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

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

(Mark one)

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

FOR THE QUARTER ENDED MARCH 31, 2006

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)	*(I.R.S. 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)

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition 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

As of February 13, 2007, 175,735,321 common shares were outstanding.

TABLE OF CONTENTS

Table of Contents

Amendment No. 1 Overview

This Amendment No. 1 on Form 10-Q/A is being filed to amend Parts I and II of our previously filed Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, as filed on May 9, 2006 (the Original Form 10-Q). 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 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;

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

- To incorporate certain exhibits in our exhibit list.

There are no other significant changes to the Original Form 10-Q other than those outlined above. This Amendment No. 1 does not reflect events occurring after the filing of the Original Form 10-Q, 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-Q have not been revised to reflect events that occurred or facts that became known to us after the filing of the Original Form 10-Q, 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.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Introduction

National Oilwell Varco is a worldwide leader in the design, manufacture and sale of equipment and components used in oil and gas drilling and production, the provision of oilfield services, and supply chain integration services to the upstream oil and gas industry. The following describes our business segments:

Rig Technology

Our Rig Technology segment designs, manufactures, sells and services complete systems for the drilling, completion, and servicing of oil and gas wells. The segment offers a comprehensive line of highly-engineered equipment that automates complex well construction and management operations, such as offshore and onshore drilling rigs; derricks; pipe lifting, racking, rotating and assembly systems; coiled tubing equipment and pressure pumping units; well workover rigs; wireline winches; and cranes. Demand for Rig Technology products is primarily dependent on capital spending plans by drilling contractors, oilfield service companies, and oil and gas companies, and secondarily on the overall level of oilfield drilling activity, which drives demand for spare parts for the segment s large installed base of equipment. We have made strategic acquisitions and other investments during the past several years in an effort to expand our product offering and our global manufacturing capabilities, including new operations in Canada, Norway, the United Kingdom, China, and Belarus.

Petroleum Services & Supplies

Our Petroleum Services & Supplies segment provides a variety of consumable goods and services used to drill, complete, remediate and workover oil and gas wells and service pipelines, flowlines and other oilfield tubular goods. The segment manufactures, rents and sells a variety of products and equipment used to perform drilling operations, including transfer pumps, solids control systems, drilling motors and other downhole tools, rig instrumentation systems, and mud pump consumables. Demand for these services and supplies is determined principally by the level of oilfield drilling and workover activity by drilling contractors, major and independent oil and gas companies, and national oil companies. Oilfield tubular services include the provision of inspection and internal coating services and equipment for drillpipe, linepipe, tubing, casing and pipelines; and the design, manufacture and sale of coiled tubing pipe and advanced composite pipe for application in highly corrosive environments. The segment sells its tubular goods and services to oil and gas companies; drilling contractors; pipe distributors, processors and manufacturers; and pipeline operators. This segment has benefited from several strategic acquisitions and other investments completed during the past few years, including operations in Canada, the United Kingdom, China, Kazakhstan, and Mexico.

Distribution Services

Our Distribution Services segment provides maintenance, repair and operating supplies and spare parts to drill site and production locations worldwide. In addition to its comprehensive network of field locations supporting land drilling operations throughout North America, the segment supports major offshore drilling contractors through locations in the Middle East, Europe, Southeast Asia and South America. Distribution Services employs advanced information technologies to provide complete procurement, inventory management and logistics services to its customers around the globe. Demand for the segment s services are determined primarily by the level of drilling and servicing activity, and oil and gas production activities.

Executive Summary

For the first quarter of 2006, National Oilwell Varco generated earnings of $120.3 million, or $0.68 per fully diluted share, on reported revenues of $1,511.8 million. These results include $6.8 million in pre-tax options expense charges ($0.03 per share after tax) related to the Company s adoption of SFAS 123(R), and $7.9 million in pre-tax charges ($0.03 per share after tax) related to the Company s integration of the operations of Varco.

