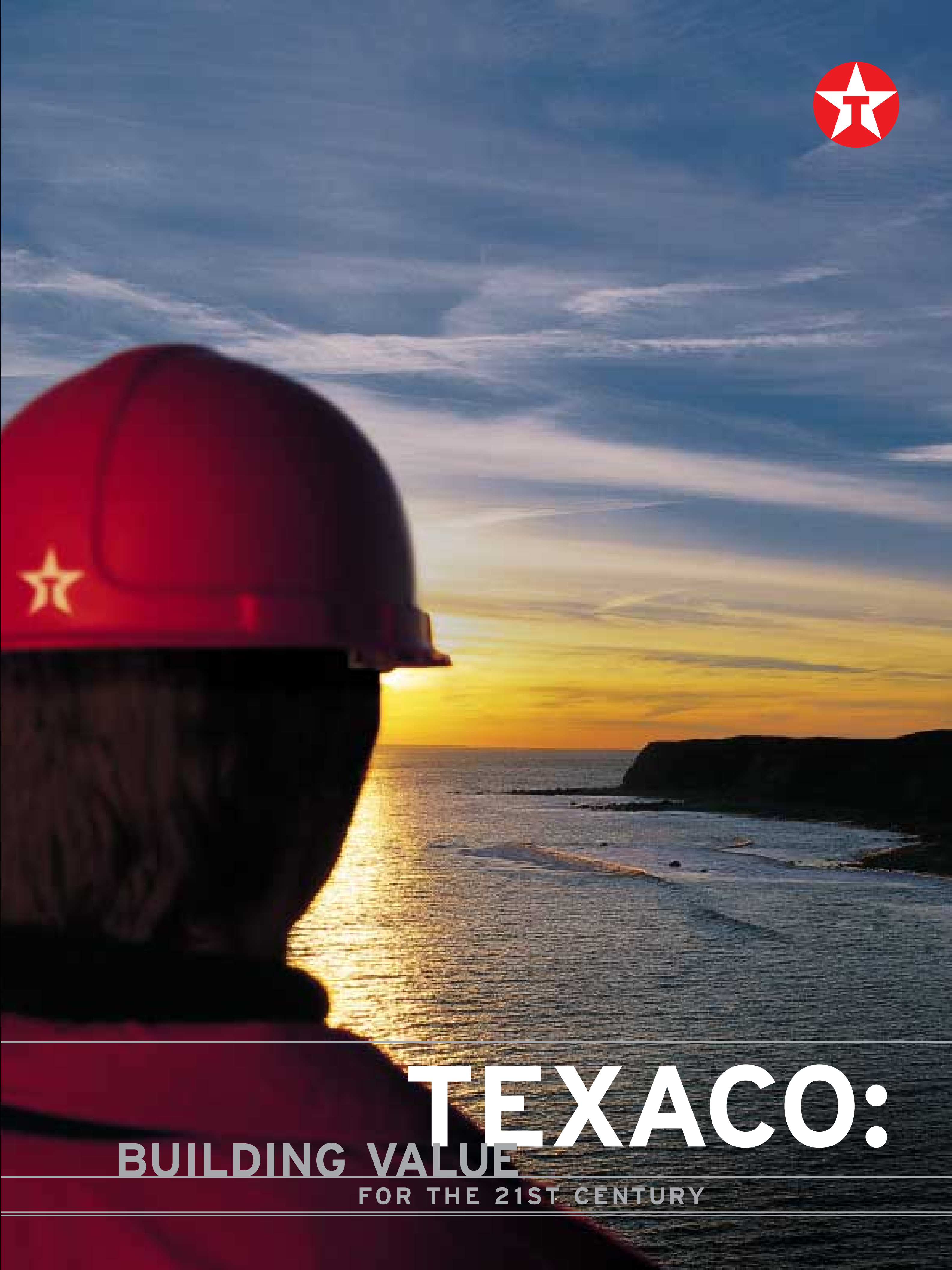

TEXACO: BUILDING VALUE FOR THE 21ST CENTURY

The use in this report of the term Texaco Inc. refers solely to Texaco Inc., a Delaware corporation. The use of such terms as Texaco, company, division, unit, organization, we, us, our and its, when referring either to Texaco Inc. and its consolidated subsidiaries or to subsidiaries and affiliates either individually or collectively, is only for convenience and is not intended to describe legal relationships. Texaco Inc.'s significant subsidiaries are listed as an exhibit to Texaco Inc.'s Form 10-K Report to the Securities and Exchange Commission.

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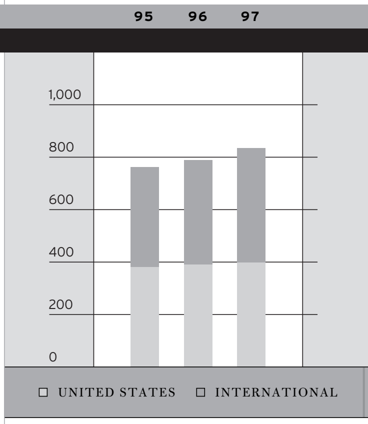
OPERATIONAL HIGHLIGHTS

TEXACO INC. AND SUBSIDIARY COMPANIES

(Including interests in affiliates)	1997	1996
Net production of crude oil and natural gas liquids		
(Thousands of barrels a day)		
United States	396	388
International	437	399
Total worldwide	833	787
Net production of natural gas – available for sale		
(Millions of cubic feet a day)		
United States	1,706	1,675
International	471	382
Total worldwide	2,177	2,057
Natural gas sales (Millions of cubic feet a day)		
United States	3,584	3,176
International	592	477
Total worldwide	4,176	3,653
Natural gas liquids sales (Thousands of barrels a day)		
United States	184	206
International	97	89
Total worldwide	281	295
Refinery input (Thousands of barrels a day)		
United States	747	724
International	804	762
Total worldwide	1,551	1,486
Refined product sales (Thousands of barrels a day)		
United States	1,022	1,036
International	1,563	1,552
Total worldwide	2,585	2,588
Worldwide net proved reserves as of year-end		
Crude oil and natural gas liquids (Millions of barrels)	3,267	2,704
Natural gas (Billions of cubic feet)	6,242	5,973

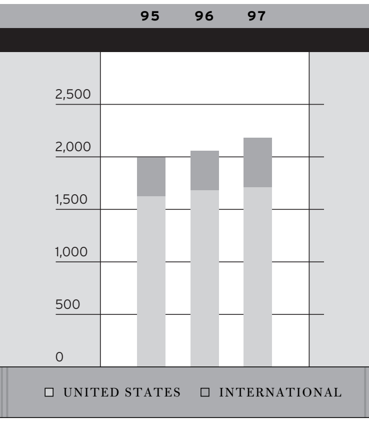
NET PRODUCTION OF CRUDE OIL AND NATURAL GAS LIQUIDS

{thousands of barrels a day}



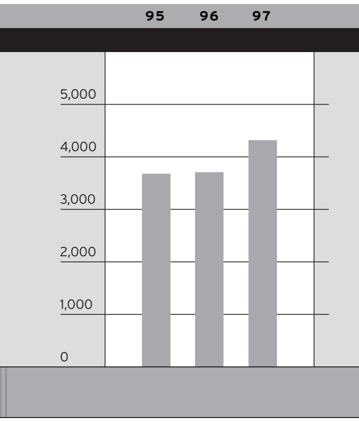
NET PRODUCTION OF NATURAL GAS AVAILABLE FOR SALE

{millions of cubic feet a day}



WORLDWIDE NET PROVED RESERVES

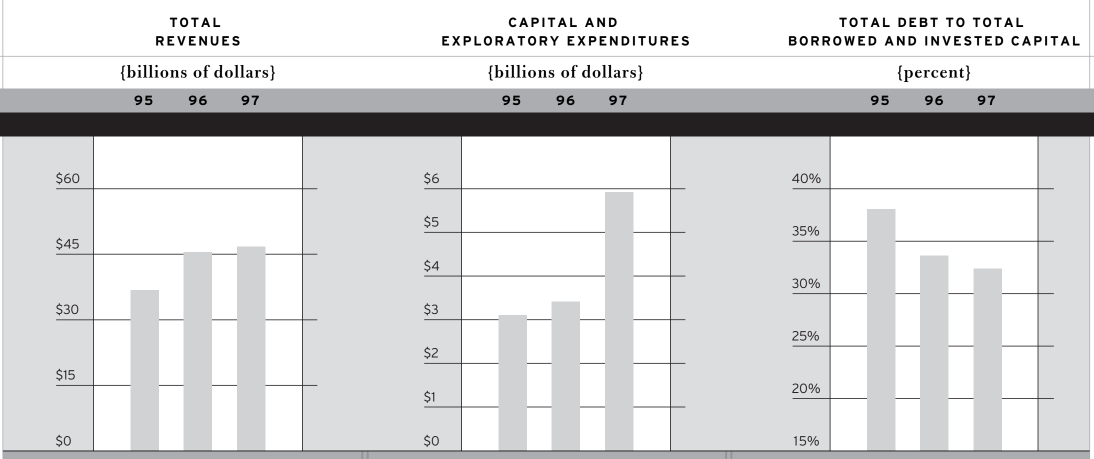
{millions of barrels of oil equivalent}



FINANCIAL HIGHLIGHTS

TEXACO INC. AND SUBSIDIARY COMPANIES

(Millions of dollars, except per share amounts in dollars and ratio data)	1997	1996
Revenues	$ 46,667	$ 45,500
Net income before special items	$ 1,894	$ 1,665
Basic per common share	$ 3.52	$ 3.09
Return on average capital employed	13.0%	12.8%
Net income	$ 2,664	$ 2,018
Basic per common share	$ 4.99	$ 3.77
Diluted per common share	$ 4.87	$ 3.68
Return on average capital employed	17.3%	14.9%
Cash dividends paid		
Common	$ 918	$ 859
Per share	$ 1.75	$ 1.65
Preferred	$ 55	$ 58
Total assets	$ 29,600	$ 26,963
Total debt	$ 6,392	$ 5,590
Stockholders' equity	$ 12,766	$ 10,372
Capital and exploratory expenditures, including equity in affiliates	$ 5,930	$ 3,431
Per common share		
Common stockholders' equity	$ 22.75	$ 18.76
Market price at year-end	$ 54.38	$ 49.06
Return on average stockholders' equity	23.5%	20.4%
Total debt to total borrowed and invested capital	32.3%	33.6%



Includes equity in affiliates.

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"I BELIEVE THAT THE SECRET OF ADDING VALUE LIES IN ENERGY. NOT THE KIND THAT'S BURIED DEEP IN THE EARTH, BUT THAT WHICH IS DEEP IN OUR MINDS.

INTELLECTUAL ENERGY IS THE FORCE THAT FUELS TEXACO. AND IT IS WHAT MAKES US A TRUE ENERGY COMPANY."

PETER I. BIJUR
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

TO OUR SHAREHOLDERS

PETER I. BIJUR
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

1997 was an outstanding year for our company. It was a year of growth, of achievement and of record earnings that added value for our shareholders. We grew our asset base during the year and exceeded many of our objectives both operationally and in the important area of diversity. We increased reserves and production while keeping expenses well under control. We concluded a major alliance in the United States that will enable our downstream business to grow profitably in the future. Our international downstream activities also showed improved performance compared to last year.

All of our activities during 1997 were aimed at positioning us to compete well in the 21st century. For the short balance of this century, we intend to become an even more aggressive player in one of the most competitive industries in the world. We are proud of the energy industry and proud to be a part of it. We will add value to the world's energy supply as demand growth continues from both economic development and a growing consumer base.

Our business philosophy is quite straightforward: profitably increase volumes in the upstream and the downstream, control costs and expenses, and grow where it is strategic to do so.

While doing this, we must invest in our employees to be able to compete effectively. Our people are our future and we must work as hard at developing them as we do at developing markets, new oil fields and new manufacturing plants.

We are also committed to technology, as you will see later in this report. With the world moving as fast as it is today, speed, agility, flexibility and decisiveness are the hallmarks of a great corporation. And the people of Texaco are working hard every day to achieve greatness.

In this letter, I will describe the progress we made in 1997 and outline the principles we will employ going forward. Following this letter, you will find four feature articles, each of which showcases a different area in which we are building significant shareholder value.

1997 PERFORMANCE

Our 1997 performance was outstanding due to the dedicated efforts of Texaco employees in every area of the company:

- Before special items, net income in 1997 was $1.894 billion, or $3.52 per share, an increase of 14% over 1996.
- Annual return on average capital employed reached 13%.
- Worldwide oil and gas production rose 6% during the year, up from a 3% increase in 1996.
- We replaced 167% of our 1997 worldwide combined oil and gas production, the strongest reserve replacement in over three decades. This excludes the acquisition of Monterey Resources and other purchases and sales.

- We increased the life of Texaco's reserves to 9.4 years compared to 8.6 years at the end of 1996.
- Downstream earnings improved significantly due to better refinery utilization, higher margins and a 3% increase in U.S. branded gasoline sales.
- We increased our quarterly dividend to 45 cents a share, the second time we've increased the dividend in the past two years, and an indicator of our confidence in future cash flows.
- Our shareholders benefited from the completion of a $500 million stock repurchase program.

We achieved these results in spite of a lower worldwide crude oil price environment and higher exploratory expenditures. Our exploratory expenses rose 24% as we aggressively searched for high-impact hydrocarbon reserves around the world.

PRINCIPLES FOR ACHIEVING SUPERIOR RETURNS

The commitment of Texaco employees to five operating principles in their day-to-day activities drove our business performance in 1997 and will continue to provide a competitive advantage in 1998 and beyond. These principles are:

1. Respect for the individual. As we pledged to do, Texaco made significant and measurable progress in our initiatives to ensure fairness and equal opportunity for those who work for and with Texaco. Minorities and women accounted for 69% of all new hires and 57% of the promotions in the U.S. In addition, expenditures with minority- and women-owned businesses more than doubled to $300 million. We also broadened our recruitment efforts, enriched our awareness programs and strengthened our procedural safeguards to ensure tolerance and respect in the workplace.

2. Maximizing resource allocation. We are always seeking to improve our portfolio so that our assets optimally leverage our strengths and achieve attractive returns. The assets in our portfolio should also be of a weight and magnitude sufficient to contribute to the company's productive critical mass and not draw down our resources.

Consistent with this strategy, we acquired Monterey Resources, one of the projects featured later in this report. This acquisition was a swift and effective use of capital to acquire a company that possessed a knowledge base and oil and gas reserves that are a strategic fit for Texaco.

Also in 1997, we took advantage of opportunities to monetize our properties in Myanmar and Western Canada for excellent value – freeing up capital to invest in other, more promising projects.

3. Cost management. In an environment of escalating costs, we were able to manage expenses in 1997 while growing our operating volumes, which we accomplished in the face of rising drilling and oil-field service expenses throughout the industry. This excellence in cost management, which has been demonstrated over the long term, will be a key advantage for Texaco in 1998, particularly if the downward pressure on the price of oil continues.

4. External focus. We reviewed our corporate structure in late 1997 to improve our focus on external competitive factors and emphasize business unit accountability. The revised corporate structure will give business unit managers increased resources they need to develop and implement their strategies. We will, in turn, hold them more accountable for results, regardless of the problems, complications or challenges that arise during a year. Fundamentally, our investors, customers, business partners and others care most that we fulfill the commitments we make to them. They don't care about the reasons we are unable to do so. We are building this philosophy into the fabric of our business and performance management systems.

5. Reducing cycle time. Making high-quality decisions in the shortest period of time is a clear competitive advantage. I am convinced that if we routinely crack the latest model of acceptable cycle time, we will consistently add measurable shareholder value.

The application of all five principles helped guide us toward the successful completion of our downstream alliance with Shell Oil Company. Called Equilon, this enterprise combines the Western and Midwestern U.S. refining and marketing assets of Texaco and Shell along with nationwide transportation, trading and lubricants businesses. This alliance will allow us to realize efficiencies and explore opportunities for growth in the challenging U.S. downstream marketplace.

BUILDING FUTURE VALUE

Growth in energy demand is inextricably linked to economic growth. During most of 1997, both factors increased throughout the world, more slowly in the industrialized world and more robustly in the developing countries. The faltering of the Asian economies since late 1997 appears to be a correction, after nearly 30 years of substantial growth in that part of the world. As the Asian economies regroup, demand growth will return, enabling the people of the region to achieve their ambitions, thereby leading to increased energy demand for both crude oil and refined products.

Notwithstanding this economic downturn and declining crude oil prices, Texaco's five-year investment plan is sound. We fully intend to push ahead with current plans to increase profitable production in line with the underlying philosophy discussed above.

We will also continue our search for energy around the world. We have promising upstream opportunities in the Caspian Sea area, in Venezuela and Brazil, in West Africa and in the United States, both in California and in the deep waters of the Gulf of Mexico, where we possess a world-class position.

Having completed the landmark downstream alliance with Shell in the Western U.S. in January 1998, we are moving forward with the implementation of this major enterprise. We expect to complete an agreement with Saudi Refining, Inc., and Shell for a similar alliance in the Eastern United States. These alliances are featured in more detail later in this report.

We will work to improve the performance of Caltex amid challenging market conditions in Asia by continuing our pressure to lower costs and grow revenues in core and developing markets. We will continue the successful growth of our marketing businesses in Brazil and other Latin American countries. Our global products, gas and power businesses will advance promising new international projects in 1998 and capture new business opportunities in the delivery of energy, products and services.

TECHNOLOGY AND LEADERSHIP AS COMPETITIVE ADVANTAGES

We know we must create our own profitability without regard to world oil prices, so our plans are based on a conservative pricing model for crude oil and natural gas. But we are also implementing other ways to enhance performance and differentiate ourselves from the competition.

One way to bolster performance is to keep our technology on the leading edge to take full advantage of recent advances in finding and extracting reserves. We must also ensure that we have a strong inventory of developing technologies – such as fuel cells and geothermal technologies – which can yield significant competitive advantages. In 1998, environmental responsibility will continue to be one of our most pressing business and technological priorities.

In the last year, there has been much public debate about "global warming," centered around whether there is a link between human activities that generate carbon dioxide emissions and climate change. As a major energy company, Texaco believes its focus should be on ways to reduce emissions and better protect the environment – not on choosing sides in the debate. We are well under way in our initiative to determine our baseline emissions of greenhouse gases worldwide.

At the same time, we are increasing research and development of technologies that result in cleaner fuels, as well as alternative fuels. We are making good progress on gas-to-liquids technologies, which hold enormous promise both for the environment and business. We are continuing our drive to make our operations more energy efficient, by using less energy and creating fewer emissions, while improving the value to our shareholders by reducing our production costs.

The single most important way to achieve competitive advantage is to systematically develop responsible, outstanding leaders at every level of our company. It is a given that business unit managers must know and understand every aspect of their business. We must also develop leaders who unambiguously demonstrate every day that our responsibility to corporate stakeholders and employees is just as important as the profitability of our operations.

As we approach the 21st century, I am pleased to report that we have the resources, the tools and, most importantly, our worldwide employees who are driving to fulfill our challenging ambitions. Whether in Angola or Brazil, Kazakhstan or Indonesia, Greece or Barbados, Texaco's employees around the world are committed to energetically meeting the challenges of a changing competitive environment and to responsibly providing energy to the world in a way that consistently creates ever greater value for our shareholders.

I want to thank the men and women of Texaco for their relentless efforts. It is their spirit, energy and commitment to exceptional performance that drove our outstanding results last year.

We are extremely fortunate to have elected two new directors during 1997: Mary K. Bush, President of Bush & Company, and former U.S. Senator Sam Nunn. Their unique expertise in global business and government brings additional depth and perspective to our Board.

Sadly, in 1997, Director Robert A. Beck, who had served on Texaco's Board of Directors since 1984, died. The Texaco family deeply appreciates his years of contributions and service.

Finally, we thank you, our shareholders and customers, for your support and confidence as we work to build greater value for your investment and deliver the quality products you expect.

Peter I. Bijur

PETER I. BIJUR
CHAIRMAN OF THE BOARD AND
CHIEF EXECUTIVE OFFICER

FEBRUARY 27, 1998

TEXACO AT A GLANCE

DURING THE PAST 96 YEARS, TEXACO HAS BECOME ONE OF THE WORLD'S LARGEST, MOST RESPECTED COMPANIES. OPERATING IN SOME 150 COUNTRIES, TEXACO AND ITS AFFILIATES EXPLORE FOR, FIND AND PRODUCE OIL AND NATURAL GAS; MANUFACTURE AND MARKET HIGH-QUALITY FUELS AND LUBRICANT PRODUCTS; OPERATE TRADING, TRANSPORTATION AND DISTRIBUTION FACILITIES; AND PRODUCE ALTERNATE FORMS OF ENERGY FOR POWER, MANUFACTURING AND CHEMICALS.

STRENGTHS We possess a solid asset base, a talented and diverse workforce and leading-edge technologies. We are aligned for nimble, decisive action. We have a worldwide reputation for quality products, service and financial management. Our total debt to total borrowed and invested capital ratio gives us financial strength and flexibility to invest in growth opportunities. We have sound environmental, health and safety practices fully integrated into our global business operations.

1997 PERFORMANCE Higher oil and natural gas production, increased gasoline sales – coupled with improved refinery utilization, higher margins and tight expense controls – contributed to outstanding results: total net income of $1.894 billion before special items; a 13% return on average capital employed; our second dividend increase in the past two years; completion of our $500 million share buyback; a two-for-one split of our common stock; a 14.3% total return to shareholders; and a 16% increase in our oil and gas reserves base.

STRATEGIES Our investments, focused on high-impact areas, are growing profitable production and reserves. By leveraging our technology, we are speeding development of these resources and reducing costs. We are strengthening assets that can deliver competitive returns and selling or restructuring those that do not. We have planned a capital and exploratory budget of $4.6 billion for 1998. We have made organizational changes – including an expanded upstream leadership team and a recently formed corporate development team – that will enable us to more quickly identify and act upon emerging opportunities around the globe. This group will identify and execute business strategies to create a portfolio of assets that leverages our strengths and achieves high returns. Respect for the individual is our number-one priority throughout the organization. Our emphasis on the individual also includes a focus on safety for our employees and contractors, as we build loss-prevention practices into our global operations.

Exploration and Production

WE FIND AND PRODUCE OIL AND NATURAL GAS FROM A GLOBAL PORTFOLIO OF NEW AND MATURE FIELDS. THE 1997 ADDITION OF MONTEREY RESOURCES IN CALIFORNIA, A 20% INTEREST IN THE HAMACA PROJECT IN VENEZUELA, ALONG WITH THE EARLY 1998 ACQUISITION OF A 20% INTEREST IN KAZAKHSTAN'S KARACHAGANAK FIELD, COMPLEMENT OUR OTHER OPERATIONS IN THE U.S., THE U.K. NORTH SEA, LATIN AMERICA, WEST AFRICA, THE MIDDLE EAST, INDONESIA AND THE PACIFIC RIM.

STRENGTHS Solid cash flow and earnings are generated by core upstream assets around the world, aided by our advanced technologies and alliance-forming skills. Examples: our aggressive exploration and production activity in the deepwater Gulf of Mexico, supported by our partnership in Project DeepStar; our leadership in recovery techniques for heavy oil, which we will utilize in developing such reserves as those of Monterey Resources and the Hamaca field in Venezuela.

1997 PERFORMANCE Increased production contributed to worldwide upstream operating earnings of $1.5 billion, despite lower crude oil prices and higher exploratory expenses. Worldwide production grew 6% to 1.2 million barrels of oil equivalent a day. Growth stemmed primarily from: higher production in the Partitioned Neutral Zone between Saudi Arabia and Kuwait; new production from the Captain field in the U.K. North Sea; additional production from the Guajira field offshore Colombia, the Dolphin field in Trinidad, and offshore Angola and Denmark. In addition, we had two months' production from Monterey Resources. Our 1997 reserve replacement rate, which excludes Monterey Resources and other purchases and sales, was 132% in the U.S. and 212% outside the U.S. – our highest rates for any single year in nearly 30 years.

STRATEGIES We have ambitious but attainable goals to significantly increase our worldwide production over the next five years, and to increase our net income per barrel of oil equivalent. We plan to grow profitable production and reserves through a balance of discovered reserve opportunities, selected acquisitions, focused exploration, and technological exploitation of our existing assets. We have sharpened our exploration focus on high-impact areas, such as the deepwater Gulf of Mexico, Latin America, West Africa and the Caspian Sea area. In 1997, we increased our upstream capital budget by 32% (excluding the Monterey Resources acquisition) to add reserves and to develop projects in the Gulf of Mexico, the Partitioned Neutral Zone, the North Sea, West Africa and Indonesia. In 1998, we will expand our focus to include developments in Kazakhstan, Venezuela and Western Australia. We are continuing to leverage technologies – such as three-dimensional visualization, vertical-cable seismic and multilateral drilling – that speed the discovery and production of new oil and gas reserves, while reducing development costs. We are conducting our drilling and producing operations in an environmentally responsible manner, in accordance with our Worldwide Environment, Health and Safety Standards.

Marketing, Manufacturing and Distribution

WE MARKET AUTOMOTIVE FUELS THROUGH SOME 23,000 TEXACO-BRANDED RETAIL FACILITIES WORLDWIDE. THROUGH OUR GLOBAL BUSINESSES, WE SELL LUBRICANTS, COOLANTS AND MARINE AND AVIATION FUELS, AS WELL AS NATURAL GAS. IN THE U.S., TEXACO, SHELL AND SAUDI REFINING ARE FORMING ALLIANCES THAT COMBINE THE COMPANIES' DOWNSTREAM AND TRANSPORTATION ASSETS. TEXACO AND ITS AFFILIATES OWN OR HAVE INTERESTS IN 24 REFINERIES.

STRENGTHS The combination of Texaco's and Shell's highly respected brands will create the number-one gasoline marketer in the U.S. With our affiliates, Texaco holds significant market shares in the world's growth areas and operates an increasingly efficient and technologically advanced manufacturing system. In addition, we have a significant marketing presence throughout Central and South America and the Caribbean. By applying innovative technologies and processes, we are improving the operating efficiency of our refineries and reducing emissions and waste. Our global products group – Worldwide Lubricants, Coolants and Fuel Additives – strives to leverage our brands and technologies in world markets. Havoline Formula3®, the top-selling motor oil among major oil companies, is distributed in more than 100 countries. And we are developing other products, such as our Extended Life Anti-Freeze/Coolant, to meet growing consumer needs. Caltex, our 50% joint venture with Chevron, operates in nearly 60 countries throughout Asia, the Pacific Rim and southern Africa, and has an overall market share in those countries of 18%.

1997 PERFORMANCE Worldwide downstream earnings grew by $350 million, led by improved refinery utilization, higher margins and a 3% increase in Texaco-branded gasoline sales in the U.S. In Latin America and Europe, stronger marketing margins and lower costs contributed to significantly higher earnings, and we are expanding our market presence in those areas – especially Latin America. In 1997, we expanded our presence in many new market countries, including Peru, Venezuela and Poland. In response to Asia's economic turmoil, our Caltex affiliate focused on cost containment and a prudent investment policy. It also sold its interest in a refinery in Bahrain and will integrate the operations of its refinery in Thailand with a nearby Shell refinery.

STRATEGIES We are committed to ensuring that our assets provide competitive returns, even under the most challenging industry conditions. Our alliances with Shell and Saudi Refining, Inc., will provide us with a platform for growth and create more value from our U.S. downstream assets. We are investing in selected Latin American and European growth markets, as well as in pipeline construction projects in the U.S. Gulf Coast. In Brazil, our second largest retail market, with more than 3,000 facilities, we have a major expansion program under way. Wherever we operate, Texaco's Global Brand Initiative will enhance the strength of our brand and the quality of our facilities.

Global Gas and Power

TEXACO HAS AN ARRAY OF WORLDWIDE OPPORTUNITIES FOR NEW REVENUE GROWTH. THEY INCLUDE OUR GLOBAL GAS AND POWER'S EXPERTISE IN POWER GENERATION AND GASIFICATION TECHNOLOGY. THESE ACTIVITIES COMPLEMENT OUR NATURAL GAS ACTIVITIES WORLDWIDE, AND FREQUENTLY ENHANCE OUR PRODUCING AND MANUFACTURING OPERATIONS.

STRENGTHS Our global focus enables us to bring increased value to customers across the entire energy value chain. In 1997, we formed Texaco Global Gas and Power to commercialize selected natural gas properties, develop gas-to-liquids conversion processes, and leverage our strengths in power generation and proprietary gasification technology, which reduce emissions and lower operating costs.

1997 PERFORMANCE In 1997, we agreed to develop the first gas-to-liquids plant using the Syntroleum Process.® We also became an equity partner in a 276-megawatt cogeneration project at a refinery in Ancona, Italy, which is scheduled for a 1999 start-up. The project will use Integrated Gasification Combined Cycle (IGCC) technology under license from Texaco. In Indonesia, we continue to supply steam for a 55-megawatt government-owned power plant and have a 70-megawatt facility under construction. The same steam source was successfully expanded with additional drilling and has proven large enough to support another 70-megawatt plant. Two Texaco affiliates signed power purchase agreements for construction of private power projects: a 300-megawatt facility in the Philippines and a 700-megawatt plant in Thailand. At our California cogeneration facilities, we are installing emission-control devices that will benefit the environment by eliminating the generation of acid wastes.

