NATIONAL OILWELL VARCO INC
Form 10-K/A
February 16, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Amendment No. 1 to
FORM 10-K/A

(Mark one)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE YEAR ENDED DECEMBER 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 1-12317

NATIONAL OILWELL VARCO, INC.

(Exact name of registrant as specified in its charter)

Delaware	**76-0475815**
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*

10000 Richmond Avenue
Houston, Texas
77042-4200
(Address of principal executive offices)
(713) 346-7500
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value $.01	**New York Stock Exchange**
(Title of Class)	*(Exchange on which registered)*

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act.

Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

The aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant as of June 30, 2005 was $8.23 billion. As of February 13, 2007, there were 175,735,321 shares of the Company s common stock ($0.01 par value) outstanding.

Documents Incorporated by Reference: None

TABLE OF CONTENTS

Table of Contents

Amendment No. 1 Overview

This Amendment No. 1 on Form 10-K/A is being filed to amend Parts II and IV of our previously filed Annual Report on Form 10-K for the year ended December 31, 2005, as filed on March 6, 2006 (the Original Form 10-K). This Amendment No. 1 is being filed to reflect the following changes in response to a comment letter issued by the Securities and Exchange Commission:

To revise the discussion of certain critical accounting policies to focus on only the policies and estimates that we have determined to be critical and to expand our analysis of those policies;

To provide a reconciliation of certain non-GAAP measures to the most directly comparable GAAP financial measures, which discussion is contained in the supplemental disclosure that provides a comparison of operating results for certain periods as though the Varco acquisition had occurred at the beginning of those periods; and

To replace the term pro forma with the term adjusted in certain places throughout the Management s Discussion and Analysis section.

There are no other significant changes to the Original Form 10-K other than those outlined above. This Amendment No. 1 does not reflect events occurring after the filing of the Original Form 10-K, or modify or update disclosures therein in any way other than as required to reflect the amendment set forth below. Among other things, forward-looking statements made in the Original Form 10-K have not been revised to reflect events that occurred or facts that became known to us after the filing of the Original Form 10-K, and such forward-looking statements should be read in their historical context. In addition, currently-dated certifications from our Chief Executive Officer and Chief Financial Officer have been included as exhibits to this Amendment No. 1.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General Overview

The Company is a leading worldwide provider of highly engineered drilling and well-servicing equipment, products and services to the exploration and production segments of the oil and gas industry. With operations in over 500 locations across six continents, we design, manufacture and service a comprehensive line of drilling and well servicing equipment; sell and rent drilling motors, specialized downhole tools, and rig instrumentation; perform inspection and internal coating of oilfield tubular products; provide drill cuttings separation, management and disposal systems and services; provide expendables and spare parts used in conjunction with our large installed base of equipment; and provide supply chain management services through our distribution network. We also manufacture coiled tubing, provide in-service pipeline inspections, manufacture high pressure fiberglass and composite tubing, and sell and rent advanced in-line inspection equipment to makers of oil country tubular goods. We have a long tradition of pioneering innovations which improve the cost-effectiveness, efficiency, safety, and environmental impact of oil and gas operations.

Our revenues and operating results are directly related to the level of worldwide oil and gas drilling and production activities and the profitability and cash flow of oil and gas companies and drilling contractors, which in turn are affected by current and anticipated prices of oil and gas. Oil and gas prices have been and are likely to continue to be volatile. See Risk Factors . We conduct our operations through three business segments: Rig Technology, Petroleum Services & Supplies and Distribution Services. See Item 1. Business for a discussion of each of these business segments.

Operating Environment Overview

Our results are dependent on, among other things, the level of worldwide oil and gas drilling, well remediation activity, the price of crude oil and natural gas, capital spending by other oilfield service companies and drilling contractors, pipeline maintenance activity, and the worldwide oil and gas inventory levels. Key industry indicators for the past three years include the following:

Table of Contents

	2005*	2004*	2003*	% 2005 vs. 2004	% 2005 vs. 2003
Active Drilling Rigs:					
U.S.	1,381	1,190	1,032	16.1%	33.8%
Canada	458	369	372	24.1%	23.1%
International	908	836	771	8.6%	17.8%
Worldwide	2,747	2,395	2,175	14.7%	26.3%
Active Workover Rigs:					
U.S.	1,354	1,236	1,130	9.5%	19.8%
Canada	654	615	350	6.3%	86.9%
North America	2,008	1,851	1,480	8.5%	35.7%
West Texas Intermediate Crude Prices (per barrel)	$ 56.65	$ 41.44	$ 30.89	36.7%	83.4%
Natural Gas Prices ($/mmbtu)	$ 8.83	$ 5.88	$ 5.49	50.2%	60.8%

* Averages for the years indicated. See sources below.

The following table details the U.S., Canadian, and international rig activity and West Texas Intermediate Oil prices for the three years ended December 31, 2005 on a quarterly basis:

Source: Rig count: Baker Hughes, Inc. (www.bakerhughes.com); West Texas Intermediate Crude Price: Department of Energy, Energy Information Administration (www.eia.doe.gov).

Oil and natural gas prices continued to be strong in 2005. The average price per barrel of West Texas Intermediate Crude reached historic heights in 2005 after rising sharply throughout the first three quarters of 2005. The 2005 average price for the year was the highest ever-annual average oil price for the year of $56.65 per barrel, an increase of 36.7% over the average for 2004. Natural gas prices were $8.83 per mmbtu, an increase of 50.2% compared to the 2004 average. High commodity prices led to stronger rig activity worldwide, increasing 14.7% for the full year in 2005 compared to 2004. However, rig activity in the Gulf of Mexico suffered from two major hurricanes during the third quarter of 2005.

At February 17, 2006 there were 1,545 rigs actively drilling in the U.S., compared to 1,471 rigs at December 31, 2005. The company believes that current industry projections are forecasting commodity prices to remain strong, and, as a result, U.S., Canada, and international drilling rig activity is expected to continue at a high level. However, numerous events could significantly alter these projections including political tensions in the Middle East, the acceleration or deceleration of the recovery of the U.S. and world economies, a build up in the world inventory levels, or numerous other events or circumstances.

Executive Summary

The Company generated earnings of $286.9 million, or $1.81 per fully diluted share, on reported revenues of $4,644.5 for the year ended December 31, 2005.

On March 11, 2005, we merged with Varco. As a result, the reported financial results for 2005 do not incorporate the results of Varco operations prior to the merger. We have presented supplemental estimated adjusted results as if we had been merged with Varco throughout 2004 and 2005. The discussion and analysis below pertain to the results on an as adjusted basis. Additionally, our disclosures since the merger have identified transaction, integration and stock-based compensation charges, including severance, restructuring, equipment and inventory rationalization, and amortization of options issued to replace Varco options. The discussion of the results that follow excludes these items, except where noted.

Oil & Gas Equipment and Services Market

Activity levels and demand for our products and services improved in most of our business segments in 2005. Demand for oil and gas continued to increase during 2005. As a result, oil and gas prices have increased significantly over the past few years, which has led to rising levels of exploration and development drilling in many oil and gas producing basins around the globe. The world-wide rig count, a good indicator of oilfield activity and spending, increased 15 percent in 2005, up for the third consecutive year. Oil and gas companies have increased their levels of investment in new oil and gas wells, to reverse the trend of declining reserves and to grow production to satisfy the rising energy needs of the world. This has led to a level of drilling activity not seen since the early 1980 s, which has, in turn, resulted in steadily rising demand for oilfield services over the last several quarters. Much of the new incremental drilling activity is occurring in harsh environments and employs increasingly sophisticated technology to find and produce reserves.