The Company underwent a major transformation on March 11, 2005, when National Oilwell and Varco merged. As a result, the reported financial results for 2005 do not include the 70 days of Varco operations prior to the merger. The Company has presented supplemental unaudited adjusted results as if Varco and National Oilwell had been merged throughout 2004 and 2005, to better identify trends in our businesses and provide more meaningful

Table of Contents

comparison. The discussion and analysis below pertain to the results on this adjusted basis, which the Company tends to look at internally to evaluate results. Additionally, the Company s disclosures since the merger have identified transaction, integration and stock-based compensation charges, including items such as severance, restructuring, equipment and inventory rationalization, amortization of options issued to replace Varco options, and write-offs of discontinued product lines related to the merger. The discussion of the results that follow generally excludes these items, except where noted, in order to better identify trends in our business and provide more meaningful comparison. The Company tends to review its results internally using this same methodology.

Oil & Gas Equipment and Services Market

Activity levels and demand for our products and services continued to improve in most of our markets during the first quarter of 2006. Recovering economies of developed nations, and the desire for improved standards of living among many in developing nations, have increased demand for oil and gas. 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 basins around the globe. The world-wide rig count, a good indicator of oilfield activity and spending, increased three percent from the fourth quarter of 2005 and 15 percent from the first quarter of 2005. 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 sharply higher over the past several quarters, which has increased cash flows and available financing to drilling contractors. Rising dayrates have caused many older rigs to be placed back into service, and we believe virtually every drilling rig that can operate is now working. The Company has played an important role in providing the equipment, consumables and services needed to reactivate many of these older rigs. Sales of individual drilling components have generally trended up over the past several quarters as operators reactivated rigs for service.

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. Technology has advanced significantly since most of the existing rig fleet was built. The industry invested little during the late 1980 s and 1990 s on new drilling equipment, but drilling technology progressed steadily nonetheless, as the Company and its 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 demand top performance from drilling rigs, particularly at the premium dayrates that are being paid today. As a result of this trend, the Company has benefited from incremental demand for new products (such as our small iron roughnecks for land rigs, our LXT BOP s, our Safe-T-Lite pump liner systems, among others) to upgrade certain rig functions to make them safer and more efficient.

Drilling rigs are now being pushed to drill deeper wells, more complex wells, highly deviated wells and horizontal wells, tasks 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. We believe this process has been accelerated by the high levels of rig utilization seen over the past several quarters. 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, the availability of used components has dwindled as well, which has spurred incremental demand for rig components from the Company.

Changing methods of drilling have further benefited the Company s business. Increasingly, hydraulic power 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. The Company is a major provider of downhole drilling motors, and has seen demand for this application of its drilling motors increase over the last several quarters. This trend has also increased demand for the Company s high pressure mud pumps, which create the hydraulic power in the drilling fluids which drive the drilling motors.

While the increasingly efficient equipment provided by the Company has mitigated the effect, high activity levels have increased demand for personnel in the oilfield. Consequently, the Company, its customers and its suppliers have experienced wage inflation in certain markets. Hiring experienced drilling crews has been challenging for the drilling industry; however, the Company believes crews generally prefer working on newer, more modern rigs. The Company s products which save labor and increase efficiency (such as its automatic slips and pipe handling equipment) also make the rig crew s jobs easier, and make the rig a more desirable place to work.

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 62 new jackup rigs and 27 new floating rigs being constructed worldwide now. The available supply of offshore rigs declined during the third quarter of 2005 due to the impact of hurricanes Katrina and Rita, which seriously damaged or sunk several offshore rigs in the Gulf of Mexico.

Segment Performance

The Company s Rig Technology group has been awarded many new orders for equipment for rigs being constructed or repaired around the world, and it completed the first quarter with a record backlog of $3,186.2 million as a result. New orders for capital equipment in to backlog were a record $1,308.1 million in the first quarter, a 39 percent increase from the fourth quarter of 2005. The company has the capability to supply up to approximately $48 million of equipment for a typical jackup rig, more than $150 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 well 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 the Company has commissioning and installation work out as far as 2010. The Company expects to generate revenue of approximately $1.8 to $2.0 billion out of backlog during 2006. Currently approximately 78 percent of the drilling equipment in backlog is for offshore rigs, and 69 percent of the backlog is destined for international locations.