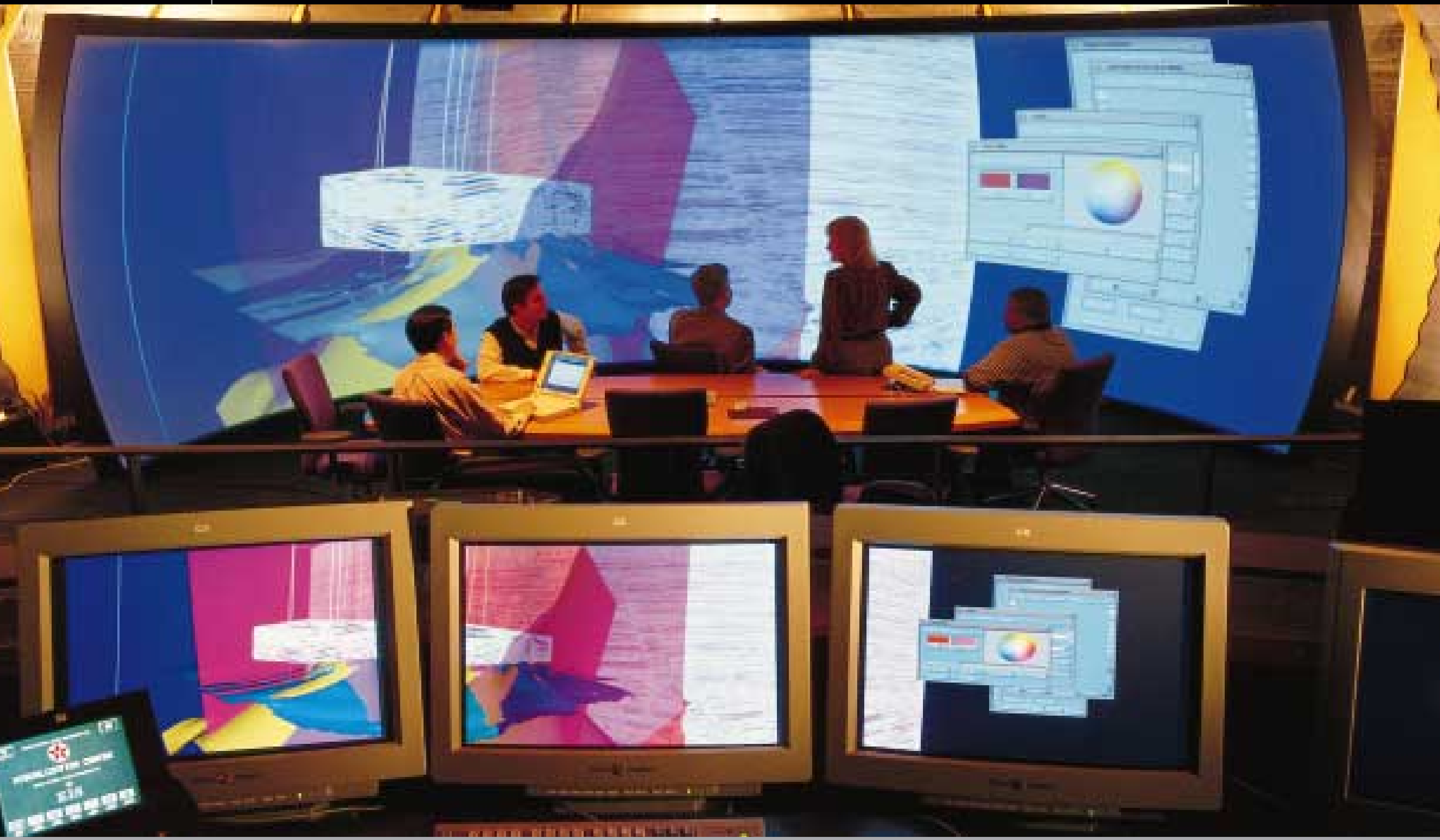
STRATEGIES We are growing our business in key markets by using clean technologies that benefit the environment, such as cogeneration and our gasification technology, through licensing and select investment. Our goal is to be a top-20 company in megawatt capacity by 2001.

BUILDING VALUE:

IN 1997, WE SHARPENED OUR FOCUS ON OPPORTUNITIES THAT WILL ADD VALUE QUICKLY. WE APPLIED OUR INTELLECTUAL CAPITAL TO IMPROVE AND GROW THE BUSINESS. OUR RELENTLESS PURSUIT OF ENERGY AND EXCELLENCE IS EXEMPLIFIED IN THE FOUR STORIES THAT FOLLOW. EACH ILLUSTRATES VIVIDLY OUR COMMITMENT TO BUILD VALUE.

TECHNOLOGY:

RELENTLESS PURSUIT OF ENERGY



TEXACO'S FIRST-IN-THE-INDUSTRY 3-D VISUALIZATION CENTER IN HOUSTON SPEEDS OUR ABILITY TO PINPOINT HYDROCARBONS, ENABLING US TO ACHIEVE GREATER RETURNS ON OUR INVESTMENTS.

TEXACO EXCELS AT APPLYING TECHNOLOGIES THAT BUILD VALUE across our business spectrum. We have the tools – and the brainpower – to achieve greater precision and speed in finding and producing energy. Our technology and our energy are recovering more reserves from existing fields; formulating new products and processes that meet emerging consumer needs; and creating new efficiencies for busy retail customers. Underpinning our technology applications is a drive to improve our environment, protect the health and safety of our employees, and enhance the communities in which we operate.

Leveraging our technologies to create greater value is one of our core strategies. Moreover, it is essential to Texaco's goals, which call for significantly increasing our earnings and raising our return on average capital employed. To achieve our goals, we are applying cutting-edge technologies and innovative approaches:

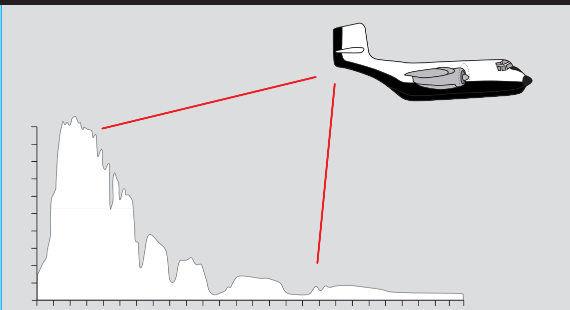
• In 1997, Texaco introduced two new 3-D Visualization Centers, one in Houston and one in Bakersfield, Calif. In both locations, Texaco people are speeding our ability to pinpoint hidden hydrocarbon deposits by applying 3-D visualization, a technology that allows our scientists to "see" inside geological formations in three dimensions. The payoff: by improving the quality of our analysis and doing so in days instead of months, we accelerate the process of increasing our energy production.

• Texaco's one-of-a-kind remote sensing device called TEEMS (Texaco Exploration and Environmental Multispectral Spectrometer) scans wide-ranging sites to collect data that reveals the potential for oil and gas deposits. The device, which is mounted aboard an aircraft, can create a detailed map across hundreds of miles in a single day. It also helps us make an environmental assessment of the new site so that our exploration and production activities can minimize impacts.

• We are using our proprietary vertical-cable seismic technology to find hydrocarbons and cut our field development costs in complex geological formations from the North Sea to the Gulf of Mexico. In the deepwater Gulf, this technology, which utilizes vertical cables to detect reflected sound waves, provided data that led to the Gemini discovery. This technology also is helping us to determine the potential size of the reservoirs in our Fuji discovery. (See p. 16, *Deepwater Gulf: Tapping Enormous Potential.*)

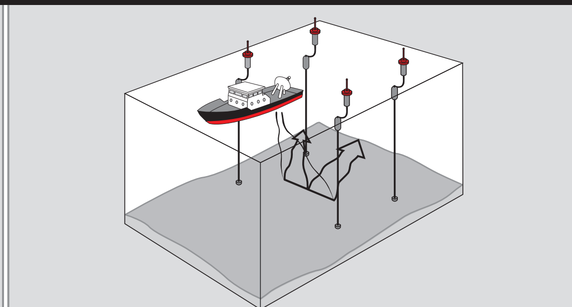
• By sharing technological advances with alliance partners, we gain knowledge and speed without incurring the high cost of going it alone. Through our leadership in DeepStar, a consortium of oil and service companies and U.S. agencies, we are solving technical problems of deepwater drilling, production

TEEMS: REMOTE SENSING



Housed in an airplane, TEEMS combines radar and unique spectrometer technology to map the Earth's surface for potential drilling sites.

VERTICAL-CABLE SEISMIC



In offshore exploration, vertical cables hold hydrophones in a 3-D grid pattern that helps reveal complex geological structures.

and subsea completions in the Gulf of Mexico. And our involvement in MoBPTeCh (Mobil, BP, Texaco and Chevron) is yielding advances in multilateral drilling, which we're applying offshore Nigeria.

• Our capability in horizontal drilling techniques and advanced production technology, such as floating production systems and high-rate submersible pumps, enabled us to accelerate the development of our 85%-owned Captain field, which came onstream in the U.K. North Sea in 1997.

• In 1997, we also began production from our 50%-owned Erskine field, the first high-temperature/high-pressure field in the North Sea, after adopting and integrating technologies that had helped us to produce natural gas under similar conditions in the Gulf of Mexico.

• We are applying our expertise in heavy-oil recovery to increase production and reduce costs from our major heavy-oil properties, from the Kern River field in California to the Hamaca field in Venezuela. (See p. 13, *Monterey: Boosting Production & Reserves.*)

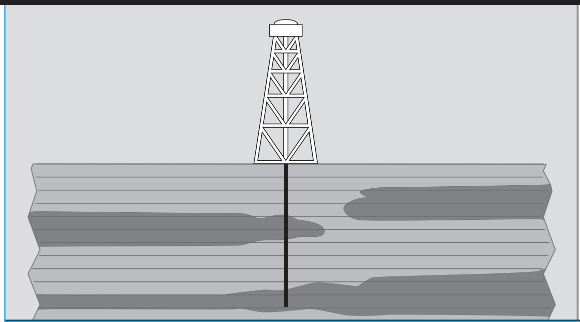
• In December 1997, we and our partners, Brown & Root and Syntroleum Corp., agreed to construct the first gas-to-liquids plant using the Syntroleum Process® by 1999. The plant will convert natural gas into synthesis gas, which can then be processed into clean, zero-sulfur diesel fuel and other petroleum products. This will allow Texaco to produce a valuable fuel from gas reserves that currently lack pipelines to markets. It will also help Texaco in its efforts to reduce emissions of carbon dioxide, sulfur dioxide and nitrogen oxides.

• The Delaware City, Del., refinery, which is expected to become part of the Eastern U.S. venture with Shell and Saudi Refining, will utilize Texaco's Integrated Gasification Combined Cycle (IGCC) power technology for production of cleaner energy. The IGCC technology will convert petroleum coke into syngas for use in the generation of electricity at the refinery's newly upgraded power plant. In addition to the environmental benefits of energy efficiency, this project will reduce overall air emissions.

• Texaco's extended-life motor-vehicle coolants, which our scientists formulated from mixtures of carboxylic acids, are surpassing our own high expectations. After passing a series of demanding road tests, Texaco Extended Life Anti-Freeze/Coolant's protection capability for heavy-duty vehicles has been increased to up to 600,000 miles.

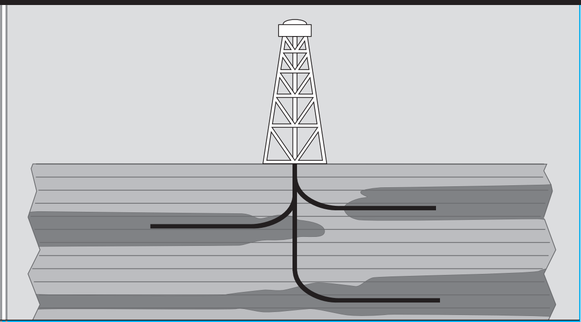
Throughout our operations, technology will continue to be a driver in our commitment to build value.

CONVENTIONAL DRILLING



Conventional drilling can only gain access to some of the available hydrocarbons.

MULTILATERAL DRILLING



Where multiple reserves are layered on top of one another, multilateral drilling extracts oil and gas from all levels simultaneously.

MONTEREY:

BOOSTING PRODUCTION & RESERVES

OUR CONTINUOUS STEAMFLOOD TECHNOLOGY ADDS IMMEDIATE PRODUCTION AND RESERVES FROM RECENTLY ACQUIRED MONTEREY RESOURCES ASSETS IN CALIFORNIA.

IN THE 1996 REPORT, WE TOLD YOU THAT WE HAD RESTRUCTURED our worldwide organization along functional lines to eliminate barriers to swift and decisive action. The benefit of this restructuring was proved when we were able to quickly acquire Monterey Resources in November 1997.

Just three months earlier, our upstream teams had identified Monterey Resources, a California independent oil and gas producer, as a prime candidate for acquisition. The company's location and resource base made it a perfect fit for Texaco's strategy of seeking selected acquisitions where we have a clear competitive advantage – and where we can apply our technologies to realize significant growth potential both in earnings and production. We expect that the acquisition will generate substantial additional profits and cash flow for Texaco over both the short and long term.

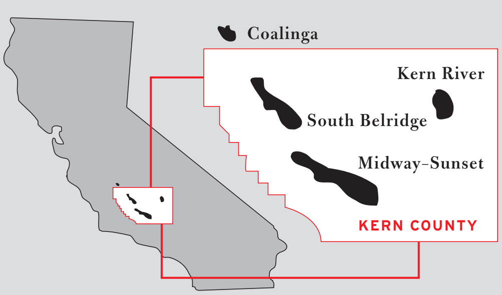
Monterey Resources' operations in California primarily lie adjacent to Texaco's operations in the Kern River and Midway-Sunset fields. Through the acquisition, Texaco added proved reserves of 420 million barrels of oil equivalent (BOE) and production of 55,500 BOE a day, an instant profitable infusion to Texaco's reserve and production base.

Moreover, Monterey Resources' concentration of heavy-oil production and reserves is a strategic fit for Texaco. Our competitive leadership in heavy oil is best demonstrated by our performance in the Kern River field. At Kern River, steamflood technology has already driven down the cost of producing oil by more than 20% since 1990, in spite of increased prices for the natural gas used as a fuel in steam generation. Reduced cost, coupled with technology application, has increased our expected recovery of the heavy oil in place from 45% to 65%. Inspired by science and experience, Texaco projects greater revenue – with a target recovery of 80% of the oil – from many of our California heavy-oil assets.

The acquisition of Monterey Resources for $1.4 billion underscores Texaco's strong commitment to investing in growth opportunities. Our manageable total debt to total borrowed and invested capital ratio of 32% provided us with the financial flexibility to move rapidly to make the acquisition. Our plan is for Monterey Resources to contribute significantly to Texaco's production goals over the next five years.

This acquisition raised our total worldwide 1997 capital and exploratory expenditures to $5.9 billion. Over the five-year period from 1998 through 2002, we project capital expenditures of about $26 billion.

MONTEREY RESOURCES ACQUISITION BOOSTS CALIFORNIA NET PRODUCTION



Monterey Resources' production sites in four fields lie in close proximity to Texaco's steamflood operations in Kern River and Midway-Sunset.

	BOEPD* MONTEREY FIELDS	BOEPD* TEXACO	BOEPD* MONTEREY/TEXACO COMBINED
MIDWAY-SUNSET	41,100	3,870	44,970
COALINGA	2,100	0	2,100
SO. BELRIDGE	2,500	0	2,500
KERN RIVER	5,600	94,570	100,170
OTHER	4,200	29,930	34,130
TOTAL	55,500	128,370	183,870

BOEPD = BARRELS OF OIL EQUIVALENT PER DAY *PRODUCTION AT TIME OF ACQUISITION

The addition of Monterey Resources significantly raised Texaco's total net production in California.

In November, Monterey Resources' production began adding to Texaco's profile. Production is expected to rise to 60,000 BOE a day in 1998, increasing our total California production to 189,000 BOE a day. Over the next three years, our strategic goal is to more than double production from Monterey Resources to 119,000 BOE a day.

Texaco's steamflood process involves the injection of steam, produced at our Bakersfield cogeneration facilities or from steam generators, to raise the temperature of the oil so that it moves more easily through the reservoir. Continuous steam injection allows the oil to be produced while maximizing the amount of heat kept in the ground. In contrast, Monterey Resources used a less efficient cyclic process. By applying Texaco's steamflood technology to Monterey Resources' fields, we expect to increase production rapidly while lowering per-barrel production costs. We expect to implement additional efficiencies in future years.

Our core competency in heavy-oil development is global: outside the U.S., Texaco has major concentrations of heavy oil in Indonesia, the Partitioned Neutral Zone, the U.K.'s Captain field, and the Hamaca field in Venezuela. Hamaca is Texaco's joint venture with ARCO, Phillips Petroleum and Corpoven, a subsidiary of the national oil company. Texaco's share of this field, scheduled to start production in 1999, is expected to rise to 36,000 barrels a day in 2006 and continue at that level for 30 years.

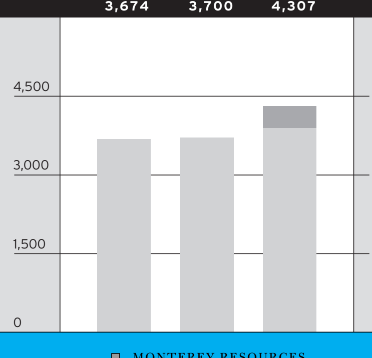
Hamaca is one of Texaco's recent investments in discovered reserve opportunities, along with our 20% interest in Kazakhstan's Karachaganak field. Together with the acquisition of Monterey Resources, these investments are expected to add 1.6 billion barrels of oil equivalent to our reserves base. These assets will maintain strong production growth and generate shareholder value over the decades ahead.

We will ratchet up this value by leveraging Texaco's leading-edge technology, which will continue to make the recovery from Texaco's holdings – in California, Venezuela, Kazakhstan and elsewhere – faster, cheaper and more profitable for our shareholders.

MONTEREY RESOURCES' IMPACT ON TEXACO'S WORLDWIDE PROVED RESERVES

{millions of barrels of oil equivalent}

95	96	97
3,674	3,700	4,307



The Monterey Resources acquisition provided an added boost to our worldwide reserves.

DEEPWATER GULF:

TAPPING ENORMOUS POTENTIAL

WE HAVE THE TECHNOLOGY AND THE HARDWARE – SUCH AS THIS DRILLING RIG IN USE AT OUR FUJI DISCOVERY – TO FAST-TRACK THE DEVELOPMENT OF OUR DEEPWATER SITES IN THE GULF OF MEXICO.

DEVELOPMENT OF OUR ASSETS IN THE DEEPWATER GULF OF MEXICO IS ON FAST-FORWARD, aided by technologies that help us find hydrocarbons and produce them at greater speeds and lower costs.

Our strategy: to leverage deepwater technologies that give us a competitive advantage and build on our solid acreage position in the deepwater Gulf. Our goal: to raise production from nearly zero to more than 100,000 barrels a day of oil equivalent by 2002. The payoff: a boost in our total production profile of profitable oil and gas and an increase in net income per barrel of oil equivalent when the first significant deepwater production begins in 1999.

We're increasing our capital expenditures to invest extra dollars in projects in the deepwater Gulf and other high-impact areas. In 1998, 70% of our planned capital expenditures of $4.6 billion will be devoted to exploration and production projects.

These expenditures flow from the potential we confirmed in the deepwater Gulf and elsewhere during 1997. In the Gulf, we are appraising and developing Petronius, Gemini and Fuji – three 1995 discoveries that form the linchpin of our deepwater projections. During 1997, we had new discoveries at Ladybug and Oudinot, and confirmed commercial projects at Arnold and Oyster. Through aggressive bidding in deepwater leases, we upgraded the quality of our exploratory prospect inventory and solidified a competitive third-place lease position, with 358 leases in depths greater than 1,300 feet.

Some of our best ideas for developing these assets come from technology alliances. Notable among them is Project DeepStar, a consortium of energy and service companies and U.S. agencies dedicated to joint technology development for producing hydrocarbon reserves in deep water. Bracketing their expertise with ours reduces cycle time from discovery to first production and lowers our costs.

At Gemini, Texaco's 60%-owned subsalt gas and condensate discovery, we applied sophisticated 3-D imaging to interpret reservoirs that lie below a 2,900-foot-thick salt sheet that initially defied scientific exploration. Coupling DeepStar technology with our subsea completion experience, we are now developing the Gemini gas discovery while we continue exploring the area for additional potential. We expect to begin gas production and reach a peak rate of about 180 million cubic feet a day by mid-1999.

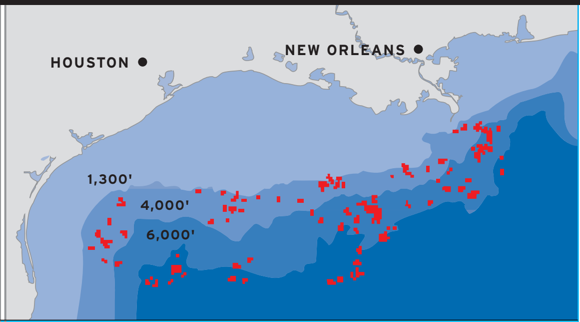
At Petronius, we are on target and on budget with construction of an 1,870-foot compliant tower for the drilling and production platform for Texaco's 50%-owned oil and gas field. We expect to bring the field onstream in early 1999 in record time – from discovery well to production in just three-and-a-half years – which will pay off in early cash flow and improved profitability.

DEEPWATER GULF DISCOVERY SITES

1995 1996 1997

Texaco has seven discoveries in the Gulf of Mexico's deepwater frontier.

DEEPWATER GULF OFFSHORE LEASES



Texaco's extensive lease acreage in the Gulf's deep waters points to further upstream development.

At Fuji, Texaco's 65%-owned discovery, we continue to delineate its potential, using both drilling and well-testing. We also are using vertical-cable 3-D surveys to define the size of its reservoirs.

Meanwhile, we are expanding our pipeline network to accommodate oil and gas production from the deepwater fields. The newly constructed Discovery pipeline transports natural gas from these fields. In 1997, we also completed Phase I of the Texaco Expanded NGL (natural gas liquids) Distribution System, a 500-mile pipeline network designed to distribute NGLs safely and efficiently throughout Southern Louisiana markets. Phase II, which will serve Eastern Louisiana markets, is due for completion in the second quarter of 1998.

To meet our goals for deepwater development, we must be creative in confronting a difficult operating environment, resulting from a tight supply of deepwater rigs, yard space and services. Texaco's ability to form strategic alliances helped us to move swiftly in 1995 to contract for a semi-submersible drilling rig, upgraded in 1996 and rechristened *Ocean Star*. The rig began working at Fuji in early 1997. Exclusive use of this rig in water depths up to 4,500 feet will enable us to continue exploration of high-potential prospects through the end of the century. To pursue our aggressive plans quickly and cost-effectively in the Gulf of Mexico, we also have contracts for two other deepwater rigs – the Sedco *Energy* and the 50% interest we have in the *Glomar Explorer.* For our deepwater acreage off West Africa, we announced a contract for a deepwater drillship capable of operating in 8,000 feet of water.

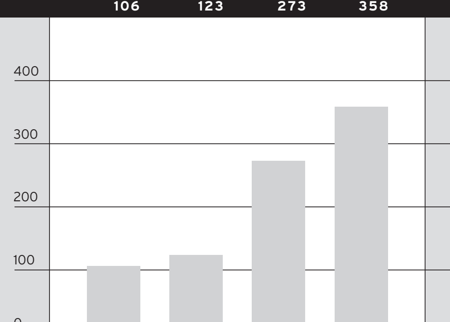
Despite rising costs of rigs and services, our return on average capital employed in our North American upstream operations was 22% for 1997.

In 1997, our North American production rose to 685,000 barrels of oil equivalent a day from 675,000 in 1996. Spurred largely by future production from the deepwater Gulf, we expect North American production to rise to an average 856,000 barrels of oil equivalent a day in 2002.

We will apply some of the technologies that are accelerating deepwater Gulf development to promising areas around the world, such as Angola, Nigeria and Australia. There, as in the U.S., our goal is to increase the profitability of our assets by speeding the process from discovery to first production.

DEEPWATER GULF: NUMBER OF LEASES

94	95	96	97
106	123	273	358



Accelerated lease-buying since 1995 has made Texaco the third-largest player in the Gulf, in water depths greater than 1,300 feet.

ALLIANCE:

LEVERAGING STRENGTHS

IN THE FIERCELY COMPETITIVE U.S. DOWNSTREAM MARKET, THE TEXACO, SHELL AND SAUDI REFINING ALLIANCES WILL HELP US TO GENERATE GREATER EFFICIENCIES, HIGHER MARGINS AND GROWTH OPPORTUNITIES.

THE HIGHLY COMPETITIVE, CAPITAL INTENSIVE U.S. downstream business has challenged us to find innovative ways to convert this business into a valuable asset. Faced with the prospect of continuing single-digit returns from these downstream operations, we decided to apply a strategy of asset management to propel our U.S. downstream business into a platform for growth. The strategy: improve returns in mature markets by managing our costs and combining our assets so that each asset provides returns greater than our cost of capital.

In a U.S. downstream initiative that promises to reinvent the country's refining and marketing industry, we formed a Western U.S. alliance with Shell Oil Company, named Equilon Enterprises LLC, and we anticipate forming an Eastern U.S. alliance with Shell and Saudi Refining, Inc., early this year. On December 18, 1997, the U.S. Federal Trade Commission (FTC) accepted a consent agreement allowing Texaco, Shell and Saudi Refining, Inc., to proceed with formation of the two new alliances.

Together, these alliances will have the size, quality of assets, scope of operations, talent and know-how to be world-class competitors. Through their formation, the ventures expect to achieve annual cost savings and margin improvements of at least $800 million, with the bulk to be realized after 1998.

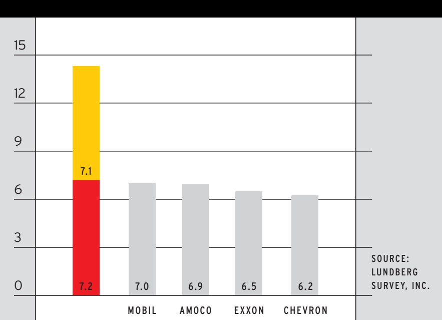
Equilon, which began operations in January 1998, combines the Western and Midwestern U.S. refining and marketing businesses and the U.S. lubricants, trading and transportation businesses of Texaco and Shell. Two of the partners in the anticipated Eastern U.S. alliance, Texaco and Saudi Refining, are joint-venture partners in Star Enterprise, which markets throughout the Gulf Coast and Eastern U.S. These operations will be combined with Shell's in the area to create the Eastern U.S. alliance. Both of the new alliances will be supported by a jointly owned service company.

The consent of the FTC and state attorneys general required Texaco and Shell to sell some assets to reduce the combined market presence in specific areas. Under these agreements, divestitures include the Shell refinery in Anacortes, Wash., certain Shell and Texaco retail facilities in Southern California and Hawaii, and certain terminal and pipeline interests. No assets in the Eastern U.S. alliance are affected by the agreements.

Even with these divestitures, the alliances will comprise a potent force in the U.S. downstream business. They will have almost 15% of total U.S. gasoline and automotive lubricants sales, as well as about 12% of total U.S. refining capacity. Their combined assets will make the ventures number one in U.S. market

GASOLINE MARKET SHARE VS. COMPETITORS

{percent of market share – 1996}

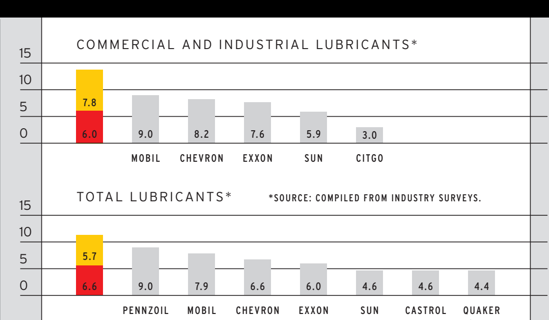


TEXACO SHELL

The allied Texaco and Shell brands will present a formidable front to their principal U.S. competitors.

TEXACO-SHELL LUBRICANTS COMPARISON

{percent of market share – 1996}



TEXACO SHELL

In the lubricants business, the combined Texaco and Shell brands will comprise an industry-leading force.

share for refining capacity, branded gasoline sales and lubricants sales. The alliances are expected to generate $45 billion in annual revenues, with capital employed of about $13 billion. The alliances will employ about 24,000 people.

Size, however, was not Texaco's prime motivation for fostering the alliances. The critical factor is that Texaco, Saudi Refining and Shell have complementary strengths with an economic potential far greater than the sum of their parts. By efficiently combining assets, we can achieve a fundamental change in our downstream operations and become an industry leader in profitability, growth and cost control.

The distinctive Texaco and Shell brands will retain their strong consumer identities. Each will be marketed by both joint-venture companies. The alliance companies are committed to protect and grow both brands and to align their retail marketing strategies on a national basis.

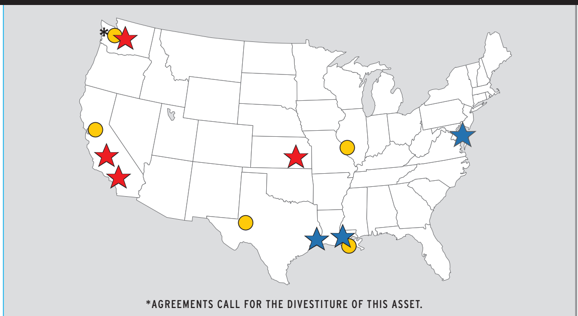
Consistent with the alliances' principle of "equal voice," sub-teams from the three parent companies have worked closely together to identify efficiencies and margin improvements that the new organizations can achieve by integrating overlapping functions and assets and by sharing best practices. For example, the new organizations expect to streamline industrial lubricant product lines, enhance the efficiency of the order-entry process, improve logistical flexibility and coordinate bulk purchases.

In cases where Shell and Texaco operate contiguous facilities, we can now optimize the sites by streamlining some areas of service and product lines. For example, in locations where Texaco and Shell refineries are near each other, feedstock purchases and product yields can be coordinated to optimize profitability.

We will also take maximum advantage of our complementary strengths. For example, Shell's Rotella® brand diesel engine oil has a strong position in the truck market, while Texaco's Havoline Formula3® brand motor oil is a top seller in the passenger vehicle market. And we will benefit by learning more about each other's strengths. By working together on reliability studies and safety practices, we will be able to further reduce lost-time incidents throughout the refining system. The sheer size of the alliances will allow us to leverage the use of best practices across a much larger network than the individual companies could achieve on their own.

Longer term, we will endeavor to leverage our cost-efficiency improvements to increase earnings, cash flow and market presence – creating a true "growth engine" in the U.S. downstream market.

REFINING ALIGNMENT

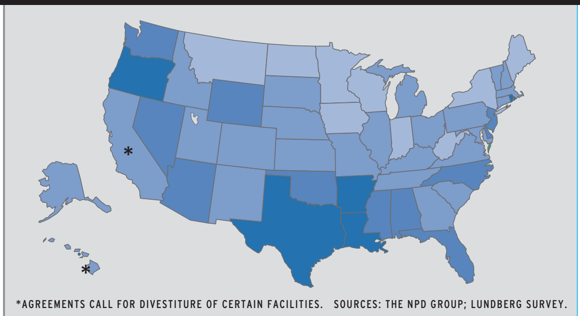


*AGREEMENTS CALL FOR THE DIVESTITURE OF THIS ASSET.

