SMITH INTERNATIONAL INC
Form 10-K
March 13, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal 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 1-8514

SMITH INTERNATIONAL, INC.
(Exact name of Registrant as specified in its charter)

Delaware	**95-3822631**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

411 North Sam Houston Parkway, Suite 600	
Houston, Texas	**77060**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (281) 443-3370
Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $1.00 par value	**New York Stock Exchange, Inc.**
	Pacific Exchange, Inc.

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 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 the 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 Act.

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 Act). Yes o No þ.

The aggregate market value of the voting stock held by non-affiliates on June 30, 2005 was $6,367,781,265 (199,930,338 shares at the closing price on the New York Stock Exchange of $31.85, as adjusted for the two-for-one stock split effective August 24, 2005). On June 30, 2005, 212,332,278 shares of common stock were outstanding. For this purpose all shares held by officers and directors and their respective affiliates are considered to be held by affiliates, but neither the Registrant nor such persons concede that they are affiliates of the Registrant.

There were 213,757,655 shares of common stock outstanding on March 6, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement related to the Registrant s 2006 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form.

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PART I

Item 1. *Business*

General

Smith International, Inc. (Smith or the Company) is a leading worldwide supplier of premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control equipment, waste-management services, production chemicals, three-cone and diamond drill bits, turbines, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply-chain management solutions through an extensive North American branch network providing pipe, valves, fittings, mill, safety and other maintenance products.

The Company was incorporated in the state of California in January 1937 and reincorporated under Delaware law in May 1983. The Company s executive offices are headquartered at 411 North Sam Houston Parkway, Suite 600, Houston, Texas 77060 and its telephone number is (281) 443-3370. The Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge on the Company s Internet website at www.smith.com as soon as reasonably practicable after the Company has electronically filed such material with, or furnished it to, the Securities and Exchange Commission. The Company s Corporate Governance Guidelines, Code of Business Conduct and Ethics and the charters of the Audit Committee, Compensation and Benefits Committee and Nominating and Corporate Governance Committee are also available on the Investor Relations section of the Company s Internet website. The Company intends to disclose on its website any amendments or waivers to its Code of Business Conduct and Ethics that are required to be disclosed pursuant to Item 5.05 of Form 8-K. Printed copies of these documents are available to stockholders upon request.

The Company s operations are aggregated into two reportable segments: Oilfield Products and Services and Distribution. The Oilfield Products and Services segment consists of: M-I SWACO, a 60 percent-owned joint venture which provides drilling and completion fluid systems and services, solids-control and separation equipment, waste-management services and oilfield production chemicals; Smith Technologies, which manufactures and sells three-cone drill bits, diamond drill bits and turbine products; and Smith Services, which manufactures and markets products and services used for drilling, workover, well completion and well re-entry operations. The Distribution segment consists of one business unit, Wilson, which markets pipe, valves and fittings as well as mill, safety and other maintenance products to energy and industrial markets.

Financial information regarding reportable segments and international operations appears in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 15 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K. Information related to business combinations appears in Note 3 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K.

Business Operations

Oilfield Products and Services Segment

M-I SWACO

Fluid Products and Services. M-I SWACO is a leading worldwide provider of drilling, reservoir drill-in and completion fluid systems, products and engineering services to end users engaged in drilling oil and natural gas wells. Drilling fluids are used to cool and lubricate the bit during drilling operations, contain formation pressures, suspend and remove rock cuttings from the hole and maintain the stability of the wellbore. Engineering services are provided to ensure that the fluid products are applied effectively to optimize drilling operations. These services include recommending products and services during the well planning phase; monitoring drilling fluid properties; recommending adjustments during the drilling phase; and analyzing/benchmarking well results after completion of the project to improve the efficiencies of future wells.