First quarter revenues for the Rig Technology group were $715.3 million, up 11 percent from the fourth quarter of 2005 and up 32 percent from the adjusted first quarter of 2005. Operating profit was $100.8 million or 14.1 percent of sales in the first quarter of 2006, compared to $80.5 million or 12.5 percent of sales in the fourth quarter of 2005 and $61.3 million or 11.3 percent of sales in the adjusted first quarter of 2005 (excluding merger, transaction and stock-based compensation from both periods, and including Varco results for the period prior to the closing of the merger). Operating flow-through or leverage (the period-to-period increase in operating profit divided by the increase in revenue) was 29 percent from the fourth quarter of 2005 to the first quarter of 2006, excluding merger, transaction and stock-based compensation from both periods. First quarter operating profit benefited from higher volumes, improving pricing, and merger-related cost savings partly offset by higher employee benefit costs and higher costs associated with purchased components. With record backlogs and improving efficiency our outlook for this business for the remainder of 2006 continues to be very good, but the nature of capital equipment shipments will continue to make quarter-to-quarter revenue changes volatile. We continue to expect normal long-term flowthroughs of 22% for this group, and hope to achieve 15 percent operating margins in the second quarter of 2006, driven by higher pricing and volumes.

The high oil and gas activity levels discussed above also increased demand for the Company s Petroleum Services & Supplies group. The segment posted very good results for the first quarter of 2006, generating $541.0 million in revenue and $118.3 million in operating profit, or 21.9 percent operating margin. Sequential revenue growth from the fourth quarter of 2005 was five percent, slightly in excess of the growth in rig count worldwide. The group generated 61 percent operating profit flowthrough, despite higher personnel costs. Revenues grew 35 percent compared to the adjusted first quarter of 2005, substantially higher than the improvement in worldwide rig count over the same timeframe. The year-over-year revenue growth generated 39 percent operating profit flowthrough, due to higher volumes and improved pricing in most areas. The strong results were broad-based, with most products and services up sequentially and year-over-year, at higher margins. Our pipeline inspection services were an exception to this, where first quarter seasonal downturns drove lower sequential results. Mission Fluid King, Griffith/Vector downhole tools, Brandt solids control equipment and services, and Quality Tubing coiled tubing brands all posted double-digit growth as compared to the fourth quarter of 2005. Tuboscope pipe inspection and coating services posted sequential higher operating margins on higher pricing and volumes, as well. Additionally, our sales of fiberglass and composite pipe were roughly flat sequentially, as increases in sales to the oilfield were offset by lower seasonal sales in China, and lower industrial sales. Nevertheless, the fiberglass group posted sequentially higher operating margins in the first quarter as compared to the fourth quarter of 2005. Most products and services within the Petroleum Services & Supplies group continue to gain increases in pricing in the range of three to seven percent each quarter, but the margin impact of these efforts is being mitigated somewhat by inflationary forces across our markets, as personnel, raw materials costs and energy expenses continue to rise.

We expect continued high levels of oilfield activity, coupled with price increases over the last few quarters, to drive continued improvement in the Petroleum Services & Supplies group in 2006, but expect to see our second quarter 2006 results affected by the seasonal breakup in Canada. In 2005 our Petroleum Services & Supplies operations in Canada saw operating profit decline over $10 million from the first quarter to the second, due to breakup. We expect the impact of breakup in Canada this year on the segment s results to be in a similar range.

We continue to invest in the Petroleum Services & Supplies group to satisfy the needs of our customers for drilling motors, solids control equipment, instrumentation systems and other machinery we lease to drilling and production operations, to meet the rising demand we see in most oilfield markets around the world. This quarter, about 70 percent of our capital expenditures went to the Petroleum Services & Supplies group. Over the long run, and excluding swings in mix and other factors, we continue to expect operating profit flowthrough from this group to be in the range of 30 percent. Our overachievement of this level the past few quarters has largely been the result of the very favorable market and pricing environment we are enjoying.

The Company s Distribution Services group has 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. The segment performed well in the first quarter as a result. Revenue improved 6 percent from the fourth quarter, and 38 percent from the first quarter of 2005, to $326.5 million. Operating profit was $20.8 million in the first quarter. The group generated 32 percent operating profit flowthrough on the incremental revenue as compared to the fourth quarter of 2005, lifting margins 160 basis points to 6.4 percent of sales. Compared to the first quarter of 2005, operating profit flowthrough was 15 percent on the revenue increase. First quarter operating margins doubled compared to the first quarter of the prior year. The group has significantly improved its efficiency and reduced the costs of its products, while expanding selectively into attractive markets. Most of the sequential first quarter growth came from North America, with the mid-continent, Texas, and Canadian regions posting the largest increases. The Gulf Coast region saw sales ease slightly during the first quarter as fourth quarter 2005 sales in support of the hurricane rebuilding effort slowed. Strategic purchasing lifted our base margins by about 0.5 percent, and we benefited from mix as well. As a result of the strong performance, after-tax return on capital employed improved this quarter. We expect the Distribution Services group to continue to perform well throughout 2006, as we continue selective expansion into key international markets, strengthen alliances with customers, and leverage our buying power and IT infrastructure to keep costs low. We continue to expect long-term flowthroughs for the Distribution Services group, excluding swings in mix and other factors, to be around 10 percent.