TEXACO STAR ENTERPRISE SHELL

Strategically situated refineries will have a combined 12% share of the nation's refining capacity.

COMBINED MARKET SHARE BY STATE – 1997



*AGREEMENTS CALL FOR DIVESTITURE OF CERTAIN FACILITIES. SOURCES: THE NPD GROUP; LUNDBERG SURVEY.

<10% 10–20% 20–30% 30–40%

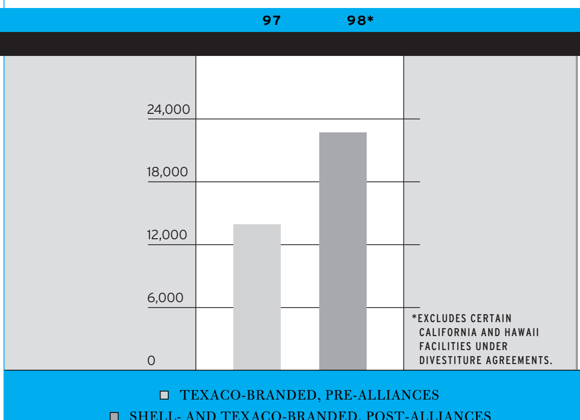
Across the U.S., the alliances' combined market presence will strengthen both brands.

Texaco enters the new alliances in the U.S. from a position of experience and confidence. We have a long-held strategic focus on active alliance management, which minimizes risk and strengthens returns. In 1995, we entered into a joint venture with Norsk Hydro, which gave us a leading market position in the countries of Scandinavia. The joint venture, Hydro Texaco, currently has about 18% of the national gasoline markets in Norway and Denmark. Our long tradition of joint ventures includes the formation in 1988 of Star Enterprise.

The largest and most enduring of Texaco's alliances is Caltex, formed in 1936 as a 50% joint downstream venture with Chevron. Caltex is a leading marketer in many of the nearly 60 countries in which it operates. Caltex reduced expenses 3.5% in 1997, compared to 1996. The company's continuing cost-containment efforts have resulted in a cost reduction of some 15% from 1994 to 1997. In the face of continued volatility in the principal Asian economies, Caltex has initiated additional programs – with active participation from its shareholders – to continue improving its cost structure and gaining greater efficiencies across its asset base. At the same time, Caltex is actively searching for valuable growth opportunities afforded by the region's economic troubles.

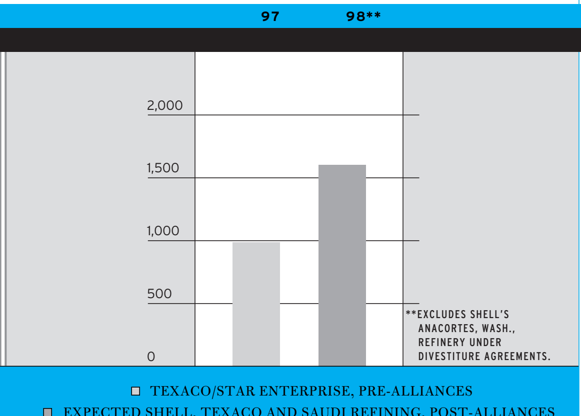
Just as Caltex has consistently added shareholder value by growing its business in markets around the world, our new downstream alliances for growth in the U.S. are expected to achieve strong results as we change the way of doing business in the competitive U.S. downstream market.

U.S. RETAIL FACILITIES



U.S. REFINING CAPACITY

{thousands of barrels a day}



Building competitive strength: with increased size will come not only greater strength but more opportunities for profitability, cost control and growth.

FINANCIAL AND OPERATIONAL INFORMATION

TEXACO INC. AND SUBSIDIARY COMPANIES

MANAGEMENT'S DISCUSSION AND ANALYSIS

TEXACO INC. AND SUBSIDIARY COMPANIES

INTRODUCTION

During 1997, we volunteered to participate in a pilot program with the Securities and Exchange Commission to write our Management's Discussion and Analysis (MD&A) in plain English. We hope by using plain English our information will be more easily understood.

In the MD&A, we explain the operating results and general financial condition of Texaco Inc. and its subsidiaries. We begin the MD&A with a table of consolidated financial highlights, which provides a financial picture of our company. The remainder of our MD&A is comprised of four main topics: *Industry Review, Results of Operations, Functional Analysis of Net Income* and *Other Items*.

In the *Industry Review*, we discuss the economic factors that affected our industry in 1997. Our near-term outlook for the industry and a worldwide supply/demand forecast are also provided.

In the *Results of Operations,* we describe comparative variances in consolidated revenues, costs, expenses, and income taxes. Summary schedules of net income complete this section. These schedules show net income before and after special items. Special items are significant events considered to be outside the scope of normal current year operations.

In the *Functional Analysis of Net Income,* we present the various segments of our business. Our net income is detailed according to the following functions:

• Exploration and Production (also known as "Upstream"): We explore for, find and produce crude oil, natural gas liquids and natural gas

• Manufacturing, Marketing and Distribution (also known as "Downstream"): We refine, transport and sell crude oil and products, such as gasoline, fuel oil and lubricants

• Nonpetroleum: Insurance, alternate energy and real estate

• Corporate/Nonoperating: Interest expense and general corporate expenses, as well as interest and other income.

Finally, in the *Other Items* section, we discuss items that we think are important to our overall business strategies:

• Liquidity and Capital Resources: Our program to manage cash, working capital, debt and other factors that provide us with financial flexibility

• Capital and Exploratory Expenditures: Our program to invest in projects aimed at future growth

• Environmental Matters: A discussion about our expenditures relating to the environment

• Reserves: A discussion about our worldwide net proved reserves of crude oil, natural gas liquids and natural gas

• U.S. Downstream Alliances: An overview of the formation of two ventures that combine our refining, marketing, transportation, trading and lubricants operations with those of Shell Oil Company and Saudi Refining, Inc. in 1998

• Year 2000: The status of our identification and correction of computers, software, and related technologies to be year 2000 compliant.

• • • • • • • •

Our discussions in the MD&A and other sections of this Annual Report represent our best estimate of the trends we know about and the trends we anticipate. Actual results may be different from our estimates.

CONSOLIDATED FINANCIAL HIGHLIGHTS

(Millions of dollars, except per share and ratio data)	1997	1996	1995
Revenues	$ 46,667	$ 45,500	$ 36,787
Net income before special items and cumulative effect of accounting change	$ 1,894	$ 1,665	$ 1,152
Special items	770	353	(424)
Cumulative effect of accounting change	—	—	(121)
Net income	$ 2,664	$ 2,018	$ 607
Net income per common share (dollars)			
Basic			
Net income before special items and cumulative effect of accounting change	$ 3.52	$ 3.09	$ 2.10
Special items	1.47	.68	(.81)
Cumulative effect of accounting change	—	—	(.24)
Net income	$ 4.99	$ 3.77	$ 1.05
Diluted			
Net income before cumulative effect of accounting change	$ 4.87	$ 3.68	$ 1.28
Net income	$ 4.87	$ 3.68	$ 1.05
Cash dividends per common share (dollars)	$ 1.75	$ 1.65	$ 1.60
Total assets	$ 29,600	$ 26,963	$ 24,937
Total debt	$ 6,392	$ 5,590	$ 6,240
Stockholders' equity	$ 12,766	$ 10,372	$ 9,519
Current ratio	1.07	1.24	1.24
Return on average stockholders' equity*	23.5%	20.4%	7.5%
Return on average capital employed*	17.3%	14.9%	6.9%
Total debt to total borrowed and invested capital	32.3%	33.6%	38.0%

*Returns for 1995 exclude the cumulative effect of accounting change.

INDUSTRY REVIEW

REVIEW OF 1997

Economic Performance – The world economy grew at a relatively healthy 3.6% rate in 1997, though growth patterns varied among regions. On balance, economic expansion in the industrialized world remained modest. The U.S. economy enjoyed robust growth in 1997, while the economies of Western Europe gained momentum, benefiting from strong export performance. However, the Japanese economy showed signs of stalling, due largely to the effects of a tax increase on consumer spending.

The economy of the former Soviet Bloc registered modest growth in 1997. Strong gains in some of the former Eastern European countries and a small increase in Russia were offset by continued stagnation in other parts of the former Soviet Bloc.

In the developing world, a financial crisis in much of Asia slowed economic expansion during the latter part of 1997. But the economies of other developing regions remained strong, and growth for the developing world as a whole was still well above the world average.

Demand & Supply Conditions – The overall favorable global economic conditions resulted in robust growth for oil demand during 1997. World petroleum demand averaged a record 73.8 million barrels per day – 2.8% higher than in 1996.

• Growth in the industrialized world was supported by the U.S., where strong demand for gasoline helped boost overall oil demand.

• The economic turmoil in some Asian markets slowed historic growth rates for the developing countries as a whole.

• Growth also took place in the former Soviet Bloc. For the first time since 1987, Russia registered a modest increase in oil consumption.

On the supply side, OPEC (Organization of Petroleum Exporting Countries) and non-OPEC liquids production rose during the year to 74.3 million barrels per day, from 72.1 million barrels per day in 1996. However, growth in non-OPEC supply was less than anticipated due to new field delays in the North Sea and technical problems in Colombia, Australia and Brazil.

Output from OPEC showed a substantial gain versus 1996. Nearly every OPEC country boosted production, with Venezuela and Nigeria showing some of the largest gains. Iraq's "oil-for-food" exports under U.N. Resolution 986 added significant volumes to the market.

World crude oil prices declined in 1997, despite the production problems in some non-OPEC areas. The spot price of U.S. benchmark West Texas Intermediate (WTI) averaged $20.61 per barrel, $1.55 below prior year levels.

WORLD PETROLEUM DEMAND/SUPPLY

(Millions of barrels a day)	Forecast 1998	1997	1996
Demand			
Industrial Nations	42.2	41.8	41.3
Developing Nations	26.9	26.0	24.8
Former Soviet Bloc	6.1	6.0	5.7
Total	75.2	73.8	71.8
Supply			
Non-OPEC Crude	38.9	37.8	37.1
OPEC Crude	27.6	27.2	25.9
Other Liquids	9.5	9.3	9.1
Total	76.0	74.3	72.1
Stock Change	0.8	0.5	0.3

NEAR-TERM OUTLOOK

Trimmed by somewhat slower growth in the industrialized world and the lingering effects of the Asian financial crisis, we expect world economic expansion to slow to a 3.0% rate in 1998.

• Within the industrialized world, the U.S. is forecast to experience slightly lower economic growth than in 1997. Also, the Japanese economy is expected to remain weak. On the other hand, economic expansion in Western Europe is expected to pick up steam, benefiting from increased investment.

• Developing Asia is likely to experience lower economic growth due to the continuing repercussions of its financial crisis. However, other developing areas are expected to remain largely unaffected.

• Despite strong economic gains in some Eastern European countries, continued economic stagnation in Russia is expected to once again prevent a significant rebound in the economy of the former Soviet Bloc.

During 1998, we project world oil consumption to increase by approximately 1.4 million barrels per day to an average of 75.2 million barrels per day. Growth in demand for oil in the industrialized world is expected to slow down, in part due to the deceleration in the U.S. economy. The relatively poor economic conditions in parts of Asia are expected to continue to slow growth in the developing countries overall. In the former Soviet Bloc, oil demand should rise, although modestly.

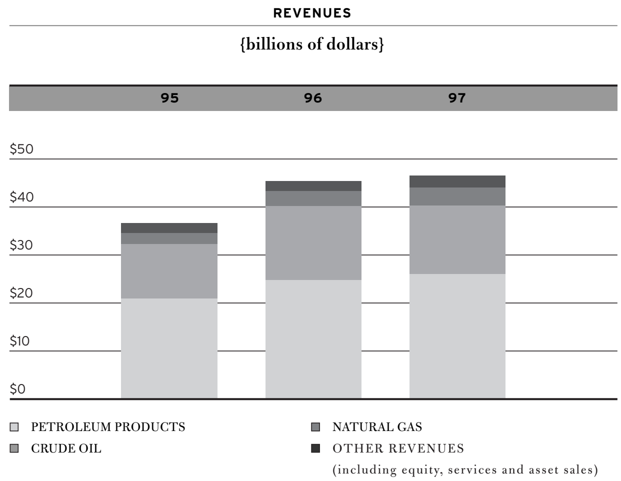
Despite the continued uptrend in demand, increases in world oil production appear to be running ahead of consumption. Many non-OPEC projects delayed in 1997 are expected to start up in 1998. Also, OPEC is continuing to increase production, particularly given higher output quotas negotiated at the end of 1997. With the supply/demand balance loosening, oil prices have declined precipitously in early 1998; however, some recovery in prices is likely as the year progresses.

Extreme weakness in some Asian economies will constrain both regional Downstream margins and petroleum product sales. The financial performance of company operations through our affiliate, Caltex, could be adversely impacted.

RESULTS OF OPERATIONS

REVENUES

Our consolidated worldwide revenues rose to $46.7 billion in 1997, an increase of almost 3% over revenues of $45.5 billion in 1996. In 1997, we had higher sales volumes of crude oil, natural gas and refined products. We also had higher prices for natural gas sales, principally in the United States. Crude oil revenues were lower due to a significant price drop late in the year. Revenues for 1995 were $36.8 billion.



This chart shows the growth in Texaco's revenues, by major components.

1997 versus 1996 – Crude oil and natural gas sales volumes increased due to higher worldwide production. Higher production resulted from new field development, field expansions and an acquisition. "Buy/Sell" activity in the U.S. increased for natural gas but was partially offset by lower international crude sales. "Buy/Sells" are the marketing of crude oil and natural gas produced by other companies and purchased by us for resale. This activity enables us to utilize our significant trading and pipeline distribution network to optimize market opportunities in the volatile petroleum industry. Our petroleum products sales rose during 1997 due to strong sales of gasoline and heating oil.

Generally declining prices for crude oil and petroleum products decreased sales revenues late in the year. This impact was only partially offset by higher prices for U.S. natural gas.

Other revenues increased due to higher duties and taxes collected on increased international refined product sales. These duties are passed on to consumers. We also had more asset sales in 1997.

1996 versus 1995 – Revenues in 1996 exceeded 1995 by 24%. Two-thirds of the 1996 rise was due to higher worldwide prices for crude oil, refined products and natural gas. Sales volumes increased across most product lines reflecting expanded trading and producing operations and our product marketing initiatives.

COSTS

Purchases and other costs were $35.2 billion in 1997, $34.6 billion in 1996 and $27.2 billion in 1995.

Costs were higher in 1997 because we purchased more natural gas for resale than in 1996. We also paid higher prices for natural gas in the United States. Costs increased further by duties on higher refined product volumes and rates imposed by foreign governments. Partially offsetting these impacts were lower worldwide purchase costs and international volumes of crude oil acquired for resale.

The 1996 increase versus 1995 was due to higher worldwide prices and volumes for purchased crude oil, refined products and natural gas.

EXPENSES

Expenses of our operations, excluding special items, rose to $7.6 billion in 1997 as compared to $7.2 billion in 1996 and $6.8 billion in 1995.

We have expanded our operations considerably over the past three years. Higher production of crude oil and natural gas, increased refinery utilization and a rise in refined product sales have led to increased expenses.

We have also increased our exploratory spending to aggressively search for new reserves of crude oil and natural gas. Expenses have seen upward pressure due to a general shortage of drilling rigs, equipment and in some cases talented manpower. Our producing and refinery operations experienced higher utility costs necessary to fuel units and equipment used in our business.

We spent more on advertising and corporate sponsorship. In 1997 we launched our *"Texaco. A World of Energy"* campaign and initiated our new eight year sponsorship of the U.S. Olympic team.

While expenses for operations increased over prior years' levels, cash operating expenses on a per barrel basis have been contained in spite of inflationary pressures. These expenses have increased only 1% from 1995 to 1997 as compared to a 5% rise in inflation. This measurement shows our ability to grow the business and enhance shareholder value while controlling expenses.

INCOME TAXES

Income tax expense was $663 million in 1997, $965 million in 1996 and $258 million in 1995. The year 1997 included a $488 million benefit resulting from an IRS settlement. The years 1996 and 1995 included benefits from the sales of a partial interest in a subsidiary of $188 million and $65 million, respectively. The year 1995 also included significant deferred tax benefit effects from the adoption of a new accounting standard.

NET INCOME SUMMARY SCHEDULES

The following schedules show net income before and after special items. Special items are significant events considered to be outside the scope of normal current year operations.

NET INCOME

(Millions of dollars)	1997	1996	1995
Net income before special items and cumulative effect of accounting change	$ 1,894	$ 1,665	$ 1,152
Special items:			
Gains on major asset sales	367	194	232
Tax benefits on asset sales	—	188	65
Tax and other issues	487	68	—
Employee separation costs	—	(65)	(56)
Asset writedowns	(41)	—	(639)
Other special items	(43)	(32)	(26)
Total special items	770	353	(424)
Net income before cumulative effect of accounting change	$ 2,664	$ 2,018	$ 728

The following schedule further details net income by major function within our U.S. and International operations.

NET INCOME

(Millions of dollars)	Before Special Items 1997	Before Special Items 1996	Before Special Items 1995	After Special Items 1997	After Special Items 1996	After Special Items 1995
Exploration and Production						
U.S.	$ 1,031	$ 1,123	$ 674	$ 957	$ 1,123	$ 293
International	438	451	343	797	478	340
Total Exploration and Production	1,469	1,574	1,017	1,754	1,601	633
Manufacturing, Marketing and Distribution						
U.S.	305	233	141	318	207	121
International	530	252	358	514	450	365
Total Manufacturing, Marketing and Distribution	835	485	499	832	657	486
Total Petroleum and Natural Gas	2,304	2,059	1,516	2,586	2,258	1,119
Nonpetroleum	17	16	32	17	16	(28)
Corporate/Nonoperating	(427)	(410)	(396)	61	(256)	(363)
Net income	$ 1,894	$ 1,665	$ 1,152	$ 2,664	$ 2,018	$ 728

FUNCTIONAL ANALYSIS OF NET INCOME

UPSTREAM

The following schedule provides financial and key operational information relating to our Upstream operations:

EXPLORATION AND PRODUCTION

(Millions of dollars)	1997	1996	1995
U.S. operating earnings before special items	$ 1,031	$ 1,123	$ 674
Special items	(74)	—	(381)
Total U.S.	957	1,123	293
International operating earnings before special items	438	451	343
Special items	359	27	(3)
Total International	797	478	340
Worldwide exploration and production earnings	$ 1,754	$ 1,601	$ 633
Worldwide return on average capital employed, before special items	18.3%	22.1%	14.9%
Total worldwide return on average capital employed	21.9%	22.5%	9.3%
Selected Operating Data			
Net production of crude oil and NGL's (thousands of barrels a day)			
U.S.	396	388	381
International	437	399	381
Worldwide	833	787	762
Net production of natural gas – available for sale (millions of cubic feet a day)			
U.S.	1,706	1,675	1,619
International	471	382	373
Worldwide	2,177	2,057	1,992
Natural gas sales (millions of cubic feet a day)			
U.S.	3,584	3,176	3,153
International	592	477	435
Worldwide	4,176	3,653	3,588

U.S. Upstream operating earnings, before special items, totaled $1,031 million in 1997, down 8% from 1996, but up 53% from 1995.

We earned less in 1997 compared with 1996, due to slightly lower crude oil prices, lower gas marketing results and higher operating expenses. Gas marketing margins were squeezed throughout the year. Our operating expenses were higher due to increased exploration and production activities, primarily in the deepwater Gulf of Mexico and California.

Increased demand, low inventory levels and uncertainty regarding the possible resumption of Iraqi crude sales drove an upward trend in crude oil prices that began in 1996 and peaked in early 1997. Crude oil prices trended lower beginning in the second quarter and continued to do so for the remainder of the year, particularly in the fourth quarter of 1997. During this time, the market reacted to weakening demand, the potential of increased OPEC and non-OPEC production and possible changes in Iraqi export volumes. For the year 1997, Texaco's average crude oil price was $17.34 per barrel, or $.59 per barrel below the 1996 price. The 1996 average price of $17.93 per barrel represented an increase of $2.83 per barrel from 1995.

Higher natural gas prices and increased production of crude oil and natural gas during 1997 had a positive impact on our financial results. Our average realized price for natural gas of $2.37 per MCF was $.18 per MCF higher than in 1996. The overall higher price in 1997 reflects industry demand to replenish natural gas inventory levels. The 1996 average natural gas price of $2.19 per MCF was $.54 per MCF higher than 1995.

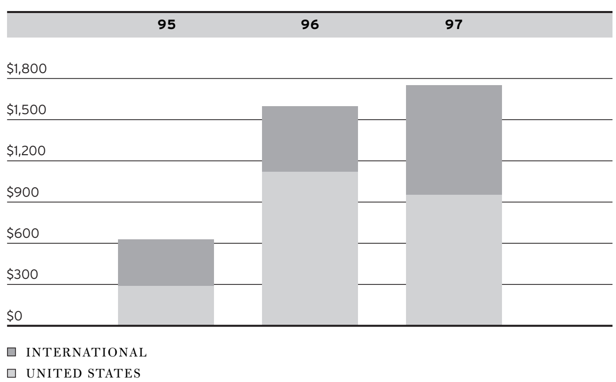
We increased our production of crude oil, natural gas liquids and natural gas in 1997 by 2% as compared with 1996. Production from new fields, most notably the acquired Monterey Resources properties, and existing fields in the

Gulf of Mexico and Louisiana, contributed to the increase. At the same time, we more than offset declines from maturing fields. During 1996, we had increased our production by 2.5% over 1995 levels. This upward trend in U.S. production over the last two years reflects our commitment to increase production through enhancements at existing fields such as Kern River, California and the deepwater Gulf, as well as through acquisitions such as Monterey Resources.

In 1997, our total U.S. operating earnings were $957 million, compared with $1,123 million in 1996 and $293 million in 1995. Results for 1997 included special charges of $43 million for the establishment of financial reserves for royalty and severance tax issues and $31 million for asset writedowns. Included in 1995 results were special items of $381 million, which included: asset writedowns of $493 million, gains from the sale of non-core producing properties totalling $125 million, and charges of $13 million for reserves for environmental remediation on the non-core properties sold.

EXPLORATION AND PRODUCTION – TOTAL OPERATING EARNINGS

{millions of dollars}



Solid 1997 Upstream results reflect higher prices and a 9% increase in worldwide production since 1995.

International Upstream operating earnings, before special items were $438 million in 1997 as compared with $451 million and $343 million for 1996 and 1995.

Even though we increased our international production, our operating earnings dropped by 3% due to lower crude oil prices, lower gas marketing results and higher expenses. Our international average crude oil price of $17.64 per barrel in 1997 was $1.91 lower than in 1996. Crude oil prices peaked very early in 1997 and then began to trend downward for the better part of the year. The decrease in 1997 average price brought to an end the upward trend in prices that began in late 1995. Texaco's international average crude oil price in 1995 was $16.29 per barrel.

The higher expenses in 1997 are associated with our expanded exploration programs. This increase in spending supports our aggressive initiative to increase production. We also increased our expenses in 1996 to support our worldwide production goals. The 1997 increase relates to enhancements made in existing fields in such locations as the Partitioned Neutral Zone, U.K. North Sea and Angola, and also includes expenses associated with new fields that came onstream, such as the Captain field.

Crude oil and natural gas production was up more than 11% in 1997. The double-digit increase in our production volumes follows the 4.5% increase we achieved in 1996 versus 1995. New production from the Captain and Erskine fields, as well as record production in the Partitioned Neutral Zone, contributed to the 1997 increase. A full year's production from activities in the Bagre field offshore Angola and in the Danish North Sea also bolstered 1997 results. These areas came onstream late in 1996. Increased natural gas production at the Dolphin field in Trinidad and from Chuchupa "B" offshore Colombia pushed our international gas production to higher levels.

Operating results for the last three years include non-cash currency translation effects. These effects relate to deferred income taxes denominated in British pounds. Results for 1997 and 1995 included benefits of $21 million and $2 million, while 1996 results included charges of $38 million.

In our international Upstream business, we had total operating earnings of $797 million for 1997. This compares with $478 million in 1996 and $340 million in 1995. Results for 1997 included a $15 million prior period tax benefit, a charge of $10 million for asset writedowns and gains of $354 million related to asset sales involving:

- a 15% interest in the Captain field in the U.K.,
- interests in Canadian gas properties and an Australian pipeline system, and
- the company's Myanmar operations.

Results for 1996 included a special non-cash gain of $27 million related to a Danish deferred tax benefit, while 1995 amounts included a special charge of $3 million related to asset writedowns.

DOWNSTREAM

The following schedule provides financial and key operational information relating to our Downstream operations:

MANUFACTURING, MARKETING AND DISTRIBUTION

(Millions of dollars)	1997	1996	1995
U.S. operating earnings before special items	$ 305	$ 233	$ 141
Special items	13	(26)	(20)
Total U.S.	318	207	121
International operating earnings before special items	530	252	358
Special items	(16)	198	7
Total International	514	450	365
Worldwide manufacturing, marketing and distribution earnings	$ 832	$ 657	$ 486
Worldwide return on average capital employed, before special items	9.3%	5.5%	5.7%
Total worldwide return on average capital employed	9.3%	7.5%	5.6%

Selected Operating Data			
Refinery input (thousands of barrels a day)			
U.S.	747	724	693
International	804	762	788
Worldwide	1,551	1,486	1,481

Refined product sales (thousands of barrels a day)			
U.S.	1,022	1,036	934
International	1,563	1,552	1,567
Worldwide	2,585	2,588	2,501

U.S. Downstream operating earnings, before special items, in 1997 were 31% higher than 1996 amounts and more than doubled the 1995 results.

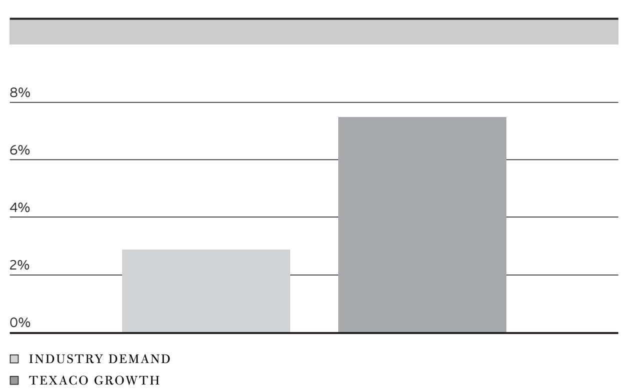
We earned more in 1997, compared to 1996, due to improvements in our refinery operations as well as stronger margins and higher gasoline volumes. These factors more than offset the effects of lower crude oil trading margins and clean-up costs from a pipeline break at Lake Barre.

Our East Coast operations benefited from improved margins for most of the year. Higher crude oil costs squeezed our West Coast margins for the first six months. However, by the third quarter of 1997, margins started to recover, allowing 1997 West Coast operations to surpass 1996 results. In 1996, we experienced just the opposite, as higher crude oil costs during the latter part of the year sent margins downward from a second quarter peak.

In addition, both first quarter 1997 and fourth quarter 1996 results were adversely impacted by fires at our Los Angeles, California and Convent, Louisiana refineries. We experienced property damage and earnings losses from lower yields. Our refined product sales were slightly lower in 1997. The 1996 level was nearly 11% above 1995 amounts.

Although refined product sales dipped slightly in 1997, gasoline sales continued to remain strong. Texaco branded gasoline sales volumes increased more than 3% in 1997, fueled by new marketing initiatives in high growth areas such as Southern California and Denver. This jump follows a 4% increase in 1996 over 1995 amounts.

U.S. BRANDED GASOLINE SALES
{1995–1997}



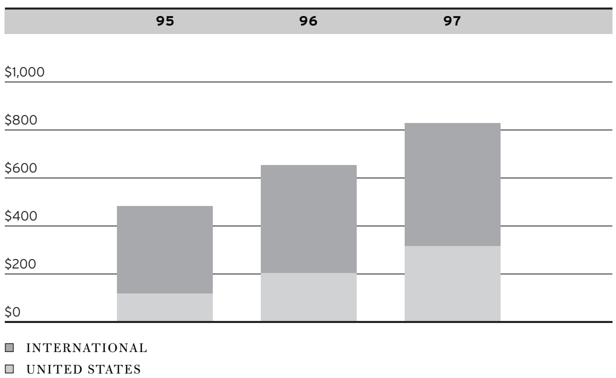
During the period 1995-1997 Texaco's branded gasoline sales rose 7.5% while industry demand increased only 2.9%.

We achieved higher results for 1996 versus 1995, mainly due to higher West Coast refinery margins, improved refinery operations and the favorable impact of cost containment efforts. Higher sales volumes of gasoline and diesel as well as improved profits in the distribution and transportation business offset the impact of lower margins in 1996.

In 1997, our total U.S. operating earnings were $318 million. Results for 1997 included a special gain of $13 million from the sale of our credit card operations. The year 1996 included special charges of $25 million related to the sale of a propylene oxide/methyl tertiary butyl ether (PO/MTBE) manufacturing site in Texas. Amounts for 1996 and 1995 included special charges of $1 million and $11 million for employee separations and 1995 results also included special charges of $9 million related to asset writedowns.

MANUFACTURING, MARKETING AND DISTRIBUTION – TOTAL OPERATING EARNINGS

{millions of dollars}



Worldwide Downstream earnings have significantly increased with 1997 results over 71% higher than 1995.

International Downstream operating earnings, before special items, were $530 million in 1997. We earned $252 million in 1996 and $358 million in 1995.

The more than doubling of earnings in 1997 reflects higher manufacturing and marketing results. In manufacturing, we improved refining operations, increased margins and lowered expenses – particularly in the U.K. and at the Panama refinery. Marketing results in 1997 also significantly improved due in large part to the recovery of margins in the United Kingdom. In 1996, our results were squeezed by significantly depressed marketing margins. In Latin America and Europe, refined product sales increased over 1996 amounts. Increased sales volumes throughout Latin America and Europe – along with stronger marketing margins in the Latin America areas, offset the impact of lower results in Scandinavia. Price wars in the Norwegian marketplace lowered our 1997 results.