The rise in demand for drilling rigs has driven rig dayrates the amount a drilling contractor charges per day for the use and operation of a drilling rig sharply higher over the past several quarters, which has increased cash flows and available financing to drilling contractors. Rising dayrates have caused many older drilling rigs to be placed back into service, and we believe that virtually every drilling rig that can operate is now in operation. We have played an important role in providing the equipment, consumables and services needed to reactivate many of these older rigs. Sales of individual drilling components, some of which do not flow through our backlog, generally trended up through the year as contractors reactivated rigs for service.

Table of Contents

Higher utilization of drilling rigs has tested the capability of the world s fleet of rigs, much of which is old and of limited capability compared to newer drilling rigs. Technology has advanced since most of the existing rig fleet was built. The industry invested little during the late 1980 s and 1990 s towards the purchase of new drilling equipment. However, drilling technology progressed steadily, as we and our competitors continued to invest in new and better ways of drilling. As a consequence, the safety, reliability, and efficiency of new, modern rigs surpass the performance of most of the older rigs at work today. Oil and gas producers often demand top performance from drilling rigs, particularly at the premium dayrates that are being paid today. As a result of this trend, we have benefited from increasing demand for new products such as our small iron roughnecks for land rigs, and our LXT BOP s to upgrade certain rig functions to make them safer and more efficient.

Drilling rigs are now being required by contractors to drill deeper wells, more complex wells, highly deviated wells and horizontal wells, which require larger rigs with more capabilities. Higher dayrates magnify the opportunity cost of rig downtime, and rigs are being pushed to maximize revenue days for their drilling contractor owners. The drilling process effectively consumes the mechanical components of a rig, which wear out and need periodic repair or replacement. This process has been accelerated by the high levels of rig utilization seen throughout 2005. In preceding years contractors could cannibalize mechanical components from their idle rigs, rather than purchase new components. As the fleet of idle rigs has dwindled in 2005, the availability of used components has dwindled as well, which has spurred high demand for our rig components.

Changing methods of drilling have further benefited our business. Increasingly, hydraulic horsepower in addition to conventional mechanical rotary power is being used to apply torque to the drill bit. This is done using downhole drilling motors powered by drilling fluids. We are a major provider of downhole drilling motors and have seen demand for this application of our drilling motors increase in 2005. This trend has also increased demand for our high pressure mud pumps, which create the hydraulic horsepower in the drilling fluid which drive the drilling motors.

While the increasingly efficient equipment we provide has mitigated the effect, high activity levels have increased demand for personnel in the oilfield. Consequently, we, our customers and our suppliers have experienced wage inflation in certain markets. Hiring experienced drilling crews has been challenging for the drilling industry; however, we believe crews generally prefer working on newer, safer, more modern rigs. Our products which save labor and increase efficiency also make the rig crew s jobs easier, and make the rig a more desirable place to work. Experienced crews are more likely to perform routine maintenance on rigs, and lapses in maintenance can add additional stress on mechanical drilling machinery. Many of our products ease the routine maintenance of rig components. Additionally, many of our products improve the safety of drilling operations, a very important factor for rig owners and their customers.

Finally, the increase in drilling rig dayrates has made the economics of building new rigs compelling in many markets. For the first time in many years, the industry is actively building land rigs and offshore rigs. Many new offshore rig construction projects were announced throughout 2005, and there are approximately 51 new jackup rigs and 21 new floating rigs being constructed worldwide now. The available supply of offshore rigs declined during the third quarter due to the impact of hurricanes Katrina and Rita, which seriously damaged or sunk several offshore rigs in the Gulf of Mexico.

Segment Performance

Our Rig Technology group has been awarded many new orders for equipment for rigs being constructed or repaired around the world, and we completed 2005 with a record backlog. Backlog nearly tripled over the course of the year to $2.3 billion. We have the capability to supply up to approximately $41 million of equipment for a typical jackup rig, more than $130 million of equipment for a new floating rig, and effectively all of a new land rig, which range in price from less than $1 million to over $20 million. Our strategy targets the high end of the market, emphasizing technology, quality and reliability. Most of the incremental growth in the backlog has been for offshore drilling packages for jackup, semi-submersible and drillship rigs being constructed or undergoing major refurbishment. The delivery of this equipment is typically tied to the construction schedule of the rig, which can take as long as four years to complete. As a result much of our backlog delivery extends well beyond 2006, and we have commissioning and installation work out as far as 2010. We expect to recognize as revenue in 2006 approximately $1.3 billion of our year end $2.3 billion total backlog, but other orders received into backlog in early 2006 may also be recognized as revenue in late 2006.

Adjusted revenues for the Rig Technology group grew $608.1 million or 35 percent, and adjusted operating profit improved $83.4 million in 2005 from the prior year. Group operating profit in 2005 benefited from higher volumes and merger-related cost savings, offset by charges taken on two rigs delivered to Kazakhstan, higher than expected costs on a new kingpost crane design, and higher fourth quarter inventory, legal, and accounts receivable reserves. Rig Technology flow-through or operating leverage defined as the increase in year-over-year adjusted operating profit divided by the increase in year-over-year adjusted revenue was 14 percent.

Table of Contents

However, excluding the fourth quarter reserve increases, the crane costs and Kazakhstan rig charges, the flow-through incremental operating profit divided by incremental revenue was 22 percent, consistent with the our long-term expectations for the Rig Technology segment.

The high oil and gas activity levels discussed above also increased demand for our Petroleum Services & Supplies group. Sales of composite fiberglass pipe, solids control products and services, drilling motors and jars, mud pump expendables, coiled tubing pipe, rig instrumentation equipment and services, and tubular coating and inspection have all benefited from the higher levels of exploration and production investment in drilling and stimulating wells. High demand enabled the group to increase some prices during the year, in roughly the 5 to 10 percent range. The margin impact of price increases was mitigated somewhat by higher costs in many areas. Adjusted revenues increased $407.2 million or 28 percent, and adjusted operating profit increased $110.1 million in 2005 from the prior year. Flow-through of adjusted operating profit was 27 percent, slightly below our long-term expectation of 30 percent. This was due to a sharp year-over-year decline in profitability from pipeline inspection, which experienced a downturn in business in the U.S. in 2005 after very strong results in 2004 due to the timing of a job performed in late 2004 rather than early 2005. Excluding the pipeline results, year-over-year flow through for the Petroleum Services & Supplies group was 30 percent.

Our Distribution Services group also benefited from higher levels of oilfield activity, which has spurred rising demand for the maintenance, repair and operating supplies it furnishes to the petroleum industry. Many oil companies and drilling contractors are outsourcing their purchasing of routine consumable items to the group, which offers greater purchasing power and sophisticated information management techniques. Revenues increased $169.4 million or 19 percent, and operating profit increased 57 percent the results were not affected by the Varco merger, so there are no adjustments. The group benefited from higher sales into international locations, where it has expanded in recent years, and from extensive sales late in the year to the Gulf of Mexico region, to support clean-up efforts following hurricanes Katrina and Rita. Margins benefited from improved expense management and higher supplier rebates on the greater volumes, partly offset by lower margin sales of line pipe. Overall operating margins improved 100 basis points compared to the prior year. Year-over-year flow-through for the Distribution Services segment was 10 percent, consistent with our long-term expectations for the segment.