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 the Company s backlog for capital equipment sales has more than quadrupled since the beginning of 2005. 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 lately, we believe 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. 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. The Company expects 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, and commodity prices remain high.

The Company expects to increase its capital spending about 40 percent in 2006, to a level in the range of $170 million, primarily to add rental equipment in its Petroleum Services & Supplies segment. Additionally the Company plans to add coiled tubing manufacturing capacity, and selectively invest in machining, assembly and fabrication equipment to improve its manufacturing efficiency in its Rig Technology and Petroleum Services & Supplies segments.

Table of Contents

Operating Environment Overview

The Company s results are dependent on, among other things, the level of worldwide oil and gas drilling, well remediation activity, the prices of crude oil and natural gas, capital spending by other oilfield service companies and drilling contractors, pipeline maintenance activity, and worldwide oil and gas inventory levels. Key industry indicators for the first quarters of 2006 and 2005, and the fourth quarter of 2005 include the following:

	1Q06*	1Q05*	4Q05*	% 1Q06 vs. 1Q05	% 1Q06 vs. 4Q05
Active Drilling Rigs:					
U.S.	1,520	1,279	1,479	18.8%	2.8%
Canada	665	521	572	27.6%	16.3%
International	893	876	929	1.9%	(3.9%)
Worldwide	3,078	2,676	2,980	15.0%	3.3%
Active Workover Rigs:					
U.S.	1,527	1,261	1,457	21.1%	4.8%
Canada	707	769	777	(8.1%)	(9.0%)
North America	2,234	2,030	2,234	10.0%	
West Texas Intermediate Crude Prices (per barrel)	$ 63.18	$ 49.88	$ 60.42	26.7%	4.6%
Natural Gas Prices ($/mmbtu)	$ 7.71	$ 6.42	$ 12.25	20.1%	(37.1%)

* Averages for the quarters indicated. See sources below.

The following table details the U.S., Canadian, and international rig activity and West Texas Intermediate Oil prices for the past nine quarters ended March 31, 2006 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).

Table of Contents

The worldwide and U.S. quarterly average rig count increased 15.0% (from 2,676 to 3,078) and 18.8% (from 1,279 to 1,520), respectively, in the first quarter of 2006 compared to the first quarter of 2005. The average per barrel price of West Texas Intermediate Crude increased 26.7% (from $49.88 per barrel to $63.18 per barrel) while natural gas prices increased 20.1% (from $6.42 per mmbtu to $7.71 per mmbtu) in the first quarter of 2006 compared to the first quarter of 2005.

U.S. rig activity at April 28, 2006 was 1,608 rigs compared to the first quarter average of 1,520 rigs. The company believes that current industry projections are forecasting commodity prices to remain strong. 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 world oil inventory levels, or numerous other events or circumstances.

Table of Contents

Results of Operations

Operating results by segment are as follows. The 2005 actual results include 20 days of Varco operations from the acquisition date of March 11, 2005 (in millions):

	Three Months Ended March 31,	
	2006	2005
Revenue:		
Rig Technology	$ 715.3	$ 424.4
Petroleum Services & Supplies	541.0	209.1
Distribution Services	326.5	235.9
Elimination	(71.0)	(54.5)
Total Revenue	$ 1,511.8	$ 814.9
Operating Profit:		
Rig Technology	$ 100.8	$ 44.9
Petroleum Services & Supplies	118.3	35.2
Distribution Services	20.8	7.6
Unallocated expenses and eliminations	(27.4)	(10.9)
Integration costs and stock-based compensation	(14.7)	(10.9)
Total operating profit	$ 197.8	$ 65.9
Operating profit %:		
Rig Technology	14.1%	10.6%
Petroleum Services & Supplies	21.9%	16.8%
Distribution Services	6.4%	3.2%
Total Operating Profit %	13.1%	8.1%

Rig Technology

Revenue from Rig Technology was $715.3 million, an increase of $290.9 million (68.5%) compared to the first quarter of 2005. The acquisition of Varco contributed approximately $118.9 million to the increase in revenue. The remainder of the increase can be attributed to the growing market for capital equipment, as evidenced by backlog growth over the past several quarters, and price increases implemented in 2005.