Caltex earnings for 1997 were bolstered by improved petrochemical results in Korea, higher refining margins and improved refining efficiencies, and higher refined product sales. This improvement occurred in spite of the economic crisis in Southeast Asia that arose during the latter part of 1997. Effective October 1, Caltex changed the functional currency used to account for its operations in Korea and Japan to the U.S. dollar. Results for the year included $70 million of benefits in Korea recorded in the fourth quarter, principally relating to currency effects. The favorable currency-related effects were primarily local tax benefits on currency losses on U.S. dollar-denominated obligations resulting from the devaluation of the won.

Two unscheduled refinery shutdowns in Thailand during 1997 and inventory valuation losses associated with a decline in crude oil prices partly offset the increase in Korean earnings. In the last half of 1997, currency devaluations in various countries drove down margins, as Caltex was unable to immediately recover dollar based crude costs.

Results for 1996 were almost 30% lower than 1995's. This decrease was driven mainly by lower margins in both the Europe and the Caltex areas. In Europe, 1996 marketing margins were significantly depressed by an excessive supply of gasoline and competitive market pressures in the United Kingdom. In the Caltex operating markets, higher crude costs significantly lowered margins in Australia, Korea, Thailand and Japan.

Operating results for all three periods included non-cash currency translation effects. These effects relate to deferred income taxes denominated in British pounds. Results for 1997 and 1995 included benefits of $7 million and $3 million, while 1996 results included charges of $20 million.

Our total international operating earnings were $514 million for 1997. This compares with $450 million in 1996 and $365 million in 1995. Results for 1997 included a special charge of $16 million, primarily for adjustments related to deferred tax issues in Ireland. Results for 1996 and 1995 included the following special items:

- gains related to asset sales: $219 million in 1996 related to sale of Caltex' interest in Nippon Petroleum Refining Company, Limited, and $80 million in 1995, principally related to sale of land in Japan by a Caltex affiliate,
- charges for employee separations: $21 million in 1996 and $29 million in 1995,
- a charge of $31 million in 1995 related to asset writedowns, and
- restructuring charges of $13 million in 1995 for certain Caltex operations.

NONPETROLEUM

(Millions of dollars)	1997	1996	1995
Operating earnings (losses) before special items	$ 17	$ 16	$ 32
Special items	—	—	(60)
Total operating earnings (losses)	$ 17	$ 16	$ (28)

Nonpetroleum operating earnings before special items were $17 million in 1997, $16 million in 1996 and $32 million in 1995. The 1995 results reflect the benefits of improved loss experience of insurance operations.

Included in total nonpetroleum operating results for 1995 was a special charge of $87 million for asset writedowns and a special gain of $27 million from the sale of our interest in Pekin Energy Company.

CORPORATE/NONOPERATING

(Millions of dollars)	1997	1996	1995
Corporate/nonoperating before special items	$ (427)	$ (410)	$ (396)
Special items	488	154	33
Total	$ 61	$ (256)	$ (363)

Corporate and nonoperating charges, before special items, were $427 million in 1997, higher than both the $410 million for 1996 and $396 million in 1995.

Our results in 1997 include higher expenses associated with the company's new "*Texaco. A World of Energy*" advertising campaign and with our human resource initiatives. These initiatives are targeted toward making Texaco a leader in opportunity and diversity. Partly offsetting these higher expenses in 1997 was a decrease in interest expense that resulted from slightly lower interest rates.

Lower debt levels and interest rates benefited 1996 results as compared with 1995. The overall lower 1995 charges included gains of $25 million, principally from the sales of equity securities held for investment by the insurance operations.

Total corporate and nonoperating results for 1997 included a first quarter special benefit of $488 million associated with an IRS settlement. Results for both 1996 and 1995 included special tax benefits from the sales of interests in a subsidiary which amounted to $188 million in 1996 and $65 million in 1995. In addition, results for 1996 and 1995 included the following:

• charges for severance – $43 million in 1996 and $16 million in 1995,

• $41 million benefit in 1996 from lower than anticipated prior years' state tax exposures,

• $32 million charge in 1996 for the establishment of reserves for various litigation matters, and

• $16 million charge in 1995 for asset writedowns.

OTHER ITEMS

LIQUIDITY AND CAPITAL RESOURCES

This section discusses our cash inflows and outflows. Our liquidity strategy is to rely primarily on cash from operations, supplemented by the proceeds from the sale of nonstrategic assets, for our cash requirements. We use these funds for our capital and exploratory programs, dividends and working capital. We manage our working capital efficiently and have strong credit ratings and ready access to global financial markets. This flexibility allows us to secure funds at low capital costs. We consider our financial position to be sufficiently strong to meet our anticipated future financial requirements.

To provide liquidity and to support our commercial paper program, we also maintain $1.5 billion in revolving credit facilities, which were unused at year-end 1997. Our debt has an average maturity in excess of 11 years and a weighted average interest rate of 7.2%. We manage our long-term debt to avoid large requirements for cash redemption in any particular year. During 1997, we issued $150 million of 7.09% noncallable notes due 2007 and $200 million of 3.50% cash-settled convertible notes due 2004. The latter was hedged by a swap which converts the interest cost into a LIBOR-based floating rate and limits our cost of redemption to the face value of these notes.

The following table highlights relevant financial information:

(Millions of dollars, except ratio data)	1997	1996	1995
Current ratio	1.07	1.24	1.24
Total debt	$ 6,392	$ 5,590	$ 6,240
Minority interest in subsidiary companies	$ 645	$ 658	$ 667
Stockholders' equity	$ 12,766	$ 10,372	$ 9,519
Total debt to total borrowed and invested capital	32.3%	33.6%	38.0%

1997 Cash Flow Highlights

The following table highlights the major components of cash flows during 1997:

(Millions of dollars)	
Inflows:	
Cash from operations	$ 3,915
Sale of non-strategic assets	1,036
Borrowings	1,135
	6,086
Outflows:	
Capital and exploratory expenditures	3,628
Payments of dividends	1,054
Repayment of borrowings	637
Stock repurchase program	382
Net purchases of leasehold interests	503
Other net outflows	82
	6,286
Decrease in cash and cash equivalents	$ 200

• In March, we exercised an option to terminate a lease arrangement and obtained ownership of the assets used in our PO/MTBE business. At the same time, we sold the PO/MTBE business to a Huntsman Corporation affiliate for cash and preferred stock. The cash proceeds of $512 million were used to substantially offset the cost of exercising the option. The preferred stock, with a stated value of $65 million, is mandatorily redeemable in 11 years.

• In April, we completed the sale of a 15% interest in our U.K. North Sea Captain field for approximately $210 million. We received $20 million in 1996 and the balance at closing.

• In April, we sold our interest in certain producing operations in Canada for approximately $80 million.

• In May, we sold our credit card services unit, including its portfolio of proprietary credit card accounts receivable, for $308 million.

• In the third quarter, the quarterly dividend on common stock was increased by 5.9%, to 45 cents per share, as adjusted for the two-for-one stock split.

• In August, we repurchased certain equipment leasehold interests in conjunction with a sale/leaseback arrangement for $522 million. This amount was less than the sales proceeds received in previous years.

• In August, we received approximately $770 million of cash related to an IRS settlement.

• In December, we sold our interest in producing and pipeline operations under development in Myanmar for $260 million.

• During 1997, we purchased about $400 million of common stock in the open market. We also purchased an additional $77 million during January of 1998. Of these total purchases, about $150 million will be used to replace shares to be issued during 1998 under various employee benefit and incentive plans.

Monterey Acquisition – In November, the shareholders of Monterey Resources approved the merger of Monterey with our company. As a result, we issued approximately 19 million additional shares of Texaco common stock, valued at $1.1 billion. We also acquired Monterey's existing debt of approximately $300 million, of which $120 million of short-term debt was paid off immediately.

Managing Market Risk – The company is exposed to the following principal types of market risk:

• the price of crude oil, natural gas and petroleum products

• the value of foreign currencies in relation to the U.S. dollar

• interest rates.

We attempt to maintain our exposure to these risks within established guidelines. We enter into arrangements that obligate us to pay cash or entitle us to receive cash when one or more of the above fluctuates from baseline reference prices or rates. Collectively, these arrangements do not expose us to material adverse effects. The change in value of these arrangements will approximate the change in value of the underlying transaction, in the opposite direction. The fees and other costs associated with these arrangements are often less than those associated with other transactions that we could use to accomplish the same result.

Our written policies allow use of these types of arrangements for managing risks only. We are not permitted to speculate on future prices. Our written policies place limits on the dollar value, the time period and the volumes of these arrangements.

CAPITAL AND EXPLORATORY EXPENDITURES

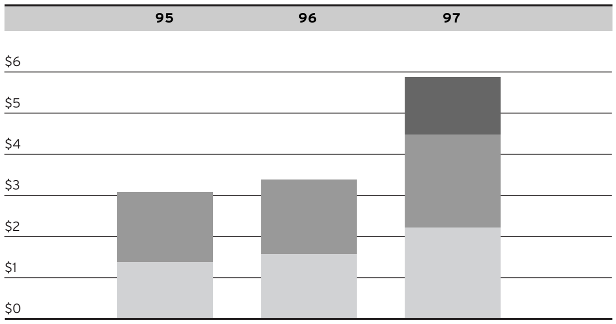
1997 Activity – Worldwide capital and exploratory expenditures, including our share of expenditures by affiliates, were $5.9 billion for the year 1997. This amount includes $1.4 billion for the acquisition of Monterey Resources, a company that produces significant quantities of heavy crude oil in California. Excluding the Monterey acquisition, expenditures were geographically and functionally split as follows:

• International ($2.3 billion, or 51%) and United States ($2.2 billion, or 49%)

• Upstream ($3.2 billion, or 71%) and Downstream and Other ($1.3 billion, or 29%).

CAPITAL AND EXPLORATORY EXPENDITURES – GEOGRAPHICAL

{billions of dollars}

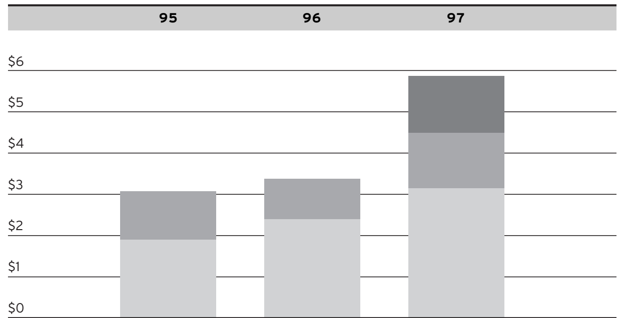


Includes equity in affiliates
■ ACQUISITION OF MONTEREY RESOURCES
■ INTERNATIONAL
■ UNITED STATES

This chart shows the growth in our capital expenditures, including the U.S. acquisition of Monterey Resources.

CAPITAL AND EXPLORATORY EXPENDITURES – FUNCTIONAL

{billions of dollars}



Includes equity in affiliates
■ ACQUISITION OF MONTEREY RESOURCES
■ MANUFACTURING, MARKETING, DISTRIBUTION AND OTHER
■ EXPLORATION AND PRODUCTION

This chart shows our continued emphasis on Upstream capital and exploratory expenditures in our drive to increase current and future production.

Exploration and Production – Significant areas of investment included:

• Acquisition of Monterey Resources

• High impact development and exploratory projects in the deepwater Gulf of Mexico

• Platform development and drilling in the U.K. North Sea, China and West Africa

• A 20% interest in the Karachaganak field in Kazakhstan

• Enhanced oil recovery spending in California and Indonesia

• Construction of a jointly-owned natural gas pipeline and processing complex in the Gulf Coast area.

Manufacturing, Marketing and Distribution – Investments in Downstream facilities included:

• Marketing facilities and service station re-imaging throughout Asia by Caltex

• Marketing expansion throughout promising areas of Latin America and Europe

• Enhancement in U.S. marketing operations to strengthen the Texaco brand

• Acquisition of the remaining interest in a refinery unit in Pembroke, Wales

• Construction of various crude oil pipeline projects in the Gulf Coast area and a refining upgrade at Port Arthur, Texas.

The following table details our capital and exploratory expenditures:

			1997			1996			1995
(Millions of dollars)	U.S.	International	Total	U.S.	International	Total	U.S.	International	Total
Exploration and production									
Exploratory expenses	$ 189	$ 282	$ 471	$ 153	$ 226	$ 379	$ 94	$ 195	$ 289
Capital expenditures*	2,994	1,129	4,123	1,090	909	1,999	810	838	1,648
Total exploration and production	3,183	1,411	4,594	1,243	1,135	2,378	904	1,033	1,937
Manufacturing, marketing and distribution	431	848	1,279	360	658	1,018	453	687	1,140
Other	55	2	57	33	2	35	44	7	51
Total	$ 3,669	$ 2,261	$ 5,930	$ 1,636	$ 1,795	$ 3,431	$ 1,401	$ 1,727	$ 3,128
Total, excluding equity in affiliates	$ 3,421	$ 1,718	$ 5,139	$ 1,535	$ 1,338	$ 2,873	$ 1,248	$ 1,242	$ 2,490

*1997 includes $1.4 billion acquisition of Monterey Resources.

1998 and Beyond – Including our affiliates, we plan to spend approximately $26 billion over the next five years. Spending for 1998 is expected to be $4.6 billion. These expenditures will be evenly divided between the U.S. and international areas.

Exploration and Production – Our Upstream expenditures will continue to be directed toward finding, developing and increasing our access to crude oil and natural gas reserves, including:

• The Gulf of Mexico, where we hold a significant inventory of valuable exploration and development acreage

• Kazakhstan, where we have a 20% interest in the giant Karachaganak oil and gas field

• The U.K. North Sea, where activities are underway in several fields slated to phase in production from 1998-2001

• Areas rich in heavy oil reserves where we can apply our world class enhanced oil recovery techniques. Some of these areas are California, including the Monterey Resources properties, and the Duri field of Indonesia

• Opportunities where our advanced geological and geophysical visualization technologies indicate that good drilling and development prospects exist

• Exploration activity focused on existing areas in West Africa and Latin America.

Manufacturing, Marketing and Distribution – Spending will be concentrated mainly in the marketing segment of our business. Our investments will focus on locations where we can enhance brand loyalty, improve market share and are positioned to achieve attractive rates of return, such as:

• Enhanced retail positions in Latin American growth areas

• Upgraded and expanded retail outlets in Asia-Pacific areas where Caltex has a major presence

• Increased cogeneration and gasification projects in international areas.

ENVIRONMENTAL MATTERS

In 1997, we spent $825 million to protect the environment and to comply with federal, state and local environmental laws and regulations. This includes our equity share in the environmental expenditures of our major affiliates. We continued to promote pollution prevention at our refineries and the refineries of our affiliates, Star Enterprise and Caltex Petroleum Corporation. We have also designed and applied processes to convert refinery wastes and used motor oil into valuable products. This minimizes the need to dispose of such materials. We are also actively involved in the remediation of hazardous waste sites which have been identified by the U. S. Environmental Protection Agency (EPA) and other regulatory agencies.

The following table provides our environmental expenditures for the past three years:

(Millions of dollars)	1997	1996	1995
Capital expenditures	$ 162	$ 185	$ 275
Non-capital:			
Ongoing operations	538	561	480
Remediation	79	111	134
Restoration and abandonment	46	48	46
Total environmental expenditures	$ 825	$ 905	$ 935

Capital Expenditures – Our capital environmental expenditures were $162 million in 1997. We spent $23 million less than in 1996, when we made large outlays for refinery upgrades to comply with government standards for reformulated fuels and low-sulfur diesel oil. Capital environmental expenditures projected for 1998 and 1999 total $222 million and $238 million, respectively.

Ongoing Activities – In 1997, we spent and expensed $538 million for ongoing operations, primarily to produce cleaner-burning fuels and to manage our environmental programs. We dedicated nearly 70% of this amount to improved air quality.

Remediation Costs and Superfund Sites – Worldwide remediation expenditures in 1997 were $79 million. This included $15 million spent on remediating Superfund waste sites. At the end of 1997, we had financial reserves of $577 million for the estimated future costs of our environmental programs. This included $57 million for the cleanup of Superfund waste sites. We have provided these reserves to the extent reasonably measurable. It is not possible to project overall costs or a range of costs beyond that disclosed, due to the uncertainty surrounding future developments in regulations and/or until further information develops regarding waste sites.

The EPA and other regulatory agencies have identified us as a potential responsible party (PRP) for clean up of certain hazardous waste sites. We have determined that we may have potential exposure, though limited in most cases, at 237 multi-party waste sites. Of these sites, 78 are on the EPA's National Priority List. Under Superfund, liability is joint and several; that is, each PRP at a site can be held liable individually for the entire cleanup cost of the site. We are, however, actively pursuing and/or participating in the sharing of Superfund costs with other identified PRP's. The sharing of these costs is on the basis of weight, volume and toxicity of the materials contributed by the PRP's.

Restoration and Abandonment – Financial reserves at year-end 1997 to cover the cost of restoration and abandonment or "closure" of our oil and gas producing properties were $845 million. Expenditures in 1997 for restoration and abandonment amounted to $46 million.

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In summary, we make every reasonable effort to fully comply with applicable governmental regulations. Changes in governmental regulations and/or our re-evaluation of our environmental programs may result in additional future costs to the company. It is assumed that any mandated future costs would be recoverable in the marketplace, since all companies within the industry would be facing similar requirements. However, it is not believed that such future costs will be material to the company's financial position nor to its operating results over any reasonable period of time.

RESERVES

Worldwide oil and gas activities are described in detail by geographic area in the section *Supplemental Oil and Gas Information.* Amounts shown below provide total crude oil and natural gas on a barrel of oil equivalent (BOE) basis. Natural gas, measured in thousands of cubic feet, is converted to a comparable equivalent of oil at a ratio of 6:1. Some key highlights of our worldwide net proved oil and gas reserves are provided below:

• At the end of 1997, our company has net proved reserves of 4.3 billion BOE, of which 57% of these reserves are located in the United States.

• The estimated life of our reserves is now 9.4 years as compared with 8.6 years at year-end 1996. We expect to increase our reserve life, as improved technology speeds up our rate of oil and gas recoveries, and as we make new discoveries and mineral right purchases.

• We replaced 167% of our 1997 worldwide combined oil and gas production. This excludes reserves added from the acquisition of Monterey Resources and other purchases and sales. The Monterey acquisition added 420 million BOE to our proved reserve base.

• Our finding and development costs in 1997 of $3.99 per BOE were 18% lower than last year.

U.S. DOWNSTREAM ALLIANCES

On January 15, 1998, we and Shell Oil Company reached agreement on the formation and operational start-up of a joint venture. The joint venture combines major elements of the two companies' western and midwestern U.S. refining and marketing businesses and nationwide trading, transportation and lubricants businesses. The new company will operate as Equilon Enterprises LLC. The venture will allow us to accomplish a fundamental change in the way we operate our Downstream business, improve performance and provide future growth. Texaco, Shell and Saudi Refining, Inc. are finalizing agreements for a separate venture involving the companies' eastern and Gulf Coast refining and marketing businesses which should conclude in early 1998.

YEAR 2000

Our computer systems, software and related technologies are affected by the Year 2000 compliance issue. We have been identifying and correcting affected applications to ensure that all of our key computer systems will be Year 2000 compliant by early 1999. We are also working with our vendors and suppliers to ensure their compliance. Costs to modify such applications have been, and are estimated to remain, immaterial to our results of operations or financial condition.

STATEMENT OF CONSOLIDATED INCOME

TEXACO INC. AND SUBSIDIARY COMPANIES

(Millions of dollars) For the years ended December 31	1997	1996	1995
REVENUES			
Sales and services (includes transactions with significant affiliates of $3,633 million in 1997, $3,867 million in 1996 and $3,146 million in 1995)	$ 45,187	$ 44,561	$ 35,551
Equity in income of affiliates, interest, asset sales and other	1,480	939	1,236
Total revenues	46,667	45,500	36,787
DEDUCTIONS			
Purchases and other costs (includes transactions with significant affiliates of $2,178 million in 1997, $2,048 million in 1996 and $1,733 million in 1995)	35,230	34,643	27,237
Operating expenses	2,990	2,978	2,907
Selling, general and administrative expenses	1,662	1,693	1,580
Maintenance and repairs	354	367	375
Exploratory expenses	471	379	289
Depreciation, depletion and amortization	1,633	1,455	2,385
Interest expense	412	434	483
Taxes other than income taxes	520	496	491
Minority interest	68	72	54
	43,340	42,517	35,801
Income before income taxes and cumulative effect of accounting change	3,327	2,983	986
Provision for income taxes	663	965	258
Net income before cumulative effect of accounting change	2,664	2,018	728
Cumulative effect of accounting change	—	—	(121)
Net Income	$ 2,664	$ 2,018	$ 607
NET INCOME PER COMMON SHARE (DOLLARS)			
Basic			
Net income before cumulative effect of accounting change	$ 4.99	$ 3.77	$ 1.29
Cumulative effect of accounting change	—	—	(.24)
Net income	$ 4.99	$ 3.77	$ 1.05
Diluted			
Net income before cumulative effect of accounting change	$ 4.87	$ 3.68	$ 1.28
Net income	$ 4.87	$ 3.68	$ 1.05
Average Number of Common Shares Outstanding (for computation of earnings per share) (thousands)			
Basic	522,234	520,392	519,793
Diluted	542,570	541,824	520,364

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEET

TEXACO INC. AND SUBSIDIARY COMPANIES

(Millions of dollars) As of December 31	1997	1996
ASSETS		
Current Assets		
Cash and cash equivalents	$ 311	$ 511
Short-term investments – at fair value	84	41
Accounts and notes receivable (includes receivables from significant affiliates of $234 million in 1997 and $299 million in 1996), less allowance for doubtful accounts of $22 million in 1997 and $34 million in 1996	4,230	5,195
Inventories	1,483	1,460
Deferred income taxes and other current assets	324	458
Total current assets	6,432	7,665
Investments and Advances	5,097	4,996
Net Properties, Plant and Equipment	17,116	13,411
Deferred Charges	955	891
Total	$ 29,600	$ 26,963
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Notes payable, commercial paper and current portion of long-term debt	$ 885	$ 465
Accounts payable and accrued liabilities (includes payables to significant affiliates of $106 million in 1997 and $144 million in 1996)		
Trade liabilities	2,669	3,472
Accrued liabilities	1,480	1,333
Estimated income and other taxes	960	914
Total current liabilities	5,994	6,184
Long-Term Debt and Capital Lease Obligations	5,507	5,125
Deferred Income Taxes	1,825	795
Employee Retirement Benefits	1,224	1,236
Deferred Credits and Other Noncurrent Liabilities	1,639	2,593
Minority Interest in Subsidiary Companies	645	658
Total	16,834	16,591
Stockholders' Equity		
Market Auction Preferred Shares	300	300
ESOP Convertible Preferred Stock	457	474
Unearned employee compensation and benefit plan trust	(389)	(378)
Common stock – Shares issued: 567,606,290 in 1997; 548,586,834 in 1996	1,774	1,714
Paid-in capital in excess of par value	1,688	630
Retained earnings	9,987	8,292
Currency translation adjustment	(105)	(65)
Minimum pension liability adjustment	(16)	—
Unrealized net gain on investments	26	33
	13,722	11,000
Less – Common stock held in treasury, at cost	956	628
Total stockholders' equity	12,766	10,372
Total	$ 29,600	$ 26,963

See accompanying notes to consolidated financial statements.

STATEMENT OF CONSOLIDATED CASH FLOWS

TEXACO INC. AND SUBSIDIARY COMPANIES

(Millions of dollars) For the years ended December 31	1997	1996	1995
OPERATING ACTIVITIES			
Net income	$ 2,664	$ 2,018	$ 607
Reconciliation to net cash provided by (used in) operating activities			
Cumulative effect of accounting change	—	—	121
Depreciation, depletion and amortization	1,633	1,455	2,385
Deferred income taxes	451	(20)	(102)
Exploratory expenses	471	379	289
Minority interest in net income	68	72	54
Dividends from affiliates, greater than (less than) equity in income	(370)	167	(103)
Gains on asset sales	(558)	(19)	(320)
Changes in operating working capital			
Accounts and notes receivable	718	(1,072)	(766)
Inventories	(56)	(104)	(29)
Accounts payable and accrued liabilities	(856)	716	(116)
Other – mainly estimated income and other taxes	(64)	97	(44)
Other – net	(186)	73	146
Net cash provided by operating activities	3,915	3,762	2,122
INVESTING ACTIVITIES			
Capital and exploratory expenditures	(3,628)	(2,897)	(2,386)
Proceeds from asset sales	1,036	125	1,150
Proceeds from sale of discontinued operations, net of cash and cash equivalents sold	—	344	—
Sales (purchases) of leasehold interests	(503)	261	248
Purchases of investment instruments	(1,102)	(1,668)	(1,238)
Sales/maturities of investment instruments	1,096	1,816	1,273
Other – net	(57)	70	12
Net cash used in investing activities	(3,158)	(1,949)	(941)
FINANCING ACTIVITIES			
Borrowings having original terms in excess of three months			
Proceeds	507	307	313
Repayments	(637)	(802)	(358)
Net increase (decrease) in other borrowings	628	(143)	(137)
Issuance of preferred stock by subsidiaries	—	—	65
Purchases of common stock	(382)	(159)	(4)
Dividends paid to the company's stockholders			
Common	(918)	(859)	(832)
Preferred	(55)	(58)	(60)
Dividends paid to minority stockholders	(81)	(87)	(55)
Other – net	—	—	(2)
Net cash used in financing activities	(938)	(1,801)	(1,070)
CASH AND CASH EQUIVALENTS			
Effect of exchange rate changes	(19)	(2)	(14)
Increase (decrease) during year	(200)	10	97
Beginning of year	511	501	404
End of year	$ 311	$ 511	$ 501

See accompanying notes to consolidated financial statements.

STATEMENT OF CONSOLIDATED STOCKHOLDERS' EQUITY

TEXACO INC. AND SUBSIDIARY COMPANIES

(Shares in thousands; amounts in millions of dollars)	Shares 1997	Amount 1997	Shares 1996	Amount 1996	Shares 1995	Amount 1995
PREFERRED STOCK						
par value $1; Shares authorized – 30,000,000						
Market Auction Preferred Shares (Series G, H, I and J) – liquidation preference of $250,000 per share						
Beginning and end of year	1	$ 300	1	$ 300	1	$ 300
Series B ESOP Convertible Preferred Stock – liquidation value of $600 per share						
Beginning of year	720	432	751	450	780	468
Retirements	(27)	(16)	(31)	(18)	(29)	(18)
End of year	693	416	720	432	751	450
Series F ESOP Convertible Preferred Stock – liquidation value of $737.50 per share						
Beginning of year	57	42	60	45	63	47
Retirements	(1)	(1)	(3)	(3)	(3)	(2)
End of year	56	41	57	42	60	45
UNEARNED EMPLOYEE COMPENSATION						
(related to ESOP preferred stock and restricted stock awards)						
Beginning of year		(175)		(234)		(282)
Awards		(16)		(22)		(8)
Amortization and other		42		81		56
End of year		(149)		(175)		(234)
BENEFIT PLAN TRUST						
(common stock)						
Beginning of year	8,000	(203)	8,000	(203)	—	—
Establishment/additions	1,200	(37)	—	—	8,000	(203)
End of year	9,200	(240)	8,000	(203)	8,000	(203)
COMMON STOCK						
par value $3.125; Shares authorized – 700,000,000						
Beginning of year	548,587	1,714	548,587	1,714	548,587	1,714
Issued for Monterey acquisition	19,019	60	—	—	—	—
End of year	567,606	1,774	548,587	1,714	548,587	1,714
COMMON STOCK HELD IN TREASURY, AT COST						
Beginning of year	21,191	(628)	20,152	(517)	29,523	(753)
Purchases of common stock	7,423	(410)	3,515	(159)	102	(4)
Transfer to benefit plan trust	(1,200)	37	—	—	—	—
Other – mainly employee benefit plans	(1,947)	45	(2,476)	48	(9,473)	240
End of year	25,467	$ (956)	21,191	$ (628)	20,152	$ (517)

See accompanying notes to consolidated financial statements.

(Continued on next page)

STATEMENT OF CONSOLIDATED STOCKHOLDERS' EQUITY

TEXACO INC. AND SUBSIDIARY COMPANIES

(Millions of dollars)	1997	1996	1995
PAID-IN-CAPITAL IN EXCESS OF PAR VALUE			
Beginning of year	$ 630	$ 655	$ 654
Monterey acquisition	1,091	—	—
Treasury stock transactions relating to investor services plan and employee compensation plans	(33)	(25)	1
End of year	1,688	630	655
RETAINED EARNINGS			
Balance at beginning of year	8,292	7,186	7,463
Add:			
Net income	2,664	2,018	607
Tax benefit associated with dividends on unallocated ESOP Convertible Preferred Stock	4	5	8
Deduct: Dividends declared on			
Common stock ($1.75 per share in 1997, $1.65 per share in 1996 and $1.60 per share in 1995)	918	859	832
Preferred stock			
Series B ESOP Convertible Preferred Stock	40	42	43
Series F ESOP Convertible Preferred Stock	4	4	4
Market Auction Preferred Shares (Series G, H, I and J)	11	12	13
Balance at end of year	9,987	8,292	7,186
CURRENCY TRANSLATION ADJUSTMENT			
Beginning of year	(65)	61	87
Change during year	(40)	(126)	(26)
End of year	(105)	(65)	61
MINIMUM PENSION LIABILITY ADJUSTMENT			
Establishment	(16)	—	—
End of year	(16)	—	—
UNREALIZED NET GAIN ON INVESTMENTS			
Beginning of year	33	62	51
Change during year	(7)	(29)	11
End of year	26	33	62
STOCKHOLDERS' EQUITY			
End of year (including preceding page)	$ 12,766	$ 10,372	$ 9,519

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

TEXACO INC. AND SUBSIDIARY COMPANIES

NOTE 1 DESCRIPTION OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements consist of the accounts of Texaco Inc. and subsidiary companies owned directly or indirectly more than 50 percent. Intercompany accounts and transactions are eliminated.

The U.S. dollar is the functional currency of all the company's operations and substantially all of the operations of its affiliates accounted for on the equity method. For these operations, translation effects and all gains and losses from transactions not denominated in the functional currency are included in income currently, except for certain hedging transactions. The cumulative translation effects for the equity affiliates using functional currencies other than the U.S. dollar are included in the currency translation adjustment in stockholders' equity.

USE OF ESTIMATES

The preparation of Texaco's consolidated financial statements in accordance with generally accepted accounting principles requires the use of estimates and management's judgment. While all available information has been considered, actual amounts could differ from those reported as assets and liabilities and related revenues, costs and expenses and the disclosed amounts of contingencies.