M-I SWACO offers water-base, oil-base and synthetic-base drilling fluid systems. Water-base drilling fluids are the world s most widely utilized systems, having application in both land and offshore environments. Typically, these systems comprise an engineered blend of weighting materials used to contain formation pressures, and a broad range of chemical additives, designed to yield the specific drilling performance characteristics required for a given drilling project. Oil-base drilling fluids, which primarily are used to drill water-sensitive shales, reduce torque and drag and are widely used in areas where stuck pipe is likely to occur. In certain drilling areas of the world, oil-base systems exhibit comparably higher penetration rates when compared to water-base systems, significantly reducing time on location and overall drilling costs. Synthetic-base drilling fluids are used in drilling environments where oil-base fluids are environmentally prohibited and provide the performance benefits of oil-base systems. Synthetic-base systems are particularly advantageous in the deepwater environment. M-I SWACO also provides a comprehensive line of reservoir drill-in fluids which combine the high performance properties of a premium drilling fluid with minimal damaging characteristics of a brine completion fluid.

Completion fluids (clear brines) are solids-free, clear-salt solutions with high specific gravities and are non-damaging to the producing formation. Operators use these specially designed fluid systems in combination with a comprehensive range of specialty chemicals to control bottom-hole pressures, while meeting the specific corrosion inhibition, viscosity and fluid loss requirements necessary during the completion and workover phase of a well. These systems are specially engineered to maximize well production by minimizing formation damage that can be caused by solids-laden systems. M-I SWACO provides a complete line of completion fluids products and services, including low- and high-density brines, specialty chemicals, filtration and chemical treatment services, wellsite engineering and technical and laboratory support services.

Fluid Competition. The major competitors in the worldwide drilling fluids market, which approximated $4.7 billion in 2005, are Halliburton Energy Services (a division of Halliburton Company (Halliburton)) and Baker Hughes Drilling Fluids (a division of Baker Hughes, Inc. (Baker Hughes)). While M-I SWACO and these companies supply a majority of the market, the drilling fluids industry is highly competitive, with a significant number of smaller, locally based competitors. The major competitors in the worldwide completion fluids market, which approximated $0.8 billion in 2005, are Baroid Completion Fluids (a division of Halliburton), Tetra Technologies, Inc., BJ Services Company and Ambar, Inc.

Generally competition for sales of drilling and completions fluids is based on a number of factors, including wellsite engineering services, product quality and availability, technical support, service response and price.

M-I SWACO Drilling Waste Management. M-I SWACO provides services, equipment and engineering for solids control, pressure control and waste management to the worldwide drilling market.

Solids-control equipment is used to remove drill cuttings from the fluid system, allowing the drilling fluid to be cleaned and recirculated. Solids are normally separated from the drilling fluid using one or a combination of the following: balanced elliptical and linear-motion shale shakers, desanders, desilters, hydroclones, mud cleaners and centrifuges. M-I SWACO designs, manufactures, sells and rents a comprehensive, proprietary line of this equipment for oil and gas drilling processes throughout the world. The Company is also a leading manufacturer and supplier of screens used in solids-control equipment for both oilfield and certain industrial markets. M-I SWACO complements its product offering by providing engineering and technical support to operators and drilling contractors from the planning stages of their projects through waste removal and site remediation.

Operators employ M-I SWACO-manufactured pressure-control equipment to drill in sour-gas and high-pressure zones. Well killing and high-pressure control drilling chokes, together with related operating consoles, are used in the drilling process during well kicks and well clean-up and testing operations. Degassers and mud gas separators are designed to remove and vent entrained gases, including toxic gases such as hydrogen sulfide and corrosive oxygen, from the drilling mud. This equipment reduces the risk of dangerous and costly blowouts caused by recirculating mud that contains natural gas. Key products in M-I SWACO s pressure control product line include the Mud D-Gasser® and Super Choke , both of which hold strong market positions as do the Super Mud Gas SeparatorÔ and the Super AutochokeÔ.