First quarter 2006 actual operating profit for Rig Technology was $100.8 million compared to $44.9 million for the first quarter of 2005, an increase of $55.9 million (124.5%). The acquisition of Varco contributed approximately $16.4 million of the increase in operating profit. In addition, operating profit benefited from higher volumes, improved pricing, and merger-related cost savings partly offset by higher employee benefit costs and higher costs associated with purchased components.

Petroleum Services & Supplies

Revenue from Petroleum Services & Supplies was $541.0 million for the first quarter of 2006 compared to $209.1 million for the first quarter of 2005, an increase of $331.9 million (158.7%). The majority of the increase is attributable to the addition of product lines acquired from Varco, which totaled approximately $192.9 million. The remaining increase is attributable to higher demand for virtually all products and services offered by the segment.

These increases were the result of strong U.S. and worldwide drilling markets, as reflected by rig count increases of 18.8% and 15.0%, respectively, in the first quarter 2006 compared to the same period 2005. Petroleum Services & Supplies also benefited from price increases implemented during 2005.

Operating profit from Petroleum Services & Supplies was $118.3 million for the first quarter of 2006 compared to $35.2 million for the first quarter of 2005, an increase of $83.1 million (236.1%). The majority of the increase was attributable to the addition of product lines acquired from Varco. Incremental operating profit from these product lines was approximately $28.4 million. The remaining increase was attributable to higher profitability across all products, driven by higher volumes and improved pricing.

Distribution Services

Revenue from Distribution Services was $326.5 million, an increase of $90.6 million (38.4%) during the first quarter of 2006 over the comparable 2005 period. The revenue growth was led by a strong demand for products in the US which was up 48%, followed by Canada up 28% and International revenues up 12%. US operations were especially impacted by robust increases in rig count activity in the Mid-Continent and Rocky Mountain regions where there is higher concentrations of drilling activity. Revenues generated from maintenance, repair and operating supplies were up 39%, spare parts up 36% and Tubular sales up 28%.

Operating income of $20.8 million in the first quarter of 2006 increased $13.2 million (173.7%) over the prior year results due to gross margin improvement on higher revenue volumes coupled with absorbing the revenue increase across an already established distribution infrastructure and expense base.

Unallocated expenses and eliminations

Unallocated expenses and eliminations were $27.4 million and $10.9 million for the quarters ended March 31, 2006 and 2005, respectively. The increase in operating costs was due to costs associated with Varco operations since the acquisition date and greater inter-segment profit eliminations.

Interest expense

Interest expense was $13.6 million for the first quarter of 2006 compared to $10.7 million for the same period of 2005. The increase was primarily due to interest costs associated with debt assumed in the Varco transaction. See summary of outstanding debt at March 31, 2006 under Liquidity and Capital Resources .

Provision for income taxes

The effective tax rate for the three months ended March 31, 2006 was 33.5% (33.6% excluding transactions costs associated with the Merger) compared to 35.1% for the same period in 2005 (32.7% excluding transaction costs associated with the merger), reflecting a lower percentage of earnings in foreign jurisdictions with lower tax rates and reduced benefits in the U.S. associated with export sales. The U.S. laws granting this tax benefit were repealed as part of the American Jobs Creation Act of 2004 and this benefit will be phased out after 2006. A new tax benefit associated with U.S. manufacturing operations passed into law under the same Act and will be phased in over the next five years. 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 approximately 33.5% for continuing operations.

Liquidity and Capital Resources

At March 31, 2006, the Company had cash and cash equivalents of $263.0 million, and total debt of $839.0 million. At December 31, 2005, cash and cash equivalents were $209.4 million and total debt was $841.3 million. The Company s outstanding debt at March 31, 2006 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 $39.0 million. Included in other debt is the revaluation of the Varco debt assumed in the acquisition which resulted in additional debt recognition of $22.7 million. The difference is being amortized to interest expense over the remaining life of the debt.