CASH EQUIVALENTS

Highly liquid investments with a maturity of three months or less when purchased are generally considered to be cash equivalents.

INVENTORIES

Virtually all inventories of crude oil, petroleum products and petrochemicals are stated at cost, determined on the last-in, first-out (LIFO) method. Other merchandise inventories are stated at cost, determined on the first-in, first-out (FIFO) method. Materials and supplies are stated at average cost. Inventories are valued at the lower of cost or market.

INVESTMENTS AND ADVANCES

The equity method of accounting is used for investments in certain affiliates owned 50 percent or less, including corporate joint-ventures, limited liability companies and partnerships. Under this method, equity in the pre-tax income or losses of limited liability companies and partnerships, and in the net income or losses of corporate joint-venture companies is reflected currently in Texaco's revenues, rather than when realized through dividends or distributions.

The company's interest in the net income of affiliates accounted for at cost is reflected in net income when realized through dividends.

Investments in debt securities and in equity securities with readily determinable fair values are accounted for at fair value if classified as available-for-sale.

PROPERTIES, PLANT AND EQUIPMENT AND DEPRECIATION, DEPLETION AND AMORTIZATION

Texaco follows the "successful efforts" method of accounting for its oil and gas exploration and producing operations.

Lease acquisition costs of properties held for oil, gas and mineral production are capitalized as incurred. Exploratory costs other than wells are charged to expense as incurred. Exploratory wells, including stratigraphic test wells, are initially capitalized pending further evaluation of whether economically recoverable proved reserves have been found. If such reserves are not found, the well costs are then charged to exploratory expenses. Intangible drilling costs of productive wells and of development dry holes, and tangible equipment costs, are capitalized. Costs of injected carbon dioxide related to development of oil and gas reserves are capitalized.

Evaluation of impairment for properties, plant and equipment intended to be held is based on comparison of carrying value against undiscounted future net pre-tax cash flows. If an impairment is identified, the asset's carrying amount is adjusted to fair value. Assets to be disposed of are generally accounted for at the lower of amortized cost or fair value less cost to sell.

Unproved oil and gas properties, when individually significant, are amortized by property using a valuation assessment. Other unproved oil and gas properties are generally amortized on an aggregate basis over the average holding period, for the portion expected to be nonproductive. Productive properties and other tangible and intangible costs of producing activities are amortized principally by field. Amortization is based on the unit-of-production basis by applying the ratio of produced oil and gas to estimated recoverable proved oil and gas reserves. Estimated future restoration and abandonment costs are included in determining amortization and depreciation rates of productive properties.

Depreciation of facilities other than producing properties is applied generally on the group plan, using the straight-line method, with composite rates reflecting the estimated useful life and cost of each class of property. Facilities not on the group plan are depreciated individually by estimated useful life using the straight-line method. Estimated salvage value is excluded from amounts subject to depreciation. Capitalized nonmineral leases are amortized over the estimated useful life of the asset or the lease term, as appropriate, using the straight-line method.

Periodic maintenance and repairs applicable to manufacturing facilities are accounted for on the accrual basis. Normal maintenance and repairs of all other properties, plant and equipment are charged to expense as incurred. Renewals, betterments and major repairs that materially extend the useful life of properties are capitalized and the assets replaced, if any, are retired.

When capital assets representing complete units of property are disposed of, the difference between the disposal proceeds and net book value is credited or charged to income.

ENVIRONMENTAL EXPENDITURES

When remediation of a property is probable and the related costs can be reasonably estimated, environmentally-related remediation costs are expensed and recorded as liabilities. If recoveries of environmental costs from third parties are probable, a receivable is recorded. Other environmental expenditures, principally maintenance or preventive in nature, are expensed or capitalized as appropriate.

DEFERRED INCOME TAXES

Deferred income taxes are determined utilizing a liability approach. The income statement effect is derived from changes in deferred income taxes on the balance sheet. This approach gives consideration to the future tax consequences associated with differences between financial accounting and tax bases of assets and liabilities. These differences relate to items such as depreciable and depletable properties, exploratory and intangible drilling costs, nonproductive leases, merchandise inventories and certain liabilities. This approach gives immediate effect to changes in income tax laws upon enactment.

Provision is not made for possible income taxes payable upon distribution of accumulated earnings of foreign subsidiary companies and affiliated corporate joint-venture companies when such earnings are deemed to be permanently reinvested.

ACCOUNTING FOR CONTINGENCIES

Certain conditions may exist as of the date financial statements are issued, which may result in a loss to the company, but which will only be resolved when one or more future events occur or fail to occur. Such contingent liabilities are assessed by the company's management and legal counsel. The assessment of loss contingencies necessarily involves an exercise of judgment and is a matter of opinion. In assessing loss contingencies related to legal proceedings that are pending against the company or unasserted claims that may result in such proceedings, the company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a material liability had been incurred and the amount of the loss can be estimated, then the estimated liability would be accrued in the company's financial statements. If the assessment indicates that a potentially material liability is not probable, but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed.

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee would be disclosed. However, in some instances in which disclosure is not otherwise required, the company may disclose contingent liabilities of an unusual nature which, in the judgment of management and its legal counsel, may be of interest to stockholders or others.

NOTE 2 ADOPTION OF NEW ACCOUNTING STANDARDS

SFAS 121 – During 1995, Texaco adopted Statement of Financial Accounting Standards, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of" (SFAS 121). Under SFAS 121, assets whose carrying amounts are not expected to be fully recovered by future use or disposition must be written down to their fair values.

Adoption of this Standard resulted in a non-cash after-tax charge of $639 million against 1995 earnings. Application of SFAS 121 to assets to be retained resulted in a pre-tax charge of $775 million, primarily recorded to depreciation, depletion and amortization expense. On an after-tax basis, this charge amounted to $514 million and primarily reflected the write-down to their estimated fair values of certain of the company's producing properties in the United States which were evaluated for impairment on a field-by-field basis rather than in the aggregate. Also, certain non-core coal and marketing properties, surplus buildings and other properties and equipment held for disposal were written down by a $184 million charge, primarily recorded to depreciation, depletion and amortization expense. Including estimated disposal costs, this charge to income was $125 million, net-of-tax. There were no material changes in the estimated fair values of assets to be disposed of subsequent to the determination of their impairment. At year-end 1997 and 1996, the carrying amounts of assets to be disposed of were not significant. Adoption of SFAS 121 by Star Enterprise and the Caltex group of companies, each owned 50% by Texaco, had no effect on 1995 net income.

In accordance with SFAS 121, a $121 million after-tax write-down of non-core domestic producing properties held for sale at January 1, 1995, previously recorded in the first quarter of 1995 in income from continuing operations, has been classified as the cumulative effect of an accounting change.

SFAS 123 – In 1996, Texaco adopted the disclosure provisions of SFAS 123, "Accounting for Stock-Based Compensation."

SFAS 128 and 129 – During 1997, Texaco adopted SFAS 128, "Earnings per Share." Texaco's basic and diluted net income per common share under SFAS 128 were approximately the same as under the comparable prior basis of reporting. In 1997, Texaco also adopted SFAS 129, "Disclosure of Information about Capital Structure." Texaco's existing disclosures complied with this standard.

NOTE 3 NET INCOME PER COMMON SHARE

Basic net income per common share is based on net income less preferred stock dividend requirements divided by the average number of common shares outstanding. Diluted net income per common share assumes issuance of the net incremental shares from stock options and full conversion of all dilutive convertible securities at the later of the beginning of the year or date of issuance. Common shares held by the benefit plan trust are not considered outstanding for purposes of net income per common share.

In July, 1997, the Board of Directors approved a two-for-one split of the company's common stock, effective September 29, 1997. The par value was halved and the number of authorized shares was doubled. Prior years financial statements and all references to number of shares and per share amounts have been restated for the stock split. Also, all agreements that include exchange, conversion or other rights based on the company's common stock have been adjusted for the stock split.

Basic Net Income Per Common Share

For the years ended December 31	1997	1996	1995
Net Income (millions of dollars)			
Net income before cumulative effect of accounting change	$ 2,664	$ 2,018	$ 728
Preferred stock dividend requirements	(56)	(58)	(60)
Net income for basic net income per share	$ 2,608	$ 1,960	$ 668
Average number of common shares outstanding (thousands)	522,234	520,392	519,793
Per Common Share – Before cumulative effect of accounting change (dollars)	$ 4.99	$ 3.77	$ 1.29

Diluted Net Income Per Common Share

For the years ended December 31	1997	1996	1995
Net Income (millions of dollars)			
Net income for basic net income per share before cumulative effect of accounting change	$ 2,608	$ 1,960	$ 668
Adjustments:			
Add: preferred stock dividend requirements of dilutive issues	43	45	—
Deduct: net income adjustments for dilutive securities	(9)	(11)	—
Net income for diluted earnings per share	$ 2,642	$ 1,994	$ 668
Average number of shares outstanding (thousands):			
Applicable for basic net income per common share	522,234	520,392	519,793
Effects of dilutive items:			
Stock options and restricted stock	776	1,090	277
Convertible debentures	287	290	294
ESOP convertible preferred stock	19,273	20,052	—
Applicable for diluted net income per common share	542,570	541,824	520,364
Per Common Share – Before cumulative effect of accounting change (dollars)	$ 4.87	$ 3.68	$ 1.28

NOTE 4 ACQUISITION OF MONTEREY RESOURCES

In November, 1997, Texaco acquired all of the outstanding common stock of Monterey Resources (Monterey) in exchange for approximately 19 million shares of Texaco common stock valued at $1.1 billion. The transaction has been accounted for as a purchase. The total purchase price was $1.4 billion, including existing Monterey debt of $.3 billion; $2.2 billion was assigned to properties, plant and equipment, and $.7 billion was assigned to deferred income tax liabilities. Monterey is an oil and gas company engaged in the production, development and acquisition of crude oil and natural gas in the State of California. Monterey's production is principally heavy crude oil.

The financial statements of Texaco reflect the consolidation of Monterey assets and liabilities at fair value effective from November 1, 1997. The pro forma effects had Monterey been consolidated at the beginning of either 1997 or 1996 are not material to Texaco's revenues, net income, and basic and diluted net income per common share for those years.

NOTE 5 DISCONTINUED OPERATIONS

In 1994, Texaco Inc. sold Texaco Chemical Company and related international chemical operations to Huntsman Corporation for $850 million, consisting of $650 million in cash and an 11-year subordinated note with a face value of $200 million. The note was prepaid in January 1996. In 1996, Texaco sold its worldwide lubricant additives business to Ethyl Corporation for $136 million in cash and a three year note with a face amount of $60 million.

The results of these operations have been classified as discontinued operations for 1996 and 1995 in the Statement of Consolidated Income. There was no net income from these operations for those periods. Revenues of discontinued operations were $32 million in 1996 and $222 million in 1995. Discontinued operations have not been segregated in the Statement of Consolidated Cash Flows.

NOTE 6 INVENTORIES

(Millions of dollars) As of December 31	1997	1996
Crude oil	$ 308	$ 296
Petroleum products and petrochemicals	893	904
Other merchandise	59	58
Materials and supplies	223	202
Total	$ 1,483	$ 1,460

The excess of estimated current cost over the book value of inventories carried on the LIFO basis of accounting was approximately $204 million and $398 million at December 31, 1997 and 1996, respectively.

NOTE 7 INVESTMENTS AND ADVANCES

Investments in affiliates, including corporate joint-ventures and partnerships, owned 50% or less are accounted for on the equity method. Texaco's total investments and advances are summarized as follows:

(Millions of dollars) As of December 31	1997	1996
Affiliates accounted for on the equity method		
Caltex group of companies		
Exploration and production	$ 437	$ 448
Manufacturing, marketing and distribution	1,860	1,679
Total Caltex group of companies	2,297	2,127
Star Enterprise	889	756
Other affiliates	635	928
	3,821	3,811
Miscellaneous investments, long-term receivables, etc., accounted for at		
Fair value	537	544
Cost, less reserve	739	641
Total	$ 5,097	$ 4,996

Texaco's equity in the net income of affiliates accounted for on the equity method, adjusted to reflect income taxes for limited liability companies and partnerships whose income is directly taxable to Texaco, is as follows:

(Millions of dollars) For the years ended December 31	1997	1996	1995
Equity in net income (loss)			
Caltex group of companies			
Exploration and production	$ 171	$ 188	$ 156
Manufacturing, marketing and distribution	252	347	294
Total Caltex group of companies	423	535	450
Star Enterprise	95	14	(47)
Other affiliates	98	120	121
Total	$ 616	$ 669	$ 524
Dividends received from these companies	$ 332	$ 878	$ 427

The undistributed earnings of these affiliates included in Texaco's retained earnings were $2,658 million, $2,609 million and $2,768 million as of December 31, 1997, 1996 and 1995, respectively.

CALTEX GROUP

Texaco has investments in the Caltex group of companies, owned 50% by Texaco and 50% by Chevron Corporation. The Caltex group consists of P.T. Caltex Pacific Indonesia, American Overseas Petroleum Limited and subsidiary and Caltex Petroleum Corporation and subsidiaries. This group of companies is engaged in the exploration for and production, transportation, refining and marketing of crude oil and products in Africa, Asia, the Middle East, Australia and New Zealand.

In 1996, Caltex Petroleum Corporation completed the sale of its 50% interest in Nippon Petroleum Refining Company, Limited (NPRC) to its partner, Nippon Oil Company, for approximately $2 billion. Caltex Petroleum Corporation's net income for 1996 includes a gain of $621 million associated with this sale. Texaco's results include a net gain of $219 million relating to this sale, comprised of its equity share of the gain, less an adjustment in the carrying value of its investment and further reduced by a tax on the dividend distributed to the shareholders.

STAR ENTERPRISE

Star Enterprise (Star) is a joint-venture partnership owned 50% by Texaco and 50% by Saudi Refining, Inc. The partnership refines, distributes and markets certain Texaco-branded petroleum products, including gasolines, in 26 East and Gulf Coast states and the District of Columbia.

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The following table provides summarized financial information on a 100% basis for the Caltex group, Star and all other affiliates accounted for on the equity method, as well as Texaco's share. The net income of all limited liability companies and partnerships, including Star, is net of estimated income taxes. The actual income tax liability is reflected in the accounts of the respective partners and not shown in the following table.

Star's assets at the respective balance sheet dates include the remaining portion of the assets which were originally transferred from Texaco to Star at the fair market value on the date of formation. Texaco's investment and equity in the income of Star, as reported in the consolidated financial statements, reflect the remaining unamortized historical carrying cost of the assets transferred to Star at formation. Additionally, Texaco's investment includes adjustments necessary to reflect contractual arrangements on the formation of this partnership, principally involving contributed inventories.

(Millions of dollars)	1997	1996	1995
CALTEX GROUP			
For the years ended December 31:			
Gross revenues	$ 18,357	$ 18,166	$ 15,622
Income before income taxes	$ 1,210	$ 2,175	$ 1,366
Net income	$ 846	$ 1,193	$ 899
As of December 31:			
Current assets	$ 2,521	$ 2,681	$ 2,323
Noncurrent assets	7,193	6,714	7,794
Current liabilities	(2,991)	(2,999)	(3,223)
Noncurrent liabilities and deferred credits	(2,116)	(2,018)	(1,799)
Minority interest in subsidiary companies	(15)	(122)	(136)
Net assets	$ 4,592	$ 4,256	$ 4,959
STAR ENTERPRISE			
For the years ended December 31:			
Gross revenues	$ 7,758	$ 8,006	$ 6,619
Income (loss) before income taxes	$ 301	$ 38	$ (135)
Net income (loss)	$ 196	$ 25	$ (88)
As of December 31:			
Current assets	$ 1,042	$ 816	$ 832
Noncurrent assets	3,260	3,204	3,299
Current liabilities	(769)	(704)	(745)
Noncurrent liabilities and deferred credits	(1,072)	(1,141)	(1,207)
Partners' equity	$ 2,461	$ 2,175	$ 2,179

(Continued on next page)

(Millions of dollars)	1997	1996	1995
OTHER EQUITY AFFILIATES			
For the years ended December 31:			
Gross revenues	$ 4,028	$ 3,940	$ 3,662
Income before income taxes	$ 605	$ 697	$ 691
Net income	$ 400	$ 451	$ 440
As of December 31:			
Current assets	$ 947	$ 1,049	$ 925
Noncurrent assets	3,607	3,853	3,622
Current liabilities	(1,032)	(1,182)	(1,180)
Noncurrent liabilities and deferred credits	(2,022)	(1,845)	(1,703)
Net assets (or partners' equity)	$ 1,500	$ 1,875	$ 1,664
TEXACO'S SHARE			
For the years ended December 31:			
Gross revenues	$ 14,641	$ 14,644	$ 12,567
Income before income taxes	$ 940	$ 1,310	$ 818
Net income	$ 616	$ 669	$ 524
As of December 31:			
Current assets	$ 1,965	$ 1,937	$ 1,739
Noncurrent assets	6,324	6,354	6,820
Current liabilities	(2,270)	(2,329)	(2,420)
Noncurrent liabilities and deferred credits	(2,191)	(2,090)	(1,986)
Minority interest in subsidiary companies	(7)	(61)	(68)
Net assets (or partners' equity)	$ 3,821	$ 3,811	$ 4,085

NOTE 8 PROPERTIES, PLANT AND EQUIPMENT

As of December 31, 1997 and 1996, net exploration and production properties, plant and equipment totaled $8,071 million and $5,258 million, respectively, relating to U.S. operations and $2,769 million and $2,474 million, respectively, relating to international operations. As of December 31, 1997 and 1996, net manufacturing, marketing, and distribution properties, plant and equipment totaled $2,770 million and $2,834 million, respectively, relating to U.S. operations and $2,894 million and $2,219 million, respectively, relating to international operations.

(Millions of dollars) As of December 31	Gross	Net 1997	Gross	Net 1996
Exploration and production	$ 29,013	$ 10,840	$ 24,786	$ 7,732
Manufacturing, marketing and distribution				
Manufacturing	3,892	2,422	3,476	2,097
Marketing	4,013	2,876	3,651	2,607
Distribution	1,071	366	1,043	349
Total manufacturing, marketing and distribution	8,976	5,664	8,170	5,053
Other	967	612	1,032	626
Total	$ 38,956	$ 17,116	$ 33,988	$ 13,411
Capital lease amounts included above	$ 450	$ 105	$ 450	$ 111

Accumulated depreciation, depletion and amortization totaled $21,840 million and $20,577 million at December 31, 1997 and 1996, respectively. Interest capitalized as part of properties, plant and equipment was $20 million in 1997, $12 million in 1996 and $20 million in 1995.

NOTE 9 SHORT-TERM DEBT, LONG-TERM DEBT, CAPITAL LEASE OBLIGATIONS AND RELATED DERIVATIVES

NOTES PAYABLE, COMMERCIAL PAPER AND CURRENT PORTION OF LONG-TERM DEBT

(Millions of dollars) As of December 31	1997	1996
Notes payable to banks and others with originating terms of one year or less	$ 473	$ 443
Commercial paper	892	326
Current portion of long-term debt and capital lease obligations		
Indebtedness	1,005	640
Capital lease obligations	15	13
	2,385	1,422
Less short-term obligations intended to be refinanced	1,500	957
Total	$ 885	$ 465

The weighted average interest rate of commercial paper and notes payable to banks at December 31, 1997 and 1996 was 6.1%.

LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS

(Millions of dollars) As of December 31	1997	1996
Long-Term Debt		
3-1/2% Guaranteed cash-settled convertible notes, due 2004	$ 205	$ —
6-7/8% Guaranteed notes, due 1999	200	200
6-7/8% Guaranteed debentures, due 2023	195	195
7.09% Guaranteed notes, due 2007	150	—
7-1/2% Guaranteed debentures, due 2043	198	198
7-3/4% Guaranteed debentures, due 2033	199	199
8% Guaranteed debentures, due 2032	147	147
8-1/4% Guaranteed debentures, due 2006	150	150
8-3/8% Guaranteed debentures, due 2022	198	198
8-1/2% Guaranteed notes, due 2003	199	199
8-5/8% Guaranteed debentures, due 2010	150	150
8-5/8% Guaranteed debentures, due 2031	199	199
8-5/8% Guaranteed debentures, due 2032	199	199
8.65% Guaranteed notes, due 1998	200	200
8-7/8% Guaranteed debentures, due 2021	150	150
9% Guaranteed notes, due 1997	—	200
9% Guaranteed notes, due 1999	200	200
9-3/4% Guaranteed debentures, due 2020	250	250
10.61% Senior notes, due 2005	206	—
Medium-term notes, maturing from 1998 to 2043 (8.0%)	489	568
Revolving Credit Facility, due 1998-2002 – variable rate (5.9%)	330	330
Pollution Control Revenue Bonds, due 2012 – variable rate (3.7%)	166	166
Other long-term debt:		
Texaco Inc. – Guarantee of ESOP Series B and F loans – fixed and variable rates (5.2%)	76	145
U.S. dollars (6.6%)	417	374
Other currencies (11.1%)	20	59
Total	4,893	4,676
Capital Lease Obligations (see Note 10)	134	145
	5,027	4,821
Less current portion of long-term debt and capital lease obligations	1,020	653
	4,007	4,168
Short-term obligations intended to be refinanced	1,500	957
Total long-term debt and capital lease obligations	$ 5,507	$ 5,125

The percentages shown for variable-rate debt are the interest rates at December 31, 1997. The percentages shown for the categories "Medium-term notes" and "Other long-term debt" are the weighted average interest rates at year-end 1997. Where applicable, principal amounts shown in the preceding schedule include unamortized premium or discount. Interest paid, net of amounts capitalized, amounted to $395 million in 1997, $433 million in 1996 and $482 million in 1995.

At December 31, 1997, Texaco was party to revolving credit facilities with commitments of $1.5 billion with syndicates of major U.S. and international banks. These facilities are available as support for the issuance of the company's commercial paper, as well as for working capital and for other general corporate purposes. Texaco has no amounts outstanding under these facilities at year-end 1997. Texaco pays facility fees on the $1.5 billion facilities. The banks reserve the right to terminate the credit facilities upon the occurrence of certain specific events, including change in control.

At December 31, 1997, Texaco's long-term debt included $1.5 billion of short-term obligations scheduled to mature during 1998, which the company has both the intent and the ability to refinance on a long-term basis, through the use of its $1.5 billion revolving credit facilities.

Contractual annual maturities of long-term debt, including sinking fund payments and other redemption requirements, for the five years subsequent to December 31, 1997 are as follows (in millions): 1998 – $1,005; 1999 – $548; 2000 – $179; 2001 – $173; and 2002 – $160. The preceding maturities are before consideration of short-term obligations intended to be refinanced and also exclude capital lease obligations.

DEBT-RELATED DERIVATIVES

Texaco seeks to maintain a balanced capital structure that will provide financial flexibility and support the company's strategic objectives while achieving a low cost of capital. This is achieved by balancing the company's liquidity and interest rate exposures. These exposures are managed primarily through the use of long-term and short-term debt instruments which are reported on the balance sheet. However, off-balance sheet derivative instruments, primarily interest rate swaps, are also used as a management tool in achieving the company's objectives. These instruments are used to manage identifiable exposures on a non-leveraged, non-speculative basis.

As part of its interest rate exposure management, the company seeks to balance the benefit of the lower cost of floating rate debt, with its inherent increased risk, with fixed rate debt having less market risk.

Summarized below are the carrying amounts and fair values of the company's debt and debt-related derivatives at December 31, 1997 and 1996, excluding a combined interest rate and equity swap entered into in 1997. Derivative usage during the periods presented was limited to interest rate swaps, where the company either paid or received the net effect of a fixed rate versus a floating rate (commercial paper or LIBOR) index at specified intervals, calculated by reference to an agreed notional principal amount.

(Millions of dollars) As of December 31	1997	1996
Notes Payable and Commercial Paper:		
Carrying amount	$ 1,365	$ 769
Fair value	1,365	769
Related Derivatives –		
Payable (Receivable):		
Carrying amount	$ —	$ —
Fair value	3	(4)
Notional principal amount	$ 300	$ 150
Weighted average maturity (years)	9.3	6.8
Weighted average fixed pay rate	6.42%	7.06%
Weighted average floating receivable rate	6.09%	5.50%
Long-Term Debt, including current maturities:		
Carrying amount	$ 4,893	$ 4,676
Fair value	5,289	4,943
Related Derivatives –		
Payable (Receivable):		
Carrying amount	$ —	$ —
Fair value	(1)	1
Notional principal amount	$ 544	$ 583
Weighted average maturity (years)	.7	1.7
Weighted average fixed receivable rate	5.71%	5.73%
Weighted average floating pay rate	5.76%	5.53%
Unamortized net gain on terminated swaps		
Carrying amount	$ 8	$ 5

The preceding 1997 derivative table for fixed pay, floating receivable includes forward-starting swaps with an aggregate notional principal amount of $200 million. These swaps were entered into to hedge expected 1998 debt issuances.

Excluded from this table is an interest rate and equity swap with a notional principal amount of $200 million entered into in 1997, related to the 3-1/2% notes due 2004. The company pays floating rate and receives fixed rate. Also, the counterparty assumes all exposure for the potential equity-based cash redemption premium on the notes. The fair value of this swap at year-end 1997 was not material.

During 1997, fixed rate pay swaps having an aggregate notional principal amount of $150 million either matured or were terminated, of which $100 million were replaced. Also during 1997, pay floating rate swaps having an aggregate notional principal amount of $39 million were amortized or matured.

Fair values of debt are based upon quoted market prices, as well as rates currently available to the company for borrowings with similar terms and maturities. The fair value of swaps is the estimated amount that would be received or paid to terminate the agreements at year-end, taking into account current interest rates and the current creditworthiness of the swap counterparties.

Amounts receivable or payable based on the interest rate differentials of derivatives are accrued monthly and are reflected in interest expense as a hedge of interest on outstanding debt. Gains and losses on terminated swaps are deferred and amortized over the life of the associated debt or the original term of the swap, whichever is shorter.

Since counterparties to the company's derivative transactions are major financial institutions with strong credit ratings, exposure to credit risk on the net interest differential is minimal. The notional amounts of derivative contracts do not represent cash flow and are not subject to credit risk. The company's counterparty credit exposure limits have been set based upon the maturity and notional amounts of these transactions.

NOTE 10 LEASE COMMITMENTS AND RENTAL EXPENSE

The company has leasing arrangements involving service stations, tanker charters, crude oil production and processing equipment, and other facilities. Amounts due under capital leases are reflected in the company's balance sheet as obligations, while Texaco's interest in the related assets is reflected as properties, plant and equipment. The remaining lease commitments are operating leases, and payments on such leases are recorded as rental expense.

As of December 31, 1997, the company had estimated minimum commitments for payment of rentals (net of noncancelable sublease rentals) under leases which, at inception, had a noncancelable term of more than one year, as follows:

(Millions of dollars)	Operating leases	Capital leases
1998	$ 276	$ 27
1999	155	27
2000	138	26
2001	127	25
2002	471	25
After 2002	559	64
Total lease commitments	$ 1,726	$ 194
Less amounts representing		
Executory costs		25
Interest		73
Add noncancelable sublease rentals netted in capital lease commitments above		38
Present value of total capital lease obligations		$ 134

Rental expense relative to operating leases, including contingent rentals based on factors such as gallons sold, is provided in the table below. Such payments do not include rentals on leases covering oil and gas mineral rights.

(Millions of dollars)	1997	1996	1995
Rental expense			
Minimum lease rentals	$ 270	$ 259	$ 224
Contingent rentals	3	10	16
Total	273	269	240
Less rental income on properties subleased to others	78	53	43
Net rental expense	$ 195	$ 216	$ 197

NOTE 11 PREFERRED STOCK AND RIGHTS

SERIES B ESOP CONVERTIBLE PREFERRED STOCK

At December 31, 1997, the outstanding shares of Series B ESOP Convertible Preferred Stock (Series B) were held by an Employee Stock Ownership Plan (ESOP). Dividends on each share of Series B are cumulative and payable semiannually at the rate of $57 per annum.

Participants may partially convert Series B holdings into common stock beginning at age 55, and may elect full conversion upon retirement or separation from the company. Presently, each share of Series B entitles a participant to 25.7 votes, voting together with the holders of common stock, and is convertible into 25.736 shares of common stock. As an alternative to conversion, a participant can elect to receive $600 per share of Series B, payable in cash or common stock. If the participant elects cash, the company will cause shares of common stock to be sold to fund such election. Texaco Inc. may redeem the outstanding shares of Series B at $605.70 per share through December 19, 1998 and at $600 per share on or after December 20, 1998.

SERIES D JUNIOR PARTICIPATING PREFERRED STOCK AND RIGHTS

In 1989, the company declared a dividend distribution of one Right for each outstanding share of common stock, adjusted to one-half Right due to the 1997 two-for-one stock split. Unless redeemed by the company, the Rights will be exercisable only after a person(s) acquires, obtains the right to acquire or commences a tender offer that would result in that person(s) acquiring 20% or more of the outstanding common stock other than pursuant to a Qualifying Offer. A Qualifying Offer is an all-cash, fully financed tender offer for all outstanding shares of common stock which remains open for 45 days, which results in the acquiror owning a majority of the company's voting stock, and in which the acquiror agrees to purchase for cash all remaining shares of common stock. The Rights entitle holders to purchase from the company Units of Series D Junior Participating Preferred Stock (Series D). In general, each Right entitles the holder to acquire shares of Series D, or in certain cases common stock, property or other securities at a formula value equal to two times the exercise price of the Right.

The Rights expire on April 3, 1999. The company will propose that the shareholders extend the Rights until May 1, 2004. The Rights may be redeemed by the company at one cent per Right at any time prior to 10 days after the Rights become exercisable. Until a Right becomes exercisable, the holder has no additional voting or dividend rights and it will not have any dilutive effect on the company's earnings. The company has reserved and designated 3 million shares as Series D for issuance upon exercise of the Rights. At December 31, 1997, the Rights are not exercisable.

SERIES F ESOP CONVERTIBLE PREFERRED STOCK

At December 31, 1997, the outstanding shares of Series F ESOP Convertible Preferred Stock (Series F) were held by an Employee Stock Ownership Plan (ESOP). Dividends on each share of Series F are cumulative and payable semiannually at the rate of $64.53 per annum.