Outlook

The outlook for the Company in 2006 is positive, as high commodity prices are expected to keep overall oil and gas activity high, and as our backlog for capital equipment sales has nearly tripled since the beginning of 2005. A decline in commodity prices would have an adverse effect on our operations. High levels of drilling across the North America land market and the Middle East, in particular, are expected to continue to drive good results. Although the warm winter across North America has led to seasonally high gas storage levels which have reduced spot gas prices, in the longer term this region faces significant gas deliverability issues. North America has been unable to meaningfully increase gas production despite significantly higher levels of gas drilling over the past few years. Likewise, gas supply disruptions in Europe in recent months have exposed that region s vulnerability to unstable gas supplies. Oil remains subject to significant political risk in many regions as well, and the growth of China and other emerging economies has added significant demand to the oil markets. We expect the high commodity prices that have resulted to sustain very high levels of oilfield activity in 2006, provided the world s major economies remain strong.

Another important factor expected to contribute to our business over the long run is the nature of mature and declining oil and gas fields. As production declines operators often increase drilling, waterflooding, workover and well-stimulation activity to maintain production and cash flow. North America is one of the most mature oil and gas production areas in the world, encompassing nearly 70% of all the rigs working around the world.

We expect to increase our capital spending about 40 percent in 2006, to approximately $170 million, primarily to add rental equipment in our Petroleum Services & Supplies segment. Additionally we plan to add coiled tubing manufacturing capacity, and selectively invest in machining, assembly and fabrication equipment to improve manufacturing efficiency in our Rig Technology group.

Table of Contents

Varco Integration; Acquisitions

Upon the completion of the merger with Varco on March 11, 2005, we commenced our integration activities to achieve merger synergies. The synergies result from, among other things, the reduction of redundant overhead between the companies, and the combining of manufacturing, sales and engineering functions in product lines where the two organizations overlap. Additionally, we have brought in-house the manufacture of certain components that were previously purchased from third party vendors. We continue to rationalize and consolidate products such as top drives, drill pipe racking systems, iron roughnecks, and handling tools, into the most efficient factories, to improve margins. Soon after the merger we announced our expectations of operating profit improvements in the range of $60 million pre-tax on an annualized run rate basis, and that we expected to achieve these results by the end of the first quarter of 2006. While there can be no guarantee that this level will be achieved, we estimated that we achieved $13 million or approximately $52 million annually during the fourth quarter, and expect to achieve our goal of $60 million per year or $15 million per quarter within our originally announced timeframe (excluding merger, transaction, integration, and stock-based compensation costs related to the merger). We may report additional merger, transaction, integration and stock-based compensation charges related to the merger during 2006.

We intend to continue to build and grow our business lines with corporate acquisitions and strategic transactions, consistent with our past strategy. We have acquired businesses in the past to supplement and broaden our offering of oilfield products, to improve our portfolio of technologies, and to obtain operating efficiencies through consolidation of like businesses. We have resumed our acquisition strategy in the second half of 2005 following the merger, and have closed eight transactions since the merger.

Results of Operations

Years Ended December 31, 2005 and December 31, 2004

The following table summarizes the Company s revenue and operating profit by operating segment in 2005 and 2004. The actual results include results from Varco operations from the acquisition date of March 11, 2005 (in millions):

	Years Ended December 31,		Variance	
	2005	2004	$	%
Revenue:				
Rig Technology	$ 2,216.8	$ 1,085.5	$ 1,131.3	104.2%
Petroleum Services & Supplies	1,645.8	505.5	1,140.3	225.6%
Distribution Services	1,074.5	905.1	169.4	18.7%
Eliminations	(292.6)	(178.0)	(114.6)	64.4%
Total Revenue	$ 4,644.5	$ 2,318.1	$ 2,326.4	100.4%
Operating Profit:				
Rig Technology	$ 247.7	$ 102.4	$ 145.3	141.9%
Petroleum Services & Supplies	300.1	62.7	237.4	378.6%
Distribution Services	46.6	29.6	17.0	57.4%
Unallocated expenses and eliminations	(70.3)	(18.7)	(51.6)	275.9%
Integration costs and stock-based compensation	(47.3)		(47.3)	
Total Operating Profit	$ 476.8	$ 176.0	$ 300.8	170.9%
Operating Profit %:				
Rig Technology	11.2%	9.4%		
Petroleum Services & Supplies	18.2%	12.4%		

Distribution Services	4.3%	3.3%
Total Operating Profit %	10.3%	7.6%

Rig Technology

Rig Technology revenue for the year ended December 31, 2005 was $2,216.8 million, an increase of $1,131.3 million (104.2%) compared to 2004. The 2005 Varco acquisition resulted in approximately $767.3 million of additional revenue in 2005. The remainder of the increase can be attributed to the growing market for capital equipment, as evidenced by backlog growth as well as increases in spare parts and service revenue. The increase in orders and backlog can be attributed to increased rig construction projects and higher capital investment by drilling contractors in 2005 as compared to 2004.

Operating profit from Rig Technology was $247.7 million for the year ended December 31, 2005, an increase of $145.3 million (141.9%) over the same period of 2004. The increase in operating profit was primarily related to the acquisition of Varco, offset partially by a second quarter charge of $21.7 million taken on a large Kazakhstan rig fabrication project as a result of additional costs attributed to higher rig-up costs and more material than originally planned.

The Rig Technology group monitors its capital equipment backlog to plan its business. New orders are added to backlog only when we receive a firm customer purchase order for major drilling rig components or a signed contract related to a construction project. The capital equipment backlog was $2.3 billion at December 31, 2005, an increase of $1.5 billion (191.6%) over backlog of $783 million (on an adjusted basis for the Varco acquisition) at December 31, 2004. Substantially all of the current backlog will be delivered by the end of 2007.

Petroleum Services & Supplies

Revenue from Petroleum Services & Supplies was $1,645.8 million for 2005 compared to $505.5 million for 2004, an increase of $1,140.3 million (226%). The majority of the increase is attributable to the addition of product lines acquired from Varco effective March 11, 2005, which totaled $984.8 million for the period. The remaining increase is attributable to high demand for downhole tools and pumping products, which had revenue increases of 28% and 26%, respectively. These increases were the result of strong North America and worldwide drilling markets, as reflected by rig count increases of 18% and 15%, respectively, for 2005 compared to 2004. Petroleum Services & Supplies also benefited from price increases implemented during 2005.

Operating profit from Petroleum Services & Supplies was $300.1 million for 2005 compared to $62.7 million for 2004, an increase of $237.4 million (379%). The majority of the increase was attributable to the addition of product lines acquired from Varco effective March 11, 2005. Operating profit from these product lines was $213.4 million for the period. The remaining increase was attributable to higher profitability from downhole tool sales and rentals, and sales of pumping products which had operating profit dollar increases of 103.6% and 31.3%, respectively.

Distribution Services

Revenue from Distribution Services totaled $1,074.5 million, an increase of $169.4 million (19%) from the prior period. The number of drilling rigs actively searching for oil and gas is a key metric for this business segment. According to the Baker Hughes rig count report, the average number of rigs operating in the world in 2005 was up 14.7% over the prior period. The average rig count in North America in 2005 was up 18.0% over the prior period to 1,839 rigs with our North American revenues up $144.8 million (20%). In the International market, revenues increased 12% while international rig count activity increased by 8.6%. From a product perspective, maintenance, repair and operating supply (MRO) commodities in 2005 experienced a 16% increase over 2004 and significant successive growth in all 4 quarters of 2005. Sales of our manufactured products increased 29% with similar sales escalations during the year. Margins were essentially flat for both MRO and original equipment manufacturer product groups largely due to a large portion of these revenues locked in at committed margin rates to contractual customers. Tubular sales were up 53% concentrated mainly in our Canadian operations.