With drilling operations expanding into more environmentally sensitive areas, there has been increased focus on the effective collection, treatment and disposal of waste produced during the drilling of a well. M-I SWACO provides operators with solutions designed to minimize and treat drilling waste. The Company provides a suite of waste handling, minimization and management products and services, including the CleanCut® pneumatic conveyance system for collection and transportation of drill cuttings related to offshore drilling programs. M-I SWACO also provides rig vacuum systems for cuttings recovery, high-gravity force drying equipment for liquid/solid separation and cuttings slurification and re-injection processes for reducing haul-off waste. In addition, through the Thermal

Phase Separation process, M-I SWACO provides operators a proven technology for maximizing the recovery of drilling fluids, while minimizing wastes. M-I SWACO s waste treatment services encompass a wide range of activities, including site assessment, drill cuttings injection, water treatment, pit closure and remediation, bioremediation, dewatering and thermal processing. The Company has established EnviroCenters® in Norway, Germany and the United States designed specifically for recovering, treating and recycling solid and liquid drilling wastes.

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M-I SWACO Drilling Waste Management Competition. M-I SWACO competes with Brandt/Rigtech (a subsidiary of National Oilwell Varco, Inc.(National-Oilwell Varco)) and Derrick/Oil Tools. Additionally, there are a number of regional suppliers that provide a limited range of equipment and services tailored for local markets. Competition is based on product availability, equipment performance, technical support and price.

Oilfield Production Chemicals. M-I SWACO provides a line of oilfield specialty chemicals and related technical services through its Oilfield Production Chemical division, acquired in 2003. Oilfield production chemicals are used to enhance the flow of hydrocarbons from the wellbore by eliminating paraffin, scale and other byproducts encountered during the production process. Oilfield production chemicals are also used to protect piping and other equipment associated with the production, transportation and processing of oil and gas.

Production Chemical Competition. The major competitors in the worldwide oilfield production chemical market include Baker Petrolite (a division of Baker Hughes), Nalco Energy Services (a division of Nalco Company) and Champion Technologies, Inc. Generally, competition is based on product quality, product performance, technical support and price.

Smith Technologies

Products and Services. Smith Technologies is a worldwide leader in the design, manufacture and marketing of drill bits primarily used in drilling oil and natural gas wells. In addition, Smith Technologies is a leading provider of downhole turbine drilling products (referred to as turbodrills) and services that enhance the operating performance of petroleum drill bits in certain applications. Smith Technologies product offerings are designed principally for the premium market segments where faster drilling rates and greater footage drilled provide significant economic benefits in reducing the total cost of a well.

Smith Technologies designs, manufactures and markets three-cone drill bits for the petroleum industry, ranging in size from $3^{1}/2$ to 32 inches in diameter. Three-cone bits work by crushing and shearing the rock formation as the bit is turned. These three-cone bits comprise two major components the body and the cones, which contain different types of pointed structures referred to as cutting structures or teeth. The cutting structures are either an integral part of the steel cone with a hardmetal-applied surface (referred to as milled tooth) or made of an inserted material (referred to as insert), which is usually tungsten carbide. The Company also produces three-cone drill bits in which the tungsten carbide insert is coated with polycrystalline diamond. In certain formations, bits produced with diamond-enhanced inserts last longer and increase penetration rates, which substantially decreases overall drilling costs. Smith Technologies is a leading provider of drill bits utilizing diamond-enhanced insert technology.

In addition, Smith Technologies designs, manufactures and markets diamond drill bits. Diamond bits consist of a single body made of either a matrix powder alloy or steel. The cutting structures of diamond bits consist of either polycrystalline diamond cutters, which are brazed on the bit, or natural or synthetic diamonds, which are impregnated in the bit. These bits, which range in size from $2^{3}/4$ to 26 inches in diameter, work by shearing the rock formation with a milling action as the bit is turned. Smith Technologies has experienced increased demand for rental of diamond bits as improved designs and manufacturing processes have allowed a diamond bit to be used to drill multiple wells in certain markets.