Participants may partially convert Series F holdings into common stock beginning at age 55, and may elect full conversion upon retirement or separation from the company. Presently, each share of Series F entitles a participant to 20 votes, voting together with the holders of common stock, and is convertible into 20 shares of common stock. As an alternative to conversion, a participant can elect to receive $737.50 per share of Series F, payable in cash or common stock. If the participant elects cash, the company will cause shares of common stock to be sold to fund such election. Texaco Inc. may redeem the outstanding shares of Series F at $750.41 and $743.95 per share through February 12, 1999 and 2000, respectively, and at $737.50 per share on or after February 13, 2000.

MARKET AUCTION PREFERRED SHARES

There are outstanding 1,200 shares of cumulative variable rate preferred stock, called Market Auction Preferred Shares (MAPS). The MAPS are grouped into four series (300 shares each of Series G, H, I and J) of $75 million each, with an aggregate value of $300 million.

The dividend rates for each series are determined by Dutch auctions conducted at seven-week intervals.

During 1997, the annual dividend rate for the MAPS ranged between 3.88% and 4.29% and dividends totaled $11 million ($9,689, $9,650, $9,675 and $9,774 per share for Series G, H, I and J, respectively).

For 1996, the annual dividend rate for the MAPS ranged between 3.90% and 4.19% and dividends totaled $12 million ($9,510, $11,043, $11,009 and $11,015 per share for series G, H, I and J, respectively). For 1995, the annual dividend rate for the MAPS ranged between 4.22% and 4.65% and dividends totaled $13 million ($12,255, $10,558, $10,521 and $10,531 per share for Series G, H, I and J, respectively).

The company may redeem the MAPS, in whole or in part, at any time at a liquidation preference of $250,000 per share, plus premium, if any, and accrued and unpaid dividends thereon.

The MAPS are non-voting, except under certain limited circumstances.

NOTE 12 FOREIGN CURRENCY

Currency translations resulted in a pre-tax loss of $59 million in 1997, compared to a loss of $60 million in 1996 and a gain of $23 million in 1995. After applicable taxes, 1997 included a gain of $154 million, compared to a loss in 1996 of $66 million and a gain in 1995 of $30 million.

Currency exchange impacts for the years 1995 through 1997 were attributable to a variety of reasons. These included the volatility in currencies throughout the world, particularly in the Asia Pacific region during 1997. Results were also impacted by the effects of deferred income taxes denominated in British pounds.

Effective October 1, 1997, Caltex changed the functional currency for its operations in its Korean and Japanese affiliates to the U.S. dollar. Major changes in economic facts and circumstances, including a significant reduction in regulatory conditions for petroleum products in those countries, supported this change in functional currency. The net currency-related effects recorded to the 1997 net income of these operations were primarily tax benefits on currency losses on U.S. dollar obligations, resulting from the devaluation of the Korean won.

Currency translation adjustments shown in the separate stockholders' equity account result from translation items pertaining to certain affiliates of Caltex. For the years 1997, 1996 and 1995 these adjustments were losses of $40 million, $126 million and $26 million, respectively. The year 1996 includes the reversal of $60 million of previously deferred gains which were recognized in earnings due to the sale by Caltex of its investment in its Japanese affiliate, NPRC.

NOTE 13 TAXES

(Millions of dollars)	United States 1997	Foreign 1997	Total 1997	United States 1996	Foreign 1996	Total 1996	United States 1995	Foreign 1995	Total 1995
Direct taxes									
Provision (benefit) for income taxes									
Current									
U.S. Federal and foreign	$ (538)	$ 689	$ 151	$ 359	$ 642	$ 1,001	$ 34	$ 357	$ 391
U.S. state and local	61	—	61	(16)	—	(16)	(31)	—	(31)
Deferred	457	(6)	451	13	(33)	(20)	(90)	(12)	(102)
Total provision (benefit) for income taxes	(20)	683	663	356	609	965	(87)	345	258
Taxes other than income taxes									
Oil and gas production	115	12	127	112	2	114	91	3	94
Sales and use	1	92	93	—	82	82	—	73	73
Property	121	18	139	105	14	119	109	18	127
Payroll	75	50	125	72	48	120	72	44	116
Other	47	(11)	36	29	32	61	63	18	81
Total taxes other than income taxes	359	161	520	318	178	496	335	156	491
Import duties and other governmental levies	53	5,414	5,467	38	4,127	4,165	43	3,914	3,957
Total direct taxes	392	6,258	6,650	712	4,914	5,626	291	4,415	4,706
Taxes collected from consumers for governmental agencies	1,480	1,890	3,370	1,413	1,824	3,237	1,266	1,803	3,069
Total	$ 1,872	$ 8,148	$10,020	$ 2,125	$ 6,738	$ 8,863	$ 1,557	$ 6,218	$ 7,775

The deferred income tax assets and liabilities included in the Consolidated Balance Sheet as of December 31, 1997 and 1996 amounted to $145 million and $242 million, respectively, as net current assets and $1,825 million and $795 million, respectively, as net noncurrent liabilities. The table that follows shows deferred income tax assets and liabilities by category. Deferred income taxes are not recorded on differences between financial reporting and tax bases of investments in stock of subsidiary companies, unless realization of the effect is probable in the foreseeable future. Certain potential deferred tax asset amounts for which possibility of realization is deemed extremely remote are not included in the following table:

(Millions of dollars) As of December 31	(Liability) Asset 1997	1996
Depreciation	$ (1,054)	$ (947)
Depletion	(601)	(271)
Intangible drilling costs	(826)	(655)
Other deferred tax liabilities	(755)	(502)
Total	(3,236)	(2,375)
Employee benefit plans	526	523
Tax loss carryforwards	728	955
Tax credit carryforwards	237	351
Environmental reserves	167	176
Other deferred tax assets	580	640
Total	2,238	2,645
Total before valuation allowance	(998)	270
Valuation allowance	(682)	(823)
Total – net	$ (1,680)	$ (553)

The following schedule reconciles the differences between the U.S. Federal income tax rate and the effective income tax rate:

	1997	1996	1995
U.S. Federal income tax rate assumed to be applicable	35.0%	35.0%	35.0%
IRS settlement	(14.7)	—	—
Net earnings and dividends attributable to affiliated corporations accounted for on the equity method	(4.7)	(5.5)	(17.1)
Aggregate earnings and losses from international operations	6.2	12.7	18.5
Sales of stock of subsidiaries	—	(6.3)	(6.6)
Energy credits	(1.4)	(1.9)	(3.3)
Other	(.5)	(1.6)	(.4)
Effective income tax rate	19.9%	32.4%	26.1%

The year 1997 included a $488 million benefit resulting from an IRS settlement.

For companies operating in the United States, pre-tax earnings from continuing operations before cumulative effect of accounting change aggregated $1,527 million in 1997, $1,783 million in 1996 and $40 million in 1995. For companies with operations located outside the United States, pre-tax earnings on that basis aggregated $1,800 million in 1997, $1,200 million in 1996 and $946 million in 1995.

Income taxes paid, net of refunds, amounted to $285 million, $917 million and $554 million in 1997, 1996 and 1995, respectively.

The undistributed earnings of subsidiary companies and of affiliated corporate joint-venture companies accounted for on the equity method, for which deferred U.S. income taxes have not been provided at December 31, 1997 amounted to $1,482 million and $2,313 million, respectively. The corresponding amounts at December 31, 1996 were $1,302 million and $2,124 million, respectively. Recording of deferred income taxes on these undistributed earnings is not required relative to foreign companies and pre-1993 earnings of domestic companies when the earnings have been permanently reinvested. These amounts would be subject to possible U.S. taxation only if remitted as dividends. The determination of the hypothetical amount of unrecognized deferred U.S. taxes on undistributed earnings of foreign entities is not practicable. For domestic entities, such unrecorded deferred income taxes were not material.

For the years 1997 and 1995 there was no utilization of loss carryforwards recorded for U.S. Federal income taxes. For the year 1996, a benefit of $184 million was recorded for the utilization of loss carryforwards. For the years 1997, 1996 and 1995, the utilization of loss carryforwards resulted in income tax benefits of $31 million, $16 million and $13 million in foreign income taxes, respectively.

At December 31, 1997, Texaco had worldwide tax basis loss carryforwards of approximately $1,717 million, including $928 million which do not have an expiration date. The remainder expire at various dates through 2013.

Foreign tax credit carryforwards available for U.S. Federal income tax purposes amounted to approximately $186 million at December 31, 1997, expiring at various dates through 2001. Alternative minimum tax and other tax credit carryforwards available for U.S. Federal income tax purposes were $237 million at December 31, 1997, of which $233 million have no expiration date. The remaining credits expire at various dates through 2012. The credits that are not utilized by the expiration dates may be taken as deductions for U.S. Federal income tax purposes. For the years 1997 and 1996 tax credit carryforwards of $24 million and $43 million, respectively, were recognized for U.S. Federal income tax purposes. There was no recognition of similar carryforwards in 1995.

NOTE 14 EMPLOYEE BENEFIT PLANS

Texaco Inc. and certain of its non-U.S. subsidiaries sponsor various benefit plans for active employees and retirees. The costs of the savings, health care and life insurance plans relative to employees' active service are shared by the company and its employees, with Texaco's costs for these plans charged to expense as incurred. In addition, reserves for employee benefit plans are provided principally for the unfunded costs of various pension plans, retiree health and life insurance benefits, incentive compensation plans and for separation benefits payable to employees.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP)

Texaco recorded ESOP expense of $2 million in 1997, $15 million in 1996 and $28 million in 1995. Company contributions to the Employees Thrift Plan of Texaco Inc. and the Employees Savings Plan of Texaco Inc. (the Plans) amounted to $2 million in 1997, $26 million in 1996 and $17 million in 1995. These Plans are designed to provide participants with a benefit of approximately 6% of base pay. Included in the 1996 and 1995 ESOP expense is $9 million and $11 million, respectively, in connection with a 1995 employee incentive award program.

In 1997, 1996 and 1995, the company paid $44 million, $46 million and $47 million, respectively, in dividends on Series B and Series F stock. The dividends are applied by the trustee to fund interest payments which amounted to $7 million, $10 million and $14 million for 1997, 1996 and 1995, respectively, as well as to reduce principal on the ESOP loans. Dividends on the shares of Series B and Series F used to service debt of the Plans are tax deductible to the company. In December 1997, a portion of the original Thrift Plan ESOP loan was refinanced through a company loan. The refinancing will extend the ESOP for a period of up to six years.

Reflected in Texaco's long-term debt are the Plans' original ESOP loans guaranteed by Texaco Inc. Commensurate with each repayment on the original and refinanced ESOP loans, there is a reduction in the remaining ESOP-related unearned employee compensation included as a component of stockholders' equity.

BENEFIT PLAN TRUST

During 1995, Texaco established a benefit plan trust (Trust) for funding company obligations under certain benefit plans. Texaco transferred eight million shares of treasury stock to the Trust in 1995 and 1.2 million shares in 1997. The company intends to continue to pay its obligations under its benefit plans. The Trust will use the shares, proceeds from the sale of such shares and dividends on such shares to pay benefits only to the extent not paid by the company. The shares held in the Trust will be voted by the trustee as instructed by the Trust's beneficiaries. The shares held by the Trust are not considered outstanding for earnings per share purposes until distributed or sold by the Trust in payment of benefit obligations.

TERMINATION BENEFITS

On October 30, 1996, Texaco announced a companywide realignment and consolidation of its operations designed to enhance the company's ability to grow existing and new businesses. An after-tax provision of $56 million was recorded in 1996 to cover the costs of employee separations, including employees of affiliates. This program has now been completed with reductions of approximately 920 employees. During the fourth quarter of 1997, an adjustment of $6 million after tax was recorded to increase reserves from previously estimated amounts. The amount of unpaid benefits remaining on the Consolidated Balance Sheet was $20 million at year end.

PENSION PLANS

The company sponsors pension plans that cover the majority of employees. Generally, these plans provide defined pension benefits based on years of service and final average pay. However, the level of benefits and terms of vesting vary among plans. Amounts charged to pension expense, as well as amounts funded, are generally based on actuarial studies. Pension plan assets are administered by trustees and are principally invested in equity and fixed income securities and deposits with insurance companies.

The total worldwide expense for all employee pension plans of Texaco, including pension supplementations and the smaller non-U.S. plans, was $92 million in 1997, $91 million in 1996 and $86 million in 1995.

The following data are provided for U.S. plans and principal non-U.S. plans:

Components of Pension Expense

	United States Plans			Non-U.S. Plans		
(Millions of dollars)	1997	1996	1995	1997	1996	1995
Benefits earned during the year	$ 54	$ 57	$ 48	$ 17	$ 16	$ 16
Actual investment return on plan assets (gain) loss	(307)	(226)	(279)	(166)	(102)	(123)
Interest cost on projected benefit obligations	117	117	114	85	81	81
Amortization of net deferred amounts	183	104	158	98	38	64
Total	$ 47	$ 52	$ 41	$ 34	$ 33	$ 38

The assumed long-term return on plan assets for U.S. plans was 10% for 1997, 1996 and 1995; for non-U.S. plans the weighted average rate was 8.5% for 1997, and 8.7% for 1996 and 1995.

Funded Status of Pension Plans

	United States Plans			
	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets
(Millions of dollars) As of December 31	1997		1996	
Present value of the estimated pension benefits to be paid in the future				
Vested benefits	$ (1,123)	$ (118)	$ (1,097)	$ (97)
Nonvested benefits	(114)	(5)	(94)	(2)
Accumulated benefit obligations (ABO)	(1,237)	(123)	(1,191)	(99)
Effect of projected future salary increases	(394)	(15)	(353)	(14)
Total projected benefit obligations (PBO)	(1,631)	(138)	(1,544)	(113)
Plan assets at fair value	1,691	11	1,483	—
Assets in excess of (less than) PBO	60	(127)	(61)	(113)
Net transition (asset) liability	(26)	5	(37)	7
Unrecognized net prior-service costs	73	12	62	14
Unrecognized net (gains) and losses	(98)	(2)	2	(7)
Net pension (liability) asset recorded in Texaco's Consolidated Balance Sheet	$ 9	$ (112)	$ (34)	$ (99)

Funded Status of Pension Plans – continued

	Non-U.S. Plans			
	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets
(Millions of dollars) As of December 31		1997		1996
Present value of the estimated pension benefits to be paid in the future				
Vested benefits	$ (497)	$ (241)	$ (436)	$ (274)
Nonvested benefits	(33)	(20)	(21)	(32)
Accumulated benefit obligations (ABO)	(530)	(261)	(457)	(306)
Effect of projected future salary increases	(31)	(13)	(19)	(19)
Total projected benefit obligations (PBO)	(561)	(274)	(476)	(325)
Plan assets at fair value	900	—	789	40
Assets in excess of (less than) PBO	339	(274)	313	(285)
Net transition (asset) liability	(26)	3	(39)	7
Unrecognized net prior-service costs	22	24	23	32
Unrecognized net (gains) and losses	(39)	(14)	(25)	(20)
Net pension (liability) asset recorded in Texaco's Consolidated Balance Sheet	$ 296	$ (261)	$ 272	$ (266)

Weighted Average Rate Assumptions Used in Estimating Pension Benefit Obligations

	United States Plans		Non-U.S. Plans	
	1997	1996	1997	1996
Discount rate	7.0%	7.5%	10.9%	12.0%
Rate of increase in compensation levels	4.0%	4.0%	6.2%	7.4%

OTHER POSTRETIREMENT BENEFITS

Texaco sponsors postretirement plans in the U.S. that provide health care and life insurance for retirees and eligible dependents. The company's U.S. health insurance obligation is its fixed dollar contribution. The plans are unfunded, and the costs are shared by the company and its employees and retirees.

The determination of the company's obligation is based on the terms of the life and health insurance plans, along with applicable actuarial assumptions. The company continues to fund these benefit costs on a pay-as-you-go basis, with retirees paying the excess over the company's fixed dollar contribution for health insurance. For employees who retire from Texaco between age 55 and 65, most will be eligible to receive health care benefits, similar to those available to active employees, as well as life insurance benefits. The company's cost to provide these postretirement benefits for health insurance is currently equal to the company's cost for an active employee. After attaining age 65, the retirees' health care coverage is coordinated with available Medicare benefits.

Fixed dollar contributions for health care benefits are determined annually by the company. For measurement purposes, the fixed dollar contribution is expected to increase by 4% per annum for both pre-age 65 and post-age 65 retirees for all future years. The assumed fixed dollar contributions do not necessarily represent an obligation of the company.

Assuming a 1% increase in the annual rate of increase in the fixed dollar contribution for health insurance, the accumulated postretirement benefit obligation and annual expense would increase by approximately $52 million and $5 million, respectively.

Certain of the company's non-U.S. subsidiaries have postretirement benefit plans. However, most retirees outside the U.S. are covered by government sponsored and administered programs, the cost of which is not significant to the company.

The following tables provide information on the status of the principal postretirement plans:

Components of Other Postretirement Benefit Expense

(Millions of dollars)	Health Care	Life Insurance	Total	Health Care	Life Insurance	Total	Health Care	Life Insurance	Total
			1997			1996			1995
Benefits earned during the year	$ 6	$ —	$ 6	$ 9	$ 3	$ 12	$ 7	$ 2	$ 9
Interest cost on accumulated postretirement benefit obligations	28	21	49	30	21	51	33	21	54
Amortization of net deferred amounts	(5)	—	(5)	(1)	—	(1)	(3)	(1)	(4)
Total	$ 29	$ 21	$ 50	$ 38	$ 24	$ 62	$ 37	$ 22	$ 59

Funded Status of Other Postretirement Plans

(Millions of dollars) As of December 31	Health Care	Life Insurance	Total 1997	Health Care	Life Insurance	Total 1996
Accumulated unfunded postretirement benefit obligations						
Retirees	$ 282	$ 256	$ 538	$ 266	$ 239	$ 505
Fully eligible active participants	36	1	37	31	1	32
Other active plan participants	112	69	181	102	60	162
Total accumulated unfunded postretirement benefit obligations	430	326	756	399	300	699
Unrecognized prior service cost	—	(5)	(5)	—	—	—
Unrecognized net gain	78	16	94	110	27	137
Net other postretirement benefit liability recorded in Texaco's Consolidated Balance Sheet	$ 508	$ 337	$ 845	$ 509	$ 327	$ 836

Weighted Average Rate Assumptions Used in Estimating Other Postretirement Benefit Obligations

	1997	1996
Discount rate	7.0%	7.5%
Rate of increase in compensation levels	4.0%	4.0%

NOTE 15 STOCK INCENTIVE PLAN

Under the company's 1997 Stock Incentive Plan (Plan) as amended, stock options, restricted stock and other incentive award forms may be granted to executives, directors and certain key employees to provide motivation to enhance the company's success and increase shareholder value. The maximum number of shares that may be awarded as stock options or restricted stock under the Plan is 1% of the common stock outstanding on December 31 of the previous year, adjusted for certain plan provisions. The following table summarizes the number of shares at December 31, 1997, 1996 and 1995 available for awards during the subsequent year:

(Shares) As of December 31	1997	1996	1995
To all participants	6,970,526	7,027,010	5,703,966
To those participants not officers or directors	2,362,273	1,932,796	1,374,178
Total	9,332,799	8,959,806	7,078,144

Restricted shares granted under the Plan contain a performance element which must be satisfied in order for all or a specified portion of the shares to vest. Restricted performance shares awarded in each year under the Plan were as follows:

	1997	1996	1995
Shares	281,174	282,476	231,610
Weighted average fair value	$ 55.09	$ 42.43	$ 33.12

Stock options granted under the Plan extend for 10 years from the date of grant and vest over a two year period at a rate of 50% in the first year and 50% in the second year. The exercise price cannot be less than the fair market value of the underlying shares of common stock on the date of the grant. The Plan provides for restored options. This feature enables a participant who exercises a stock option by exchanging previously acquired common stock or who has shares withheld by the company to satisfy tax withholding obligations, to receive new options equal to the number of shares exchanged or withheld. The restored options are fully exercisable six months after the date of grant and the exercise price is the fair market value of the common stock on the day the restored option is granted.

We apply APB Opinion 25 in accounting for our stock-based compensation programs. Stock-based compensation expense recognized in connection with the Plan was $17.9 million in 1997, $12.5 million in 1996 and $7.1 million in 1995. Had we accounted for our Plan using the accounting method recommended by SFAS 123, net income and earnings per share would have been the pro forma amounts below:

	1997	1996	1995
Net Income			
(Millions of dollars)			
As reported	$ 2,664	$ 2,018	$ 607
Pro forma	$ 2,621	$ 1,997	$ 601
Earnings per share (dollars)			
Basic — as reported	$ 4.99	$ 3.77	$ 1.05
— pro forma	$ 4.91	$ 3.73	$ 1.04
Diluted — as reported	$ 4.87	$ 3.68	$ 1.05
— pro forma	$ 4.79	$ 3.64	$ 1.04

The fair market value of options at date of grant was estimated using the Black-Scholes model with the following assumptions:

	1997	1996	1995
Expected life	2 yrs	3 yrs	3 yrs
Interest rate	6.0%	6.1%	5.9%
Volatility	18.6%	15.0%	15.0%
Dividend yield	3.0%	3.3%	3.2%

Option award activity during 1997, 1996 and 1995 is summarized in the following table:

(Stock Options)	1997 Shares	1997 Weighted-Average Exercise Price	1996 Shares	1996 Weighted-Average Exercise Price	1995 Shares	1995 Weighted-Average Exercise Price
Outstanding January 1	9,436,406	$ 42.73	9,335,288	$ 33.45	7,928,196	$ 31.88
Granted	2,084,902	55.06	2,040,530	42.43	1,890,734	32.99
Exercised	(9,533,861)	44.86	(8,088,040)	34.22	(4,355,260)	31.55
Restored	8,103,502	55.32	6,271,720	45.52	3,871,618	34.73
Canceled	(19,642)	51.43	(123,092)	36.77	—	—
Outstanding December 31	10,071,307	53.31	9,436,406	42.73	9,335,288	33.45
Exercisable December 31	3,197,262	51.21	2,853,236	39.20	4,297,486	32.97
Weighted-average fair value of options granted during the year		$ 6.92		$ 5.50		$ 3.56

The following table summarizes information on stock options outstanding at December 31, 1997:

	Options Outstanding			Options Exercisable	
Exercisable Price Range (per share)	Shares	Weighted-Average Remaining Life	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
$ 23.39 – 31.84	116,058	4.7 yrs.	$ 30.41	103,502	$ 30.60
$ 32.06 – 78.08	9,955,249	6.4 yrs.	$ 53.58	3,093,760	$ 51.90
$ 23.39 – 78.08	10,071,307	6.4 yrs.	$ 53.31	3,197,262	$ 51.21

NOTE 16 OTHER FINANCIAL INFORMATION AND COMMITMENTS

ENVIRONMENTAL RESERVES

Texaco Inc. and subsidiary companies have financial reserves relating to environmental remediation programs which the company believes are sufficient for known requirements. At December 31, 1997, reserves for future environmental remediation costs amounted to $531 million and reserves relative to the future cost of restoring and abandoning existing oil and gas properties were $801 million. Texaco's significant affiliates also have recorded reserves for environmental remediation and restoration and abandonment costs.

Texaco has provided, to the extent reasonably measurable, financial reserves for its probable environmental remediation liabilities. The recording of these obligations is based on technical evaluations of the currently available facts, interpretation of the regulations and the company's experience with similar sites. Additional financial reserve requirements relative to existing and new remediation sites may be necessary in the future when more facts are known. The potential also exists for further legislation to provide limitations on liability. It is not possible to project the overall costs or a range of costs for environmental items beyond that disclosed above due to uncertainty surrounding future developments, both in relation to remediation exposure and to regulatory initiatives. However, while future environmental expenditures that will be incurred by the petroleum industry are expected to be significant in the absolute, they will be a cost of doing business that will have to be recovered in the marketplace. Moreover, it is not believed that such future costs will be material to the company's financial position nor to its operating results over any reasonable period of time.

PREFERRED SHARES OF SUBSIDIARIES

Minority holders own $602 million of preferred shares of subsidiary companies, which is reflected as minority interest in subsidiary companies in the Consolidated Balance Sheet.

MVP Production Inc., a subsidiary, has variable rate cumulative preferred shares of $75 million owned by one minority holder. The shares have voting rights and are redeemable in 2003. Dividends on these shares were $4 million in 1997, 1996 and 1995.

Texaco Capital LLC, another subsidiary, has three classes of preferred shares, all held by minority holders. The first class is 14 million shares totalling $350 million of Cumulative Guaranteed Monthly Income Preferred Shares, Series A (Series A). The second class is 4.5 million shares totalling $112 million of Cumulative Adjustable Rate Monthly Income Preferred Shares, Series B (Series B). The third class, issued in Canadian dollars and hedged for currency risk, is 3.6 million shares totalling $65 million of Deferred Preferred Shares, Series C (Series C). Texaco Capital LLC's sole assets are notes receivable from Texaco Inc. The payment of dividends and payments on liquidation or redemption with respect to Series A, Series B and Series C are guaranteed by Texaco Inc.

The fixed dividend rate for Series A is 6-7/8% per annum. The annual dividend rate for Series B averaged 5.9% for both 1997 and 1996 and 6.26% for 1995. The dividend rate on Series B is reset quarterly and is equal to 88% of the highest of three U.S. Treasury maturities (three-month, ten-year and thirty-year), but in no event less than 4.5% per annum nor greater than 10.5% per annum. Dividends on Series A and Series B are paid monthly. Dividends on Series A for 1997, 1996 and 1995 totaled $24 million for each year. Annual dividends on Series B totaled $7 million for 1997, 1996 and 1995.

Series A and Series B are redeemable under certain circumstances and, at the option of Texaco Capital LLC (with Texaco Inc.'s consent) in whole or in part, from time to time, at $25 per share on or after October 31, 1998 for Series A and June 30, 1999 for Series B, plus, in each case, accrued and unpaid dividends to the date fixed for redemption.

Dividends on Series C at a rate of 7.17% per annum, compounded annually, will be paid at the redemption date of February 28, 2005, unless earlier redemption occurs. Early redemption may result upon the occurrence of certain specific events. The par value and dividends payable in Canadian dollars have been hedged by a swap contract to eliminate foreign currency risk.

Series A, Series B and Series C are non-voting, except under certain limited circumstances.

The above preferred stock issues currently require annual dividend payments of approximately $35 million. The company is required to redeem $75 million of this preferred stock in 2003, $65 million (plus accreted dividends of $59 million) in 2005, $112 million in 2024 and $350 million in 2043. Texaco has the ability to extend the required redemption dates for the $112 million and $350 million of preferred stock beyond 2024 and 2043, respectively.

FINANCIAL GUARANTEES

The company has guaranteed the payment of certain debt and other obligations of third parties and affiliate companies. These guarantees totaled $372 million and $246 million at December 31, 1997 and 1996, respectively.

Exposure to credit risk in the event of non-payment by the obligors is represented by the contractual amount of these instruments. No loss is anticipated under these guarantees.

Additionally, in June 1997, Texaco's 50 percent owned affiliate, Caltex Petroleum Corporation (Caltex) received a claim from the United States Internal Revenue Service (IRS) for $292 million in excise taxes, $140 million in penalties and $1.6 billion in interest. The IRS claim relates to sales of crude oil by Caltex to Japanese customers beginning in 1980. Caltex believes that the underlying claim for excise taxes and penalties is wrong and that the claim for interest is flawed. Texaco believes that this claim is without merit and is not anticipated to be materially important in relation to its consolidated financial position or results of operations. In February 1998, Caltex arranged for the issuance of a letter of credit for $2.3 billion to the IRS in order to litigate this claim. Texaco and its 50 percent partner, Chevron Corporation, have severally guaranteed Caltex' letter of credit obligation to a syndicate of banks.

THROUGHPUT AGREEMENTS

Texaco Inc. and certain of its subsidiary companies have entered into certain long-term agreements wherein they have committed to ship through affiliated pipeline companies and an offshore oil port sufficient volume of crude oil or petroleum products to enable these affiliated companies to meet a specified portion of their individual debt obligations, or, in lieu thereof, to advance sufficient funds to enable these affiliated companies to meet these obligations. Additionally, Texaco has entered into long-term purchase commitments with third parties for take or pay gas transportation. At December 31, 1997 and 1996 the company's maximum exposure to loss was estimated to be $525 million and $629 million, respectively.

However, based on Texaco's right of counterclaim against third parties in the event of nonperformance, Texaco's net exposure was estimated to be $422 million and $489 million at December 31, 1997 and 1996, respectively.

No losses are anticipated as a result of these obligations.

OTHER COMMITMENTS

During 1995, 1996 and 1997, Texaco sold leasehold interests in certain equipment not yet in service and received British pound payments totalling $530 million. Under a related agreement, in 1997 Texaco leased back these leasehold interests. Texaco made a British pound payment in 1997, which released Texaco from future lease commitments under this agreement. This payment effectively repurchased the leasehold interests previously sold.

NOTE 17 FINANCIAL INSTRUMENTS

In the normal course of its business, the company utilizes various types of financial instruments. These instruments include recorded assets and liabilities, and also items such as derivatives which principally involve off-balance sheet risk.

Derivatives are contracts or securities whose value is derived from the value of an underlying asset or a reference rate. Texaco uses derivatives to reduce the impact of market price changes in the areas of investments, foreign currencies, interest rates and oil and natural gas commodities. Texaco does not enter into derivatives for speculative purposes.

The disclosures below include the following terms. "Held-to-maturity" means the company intends to hold until stated maturity date. "Available-for-sale" means that the item may possibly be sold before maturity date. "Amortized cost" is the remaining cost basis at the balance sheet date. "Fair value" is the amount that a third party would pay for the item. "Gross unrealized gain or (loss)" means the change in fair value of the instrument during the holding period.

Cash and cash equivalents – Fair value approximates cost as reflected in the Consolidated Balance Sheet at December 31, 1997 and 1996 because of the short-term maturities of these instruments. Cash equivalents (see Note 1) are classified as held-to-maturity. The amortized cost of cash equivalents was as follows:

(Millions of dollars) As of December 31	1997	1996
Time deposits and certificates of deposit	$ 129	$ 62
Commercial paper and other	47	197
	$ 176	$ 259

Short-term and long-term investments – Fair value is primarily based on quoted market prices and valuation statements obtained from major financial institutions. Information concerning investments held at December 31, 1997 and 1996 in short-term and long-term debt securities and in publicly-traded equity securities that are classified as available-for-sale is shown in the tables that follow. Excluded from the tables is a $4 million investment in a time deposit at December 31, 1997 and 1996, which the company intends to hold to its maturity in the year 2001.