Operating income increased $17.0 million in 2005 to $46.6 million or 4.3% of revenue. Improved supplier rebates coupled with increased operating efficiencies largely achieved by absorbing the revenue increase across an already established distribution infrastructure and expense base were the main contributors to operating income improvement.

Unallocated expenses and eliminations

Unallocated expenses and eliminations were $70.3 million for the year ended December 31, 2005 compared to $18.7 million for 2004. The increase in operations costs was primarily due to costs associated with Varco operations since the acquisition date and greater inter-segment profit eliminations.

Stock-based compensation

Stock-based compensation expense of $15.6 million for 2005 was related to the amortization of unvested options assumed as a result of the merger.

On February 21, 2006, the Company issued 2,344,000 stock options at an exercise price of $66.58. The Company expects to recognize stock option expense of approximately $40 million in 2006.

Table of Contents

Integration costs
Integration costs were $31.7 million for 2005 and consisted primarily of severance costs related to former executive officers and employees of the Company.
Interest and financial costs
Interest and financial costs were $52.9 million for 2005 compared to $38.4 million for 2004. The increase was primarily due to interest costs associated with debt assumed in the Varco transaction. See summary of outstanding debt at December 31, 2005 under Liquidity and Capital Resources.
Provision for income taxes
The effective tax rate for the fiscal year-ended December 31, 2005 was 32.3% (32.3% excluding integration costs and stock-based compensation associated with the Varco merger) compared to 15.6% for 2004. The lower 2004 tax rate was due primarily to a non-recurring tax credit of $17 million resulting from the release of a valuation allowance related to the American Jobs Creation Act of 2004. The tax rates reflect a lower percentage of earnings in foreign jurisdictions with lower tax rates and reduced benefits in the US associated with export sales in 2005 compared to 2004. The US laws granting this tax benefit were modified as part of the American Jobs Creation Act of 2004 and this benefit will be phased out over the next year. A new tax benefit associated with US manufacturing operations passed into law under the same Act will be phased in over the five years beginning in 2005. Whereas the timing of the phase out of the export tax benefit and the phase in of the manufacturing tax benefit may differ, we expect the tax reduction associated with the new manufacturing deduction, when fully implemented, to be similar in amount to the export benefit. We anticipate our tax rate for 2006 to be in the range of approximately 32% to 34% for continuing operations.
Years Ended December 31, 2004 and December 31, 2003
The following table summarizes the Company s revenue and operating profit by operating segment in 2004 and 2003 (in millions):

	Years Ended December 31,		Variance	
	2004	**2003**	**$**	**%**
Revenue:				
Rig Technology	$ 1,085.5	$ 880.1	$ 205.4	23.3%
Petroleum Services & Supplies	505.5	446.3	59.2	13.3%
Distribution Services	905.1	792.0	113.1	14.3%
Eliminations	(178.0)	(113.5)	(64.5)	56.8%
Total Revenue	$ 2,318.1	$ 2,004.9	$ 313.2	15.6%
Operating Profit:				
Rig Technology	$ 102.4	$ 96.8	$ 5.6	5.8%
Petroleum Services & Supplies	62.7	73.7	(11.0)	(14.9%)
Distribution Services	29.6	6.5	23.1	355.4%
Unallocated expenses and eliminations	(18.7)	(12.9)	(5.8)	45.0%
Total Operating Profit	$ 176.0	$ 164.1	$ 11.9	7.3%
Operating Profit %:				
Rig Technology	9.4%	11.0%		
Petroleum Services & Supplies	12.4%	16.5%		
Distribution Services	3.3%	0.8%		

Total Operating Profit %	7.6%	8.2%

Table of Contents

Operations

Revenues in 2004 were $313.2 million (15.6%) higher than the previous year, while operating profit was up 7.3%. Yearly average oil and gas prices in 2004 were $41.37 and $5.95, an increase of 34% and 8% over 2003. These higher oil and gas prices have encouraged many of our customers to order new capital equipment, or refurbish their existing equipment, generating additional capital equipment revenues in 2004 of $72 million. The number of worldwide rigs actively searching for oil and gas increased approximately 10% in 2004 to a yearly average of 2,395 rigs. This metric is a key driver of our noncapital equipment revenues which were $150 million higher in 2004. Drilling spare parts, expendable pumps and related parts, downhole motors and fishing tools, service work, and Distribution Services all showed significant increases during 2004. Despite the higher revenues and operating profit, operating profit percent margins (down from 8.2% to 7.3%) were negatively impacted by the increase of lower margin capital equipment revenues, higher steel prices during the first half of the year and higher agent commissions. Operating expenses increased primarily due to higher employee benefit costs.

One of our metrics used to plan the business is the capital equipment backlog. New orders are added to backlog only when we receive a firm customer purchase order for major drilling rig components or a signed contract related to a construction project. New orders received in 2004 for capital equipment totaled $961 million, far exceeding the previous year s record of $598 million. The capital equipment backlog was $605 million at December 31, 2004, $339 million at December 31, 2003 and $364 million at December 31, 2002. All of the current backlog will be delivered by the end of 2006.

Unallocated Expenses and Eliminations

Unallocated expenses charges represent the unallocated portion of centralized and executive management costs. Costs for 2004 totaled $18.7 million, an increase of $5.8 million from the prior year. The majority of this increase is due to expenses incurred in conjunction with our efforts to comply with the Sarbanes Oxley Act of 2002 and consulting fees incurred with various tax initiatives.

Interest and Financial Costs

Interest expense incurred in 2004 of $38.4 million was slightly below interest expense of $38.9 million incurred 2003. Our average borrowing cost for the year of 5.6 % was essentially the same as 2003.

Provision for Income Taxes

The Company is subject to U.S. federal, state and foreign taxes and recorded a combined tax rate of 15.6% in 2004 and 29.5% in 2003. The reduction in the 2004 effective tax rate was primarily due to a non-recurring tax credit of $17 million resulting from the release of a valuation allowance related to the American Jobs Creation Act of 2004. The reduction in the 2003 effective tax rate was primarily due to the lower tax rate on increased foreign income and the benefit associated with export sales.

Liquidity and Capital Resources

At December 31, 2005, the Company had cash and cash equivalents of $209.4 million, and total debt of $841.3 million. At December 31, 2004, cash and cash equivalents were $142.7 million and total debt was $500.0 million. The increase in cash holdings and outstanding debt was primarily a result of cash acquired of $163.5 million and debt assumed of $492.8 million related to the Varco acquisition. The Company s outstanding debt at December 31, 2005 consisted of $200.0 million of 5.65% senior notes due 2012, $200.0 million of 7.25% senior notes due 2011, $150.0 million of 6.5% senior notes due 2011, $150.0 million of 5.5% senior notes due 2012, $100.0 million of 7.5% senior notes due 2008, and other debt of $41.3 million. Included in other debt is the fair market value adjustment of the Varco debt assumed in the acquisition, which resulted in additional debt recognition of $29.2 million. The difference is being amortized to interest expense over the remaining life of the debt.

Cash provided by operating activities in 2005 was $77.5 million compared to cash provided by operating activities of $166.2 million in 2004. Cash was used by operations primarily through increases in receivables of $293.9 million, inventories of $215.4 million, and costs in excess of billings of $131.1 million. These negative cash flows were offset by net income of $286.9 million plus non-cash charges of $114.6 million and $29.7 million of tax benefit from the exercise of nonqualified stock options. Receivables and costs in excess of billings increased due to greater revenue and activity in the fourth quarter of 2005 compared to the fourth quarter of 2004, while inventory increased due to growing backlog orders.