For the first quarter of 2006, cash provided by operating activities was $86.6 million compared to cash used for operating activities of $42.5 million in the same period of 2005. Cash was provided by operations primarily through net income of $120.3 million plus non-cash charges of $38.4 million, and increases in billings in excess of

Table of Contents

costs of $96.3 million. These positive cash flows were offset by increases in receivables of $65.3 million, inventories of $155.2 million, and costs in excess of billings of $6.8 million. Receivables and costs in excess of billings increased due to greater revenue and activity in the first quarter of 2006 compared to the fourth quarter of 2005, while inventory increased due to growing backlog orders.

For the first quarter of 2006, cash used by investing activities was $51.2 million compared to cash provided of $152.1 million for the same period of 2005. Capital expenditures totaled approximately $30.2 million in the first quarter of 2006, primarily related to the Petroleum Services & Supplies service and rental businesses.

For the first quarter of 2006, cash provided by financing activities was $16.3 million compared to cash provided of $44.4 million for the same period of 2005. Cash proceeds from exercised stock options was $13.2 million.

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. This facility will expire in July 2010, and replaced the Company s $175 million North American revolving credit facility and our Norwegian facility. The facility is available for general corporate purposes and acquisitions, including letters of credit and performance bonds. 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 March 31, 2006, there were no borrowings against this facility, and there were $142 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 any significant increases in capital expenditures caused by any need to increase manufacturing capacity can be funded from operations or through debt financing.

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. We expect to fund future cash acquisitions 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 not had a material impact on our operating results or financial condition 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, energy or other commodity prices may adversely impact future periods.

Critical Accounting Policies and Estimates

In preparing the financial statements, we make assumptions, estimates and judgments that affect the amounts reported. We periodically evaluate our estimates and judgments related to allowance for doubtful accounts; inventory reserves; warranty accruals; impairments of long-lived assets (including goodwill); income taxes and pensions and other postretirement benefits. 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

The Company s products and services are sold based upon purchase orders or contracts with the customer that include fixed or determinable prices and that do not include right of return or other similar provisions or other significant post delivery obligations. Except for certain construction contracts described below, the Company records revenue at the time its manufacturing process is complete, the customer has been provided with all proper inspection and other required documentation, title and risk of loss has passed to the customer, collectibility is reasonably assured and the product has been delivered. Customer advances or deposits are deferred and recognized as revenue when the Company has completed all of its performance obligations related to the sale. The Company also recognizes revenue as services are performed. The amounts billed for shipping and handling cost are included in revenue and related costs are included in costs of sales.

Table of Contents

Revenue Recognition under Long-term Construction Contracts

The Company uses the percentage-of-completion method to account for certain long-term construction contracts that are built or constructed to the customer s specifications, and are manufactured outside the Company s normal manufacturing process and marketed outside of the Company s normal marketing channels. Projects recognized under the percentage-of-completion method include the following characteristics: 1) the contracts include custom designs for customer specific applications; 2) components are often modified with change orders throughout the project; 3) the structural design is unique and requires significant engineering efforts; and 4) construction projects often have progress payments. This method requires us to make estimates regarding the total costs of the project, our progress against the project schedule and the estimated completion date, all of which impact the amount of revenue and gross margin we recognize in each reporting period. Changes in job performance, job conditions, and estimated profitability, including those arising from contract penalty provisions, and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Profit incentives are included in revenues when their realization is reasonably assured. Provisions for anticipated losses on uncompleted contracts are recorded in full when such losses become evident. The Company measures the extent of progress towards completion on these projects using either input or output based methods that are appropriate to the contract circumstances. The output methods are based upon engineering estimates and the input measures are based upon the ratio of costs incurred to the total projected costs.

Allowance for Doubtful Accounts

Allowance for doubtful accounts are determined on a specific identification basis when we believe that the required payment of specific amounts owed to us is not probable. A substantial portion of the Company s revenues come from international oil companies, 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, our customers may be unable to repay these receivables, and additional allowances could be required.

Inventory Reserves

Reserves for inventory are determined based on our historical usage of inventory on-hand as well as our future expectations related to requirements to provide spare parts for our substantial installed base and new products. Changes in worldwide oil and gas drilling activity and the development of new technologies associated with the drilling industry could require the Company to record additional allowances to reduce the value of inventory to the lower of its cost or net realizable value.