	Amortized Cost	Gross unrealized		Estimated Fair Value	Amortized Cost	Gross unrealized		Estimated Fair Value
		Gains	Losses			Gains	Losses	
(Millions of dollars) As of December 31				1997				1996
U.S. government securities	$ 312	$ 5	$ —	$ 317	$ 141	$ 1	$ 2	$ 140
Foreign government securities	73	5	2	76	189	9	2	196
Corporate and other debt securities	129	3	—	132	160	2	1	161
Total available-for-sale debt securities	514	13	2	525	490	12	5	497
Equity securities	73	34	11	96	64	28	4	88
	$ 587	$ 47	$ 13	$ 621	$ 554	$ 40	$ 9	$ 585

Proceeds from sales of available-for-sale securities were $1,040 million in 1997, $1,503 million in 1996 and $1,175 million in 1995. These sales resulted in gross realized gains of $48 million in 1997, $51 million in 1996 and $81 million in 1995, and, gross realized losses of $19 million, $17 million, and $27 million, respectively.

At December 31, 1997, available-for-sale debt securities had the following scheduled maturities:

(Millions of dollars) As of December 31	Amortized Cost	Estimated Fair Value
		1997
Due in one year or less	$ 83	$ 83
Due after one year through five years	224	229
Due after five years	207	213
	$ 514	$ 525

The estimated fair value of other long-term investments not included above, for which it is practicable to estimate fair value, approximated the December 31, 1997 and 1996 carrying values of $197 million and $192 million, respectively.

Short-term debt, long-term debt and related derivatives – Shown below are the carrying amounts and fair values of Texaco's debt and related derivatives as of year-end 1997 and 1996:

(Millions of dollars) As of December 31	1997	1996
Short-term and long-term debt:		
Carrying amount	$ 6,258	$ 5,455
Fair value	$ 6,654	$ 5,712
Related derivatives –		
Payable (Receivable):		
Carrying amount	$ —	$ —
Fair value	$ 2	$ (3)

Refer to Note 9 for additional information about debt and related derivatives outstanding at December 31, 1997 and 1996.

Forward Exchange and Option Contracts – As an international company, Texaco is exposed to currency exchange risk. To hedge against adverse changes in foreign currency exchange rates, the company will enter into forward and option contracts to buy and sell foreign currencies. Shown below in U.S. dollars are the notional amounts of outstanding forward exchange contracts to buy and sell foreign currencies.

(Millions of dollars) As of December 31	Buy	Sell	Buy	Sell
		1997		1996
Australian dollars	$ 203	$ 2	$ 284	$ 18
British pounds	902	363	1,030	54
Danish krone	260	48	173	2
Dutch guilders	220	3	228	29
New Zealand dollars	142	13	130	—
Other European currencies	104	102	114	201
Other currencies	14	75	67	39
	$ 1,845	$ 606	$ 2,026	$ 343

Market risk exposure on these contracts is essentially limited to currency rate movements. At year-end 1997, there were $5 million unrealized gains and $29 million unrealized losses related to these contracts. At year-end 1996, there were $39 million unrealized gains and $2 million unrealized losses. The company's exposure to credit risk on forward exchange contracts is minimal, since the counterparties are major financial institutions with strong credit ratings. The company does not anticipate nonperformance by any of the various counterparties.

The company uses forward exchange contracts to buy foreign currencies primarily to hedge the net monetary liability position of its European, Canadian, Australian and New Zealand operations and to hedge portions of significant foreign currency capital expenditures and lease commitments. These contracts generally have terms of 60 days or less. Contracts that hedge foreign currency monetary positions are marked-to-market monthly. Any resultant gains and losses are included in income currently as other costs. At year-end 1997 and 1996, hedges of foreign currency commitments principally involve capital projects requiring expenditure of British pounds and Danish krone. The percentages of planned capital expenditures hedged at year-end were: British pounds – 62% in 1997 and 68% in 1996; Danish krone – 74% in 1997 and 49% in 1996. Realized gains and losses on hedges of foreign currency commitments are initially recorded to deferred charges. Subsequently, the amounts are applied to the capitalized project cost on a percentage-of-completion basis, and are then amortized over the lives of the applicable projects. At year-end 1997 and 1996, net hedging gains of $51 million and $84 million, respectively, had yet to be amortized.

Contracts to sell foreign currencies are primarily related to a separately managed program to hedge the value of the company's investment portfolio denominated in foreign currencies. The company's strategy is to hedge the full value of this portion of its investment portfolio and to close out forward contracts upon the sale or maturity of the corresponding investments. These contracts are valued at market based on the foreign exchange rates in effect on the balance sheet dates. Changes in the value of these contracts are recorded as part of the carrying amount of the related investments. Related gains and losses are recorded, net of applicable income taxes, to stockholders' equity until the underlying investments are sold or mature.

Preferred Shares of Subsidiaries – Texaco has entered into an interest rate swap related to dividends payable on Series B preferred shares of Texaco Capital LLC. The swap has a notional principal amount of $112 million and expires in the year 2007. The swap provides for Texaco to pay a LIBOR-based floating rate and to receive the contractual dividend rate of the Series B preferred stock monthly. The fair value of the swap is not material.

Texaco also has entered into an interest rate and currency swap related to Series C preferred shares of Texaco Capital LLC. The swap matures in the year 2005. Over the life of the interest rate swap component of the contract, Texaco will make LIBOR-based floating rate interest payments based on a notional principal amount of $65 million. Canadian dollar interest will accrue to Texaco at a fixed rate applied to the accreted notional principal amount, which was Cdn. $87 million at the inception of the swap.

The currency swap component of the transaction calls for Texaco to exchange $65 million for Cdn. $170 million, which includes Cdn. $87 million plus accrued interest on the contract's maturity date. The carrying amount of this contract represents the Canadian dollar accrued interest receivable by Texaco. At year-end 1997 and 1996, the carrying amount and the fair value of this transaction were not material.

Petroleum and Natural Gas Hedging – The company hedges a portion of the market risks associated with its crude oil, natural gas and petroleum product purchases, sales and exchange activities. All hedge transactions are subject to the company's corporate risk management policy which sets out dollar, volumetric and term limits, as well as to management approvals as set forth in the company's delegations of authorities. Company policy does not permit speculative position-taking using derivative financial instruments.

The company uses established petroleum futures exchanges, as well as "over-the-counter" hedge instruments, including futures, options, swaps and other derivative products. These hedge tools are used to reduce our exposure to price volatility by establishing margins, costs or revenues on designated transactions as well as for planned future purchases and sales, inventory, production and processing. In carrying out its hedging programs, the company analyzes its major commodity streams for fixed cost, fixed revenue and margin exposure to market price changes. Based on this corporate risk profile, forecasted trends, and overall business objectives, a determination is made as to an appropriate strategy for risk reduction.

Hedge positions are marked-to-market for valuation purposes. Gains and losses on hedge transactions, which offset losses and gains on the underlying "cash market" transactions, are recorded to deferred income or charges until the hedged transaction is closed, or until the anticipated future purchases, sales, or production occur. At that time, any gain or loss on the hedging contract is recorded to operating revenues as an increase or decrease in margins, or to inventory, as appropriate.

Over-the-counter hedge positions expose the company to counterparty credit risk. However, because the hedge contracts are placed with parties whose creditworthiness has been pre-determined in accordance with the company's credit policy, non-performance by any counterparty is not anticipated. Such over-the-counter commodity contracts do not expose the company to any concentrations of credit risk because of the dollar limits incorporated in risk management policies.

At December 31, 1997 and 1996, there were open derivative commodity contracts required to be settled in cash, consisting mostly of swaps. Notional contract amounts, excluding unrealized gains and losses, were $974 million and

$1,327 million, respectively, at year-end 1997 and 1996. These amounts principally represent future values of contract volumes over the remaining duration of outstanding swap contracts at the respective dates. These contracts hedge a small fraction of the company's business activities, generally for the next twelve months. Unrealized gains and losses on contracts outstanding at year-end 1997 were $93 million and $58 million, respectively. At year-end 1996, unrealized gains and losses were $63 million and $48 million, respectively.

NOTE 18 CONTINGENT LIABILITIES

Texaco and approximately fifty other oil companies are defendants in seventeen purported class actions in which the plaintiffs allege that the defendants undervalued oil produced from properties leased from the plaintiffs by establishing artificially low selling prices, thereby underpaying to plaintiffs royalties or severance taxes based on those prices. The actions are pending in Texas, New Mexico, Oklahoma, Louisiana, Utah, Mississippi and Alabama. Plaintiffs seek to recover royalty underpayments and interest and in some cases severance taxes and treble and punitive damages. Texaco and twenty-four other defendants have executed a settlement agreement with some of the plaintiffs that will resolve many of these disputes in whole or in part. The settlement is pending approval in federal court in Texas.

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In the company's opinion, while it is impossible to ascertain the ultimate legal and financial liability with respect to contingent liabilities and commitments, the aggregate amount of such liability in excess of financial reserves is not anticipated to be materially important in relation to the consolidated financial position or results of operations of Texaco.

NOTE 19 FINANCIAL DATA BY GEOGRAPHIC AREA

Texaco Inc. and its subsidiary companies, together with affiliates, represent a vertically integrated enterprise principally engaged in the worldwide exploration for and production, transportation, refining and marketing of crude oil, natural gas and petroleum and other processed products, as well as nonpetroleum operations such as insurance and alternate energy activities. These products and services are sold and provided to various purchasers including wholesale and retail distributors, utilities, industrial end users and governmental agencies throughout the world. Operations and investments in some foreign areas are subject to political and business risks, the nature of which varies from country to country and from time to time. At year-end 1997, net assets located outside the United States amounted to $1,932 million, $4,072 million and $2,794 million in Other Western Hemisphere, Europe and Other Eastern Hemisphere areas, respectively.

Operating profit represents total sales and services as shown on the Statement of Consolidated Income less operating costs and expenses, net of income taxes. Corporate/nonoperating includes interest income and expense, general corporate expenses and other nonoperating items, net of income taxes. Equity in income or losses of partnership joint-venture companies is reflected net of taxes, since this income is directly taxable to Texaco.

Intergeographic sales and services shown are based on prices which are generally representative of market prices or arm's-length negotiated prices.

Identifiable assets are those from continuing operations which can be directly identified or associated with operations which have been geographically segregated. Net assets of discontinued operations (see Note 5) are reflected in corporate/nonoperating to conform to the presentation of net loss from discontinued operations. Investments in affiliates pertain to those affiliates which are accounted for on the equity method. Corporate assets include cash and cash investments, as well as receivables, properties, plant and equipment and other assets which are corporate in nature.

(Millions of dollars)	United States	Other Western Hemisphere	Europe	Other Eastern Hemisphere	Corporate/ Non-operating*	Consolidated
1997						
Sales and services						
Outside	$ 22,147	$ 7,525	$ 10,947	$ 4,568	$ —	$ 45,187
Intergeographic	784	258	248	1	(1,291)	—
Total sales and services	$ 22,931	$ 7,783	$ 11,195	$ 4,569	$ (1,291)	$ 45,187
Net income (loss)						
Operating profit	$ 1,095	$ 323	$ 381	$ 188	$ —	$ 1,987
Equity in income of affiliates	195	1	(3)	423	—	616
Corporate/nonoperating	—	—	—	—	61	61
Total net income	$ 1,290	$ 324	$ 378	$ 611	$ 61	$ 2,664
Identifiable assets	$ 14,224	$ 2,454	$ 5,480	$ 1,645	$ —	$ 23,803
Investments in affiliates	1,265	35	198	2,323	—	3,821
Corporate assets	—	—	—	—	1,976	1,976
Total assets	$ 15,489	$ 2,489	$ 5,678	$ 3,968	$ 1,976	$ 29,600

*Includes intergeographic sales and services eliminations.

(Continued on next page)

(Millions of dollars)	United States	Other Western Hemisphere	Europe	Other Eastern Hemisphere	Corporate/ Non-operating*	Consolidated
1996						
Sales and services						
Outside	$ 23,320	$ 6,486	$ 10,258	$ 4,497	$ —	$ 44,561
Intergeographic	838	31	502	28	(1,399)	—
Total sales and services	$ 24,158	$ 6,517	$ 10,760	$ 4,525	$ (1,399)	$ 44,561
Net income (loss)						
Operating profit	$ 1,229	$ 179	$ 93	$ 104	$ —	$ 1,605
Equity in income of affiliates	114	1	16	538	—	669
Corporate/nonoperating	—	—	—	—	(256)	(256)
Total net income (loss)	$ 1,343	$ 180	$ 109	$ 642	$ (256)	$ 2,018
Identifiable assets	$ 12,477	$ 2,047	$ 4,861	$ 1,628	$ —	$ 21,013
Investments in affiliates	1,098	28	543	2,142	—	3,811
Corporate assets	—	—	—	—	2,139	2,139
Total assets	$ 13,575	$ 2,075	$ 5,404	$ 3,770	$ 2,139	$ 26,963
1995						
Sales and services						
Outside	$ 17,302	$ 5,440	$ 8,906	$ 3,903	$ —	$ 35,551
Intergeographic	410	40	228	59	(737)	—
Total sales and services	$ 17,712	$ 5,480	$ 9,134	$ 3,962	$ (737)	$ 35,551
Net income (loss)						
Operating profit	$ 291	$ 166	$ 32	$ 78	$ —	$ 567
Equity in income of affiliates	45	6	21	452	—	524
Corporate/nonoperating	—	—	—	—	(363)	(363)
Net income (loss) before cumulative effect of accounting change	336	172	53	530	(363)	728
Cumulative effect of accounting change	—	—	—	—	(121)	(121)
Total net income (loss)	$ 336	$ 172	$ 53	$ 530	$ (484)	$ 607
Identifiable assets	$ 11,068	$ 1,800	$ 4,480	$ 1,386	$ —	$ 18,734
Net assets of discontinued operations	—	—	—	—	164	164
Investments in affiliates	1,042	24	540	2,479	—	4,085
Corporate assets	—	—	—	—	1,954	1,954
Total assets	$ 12,110	$ 1,824	$ 5,020	$ 3,865	$ 2,118	$ 24,937

*Includes intergeographic sales and services eliminations.

NOTE 20 SUBSEQUENT EVENT

On January 15, 1998, Texaco and Shell Oil Company reached agreement on the formation and operational start-up of Equilon Enterprises LLC (Equilon), a newly formed Delaware limited liability company. Equilon is a joint venture that combines major elements of the companies' western and midwestern U.S. refining and marketing businesses and their nationwide trading, transportation and lubricants businesses. Texaco owns 44% and Shell owns 56% of Equilon.

Texaco will account for its interest in Equilon using the equity method. Commencing 1998, Texaco will record its share of Equilon's results of operations on a one-line basis in the Consolidated Statement of Income and will reclassify the net amount of assets and liabilities of the businesses contributed to Equilon to Investments and Advances in the Consolidated Balance Sheet. The approximate carrying amounts at December 31, 1997, of the principal assets and liabilities of these businesses were $.3 billion of net working capital assets, $2.8 billion of net properties, plant and equipment and $.2 billion of debt. In addition, Texaco will record a receivable from Equilon of approximately $.5 billion, representing a portion of proceeds from a planned financing by Equilon.

Texaco, Shell and Saudi Refining, Inc. are finalizing agreements for a separate joint venture involving their eastern and Gulf Coast refining and marketing businesses in the United States. This transaction is expected to be completed in early 1998. Initially, Texaco and Saudi Refining, Inc. will each own 32.5% and Shell will own 35% of the joint venture.

REPORT OF MANAGEMENT

TEXACO INC. AND SUBSIDIARY COMPANIES

We are responsible for preparing Texaco's consolidated financial statements in accordance with generally accepted accounting principles. In doing so, we must use judgment and estimates when the outcome of events and transactions is not certain. Information appearing in other sections of this Annual Report is consistent with the financial statements.

Texaco's financial statements are based on its financial records. We rely on Texaco's internal control system to provide us reasonable assurance that these financial records are being accurately and objectively maintained and that the company's assets are being protected. The internal control system comprises:

• Corporate Conduct Guidelines that require all employees to obey all applicable laws, comply with company policies and maintain the highest ethical standards in conducting company business,

• An organizational structure in which responsibilities are defined and divided, and

• Written policies and procedures that cover initiating, reviewing, approving and recording transactions.

We require members of our management team to formally certify each year that the internal controls for their business units are operating effectively.

Texaco's internal auditors review and report on the effectiveness of internal controls during the course of their audits. Arthur Andersen LLP, selected by the Audit Committee and approved by stockholders, independently audits Texaco's financial statements. Arthur Andersen assesses the adequacy and effectiveness of Texaco's internal controls when determining the nature, timing and scope of their audit. We seriously consider all suggestions for improving Texaco's internal controls that are made by the internal and independent auditors.

The Audit Committee is comprised of six directors who are not employees of Texaco. This Committee reviews and evaluates Texaco's accounting policies and reporting practices, internal auditing, internal controls, security and other matters. The Committee also evaluates the independence and professional competence of Arthur Andersen LLP and reviews the results and scope of their audit. The internal and independent auditors have free access to the Committee to discuss financial reporting and internal control issues.

Peter I. Bijur
Chairman of the Board and Chief Executive Officer

Patrick J. Lynch
Senior Vice President and Chief Financial Officer

Robert C. Oelkers
Vice President and Comptroller

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders, Texaco Inc.:

We have audited the accompanying consolidated balance sheet of Texaco Inc. (a Delaware corporation) and subsidiary companies as of December 31, 1997 and 1996, and the related statements of consolidated income, cash flows and stockholders' equity for each of the three years in the period ended December 31, 1997. 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 generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Texaco Inc. and subsidiary companies as of December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles.

As explained in Note 2 to the Consolidated Financial Statements, in 1995 the company changed its method of accounting for long-lived assets to be held and used and long-lived assets to be disposed of.

Arthur Andersen LLP
February 26, 1998
New York, N.Y.

SUPPLEMENTAL OIL AND GAS INFORMATION

TEXACO INC. AND SUBSIDIARY COMPANIES

The following tables reflect the supplemental oil and gas information that is required by Statement of Financial Accounting Standards No. 69, Disclosures about Oil and Gas Producing Activities. Additionally, we provide information concerning recoverable proved oil and gas reserve quantities to the U.S. Department of Energy and to other government bodies annually. Such information is consistent with the information presented here.

The first three tables present the estimated quantities of our proved reserves and the estimated discounted future net cash flows data for these reserves. The remaining tables provide historical information about our exploration and producing operations. The "Other West" region includes Canada, Central America and South America. The "Other East" region includes West Africa, Eurasia, Asia, the Pacific Rim and the Middle East. Texaco's 50% affiliate is P.T. Caltex Pacific Indonesia (CPI), and CPI's estimated reserves are based on our production-sharing contract.

TABLE I – NET PROVED RESERVES

The liquids and gas reserve quantities shown below include only those quantities that are recoverable. "Net" reserve quantities represent the quantities estimated to be available to us after deducting any royalties or interests owned by others. Recoverable quantities are based upon reasonable estimates from sound geological and engineering principles. As additional information becomes available, these estimates are subject to revision. In addition to the reported reserve quantities, we have large potential reserves that we expect will increase our reserve base, as future investments are made in exploration and development programs.

TABLE I

NET PROVED RESERVES OF CRUDE OIL AND NATURAL GAS LIQUIDS

Millions of Barrels

	Consolidated Subsidiaries					Equity	
	United States	Other West	Europe	Other East	Total	Affiliate – Other East	World-wide
As of December 31, 1994	1,396	73	343	427	2,239	445	2,684
Changes attributable to:							
Extensions and discoveries	58	—	37	71	166	1	167
Improved recovery	56	—	15	—	71	45	116
Revisions	78	(2)	(3)	25	98	2	100
Purchases	1	—	—	—	1	—	1
Sales	(109)	(11)	—	—	(120)	—	(120)
Production	(139)	(6)	(42)	(48)	(235)	(55)	(290)
As of December 31, 1995*	1,341	54	350	475	2,220	438	2,658
Changes attributable to:							
Extensions and discoveries	82	4	80	29	195	1	196
Improved recovery	20	—	—	—	20	81	101
Revisions	44	2	6	21	73	(3)	70
Purchases	8	—	3	—	11	—	11
Sales	(31)	—	—	(1)	(32)	—	(32)
Production	(142)	(4)	(42)	(58)	(246)	(54)	(300)
As of December 31, 1996*	1,322	56	397	466	2,241	463	2,704
Changes attributable to:							
Extensions and discoveries	107	13	34	61	215	4	219
Improved recovery	15	—	65	—	80	18	98
Revisions	55	3	11	100	169	22	191
Purchases	416	—	—	—	416	—	416
Sales	(3)	(2)	(31)	(8)	(44)	—	(44)
Production	(145)	(5)	(45)	(66)	(261)	(56)	(317)
As of December 31, 1997*	1,767	65	431	553	2,816	451	3,267
*Includes net proved developed reserves							
As of December 31, 1995	1,125	52	142	413	1,732	350	2,082
As of December 31, 1996	1,100	50	165	418	1,733	354	2,087
As of December 31, 1997	1,374	54	210	463	2,101	354	2,455
*Includes net proved NGL reserves							
As of December 31, 1995	206	1	28	—	235	6	241
As of December 31, 1996	207	1	54	1	263	6	269
As of December 31, 1997	246	—	71	—	317	4	321

NET PROVED RESERVES OF NATURAL GAS

Billions of Cubic Feet

	Consolidated Subsidiaries					Equity	
	United States	Other West	Europe	Other East	Total	Affiliate – Other East	World-wide
As of December 31, 1994	4,407	712	877	47	6,043	150	6,193
Changes attributable to:							
Extensions and discoveries	397	100	164	6	667	6	673
Improved recovery	21	—	—	—	21	—	21
Revisions	103	103	(15)	39	230	14	244
Purchases	26	—	—	—	26	—	26
Sales	(287)	(6)	(2)	(1)	(296)	—	(296)
Production	(605)	(62)	(80)	(4)	(751)	(15)	(766)
As of December 31, 1995*	4,062	847	944	87	5,940	155	6,095
Changes attributable to:							
Extensions and discoveries	436	263	34	3	736	15	751
Improved recovery	8	—	—	—	8	1	9
Revisions	(99)	(1)	58	13	(29)	—	(29)
Purchases	5	—	—	—	5	—	5
Sales	(58)	(7)	—	1	(64)	—	(64)
Production	(626)	(71)	(75)	(4)	(776)	(18)	(794)
As of December 31, 1996*	3,728	1,031[a]	961	100	5,820[a]	153	5,973[a]
Changes attributable to:							
Extensions and discoveries	692	26	92	346	1,156	2	1,158
Improved recovery	7	—	22	—	29	5	34
Revisions	228	75	41	(22)	322	19	341
Purchases	24	—	—	—	24	—	24
Sales	(14)	(118)	(7)	(310)	(449)	—	(449)
Production	(643)	(96)	(81)	(2)	(822)	(17)	(839)
As of December 31, 1997*	4,022	918[a]	1,028	112	6,080[a]	162	6,242[a]
*Includes net proved developed reserves							
As of December 31, 1995	3,666	522	452	84	4,724	140	4,864
As of December 31, 1996	3,360	893	452	96	4,801	136	4,937
As of December 31, 1997	3,379	792	576	110	4,857	145	5,002

(a) Additionally, there is approximately 414 BCF of natural gas in Other West which will be available from production during the period 2005-2016 under a long-term purchase associated with a service agreement.

The following chart summarizes our experience in finding new quantities of oil and gas to replace our related production. Our reserve replacement performance is calculated by dividing our reserve additions by our production. Our additions relate to new discoveries, existing reserve extensions and revisions to previous reserve estimates. The chart excludes oil and gas quantities that were generated from purchases and sales, such as the Monterey acquisition, which added 420 million barrels of oil equivalent (BOE) to the company's reserve base.

TEXACO'S RESERVE REPLACEMENT PERFORMANCE

	Worldwide	United States	Outside United States
Year 1997	167%	132%	212%
Year 1996	113%	83%	154%
Year 1995	129%	116%	146%
3 Year Average (1995–1997)	137%	110%	172%
5 Year Average (1993–1997)	127%	102%	163%

Increases in proved reserves during 1997 were primarily due to the following:

In the United States, liquid and gas reserves were added from the Monterey Resources acquisition and drilling that extended the productive limits of existing fields, such as the McAllen Ranch field in Texas and Caillou Island field onshore Louisiana. Other drilling-related reserve increases resulted from the new field discovery of Ewing Bank Block 963 and new sand discovery at Mound Point, both offshore Louisiana. Liquid reserve increases also resulted from new horizontal wells and steamflood expansion in the California fields of Kern River and Midway-Sunset. Extension of contracts and fields supporting gas plants in New Mexico and Oklahoma added major NGL reserves.

Outside the United States, in the Other West area, significant reserves were added from offshore Trinidad with the extension of the Dolphin field and infill drilling in the Soldado field. Revised gas demand added new gas reserves from Chuchupa, offshore Colombia. In Europe, three new field discoveries, Galley, Elgin and Franklin, all in the North Sea, added impressive reserves. Also in the North Sea, a positive waterflood response at the Captain field and a waterflood extension at the Dan field added secondary reserves. In the Other East area, undeveloped reserves were added from planned drilling which will extend limits of the Wafra field in the Partitioned Neutral Zone between Kuwait and Saudi Arabia. The Yetagun gas field discovery in Myanmar added large gas reserves in mid-year (which were later sold).

On a worldwide basis in 1997, we spent $3.99 for each BOE we added. Finding and development costs averaged $4.02 per BOE for the three-year period 1995–1997 and $3.91 per BOE for the five-year period 1993–1997.

During 1998, Texaco expects that the net production of natural gas will approximate 2.3 billion cubic feet per day. This estimate is based upon past performance and on the assumption that such gas quantities can be produced under operating and economic conditions existing at December 31, 1997. Possible future changes in prices or world economic conditions were not factored into this estimate. These expected production volumes, together with normal related supply arrangements, are sufficient to meet anticipated delivery requirements under contractual arrangements. Approximately 34% of Texaco's proved natural gas reserves in the United States at December 31, 1997, 34% at December 31, 1996 and 31% at December 31, 1995 were covered by long-term sales contracts. These agreements are primarily priced at market.

TABLES II AND III – STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS DATA

The estimated "net" cash flows (after income taxes) are based on the future income of the recoverable reserves presented in Table I. In accordance with the requirements of SFAS 69, the standardized measure is calculated at a 10% discount rate, and future revenues are based on December 31 prices for liquids and gas. Future production costs for 1997 data are based on 1997 costs, and future development costs include restoration and abandonment estimates after deducting any salvage value. Future income taxes are calculated based on each country's statutory tax rate.

The purpose of this disclosure is to provide a common benchmark among those companies that engage in exploration and producing activities, and it is not necessarily indicative of our perception of the future cash flows from our proved reserves. The standardized measure excludes the effect of future changes in prices, costs and tax rates which past experience indicates will occur.

Additionally, probable and possible reserves, which may become proved in the future, are excluded from these calculations. Such future changes could significantly impact the standardized measure in these tables. Extensive judgment is used to estimate the timing of production and future costs over the remaining life of the reserves. However, these calculations should not be relied upon as an indicator of our future cash flows or value of our oil and gas reserves.

TABLE II – STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS

(Millions of dollars)	Consolidated Subsidiaries United States	Other West	Europe	Other East	Total	Equity Affiliate – Other East	Worldwide
As of December 31, 1997							
Future cash inflows from sale of oil & gas, and service fee revenue	$ 34,084	$ 2,305	$ 9,395	$ 7,690	$ 53,474	$ 5,182	$ 58,656
Future production costs	(10,980)	(807)	(2,854)	(2,303)	(16,944)	(1,840)	(18,784)
Future development costs	(4,693)	(132)	(1,809)	(749)	(7,383)	(476)	(7,859)
Future income tax expense	(5,512)	(652)	(898)	(3,445)	(10,507)	(1,519)	(12,026)
Net future cash flows before discount	12,899	714	3,834	1,193	18,640	1,347	19,987
10% discount for timing of future cash flows	(5,361)	(252)	(1,424)	(374)	(7,411)	(519)	(7,930)
Standardized measure of discounted future net cash flows	$ 7,538	$ 462	$ 2,410	$ 819	$ 11,229	$ 828	$ 12,057
As of December 31, 1996							
Future cash inflows from sale of oil & gas, and service fee revenue	$ 41,807	$ 2,863	$ 11,242	$ 9,261	$ 65,173	$ 6,632	$ 71,805
Future production costs	(8,080)	(894)	(2,368)	(1,993)	(13,335)	(1,776)	(15,111)
Future development costs	(2,790)	(141)	(2,094)	(551)	(5,576)	(740)	(6,316)
Future income tax expense	(10,444)	(758)	(1,946)	(5,099)	(18,247)	(2,181)	(20,428)
Net future cash flows before discount	20,493	1,070	4,834	1,618	28,015	1,935	29,950
10% discount for timing of future cash flows	(8,602)	(458)	(1,740)	(489)	(11,289)	(695)	(11,984)
Standardized measure of discounted future net cash flows	$ 11,891	$ 612	$ 3,094	$ 1,129	$ 16,726	$ 1,240	$ 17,966
As of December 31, 1995							
Future cash inflows from sale of oil & gas, and service fee revenue	$ 28,603	$ 2,144	$ 8,753	$ 7,820	$ 47,320	$ 5,357	$ 52,677
Future production costs	(8,232)	(628)	(2,150)	(2,210)	(13,220)	(1,448)	(14,668)
Future development costs	(2,618)	(181)	(1,352)	(439)	(4,590)	(515)	(5,105)
Future income tax expense	(5,505)	(573)	(1,457)	(3,862)	(11,397)	(1,799)	(13,196)
Net future cash flows before discount	12,248	762	3,794	1,309	18,113	1,595	19,708
10% discount for timing of future cash flows	(4,988)	(375)	(1,502)	(418)	(7,283)	(553)	(7,836)
Standardized measure of discounted future net cash flows	$ 7,260	$ 387	$ 2,292	$ 891	$ 10,830	$ 1,042	$ 11,872

TABLE III – CHANGES IN THE STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS

(Millions of dollars)	Consolidated Subsidiaries – Total 1997	1996	1995	Worldwide Including Equity in Affiliate – Other East 1997	1996	1995
Standardized measure – Beginning of year	$ 16,726	$ 10,830	$ 8,120	$ 17,966	$ 11,872	$ 9,012
Sales of minerals-in-place	(79)	(458)	(679)	(79)	(458)	(679)
	16,647	10,372	7,441	17,887	11,414	8,333
Changes in ongoing oil and gas operations:						
Sales and transfers of produced oil and gas, net of production costs during the period	(4,460)	(4,349)	(3,185)	(4,921)	(4,859)	(3,634)
Net changes in prices, production and development costs	(13,744)	8,407	4,265	(14,633)	8,820	4,564
Extensions, discoveries and improved recovery, less related costs	2,532	2,950	1,770	2,681	3,182	1,891
Development costs incurred during the period	1,810	1,431	1,223	1,977	1,575	1,322
Timing of production and other changes	(760)	(209)	(733)	(969)	(251)	(677)
Revisions of previous quantity estimates	1,374	563	988	1,476	527	990
Purchases of minerals-in-place	449	138	42	449	138	42
Accretion of discount	2,763	1,731	1,238	3,027	1,952	1,428
Net change in discounted future income taxes	4,618	(4,308)	(2,219)	5,083	(4,532)	(2,387)
Standardized measure – End of year	$ 11,229	$ 16,726	$ 10,830	$ 12,057	$ 17,966	$ 11,872

TABLE IV – CAPITALIZED COSTS

Gross capitalized costs represent the accumulated expenditures for the exploration and producing operations. The accumulated depreciation, depletion and amortization includes provision for restoration and abandonment activity that has not occurred. The net capitalized costs represent the undepreciated value for these assets.