8

For the fiscal year-ended 2005, cash provided by investing activities was $38.0 million compared to $6.0 million used for 2004. Cash acquired in the Varco acquisition in the first quarter of 2005 was $163.5 million. Capital spending of $105.0 million was primarily related to rental assets associated with the Company s Petroleum Services & Supplies operations and capital expansion related to increased capacity for manufacturing operations.
For the fiscal year-ended 2005, cash used by financing activities was $40.4 million compared to cash used of $95.3 million in 2004. Cash was used by financing activities through the repayment of the Company s $150 million 6.875% senior notes offset partly by proceeds from exercised stock options of $111.9 million.
The Company s $150 million 6.875% senior notes were repaid on July 1, 2005 using available cash balances. On June 21, 2005, we amended and restated our existing $150 million revolving credit facility with a syndicate of lenders to provide the Company a $500 million unsecured revolving credit facility. The facility will expire in July 2010, and replaces the Company s $175 million North American revolving credit facility and our Norwegian facility. The Company has the right to increase the facility to $750 million and to extend the term of the facility for an additional year. At December 31, 2005, there were no borrowings against this facility, and there were $123 million in outstanding letters of credit. Interest under this multicurrency facility is based upon LIBOR, NIBOR or EURIBOR plus 0.30% subject to a ratings-based grid, or the prime rate.
We believe cash generated from operations and amounts available under the credit facilities and from other sources of debt will be sufficient to fund operations, working capital needs, capital expenditure requirements and financing obligations. We also believe increases in capital expenditures caused by any need to increase manufacturing capacity can be funded from operations or through debt financing.
A summary of the Company s outstanding contractual obligations at December 31, 2005 is as follows (in millions):

		Payment Due by Period			
	Total	**Less than 1 Year**	**2-3 Years**	**4-5 Years**	**After 5 Years**
Total debt	$ 841.3	$ 5.7	$ 111.1	$ 2.7	$ 721.8
Operating leases	198.8	52.8	65.5	35.2	45.3
Total contractual obligations	$ 1,040.1	$ 58.5	$ 176.6	$ 37.9	$ 767.1
Standby letters of credit	$ 262.2	$ 160.2	$ 76.8	$ 25.2	$

We intend to pursue additional acquisition candidates, but the timing, size or success of any acquisition effort and the related potential capital commitments cannot be predicted. While not a contractual obligation, the Company does expect to increase its capital spending approximately 40% in 2006 to a range of $170 million, primarily for rental equipment for its Petroleum Services and Supplies segment. We expect to fund future cash acquisitions and capital spending primarily with cash flow from operations and borrowings, including the unborrowed portion of the credit facility or new debt issuances, but may also issue additional equity either directly or in connection with acquisitions. There can be no assurance that additional financing for acquisitions will be available at terms acceptable to us.
Inflation has had an impact on certain of our operations in recent years. We believe that the higher costs for energy, steel and other commodities experienced in 2005 have largely been mitigated by increased prices and component surcharges for the products we sell. However, higher steel, labor, energy or other commodity prices may adversely impact future periods.

Critical Accounting Estimates

In preparing the financial statements, we make assumptions, estimates and judgments that affect the amounts reported. We periodically evaluate our estimates and judgments that are most critical in nature which are related to revenue recognition under long-term construction contracts; allowance for doubtful accounts; inventory reserves; impairments of long-lived assets (excluding goodwill); goodwill impairment and income taxes. Our estimates are based on historical experience and on our future expectations that we believe are reasonable. The combination of these factors forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results are likely to differ from our current estimates and those differences may be material.

Revenue Recognition under Long-term Construction Contracts

Table of Contents

The Company uses the percentage-of-completion method to account for certain long-term construction contracts in the Rig Technology group. These long-term construction contracts include the following characteristics:

- the contracts include custom designs for customer specific applications;
- the structural design is unique and requires significant engineering efforts; and
- construction projects often have progress payments.

This method requires the Company to make estimates regarding the total costs of the project, progress against the project schedule and the estimated completion date, all of which impact the amount of revenue and gross margin the Company recognizes in each reporting period. The Company prepares detailed cost to complete estimates at the beginning of each project. Significant projects and their related costs and profit margins are updated and reviewed at least quarterly by senior management. Factors that may affect future project costs and margins include shipyard access, weather, production efficiencies, availability and costs of labor, materials and subcomponents and other factors as mentioned in Risk Factors. These factors can impact the accuracy of the Company s estimates and materially impact the Company s future reported earnings.

Historically, the Company s estimates have been reasonably dependable regarding the recognition of revenues and gross profits on percentage of completion contracts, excluding $21.7 million of losses resulting from changes in cost estimates relating to two rigs delivered to Kazakhstan as discussed in Management s Discussion and Analysis of Financial Condition and Results of Operations. Excluding these losses, and based upon an analysis of percentage of completion contracts for all open contracts outstanding at December 31, 2005, 2004, and 2003, adjustments (representing the differences between the estimated and actual results) to all outstanding contracts resulted in changes to gross profit margins of 1.1% ($12.1 million on $1.1 billion of outstanding contracts), 0.9% ($7.3 million on $697.3 million of outstanding contracts), and 2.5% ($6.7 million on $266.8 million of outstanding contracts). While the Company believes that its estimates will continue to be reasonably dependable under percentage of completion accounting, the factors identified in the preceding paragraph could result in significant adjustments in future periods.

Allowance for Doubtful Accounts

The determination of the collectibility of amounts due from customer accounts requires the Company to make judgments regarding future events and trends. Allowances for doubtful accounts are determined based on a continuous process of assessing the Company s portfolio on an individual customer and overall basis. This process consists of a thorough review of historical collection experience, current aging status of the customer accounts, and financial condition of the Company s customers. Based on a review of these factors, the Company will establish or adjust allowances for specific customers and the accounts receivable portfolio as a whole. A substantial portion of the Company s revenues come from international oil companies, international shipyards, international oilfield service companies, and government-owned or government-controlled oil companies. Therefore, the Company has significant receivables in many foreign jurisdictions. If worldwide oil and gas drilling activity or changes in economic conditions in foreign jurisdictions deteriorate, the creditworthiness of the Company s customers could also deteriorate and they may be unable to repay these receivables, and additional allowances could be required. At December 31, 2005 and 2004, allowance for bad debts totaled $17.4 million and $12.8 million, or 1.5% and 2.6% of accounts receivable before the allowance, respectively. The decrease of the allowance for bad debts as a percentage of accounts receivable of 1.1% is primarily due to the 2005 Varco acquisition which resulted in an addition of approximately $385.3 million of accounts receivable recorded at fair value.

Historically, the Company s charge-offs and provisions for the allowance for doubtful accounts have been immaterial to the Company s consolidated financial statements. However, because of the risk factors mentioned above, changes in our estimates could become material in future periods.

Inventory Reserves

Inventory is carried at the lower of cost or estimated net realizable value. The Company determines reserves for inventory based on historical usage of inventory on-hand, assumptions about future demand and market conditions, and estimates about potential alternative uses, which are usually limited. The Company s inventory consists of specialized spare parts, work in process, and raw materials to support ongoing manufacturing operations and the

Company s large installed base of specialized equipment used throughout the oilfield. Customers rely on the Company to stock these specialized items to ensure that their equipment can be repaired and serviced in a timely manner. The Company s estimated carrying value of inventory therefore depends upon demand driven by oil

10

and gas drilling and well remediation activity, which depends in turn upon oil and gas prices, the general outlook for economic growth worldwide, available financing for the Company s customers, and political stability in major oil and gas producing areas, among other factors. At December 31, 2005 and 2004, inventory reserves totaled 4.5% and 6.0% of gross inventory, respectively. Recent high demand and a strong outlook for oilfield equipment sales provide the basis for the Company s December 31, 2005 and 2004 estimates regarding the future usage and realizable value of inventory. The decrease of inventory reserves as a percentage of gross inventory is due primarily to the 2005 Varco acquisition which resulted in the addition of approximately $377.1 million of inventory recorded at fair value, as discussed in Note 3 of the Consolidated Financial Statements.