Impairment of Long-Lived Assets (Including Goodwill)

Long-lived assets, which include property and equipment, goodwill, 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 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. Significant and unanticipated changes to these assumptions or the intended use of these assets could require a provision for impairment in a future period.

In accordance with SFAS 142, 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 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 has been impaired. Fair value of the reporting units is determined based on internal management estimates, 12

using a combination of three methods: discounted cash flow, comparable companies, and representative transactions.

Income Taxes

In accordance with the provisions of SFAS No. 109, Accounting for Income Taxes, we account for income taxes using the asset and liability method. In determining income (loss) for financial statement purposes, we must make certain estimates and judgments. These estimates and judgments affect the calculation of certain tax liabilities and the determination of the recoverability of certain of the deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. Deferred tax assets are also reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods. In evaluating our ability to recover our deferred tax assets we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent years and our forecast of future taxable income. In estimating future taxable income, we develop assumptions including the amount of future state, federal and international pretax operating income, reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we are using to manage the underlying businesses.

We currently have recorded valuation allowances that we intend 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, our income tax expense recorded in the future will be reduced to the extent of decreases in our valuation allowances. The realization of our 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 we record an additional valuation allowance against our 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 our 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. In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions across our global operations. We recognize potential liabilities and record tax reserves for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. These tax liabilities are reflected net of related tax loss carry forwards. We adjust these reserves in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional charge to expense would result. If payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the reserves are no longer necessary. If the tax liabilities relate to tax uncertainties existing at the date of the acquisition of a business, the adjustment of such tax liabilities will result in an adjustment to the goodwill recorded at the date of acquisition.

Pensions and Other Postretirement Benefits

The Company accounts for our defined benefit pension plans in accordance with Statement of Financial Accounting Standards No. 87, Employers Accounting for Pensions (FAS 87), which requires that amounts recognized in the financial statements be determined on an actuarial basis. Significant elements in determining our pension income or expense in accordance with FAS 87 are the discount rate assumption and the expected return on plan assets. The discount rate used approximates the weighted average rate of return on high-quality fixed income investments whose maturities match the expected payouts. The expected return on plan assets is based upon the geometric mean of historical returns of a number of different equities, including stocks, bonds and U.S. treasury bills. The assumed long-term rate of return on assets is applied to a calculated value of plan assets which results in an estimated return on plan assets that is included in current year pension income or expense. The difference between this expected return and the actual return on plan assets is deferred and amortized against future pension income or expense. The total net expense associated with the Company s defined benefit pension and postretirement benefit plans was approximately $1.2 million for the three months ended March 31, 2006, compared to $1.2 million for the same period of 2005.

Table of Contents

Recently Issued Accounting Standards

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. SFAS No. 155 simplifies accounting for certain hybrid instruments under SFAS No. 133 by permitting fair value remeasurement for financial instruments containing an embedded derivative that otherwise would require bifurcation. SFAS No. 155 eliminates both the previous restriction under SFAS No. 140 on passive derivative instruments that a qualifying special-purpose entity may hold and SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets, which provides that beneficial interests are not subject to the provisions of SFAS No. 133. SFAS No. 155 also establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, and clarifies that concentrations of credit risk in the form of subordination are not imbedded derivatives. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event occurring after the beginning of an entity s fiscal year that begins after September 15, 2006. We are currently evaluating the effect SFAS No. 155 will have on our consolidated financial position, liquidity, or results from operations.

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. All statements herein regarding expected Merger synergies are forward-looking statements. 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, difficulties encountered in integrating mergers and acquisitions, and worldwide economic activity. You should also consider carefully the statements under Risk Factors, as disclosed in our Annual Report on Form 10-K for the year ending December 31, 2005, 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.

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
Three Months ended March 31, 2006:				
Revenue:				
Rig Technology	$ 715.3	$	$	$ 715.3

Petroleum Services & Supplies	541.0			541.0
Distribution Services	326.5			326.5
Eliminations	(71.0)			(71.0)
Total Revenue	$ 1,511.8	$	$	$ 1,511.8

14

Table of Contents

	GAAP Results As Reported	January 1, 2005 to March 10, 2005 Varco Results Historical	Adjustments	Adjusted Results
Operating Profit:				
Rig Technology	$ 100.8	$	$	$ 100.8
Petroleum Services & Supplies	118.3			118.3
Distribution Services	20.8			20.8
Unallocated expenses and eliminations	(27.4)			(27.4)
Integration costs and stock-based compensation	(14.7)		14.7(1)	
Total Operating Profit	$ 197.8	$	$ 14.7	$ 212.5