(Millions of dollars)	Consolidated Subsidiaries United States	Other West	Europe	Other East	Total	Equity Affiliate – Other East	Worldwide
As of December 31, 1997							
Proved properties	$ 20,196	$ 581	$ 4,584	$ 1,623	$ 26,984	$ 1,112	$ 28,096
Unproved properties	1,248	16	89	225	1,578	338	1,916
Support equipment and facilities	438	26	37	228	729	578	1,307
Gross capitalized costs	21,882	623	4,710	2,076	29,291	2,028	31,319
Accumulated depreciation, depletion and amortization	(13,849)	(298)	(3,135)	(1,131)	(18,413)	(1,013)	(19,426)
Net capitalized costs	$ 8,033	$ 325	$ 1,575	$ 945	$ 10,878	$ 1,015	$ 11,893
As of December 31, 1996							
Proved properties	$ 17,450	$ 603	$ 4,102	$ 1,372	$ 23,527	$ 1,018	$ 24,545
Unproved properties	370	15	81	210	676	293	969
Support equipment and facilities	432	32	38	185	687	548	1,235
Gross capitalized costs	18,252	650	4,221	1,767	24,890	1,859	26,749
Accumulated depreciation, depletion and amortization	(13,158)	(308)	(2,739)	(1,012)	(17,217)	(903)	(18,120)
Net capitalized costs	$ 5,094	$ 342	$ 1,482	$ 755	$ 7,673	$ 956	$ 8,629

TABLE V – COSTS INCURRED

Costs incurred represent the amount we spent to explore for and develop our existing reserve base, and the amount we spent to acquire mineral rights from others. Our exploration costs include the costs of geological and geophysical work, carrying and retaining undeveloped properties, and drilling and equipping exploratory wells. Our development costs are associated with drilling and equipping development wells, improved recovery systems, facilities for extraction, treating, gathering and storage, and producing facilities for existing developed reserves.

(Millions of dollars)	Consolidated Subsidiaries United States	Other West	Europe	Other East	Total	Equity Affiliate – Other East	Worldwide
For the year ended December 31, 1997							
Proved property acquisition	$ 1,099*	$ —	$ —	$ —	$ 1,099	$ —	$ 1,099
Unproved property acquisition	527*	1	—	23	551	—	551
Exploration	480	15	59	234	788	18	806
Development	1,220	62	419	108	1,809	167	1,976
Total	$ 3,326	$ 78	$ 478	$ 365	$ 4,247	$ 185	$ 4,432
For the year ended December 31, 1996							
Proved property acquisition	$ 56	$ —	$ —	$ —	$ 56	$ —	$ 56
Unproved property acquisition	91	5	—	20	116	—	116
Exploration	356	18	90	225	689	9	698
Development	827	107	384	113	1,431	144	1,575
Total	$ 1,330	$ 130	$ 474	$ 358	$ 2,292	$ 153	$ 2,445
For the year ended December 31, 1995							
Proved property acquisition	$ 7	$ 31	$ —	$ —	$ 38	$ —	$ 38
Unproved property acquisition	35	3	2	11	51	—	51
Exploration	151	48	76	117	392	11	403
Development	845	66	207	105	1,223	99	1,322
Total	$ 1,038	$ 148	$ 285	$ 233	$ 1,704	$ 110	$ 1,814

*Includes the acquisition of Monterey Resources on a net cost basis of $1,520 million, which is net of deferred income taxes amounting to $469 million and $245 million for the acquired proved and unproved properties, respectively.

TABLE VI – RESULTS OF OPERATIONS

This table details the components of our net income from oil and gas activities. Revenues are based upon our production that is available for sale and will exclude revenues from resale of third party volumes, equity earnings of certain smaller affiliates, trading activity and miscellaneous operating income. Expenses are associated with current year operations but do not include general overhead and special items.

	Consolidated Subsidiaries					Equity	
(Millions of dollars)	United States	Other West	Europe	Other East	Total	Affiliate – Other East	Worldwide
For the year ended December 31, 1997							
Gross revenues from:							
Sales and transfers	$ 3,492	$ —	$ 495	$ 934	$ 4,921	$ 610	$ 5,531
Sales to unaffiliated entities	312	165	499	178	1,154	43	1,197
Production costs	(986)	(57)	(323)	(249)	(1,615)	(192)	(1,807)
Exploration costs	(238)	(10)	(60)	(195)	(503)	(16)	(519)
Depreciation, depletion and amortization	(735)	(27)	(382)	(129)	(1,273)	(110)	(1,383)
Other expenses	(249)	—	—	(24)	(273)	9	(264)
Results before estimated income taxes	1,596	71	229	515	2,411	344	2,755
Estimated income taxes	(511)	(40)	(85)	(418)	(1,054)	(173)	(1,227)
Net results	$ 1,085	$ 31	$ 144	$ 97	$ 1,357	$ 171	$ 1,528
For the year ended December 31, 1996							
Gross revenues from:							
Sales and transfers	$ 3,383	$ —	$ 524	$ 863	$ 4,770	$ 648	$ 5,418
Sales to unaffiliated entities	310	140	475	181	1,106	45	1,151
Production costs	(937)	(54)	(321)	(215)	(1,527)	(183)	(1,710)
Exploration costs	(196)	(27)	(57)	(150)	(430)	(8)	(438)
Depreciation, depletion and amortization	(652)	(24)	(310)	(107)	(1,093)	(110)	(1,203)
Other expenses	(241)	(1)	(1)	(40)	(283)	8	(275)
Results before estimated income taxes	1,667	34	310	532	2,543	400	2,943
Estimated income taxes	(534)	(26)	(112)	(417)	(1,089)	(212)	(1,301)
Net results	$ 1,133	$ 8	$ 198	$ 115	$ 1,454	$ 188	$ 1,642
For the year ended December 31, 1995							
Gross revenues from:							
Sales and transfers	$ 2,652	$ —	$ 394	$ 613	$ 3,659	$ 583	$ 4,242
Sales to unaffiliated entities	291	127	485	131	1,034	35	1,069
Production costs	(951)	(45)	(314)	(198)	(1,508)	(169)	(1,677)
Exploration costs	(87)	(35)	(79)	(96)	(297)	(9)	(306)
Depreciation, depletion and amortization	(682)	(20)	(293)	(109)	(1,104)	(94)	(1,198)
Other expenses	(254)	(6)	—	(24)	(284)	(13)	(297)
Results before estimated income taxes	969	21	193	317	1,500	333	1,833
Estimated income taxes	(295)	(14)	(74)	(260)	(643)	(177)	(820)
Net results	$ 674	$ 7	$ 119	$ 57	$ 857	$ 156	$ 1,013

TABLE VII – AVERAGE SALES PRICES AND PRODUCTION COSTS — PER UNIT

Average sales prices for liquids and natural gas are calculated using our gross revenues in Table VI. Average production costs include depreciation, depletion and amortization of support equipment and facilities and lifting costs, and exclude payments for royalties and income taxes.

	Average sales prices						Average production costs (per composite barrel)		
	Liquids per barrel	Natural gas per thousand cubic feet	Liquids per barrel	Natural gas per thousand cubic feet	Liquids per barrel	Natural gas per thousand cubic feet			
	1997		1996		1995		1997	1996	1995
United States	$ 16.32	$ 2.32	$ 16.97	$ 2.10	$ 14.25	$ 1.62	$ 3.94	$ 3.82	$ 3.97
Other West	14.40	1.03	16.80	.96	13.34	.87	2.80	3.44	2.92
Europe	18.41	2.42	20.37	2.47	16.57	2.50	5.58	5.95	6.08
Other East	16.87	1.89	18.61	3.20	15.90	2.61	4.11	4.07	4.30
Affiliate – Other East	14.89	—	16.30	—	14.27	—	3.76	3.71	3.37

SUPPLEMENTAL MARKET RISK DISCLOSURES

TEXACO INC. AND SUBSIDIARY COMPANIES

Texaco only uses derivative financial instruments for hedging purposes. These instruments principally include interest rate and/or currency swap contracts, forward and option contracts to buy and to sell foreign currencies, and commodity futures, options, swaps, and other derivative instruments. Gains and losses on these derivatives are entirely offset by losses and gains on the respective hedged exposures. Hedged market risk exposures include certain portions of assets, liabilities, future commitments and anticipated production and sales. We continually adjust our positions in derivative financial instruments for the ongoing changes in the exposures being hedged. However, since Texaco hedges only a portion of its market risk exposures, we bear market risk exposure on the unhedged portion of such exposures, including the exposure to non-cash currency translation impacts related to deferred income taxes denominated in British pounds. Notes 9 and 17 to the financial statements provide data related to derivatives and related accounting policies.

The estimated sensitivity effects below assume that valuations of all items within a risk category will move in tandem. This cannot be assured for exposures involving interest rates, currency exchange rates, petroleum and natural gas.

The hypothetical changes in interest rates, currency exchange rates and prices chosen for the estimated sensitivity effects are generally based upon a review of past fluctuations for each risk category in this disclosure. We caution users of this information that past fluctuations in rates and prices may not necessarily be an indicator of probable future fluctuations, as illustrated by the recent currency crisis in Asia.

Following are disclosures regarding our market risk sensitive instruments by major category. The information has been prepared with all due care in accordance with current requirements of the U.S. Securities and Exchange Commission. We caution investors and other users to avoid simplistic use of these disclosures. Disclosed estimated impacts are based upon Texaco's year-end 1997 risk exposure profile. Users should realize that actual impacts from future interest rate, currency exchange and petroleum and natural gas price movements will likely differ from the disclosed impacts due to ongoing changes in risk exposure levels and concurrent adjustments of hedging derivative positions. Additionally, actual results would be affected by changes in assumed tax rates. It is not possible to accurately predict future movements in interest rates, currency exchange rates, and petroleum and natural gas prices.

DEBT AND DEBT-RELATED DERIVATIVES

Texaco is exposed to interest rate risk on short-term and long-term debt carrying short-term interest rates. The amount of our variable rate debt was approximately $2.0 billion at December 31, 1997, before effects of related interest rate swaps. Under our interest rate exposure management, the company seeks to balance the benefit of the lower cost of debt based on short-term rates, having inherent increased risk, with more expensive fixed rate debt based on long-term rates, having less market risk. This is accomplished through a mix of long-term and short-term debt as well as the use of derivative financial instruments, principally interest rate swaps.

During 1997 and 1996, derivative usage was limited to interest rate swaps, where the company either paid or received the net effect of a fixed rate versus a floating rate. At December 31, 1997, the notional principal amount and fair value of outstanding floating rate pay interest rate swaps were respectively $544 million and a gain of $1 million. The notional principal amount and fair value of outstanding fixed rate pay interest rate swaps were respectively $300 million and a loss of $3 million.

Not included above is a combined interest rate and equity swap with a notional principal amount of $200 million. In this transaction, Texaco pays floating rate and receives fixed rate. The counterparty assumes all risk for the equity-based cash redemption premium on the related hedged debt. The fair value of this swap was not material at year-end 1997.

Based on our overall interest rate exposure on variable rate debt and interest rate swaps at December 31, 1997 (including the interest rate and equity swap), a hypothetical 2% increase or decrease in interest rates would not materially affect the company's consolidated financial position, net income or cash flows. The effect on fair value of the interest rate and equity swap from a $10 per share change in Texaco common share price would not be material.

FOREIGN EXCHANGE AND OPTION CONTRACTS

As an international company, Texaco is exposed to currency exchange risk. To hedge against adverse changes in foreign currency exchange rates, the company enters into forward and option contracts to buy and sell foreign currencies.

The company uses forward exchange contracts to buy and sell foreign currencies primarily to hedge the net monetary liability position of its European, Canadian, Australian, and New Zealand operations, to hedge investments in foreign currency denominated investments in debt and equity securities, and to hedge portions of significant foreign currency capital expenditures and lease commitments.

The effect on fair value of Texaco's forward exchange contracts at year-end 1997 from a hypothetical 10% change in currency exchange rates would be an increase or decrease of approximately $124 million, respectively. This would be offset by an opposite effect on the related hedged exposures.

Outstanding forward exchange contracts at year-end 1997 ($1,239 million net buy contracts) decreased by $444 million from the net year-end 1996 level. The decrease principally resulted from a net decrease related to hedged capital projects and to the termination of British pound forward exchange contracts that hedged the 1997 repurchase of leasehold interests.

PETROLEUM AND NATURAL GAS HEDGING

Texaco hedges a portion of the market risks associated with its crude oil, natural gas and petroleum product purchases, sales and exchange activities. The company uses established petroleum futures exchanges, as well as "over-the-counter" hedge instruments, including futures, options, swaps and other derivative products. These hedge tools reduce the company's exposure to price volatility in the physical markets. Utilizing them establishes margins, costs or revenues for designated transactions as well as for planned future purchases and sales, inventory, production and processing. In carrying out the hedging program, major petroleum and natural gas streams are reviewed for fixed cost, fixed revenue and margin exposure to market price changes. Based on this risk profile, forecasted trends and overall business objectives, we determine appropriate strategies for risk reduction.

For commodity derivatives permitted to be settled in cash or another financial instrument, sensitivity effects are as follows. At year-end 1997, the aggregate effect of a hypothetical 22% change in natural gas prices and a 13% change in crude oil and petroleum product prices would not materially affect Texaco's consolidated financial position, net income or cash flows.

PUBLICLY TRADED INVESTMENTS IN DEBT AND EQUITY SECURITIES

Texaco is subject to price risk on its unhedged portfolio of publicly traded investments in debt and equity securities. These securities were classified as available-for-sale as of year-end 1997 and 1996. The fair value of these securities at December 31, 1997 was approximately $621 million. During 1997, market risk exposure increased approximately $36 million principally due to security purchases. At year-end 1997, a 10% appreciation or depreciation in debt and equity prices would increase or decrease portfolio fair value by approximately $62 million. This assumes no fluctuations in currency exchange rates.

PREFERRED SHARES OF SUBSIDIARIES

Texaco is exposed to interest rate risk on dividend requirements of Series B preferred shares of Texaco Capital LLC. An interest rate swap adjusts the contractual dividend cash requirement to a LIBOR-based floating rate. This swap expires in the year 2007.

Texaco is exposed to currency exchange risk on the Canadian dollar denominated Series C preferred shares of Texaco Capital LLC. Texaco has entered into an interest rate and currency swap contract that matures in the year 2005. That contract fixes the Canadian dollar value (including dividends payable) in U.S. dollars. It also adjusts the fixed-rate dividends to a floating short-term rate.

At December 31, 1997, the total carrying amount and fair value of the two swap contracts was not material.

Based on Texaco's interest rate exposure on the two swaps and the Series B preferred shares at December 31, 1997, a hypothetical 2% increase or decrease in the applicable variable interest rates would not materially affect the company's consolidated financial position, net income or cash flows. This estimate assumes a constant Canadian dollar exchange rate.

Based on Texaco's exposure to foreign currency risk on the Canadian dollar swap and the Series C preferred shares at December 31, 1997, a hypothetical 10% appreciation or depreciation in the Canadian dollar exchange rate would not materially affect the company's consolidated financial position, net income or cash flows. This estimate assumes a constant average floating LIBOR interest rate.

Actual impacts of changes in the Canadian dollar exchange rate and interest rates on contract fair values and after-tax cash flows would be entirely offset by opposite impacts to the fair values and after-tax cash flows related to the hedged Series B and Series C preferred shares.

MARKET AUCTION PREFERRED SHARES (MAPS)

Texaco is exposed to interest rate risk on dividend requirements of MAPS as determined by Dutch auctions, or, as negotiated short-term rates. A hypothetical 2% increase or decrease in interest rates would not materially affect the company's consolidated financial position or cash flows. There are no derivatives related to MAPS.

SELECTED FINANCIAL DATA

TEXACO INC. AND SUBSIDIARY COMPANIES

SELECTED QUARTERLY FINANCIAL DATA

(Millions of dollars)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter 1997	First Quarter	Second Quarter	Third Quarter	Fourth Quarter 1996
Revenues								
Sales and services	$ 11,813	$ 10,983	$ 10,834	$ 11,557	$ 10,059	$ 10,817	$ 10,901	$ 12,784
Equity in income of affiliates, interest, asset sales and other	216	513	259	492	212	444	196	87
	12,029	11,496	11,093	12,049	10,271	11,261	11,097	12,871
Deductions								
Purchases and other costs	9,298	8,671	8,355	8,906	7,782	8,345	8,399	10,117
Operating expenses	716	728	740	806	684	700	721	873
Selling, general and administrative expenses	397	395	427	443	400	399	406	488
Maintenance and repairs	87	84	89	94	88	90	88	101
Exploratory expenses	99	93	114	165	69	90	84	136
Depreciation, depletion and amortization	385	372	388	488	350	354	364	387
Interest expense, taxes other than income taxes and minority interest	261	247	220	272	234	252	253	263
	11,243	10,590	10,333	11,174	9,607	10,230	10,315	12,365
Income before income taxes	786	906	760	875	664	1,031	782	506
Provision for (benefit from) income taxes	(194)	335	270	252	278	342	348	(3)
Net income	$ 980	$ 571	$ 490	$ 623	$ 386	$ 689	$ 434	$ 509
Net income per common share (dollars)								
Basic	$ 1.86	$ 1.07	$ .91	$ 1.15	$ .71	$ 1.30	$ .81	$ .95
Diluted	$ 1.80	$ 1.05	$ .90	$ 1.12	$ .70	$ 1.26	$ .79	$ .93

See accompanying notes to consolidated financial statements.

FIVE-YEAR COMPARISON OF SELECTED FINANCIAL DATA

(Millions of dollars)	1997	1996	1995	1994	1993
For the year:					
Revenues from continuing operations	$ 46,667	$ 45,500	$ 36,787	$ 33,353	$ 34,071
Net income (loss) before cumulative effect of accounting change					
Continuing operations	$ 2,664	$ 2,018	$ 728	$ 979	$ 1,259
Discontinued operations	—	—	—	(69)	(191)
Cumulative effect of accounting change	—	—	(121)	—	—
Net income	$ 2,664	$ 2,018	$ 607	$ 910	$ 1,068
Net income per common share (dollars)					
Basic					
Net income (loss) before cumulative effect of accounting change					
Continuing operations	$ 4.99	$ 3.77	$ 1.29	$ 1.72	$ 2.24
Discontinued operations	—	—	—	(.14)	(.37)
Cumulative effect of accounting change	—	—	(.24)	—	—
Net income	$ 4.99	$ 3.77	$ 1.05	$ 1.58	$ 1.87
Diluted					
Net income from continuing operations	$ 4.87	$ 3.68	$ 1.28	$ 1.72	$ 2.21
Net income	$ 4.87	$ 3.68	$ 1.05	$ 1.58	$ 1.87
Cash dividends per common share (dollars)	$ 1.75	$ 1.65	$ 1.60	$ 1.60	$ 1.60
Total cash dividends paid on common stock	$ 918	$ 859	$ 832	$ 830	$ 828
At end of year:					
Total assets	$ 29,600	$ 26,963	$ 24,937	$ 25,505	$ 26,626
Debt and capital lease obligations					
Short-term	$ 885	$ 465	$ 737	$ 917	$ 669
Long-term	5,507	5,125	5,503	5,564	6,157
Total debt and capital lease obligations	$ 6,392	$ 5,590	$ 6,240	$ 6,481	$ 6,826

See accompanying notes to consolidated financial statements.

INVESTOR INFORMATION

TEXACO INC. AND SUBSIDIARY COMPANIES

SHAREHOLDER COMMUNICATIONS

For information about Texaco or assistance with your account, please contact:

Texaco Inc.
Investor Services
2000 Westchester Avenue
White Plains, NY 10650-0001
Phone: 1-800-283-9785
Fax: (914) 253-6286
E-mail: invest@texaco.com

Security analysts and institutional investors should contact:

Elizabeth P. Smith
Vice President, Texaco Inc.
Phone: (914) 253-4478
Fax: (914) 253-6269
E-mail: smithep@texaco.com

COMMON STOCK – MARKET AND DIVIDEND INFORMATION

Texaco Inc. common stock (symbol TX) is traded principally on the New York Stock Exchange. As of February 26, 1998, there were 212,887 shareholders of record. Texaco's common stock split, two-for-one, effective September 29, 1997. Texaco's common stock price reached a post-split high of $63 7/16, and closed December 31, 1997, at $54 3/8. The stock appreciation, plus quarterly dividends, provided a total return to Texaco shareholders of 14.3% for the year. The dividend was increased by 5.9% in the third quarter of 1997.

	Common Stock Price Range*				Dividends*	
	High	Low	High	Low		
	1997		1996		1997	1996
First Quarter	$ 55 3/4	$ 48 7/8	$ 44 3/8	$ 37 3/4	$ .425	$ .40
Second Quarter	57 7/16	50 1/2	44 1/4	39 7/16	.425	.40
Third Quarter	61 11/16	54 11/32	48 1/16	41 9/16	.45	.425
Fourth Quarter	63 7/16	51 1/8	53 9/16	45 3/4	.45	.425

*Reflects two-for-one stock split, effective September 29, 1997.

STOCK TRANSFER AGENT

Texaco Inc.
Investor Services
2000 Westchester Avenue
White Plains, NY 10650-0001
Phone: 1-800-283-9785
Fax: (914) 253-6286

NY DROP AGENT

ChaseMellon Shareholder Services
120 Broadway – 13th Floor
New York, NY 10271
Phone: (212) 374-2500
Fax: (212) 571-0871

CO-TRANSFER AGENT

Montreal Trust Company
151 Front Street West – 8th Floor
Toronto, Ontario, Canada M5J 2N1
Phone: 1-800-663-9097
Fax: (416) 981-9507

ANNUAL MEETING

Texaco Inc.'s Annual Shareholders Meeting will be held at the Rye Town Hilton, Rye Brook, NY, on Tuesday, April 28, 1998. A formal notice of the meeting, together with a proxy statement and proxy form, is being mailed to shareholders with this report.

INVESTOR SERVICES PLAN

The company's Investor Services Plan offers a variety of benefits to individuals seeking an easy way to invest in Texaco Inc. common stock. Enrollment in the Plan is open to anyone, and investors may make initial investments directly through the company. The Plan features dividend reinvestment, optional cash investments, and custodial service for stock certificates. Texaco's Investor Services Plan is an excellent way to start an investment program for family or friends. For a complete informational package, including a Plan prospectus, call 1-800-283-9785, e-mail at invest@texaco.com, or visit Texaco's Internet home page at www.texaco.com.

PUBLICATIONS FOR SHAREHOLDERS

In addition to the *Annual Report*, Texaco issues several financial and informational publications that are available free of charge to interested shareholders on request from Investor Services at the above address:

***Texaco Inc.'s 1997 Annual Report on Form 10-K* filed with the U.S. Securities and Exchange Commission.**

Financial and Operational Supplement – Comprehensive data on Texaco's 1997 activities.

Equal Opportunity and Texaco: A Report – A description of Texaco's programs that foster equal employment opportunity.

Equality and Fairness Task Force Report – A report prepared pursuant to the settlement in the civil rights action *Roberts v. Texaco Inc.*

Environment, Health and Safety Review – A report on Texaco's programs, policies and results in the areas of corporate responsibility.

TEXACO INC. BOARD OF DIRECTORS

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White Plains, NY

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New York University
New York, NY

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Bush & Company
Washington, DC

WILLARD C. BUTCHER
Former Chairman and
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Chief Operating Officer
The Gillette Company
Boston, MA

FRANKLYN G. JENIFER
President
University of Texas at Dallas
Dallas, TX

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Former Chairman and
Chief Executive Officer
Capital Cities/ABC, Inc.
New York, NY

SAM NUNN
Partner
King & Spalding
Atlanta, GA

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Former Chairman
Mercantile Bank of Kansas City
Kansas City, MO

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Chairman and
Chief Executive Officer
Publishers Clearing House
Port Washington, NY

WILLIAM C. STEERE, JR.
Chairman and
Chief Executive Officer
Pfizer Inc.
New York, NY

THOMAS A. VANDERSLICE
President
TAV Associates
Boston, MA

WILLIAM WRIGLEY
President and
Chief Executive Officer
Wm. Wrigley Jr. Company
Chicago, IL

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EDMUND M. CARPENTER
THOMAS S. MURPHY
CHARLES H. PRICE, II
ROBIN B. SMITH
THOMAS A. VANDERSLICE

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THOMAS S. MURPHY, Chair
All non-employee Directors

AUDIT COMMITTEE

THOMAS A. VANDERSLICE, Chair
JOHN BRADEMAS
MICHAEL C. HAWLEY
FRANKLYN G. JENIFER
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PENSION COMMITTEE

WILLIAM WRIGLEY, Chair
THOMAS S. MURPHY
CHARLES H. PRICE, II
WILLIAM C. STEERE, JR.

COMPENSATION COMMITTEE

WILLARD C. BUTCHER, Chair
EDMUND M. CARPENTER
CHARLES H. PRICE, II
WILLIAM C. STEERE, JR.
THOMAS A. VANDERSLICE

PUBLIC RESPONSIBILITY COMMITTEE

JOHN BRADEMAS, Chair
MICHAEL C. HAWLEY
FRANKLYN G. JENIFER
SAM NUNN
ROBIN B. SMITH
WILLIAM C. STEERE, JR.

FINANCE COMMITTEE

PETER I. BIJUR, Chair
MARY K. BUSH
WILLARD C. BUTCHER
EDMUND M. CARPENTER
CHARLES H. PRICE, II
WILLIAM WRIGLEY

We remember with sorrow and respect Robert A. Beck, who passed away on May 4, 1997. He served as a Director of Texaco Inc. since 1984. His wisdom and guidance contributed greatly to the company's success.

FROM LEFT: Edmund M. Carpenter, Willard C. Butcher (seated), Charles H. Price, II, Mary K. Bush, John Brademas, William Wrigley, Peter I. Bijur, William C. Steere, Jr., Robin B. Smith, Thomas A. Vanderslice (seated), Thomas S. Murphy, Sam Nunn, Franklyn G. Jenifer, Michael C. Hawley

TEXACO INC. OFFICERS

TEXACO INC. AND SUBSIDIARY COMPANIES • ALL INFORMATION AS OF FEBRUARY 26, 1998

CORPORATE OFFICERS

PETER I. BIJUR
Chairman of the Board and
Chief Executive Officer

C. ROBERT BLACK
Senior Vice President

PATRICK J. LYNCH
Senior Vice President and
Chief Financial Officer

JOHN J. O'CONNOR
Senior Vice President
Worldwide Exploration &
Production

GLENN F. TILTON
Senior Vice President
Global Businesses

STEPHEN M. TURNER
Senior Vice President and
General Counsel

WILLIAM M. WICKER
Senior Vice President
Corporate Development

CLARENCE P. CAZALOT, JR.
Vice President
International Production
Europe, Eurasia & Middle East

EUGENE CELENTANO
Vice President
International Marketing &
Manufacturing

DAVID C. CRIKELAIR
Vice President

CARL B. DAVIDSON
Vice President and Secretary

CLAIRE S. FARLEY
Vice President
North America Production

JAMES R. METZGER
Vice President
Corporate Planning & Economics

ROBERT C. OELKERS
Vice President and Comptroller

ELIZABETH P. SMITH
Vice President
Investor Relations &
Shareholder Services

ROBERT A. SOLBERG
Vice President
International Production
Asia, Pacific Rim, West Africa &
Latin America

JANET L. STONER
Vice President
Human Resources

MICHAEL N. AMBLER
General Tax Counsel

JAMES F. LINK
Treasurer

OFFICER ANNOUNCEMENTS

- Allen J. Krowe, Vice Chairman of Texaco Inc., retired on July 1, 1997, after eight years of service. He reached the company's normal retirement age.
- C. Robert Black, Senior Vice President of Texaco Inc., was appointed to the new position of Senior Vice President in the office of the Chairman, effective January 1, 1998.
- William K. Tell, Jr., a Senior Vice President of Texaco Inc., elected to retire, effective January 1, 1998, after 34 years of service.
- William M. Wicker joined the company as a Senior Vice President of Texaco Inc. responsible for Corporate Development, effective August 1, 1997.
- John J. O'Connor joined the company as a Senior Vice President of Texaco Inc. and the President of Worldwide Exploration and Production, effective January 1, 1998.
- Janet L. Stoner was elected a Vice President of Texaco Inc. responsible for Worldwide Human Resources, effective October 1, 1997, succeeding Richard F. Brenner, who elected early retirement.
- Clarence P. Cazalot, Jr., a Vice President of Texaco Inc., was appointed as President, International Production, and Chairman of Texaco Limited, effective January 1, 1998.
- Eugene Celentano, a Vice President of Texaco Inc., was appointed as President, Texaco International Marketing and Manufacturing, effective January 1, 1998.