While inventory reserves and accruals have not had a material impact on the Company s financial results for the periods covered in this report, changes in worldwide oil and gas activity, or the development of new technologies which make older drilling technologies obsolete, could require the Company to record additional allowances to reduce the value of its inventory. Such changes in our estimates could be material under weaker market conditions or outlook.

Impairment of Long-Lived Assets (Excluding Goodwill)

Long-lived assets, which include property, plant and equipment and identified intangible assets, comprise a significant amount of the Company s total assets. The Company makes judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and amortization methods and estimated useful lives.

Additionally, the carrying values of these assets are reviewed for impairment periodically or whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. An impairment loss is recorded in the period in which it is determined that the carrying amount is not recoverable. This requires the Company to make long-term forecasts of its future revenues and costs related to the assets subject to review. These forecasts require assumptions about demand for the Company s products and services, future market conditions and technological developments. The forecasts are dependent upon assumptions regarding oil and gas prices, the general outlook for economic growth worldwide, available financing for the Company s customers, and political stability in major oil and gas producing areas, among other factors. Significant and unanticipated changes to these assumptions or the intended use of these assets could require a provision for impairment in a future period. There have been no impairment charges of long-lived assets for the years ended December 31, 2005, 2004, and 2003.

Goodwill Impairment

The Company recorded approximately $2.1 billion of goodwill on its consolidated balance sheet as of December 31, 2005. Generally accepted accounting principles require the Company to test goodwill for impairment on an annual basis or whenever events or circumstances occur indicating that goodwill might be impaired. Events or circumstances which could indicate a potential impairment of goodwill could include (but are not limited to) a significant reduction in worldwide oil and gas prices or drilling; a significant reduction in profitability or cash flow of oil and gas companies or drilling contractors; a significant reduction in worldwide well remediation activity; a significant reduction in capital investment by other oilfield service companies; or a significant increase in worldwide inventories of oil or gas. The timing and magnitude of any goodwill impairment charge, which could be material, would depend on the timing and severity of the event or events triggering the charge and would require a high degree of management judgment.

The Company performs a review of goodwill for impairment annually or earlier if indicators of potential impairment exist. The annual impairment tests are performed during the fourth quarter of each year. If it is determined that goodwill is impaired, that impairment is measured based on the amount by which the book value of goodwill exceeds its implied fair value. The implied fair value of goodwill and identified intangibles is determined by deducting the fair value of a reporting unit s identifiable assets and liabilities from the fair value of that reporting unit as a whole. Additional impairment assessments may be performed on an interim basis if the Company encounters events or changes in circumstances that would indicate that, more likely than not, the carrying amount of goodwill and identified intangibles has been impaired. Fair value of the reporting units is determined based on internal management estimates, using a combination of three methods: discounted cash flow, comparable companies, and representative transactions. Changes in the assumptions used in the fair value calculation could result in an estimated reporting unit fair value that is below the carrying value, which may give rise to an impairment of goodwill. The Company had no impairment of goodwill for the years ended December 31, 2005, 2004, and 2003.

Income Taxes

The Company is a US registered company and is subject to income taxes in the US. The Company operates through various subsidiaries in a number of countries throughout the world. Income taxes have been provided based upon the tax laws and rates of the countries in which the Company operates and income is earned.

The Company s annual tax provision is based on expected taxable income, statutory rates and credits and deductions available in the various jurisdictions in which it operates. The determination and evaluation of the annual tax provision and tax positions involves the interpretation of the tax laws in the various jurisdictions in which the Company operates. It requires significant judgment and the use of estimates and assumptions regarding significant future events such as the amount, timing and character of income, deductions and tax credits. Changes in tax laws, regulations, and treaties, foreign currency exchange restrictions or the Company s level of operations or profitability in each jurisdiction could impact the tax liability in any given year. The Company also operates in many jurisdictions where the tax laws relating to the pricing of transactions between related parties are open to interpretation, which could potentially result in aggressive tax authorities asserting additional tax liabilities with no offsetting tax recovery in other countries.

The Company maintains liabilities for estimated tax exposures in jurisdictions of operation. The annual tax provision includes the impact of income tax provisions and benefits for changes to liabilities that the Company considers appropriate, as well as related interest. Tax exposure items primarily include potential challenges to intercompany pricing and certain tax credits which may not ultimately be sustained. These exposures are resolved primarily through the settlement of audits within these tax jurisdictions or by judicial means. The Company is subject to audits by federal, state and foreign jurisdictions which may result in proposed assessments. The Company believes that an appropriate liability has been established for estimated exposures under the guidance in Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies. However, actual results may differ materially from these estimates. The Company reviews these liabilities quarterly and to the extent audits or other events result in an adjustment to the liability accrued for a prior year, the effect will be recognized in the period of the event.

The Company currently has recorded valuation allowances that the Company intends to maintain until it is more likely than not the deferred tax assets will be realized. Other than valuation allowances associated with tax attributes acquired through acquisitions, income tax expense recorded in the future will be reduced to the extent of decreases in the Company s valuation allowances. The realization of remaining deferred tax assets is primarily dependent on future taxable income. Any reduction in future taxable income including but not limited to any future restructuring activities may require that the Company record an additional valuation allowance against deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in such period and could have a significant impact on future earnings. If a change in a valuation allowance occurs, which was established in connection with an acquisition, such adjustment may impact goodwill rather than the income tax provision.

As the result of current period earnings and changes in estimates of future taxable income in certain tax jurisdictions, the Company recognized a decrease of $18.6 million in goodwill during the fourth quarter of 2005 related to the reversal of a valuation allowance associated with net operating loss carryovers acquired in the February 28, 2000 acquisition of Hitec, AS.

The Company has not provided for deferred taxes on the unremitted earnings of certain subsidiaries that are permanently reinvested. Should the Company make a distribution from the unremitted earnings of these subsidiaries, the Company may be required to record additional taxes. Unremitted earnings of these subsidiaries were $441.4 million and $299.9 million at December 31, 2005 and 2004. The Company makes an annual determination whether to permanently reinvest these earnings. If, as a result of these reassessments, the company distributes these earnings in the future, additional tax liability would result, offset by any available foreign tax credits.

The Company does not believe it is possible to reasonably estimate the potential impact of changes to the assumptions and estimates identified because the resulting change to our tax liability, if any, is dependent on numerous factors which cannot be reasonably estimated. These include, among others, the amount and nature of additional taxes potentially asserted by local tax authorities; the willingness of local tax authorities to negotiate a fair settlement through an administrative process; the impartiality of the local courts; and the potential for changes in the tax paid to one country to either produce, or fail to produce, an offsetting tax change in other countries.

Recently Issued Accounting Standards

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs an amendment of ARB 43, Chapter 4 (SFAS 151). SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. Paragraph 5 of Accounting Research Bulletin (ARB) 43, Chapter 4 Inventory Pricing, previously stated that under certain circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs

12

may be so abnormal as to require treatment as current-period charges. SFAS 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, SFAS 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for fiscal years beginning after June 15, 2005. We do not believe the implementation of SFAS 151 will have a material impact on our financial position, results of operations or cash flows.