	GAAP Results As Reported	January 1, 2005 to March 10, 2005 Varco Results Historical	Adjustments	Adjusted Results
Three months ended March 31, 2005:				
Revenue:				
Rig Technology	$ 424.4	$ 118.9	$	$ 543.3
Petroleum Services & Supplies	209.1	192.9		402.0
Distribution Services	235.9			235.9
Eliminations	(54.5)		(3.9)(2)	(58.4)
Total Revenue	$ 814.9	$ 311.8	$ (3.9)	$ 1,122.8
Operating Profit:				
Rig Technology	$ 44.9	$ 16.4	$	$ 61.3
Petroleum Services & Supplies	35.2	28.4		63.6
Distribution Services	7.6			7.6
Unallocated expenses and eliminations	(10.9)	(7.5)	(3.6)(3)	(22.0)
Integration costs and stock-based compensation	(10.9)		10.9(4)	

Total Operating Profit	$	65.9	$	37.3	$	7.3	$	110.5

(1) The $14.7 million is comprised of $7.9 million of integration costs directly related to the Varco acquisition and $6.8 million of stock-based compensation.

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

(3) 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.

(4) The $10.9 million is comprised of $9.8 million of integration costs and $1.1 million of stock-based compensation, both directly related to the Varco acquisition.

Rig Technology revenue on an adjusted basis increased $172.0 million (31.7%), from $543.3 million in the first quarter of 2005 to $715.3 million for the quarter ended March 31, 2006. This was principally due to the growing capital equipment market for drilling, workover and coiled tubing products discussed above. Rig Technology operating profit was $100.8 million for the first quarter, an increase of $39.5 million over the same period of 2005 on an adjusted basis. The increase was due to higher sales volumes and merger-related cost savings which were partly offset by increases in employee benefit costs and higher material costs. Backlog of the Rig Technology capital products was $3.2 billion at March 31, 2006, an increase of 39% over backlog of $2.3 billion at December 31, 2005. Adjusted orders for the period ending March 31, 2006 were $1.3 billion, reflective of the growing demand for the Company s drilling and well servicing products.

Revenue from Petroleum Services & Supplies was $541.0 million for the first quarter of 2006 compared to $402.0 million for the first quarter of 2005 on an adjusted basis, an increase of $139.0 million (34.6%). The increase is attributable to a significant increase in U.S. and worldwide drilling activity; price increases implemented during 2005; and strong spare parts and consumable sales to support increased drilling. Operating profit for Petroleum

Table of Contents

Services & Supplies was $118.3 million for the first quarter of 2006 compared to $63.6 million for the first quarter of 2005 on an adjusted basis, an increase of $54.7 million (86.0%). Improved year-over-year results were posted across all products and services.

Revenue from Distribution Services was $326.5 million, an increase of $90.6 million (38.4%), during the first quarter of 2006 over the comparable 2005 period as all geographic regions showed improvement. Operating income of $20.8 million in the first quarter of 2006 increased $13.2 million over the prior year results, due to the increased revenue and higher base margins resulting from price increases on certain products.

Unallocated expenses and eliminations on an adjusted basis were $27.4 million and $22.0 million for the first quarter of 2006 and 2005. The increase in operating loss was due to greater inter-segment profit eliminations, greater employee benefit costs, and greater legal costs.

Table of Contents

PART II OTHER INFORMATION

Item 6. Exhibits

Reference is hereby made to the Exhibit Index commencing on Page 18.

SIGNATURE

Pursuant to the requirements 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.

Date: February 16 , 2007

/s/ Clay C. Williams

Clay C. Williams
Senior Vice President and Chief Financial Officer
(Duly Authorized Officer, Principal Financial and Accounting Officer)

Table of Contents

INDEX TO EXHIBITS

(a) Exhibits

3.1 Amended and Restated Certificate of Incorporation of National Oilwell, Inc. (incorporated by reference to exhibit 3.1 to our Quarterly Report on Form 10-Q filed on August 11, 2000).

3.2 Amended and Restated By-laws of National Oilwell Varco, Inc. (incorporated by reference to exhibit 3.2 to our Current Report on Form 8-K filed on November 18, 2005).

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.