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107 which expressed the views of the SEC regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations. SAB No. 107 provides guidance related to the valuation of share-based payment arrangements for public companies, including assumptions such as expected volatility and expected term. We are assessing the impact SFAS No. 123(R) and SAB No. 107 will have on our consolidated financial statements and which transition methods allowed by SFAS No. 123(R) will be elected. In April 2005, the SEC approved a rule that delayed the effective date of SFAS No. 123(R) for public companies. As a result, SFAS No. 123(R) will be effective for us on January 1, 2006.

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, (FIN 47) which clarifies when an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation. FIN 47 will be effective for fiscal years ending after December 15, 2005, with earlier adoption encouraged. We are currently evaluating the impact this interpretation may have on our financial position, results of operations or cash flows.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections (SFAS 154), which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS 154 requires a voluntary change in accounting principle to be applied retrospectively to all prior period financial statements so that those financial statements are presented as if the current accounting principle had always been applied. SFAS 154 is effective for accounting changes and correction of errors made after January 1, 2006, with early adoption permitted. We do not expect the adoption of SFAS 154 to have a material impact on our financial position, results of operations or cash flows.

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), which originally required implementation for interim or annual reporting periods beginning after June 15, 2005. However, in April 2005, the SEC adopted a new rule to amend the compliance date to the beginning of the Company s next fiscal year, January 1, 2006. SFAS 123R requires us to recognize the cost of employee services received in exchange for the company s equity instruments. Currently, in accordance with APB Opinion 25, we record the intrinsic value of stock based compensation as expense. Accordingly, no compensation expense is currently recognized for fixed stock option plans, except as described in Notes 2 and 3 related to the Varco Merger, as the exercise price equals the stock price on the date of grant. Under SFAS 123R, we will be required to measure compensation expense over the options vesting period based on the stock options fair value at the date the options are granted and classify the tax benefit from the exercise of nonqualified stock options as a financing activity in the statement of cash flow. SFAS 123R allows for the use of the Black-Scholes or a lattice option-pricing model to value such options. We will use the Black-Scholes option-pricing model to calculate the fair value of the options. We have elected to adopt SFAS 123R on a modified prospective basis. Note 2 illustrates the effects on net income and earnings per share if we had adopted SFAS 123R using the Black-Scholes option-pricing model.

Forward Looking Statements

Some of the information in this document contains, or has incorporated by reference, forward-looking statements. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements. Forward-looking statements typically are identified by use of terms such as may, will, expect, anticipate, estimate, and similar words, although some forward-looking statements are expressed differently. You should be aware that our actual results could differ materially from results anticipated in the forward-looking statements due to a number of factors, including but not limited to changes in oil and gas prices, customer demand for our products and worldwide economic activity. You should also consider carefully the statements under Risk Factors which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements. Given these uncertainties, current or prospective investors are cautioned not to place undue reliance on any such forward-looking statements. We undertake no obligation to update any such factors or forward-looking statements to reflect future events or developments.

Table of Contents

Supplemental Adjusted Comparison of Operating Results

The Company believes that reporting revenue and operating profit as if the Varco acquisition occurred at the beginning of each period presented provides useful supplemental information regarding the Company s on-going economic performance and, therefore, uses these financial measures internally to evaluate and manage the Company s operations. The Company has chosen to provide this information to investors to enable them to perform more meaningful comparisons of operating results and as a means to emphasize the results of on-going operations.

The following table reconciles the GAAP Business Segment financial results to the Adjusted Results of the Company for the Varco acquisition (in millions):

	GAAP Results As Reported	January 1, 2005 to March 10, 2005 Varco Results Historical	Adjustments	Adjusted Results
Year ended December 31, 2005:				
Revenue:				
Rig Technology	$ 2,216.8	$ 118.9	$	$ 2,335.7
Petroleum Services & Supplies	1,645.8	192.9		1,838.7
Distribution Services	1,074.5			1,074.5
Eliminations	(292.6)		(3.9)(1)	(296.5)
Total Revenue	$ 4,644.5	$ 311.8	$ (3.9)	$ 4,952.4
Operating Profit:				
Rig Technology	$ 247.7	$ 16.4	$	$ 264.1
Petroleum Services & Supplies	300.1	28.5		328.6
Distribution Services	46.6			46.6
Unallocated expenses and eliminations	(70.3)	(7.6)	(3.6)(2)	(81.5)
Integration costs and stock-based compensation	(47.3)		47.3 (3)	
Total Operating Profit	$ 476.8	$ 37.3	$ 43.7	$ 557.8

	GAAP Results As Reported	Fiscal Year End 2004 Varco Results Historical	Adjustments	Adjusted Results
Year ended December 31, 2004:				
Revenue:				
Rig Technology	$ 1,085.5	$ 642.1	$	$ 1,727.6
Petroleum Services & Supplies	505.5	926.0		1,431.5
Distribution Services	905.1			905.1
Eliminations	(178.0)			(178.0)

Total Revenue	$	2,318.1	$	1,568.1	$		$	3,886.2
Operating Profit:								
Rig Technology	$	102.4	$	78.3	$		$	180.7
Petroleum Services & Supplies		62.7		155.8				218.5
Distribution Services		29.6						29.6
Unallocated expenses and eliminations		(18.7)		(35.7)		(3.3)(4)		(57.7)
Total Operating Profit	$	176.0	$	198.4	$	(3.3)	$	371.1

(1) The $3.9 million is 2005 pre-merger sales between National-Oilwell and Varco.

(2) The $3.6 million is comprised of $1.7 million of 2005 pre-merger cost-of-sales between National-Oilwell and Varco and $1.9 million of estimated depreciation/amortization step-up related to the Varco acquisition.

(3) The $47.3 million is comprised of $31.7 million of integration costs and $15.6 million of stock-based compensation, both directly related to the Varco acquisition.

(4) The $3.3 million adjustment includes $10.2 million of estimated depreciation/amortization step-up related to the Varco acquisition. The adjustment also excludes certain items included in the Varco results, comprised of $5.0 million of integration costs related to the merger, $5.7 million of

non-merger Rig
Technology restructuring
costs, and a $3.8 million
non-merger gain related
to a settlement of
insurance litigation.

Table of Contents

Rig Technology

Revenue on an adjusted basis from Rig Technology was $2.3 billion for 2005, an increase of $608.1 million (35.2%) compared to 2004. The increase can be attributed to the growing market for capital equipment, as evidenced by backlog growth, as well as increases in spare parts and service revenue. The increase in orders and backlog can be attributed to increased rig construction projects and higher capital investment by drilling contractors in 2005 as compared to 2004. Operating profit from Rig Technology was $264.1 million for the for the year ended December 31, 2005, an increase of $83.4 million (46.2%) over 2004, primarily as result of the increase in business activity discussed above, partially offset by the second quarter charge of $21.7 million taken on a large Kazakhstan rig fabrication project as a result of additional costs attributed to higher rig-up costs and more material than originally planned. Additionally, the group was adversely affected by inventory, legal, allowance for doubtful accounts charges, and charges on a crane order, which totaled $10.5 million in 2005.

Petroleum Services & Supplies

Revenue on an adjusted basis from Petroleum Services & Supplies was $1,838.7 million for 2005 compared to $1,431.5 million for 2004, an increase of $407.2 million (28.4%). The increase is attributable to a significant increase in North America and worldwide drilling activity, price increases implemented during 2005, strong spare parts and consumable sales to support increased drilling and acquisitions made in 2004 and 2005. The revenue increase attributable to acquisitions is approximately $17.6 million. Operating profit on an adjusted basis for Petroleum Services & Supplies was $328.6 million for 2005 compared to $218.5 million for 2004, an increase of $110.1 million (50.4%). Improved results were posted across all product line with the exception of pipeline inspection.

Distribution Services

Results for Distribution Services on an adjusted basis are the same as they are for actual. See discussion above regarding Distribution Services.

Unallocated expenses and eliminations

Unallocated expenses and eliminations on an adjusted basis were $81.5 million for 2005 compared to $57.7 million for 2004. The increase in unallocated operating costs was due to greater inter-segment profit eliminations, cost increases associated with complying with Sarbanes-Oxley legislation, and greater legal costs, offset by corporate overhead consolidation savings. The 2004 unallocated expenses and eliminations amounts benefited from several miscellaneous credits, including litigation recoveries, insurance recoveries, the expiration of an excise tax accrual, and other items which did not recur in 2005.

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Financial Statements and Exhibits

(1) Financial Statements

The following financial statements were presented in response to Part II, Item 8 on our Original 10-K:

Consolidated Balance Sheets
Consolidated Statement of Income
Consolidated Statements of Cash Flows
Consolidated Statements of Stockholders Equity and Comprehensive Income
Notes to Consolidated Financial Statements

(2) Financial Statement Schedule

Schedule II Valuation and Qualifying Accounts

All schedules, other than Schedule II, are omitted because they are not applicable, not required or the information is included in the financial statements or notes thereto.

(3) Exhibits

2.1	Amended and Restated Agreement and Plan of Merger, effective as of August 11, between National-Oilwell, Inc. and Varco International, Inc. (4).
3.1	Amended and Restated Certificate of Incorporation of National-Oilwell, Inc. (Exhibit 3.1) (1).
3.2	Amended and Restated By-laws of National Oilwell Varco, Inc. (Exhibit 3.2) (7).
10.1	Employment Agreement dated as of January 1, 2002 between Merrill A. Miller, Jr. and National Oilwell. (Exhibit 10.1) (2).
10.2	Employment Agreement dated as of January 1, 2002 between Dwight W. Rettig and National Oilwell, with similar agreements with Kevin A. Neveu and Mark A. Reese. (Exhibit 10.2) (2).
10.3	Form of Amended and Restated Executive Agreement of Clay C. Williams and Haynes Smith. (Exhibit 10.12) (3).
10.4	National Oilwell Varco Long-Term Incentive Plan (5)*.
10.5	Form of Employee Stock Option Agreement (Exhibit 10.1) (8).
10.6	Form of Non-Employee Director Stock Option Agreement (Exhibit 10.2) (8).
10.7	Amended and Restated Credit Agreement, dated as of June 21, 2005, among National Oilwell Varco, Inc., the financial institutions signatory thereto, including Wells Fargo Bank, National Association, in their capacities as lenders thereunder, as US administrative agent for the lenders, as Lead Arranger and Sole Book Runner, DnB NOR Bank ASA, as Norwegian Administrative Agent, DnB NOR Bank ASA and the Bank of Nova Scotia as Co-Documentation Agents, and Comerica Bank and JPMorgan Chase Bank, N.A. as Co-Syndication Agents. (Exhibit 10.1) (6).
21.1	Subsidiaries of the Registrant (9).
23.1	Consent of Ernst & Young LLP (9).

24.1	Power of Attorney (9).

Table of Contents

31.1	Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended.
31.2	Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended.
32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (9).
32.2	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (9).

* Compensatory plan or arrangement for management or others

(1) Filed as an Exhibit to our Quarterly Report on Form 10-Q filed on August 11, 2000.

(2) Filed as an Exhibit to our Annual Report on Form 10-K filed on March 28, 2002.

(3) Filed as an Exhibit to Varco International, Inc. s Quarterly Report on Form 10-Q filed on May 6, 2004.

(4) Filed as Annex A to our Registration Statement on Form S-4 filed on September 16, 2004.

(5) Filed as Annex D to our Amendment No. 1 to Registration Statement on Form S-4 filed on January 31, 2005.

(6) Filed as an Exhibit to our Current Report on Form 8-K filed on June 23, 2005.

(7) Filed as an Exhibit to our Current Report on Form 8-K filed on November 18, 2005.

(8) Filed as an Exhibit to our Current Report on Form 8-K filed on February 23, 2006.

(9) Previously filed as an Exhibit to our Annual Report on Form 10-K filed on March 8, 2006.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	NATIONAL OILWELL VARCO, INC.
Dated: February 16, 2007	By: /s/ Merrill A. Miller, Jr.
	Merrill A. Miller, Jr. Chairman, President and Chief Executive Officer

Table of Contents

EXHIBIT INDEX

2.1	Amended and Restated Agreement and Plan of Merger, effective as of August 11, between National-Oilwell, Inc. and Varco International, Inc. (4).
3.1	Amended and Restated Certificate of Incorporation of National-Oilwell, Inc. (Exhibit 3.1) (1).
3.2	Amended and Restated By-laws of National Oilwell Varco, Inc. (Exhibit 3.2) (7).
10.1	Employment Agreement dated as of January 1, 2002 between Merrill A. Miller, Jr. and National Oilwell. (Exhibit 10.1) (2).
10.2	Employment Agreement dated as of January 1, 2002 between Dwight W. Rettig and National Oilwell, with similar agreements with Kevin A. Neveu and Mark A. Reese. (Exhibit 10.2) (2).
10.3	Form of Amended and Restated Executive Agreement of Clay C. Williams and Haynes Smith. (Exhibit 10.12) (3).
10.4	National Oilwell Varco Long-Term Incentive Plan (5)*.
10.5	Form of Employee Stock Option Agreement (Exhibit 10.1) (8).
10.6	Form of Non-Employee Director Stock Option Agreement (Exhibit 10.2) (8).
10.7	Amended and Restated Credit Agreement, dated as of June 21, 2005, among National Oilwell Varco, Inc., the financial institutions signatory thereto, including Wells Fargo Bank, National Association, in their capacities as lenders thereunder, as US administrative agent for the lenders, as Lead Arranger and Sole Book Runner, DnB NOR Bank ASA, as Norwegian Administrative Agent, DnB NOR Bank ASA and the Bank of Nova Scotia as Co-Documentation Agents, and Comerica Bank and JPMorgan Chase Bank, N.A. as Co-Syndication Agents. (Exhibit 10.1) (6).
21.1	Subsidiaries of the Registrant (9).
23.1	Consent of Ernst & Young LLP (9).
24.1	Power of Attorney (9).
31.1	Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended.
31.2	Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended.
32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (9).
32.2	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (9).

* Compensatory plan or

arrangement for
management or
others

(1) Filed as an Exhibit to our Quarterly Report on Form 10-Q filed on August 11, 2000.

(2) Filed as an Exhibit to our Annual Report on Form 10-K filed on March 28, 2002.

(3) Filed as an Exhibit to Varco International, Inc. s Quarterly Report on Form 10-Q filed on May 6, 2004.

(4) Filed as Annex A to our Registration Statement on Form S-4 filed on September 16, 2004.

(5) Filed as Annex D to our Amendment No. 1 to Registration Statement on Form S-4 filed on January 31, 2005.

(6) Filed as an Exhibit to our Current Report on Form 8-K filed on June 23, 2005.

(7) Filed as an Exhibit to our Current Report on Form 8-K filed on November 18, 2005.

(8) Filed as an Exhibit to our Current Report on Form 8-K filed on February 23, 2006.

(9) Previously filed as an Exhibit to our Annual Report on Form 10-K filed on March 8, 2006.