Smith Technologies also designs, assembles and markets a comprehensive line of turbodrills and provides related technical support. Turbodrills, which operate directly above the drill bit, use the hydraulic energy provided by drilling fluid pumps on the rig floor to deliver torque to and rotate the drill bit. These proprietary tools are designed to provide faster rates of penetration, operate in much higher temperature formations, deliver longer downhole life and produce better wellbore quality than conventional positive displacement drilling motors. The turbine drilling motor provides operators with cost effective solutions in demanding environments such as horizontal applications, hard formations and high-temperature zones.

The Company manufactures polycrystalline diamond and cubic boron nitride materials that are used in the Company s three-cone and diamond drill bits and other specialized cutting tools. The Company believes that it is one of the world s largest manufacturers of polycrystalline diamond for use in oilfield applications. Smith Technologies also develops and uses patented processes for applying diamonds to a curved surface which optimize the performance of inserts used in drill bits. As a result, the Company believes that Smith Technologies enjoys a competitive advantage in both material cost and technical ability over other drill bit companies. In addition, the Company s in-house diamond research, engineering and manufacturing capabilities enhance the Company s ability to develop the application of diamond technology across other Smith product lines and into non-energy markets.

Competition. Hughes Christensen (a division of Baker Hughes), Security DBS (a division of Halliburton) and ReedHycalog (a division of Grant Prideco, Inc.) are the three major competitors of Smith Technologies in the drill bit business. While Smith Technologies and these companies supply the majority of the worldwide drill bit market, which approximated $2.0

billion in 2005, they compete with more than 20 companies. Generally, competition for sales of drill bits is based on a number of factors, including performance, quality, reliability, service, price, technological advances and breadth of products. The Company believes its quality, reliability and technological advances, such as diamond-enhanced inserts, provide its products with a competitive advantage.

Smith Services

Products and Services. Smith Services is a leading global provider of technologically advanced drilling, fishing, remedial, multilateral and completion products, services and solutions to the oil and gas drilling industry.

Smith Services Drilling Products and Services business provides a broad range of downhole impact tools for drilling applications as well as numerous other specialized downhole drilling products and services. Smith Services sells and rents impact drilling tools such as the Hydra-Jar®Tool and the Accelerator®Tool, which are used to free stuck drill strings during the drilling process. Additionally, Drilling on Gauge Subs and Borrox AP Reamers are some of the Company s tools used by operators for maintaining hole gauge and quality of the wellbore. Smith Services also offers tubular drill string components, such as drill collars, subs, stabilizers, kellys and Hevi-WateÔDrillPipe, and provides related inspection services, including drillstring repair and rebuild services. These components and their placement in the drillstring are supported by engineering and field technical services in order to optimize bottom hole management techniques. Through state-of-the-art software, Smith Services aids the customer in maximizing the life of drillstring components. Rotating control devices for flow control in underbalanced / managed pressure drilling applications and automatic connection torque monitoring and control systems are designed and manufactured by Smith Services. Smith Services also manufactures and markets hole openers and underreamers which are designed to create larger hole diameters in certain sections of the wellbore. The Company s patented Rhino®Reamer, Reamaster® and simultaneous drilling and hole enlargement system are three examples of products that aid the customer in realizing lower drilling costs through technology. Through the use of the simultaneous drilling and hole enlargement system above the drill bit, the operator may drill the main well bore with the bit and enlarge the diameter of the hole above the drill bit in the same run.

Smith Services Fishing and Remedial Services business provides a comprehensive package of fishing, remedial and thru-tubing services. Fishing operations clear and remove obstructions from a wellbore that may arise during drilling, completion or workover activities or during a well s production phase. This operation requires a wide variety of specialty tools, including fishing jars, milling tools and casing cutters, all of which are manufactured by Smith Services. These tools are operated by Company service personnel or sold or rented to third-party fishing companies.

Smith Services provides Wellbore Departure Systems through the manufacture of proprietary casing exit tools which are installed by trained technicians. These systems, which include the patented Trackmaster® Plus Whipstock System, allow the operator to divert around obstructions in the main wellbore or reach multiple production zones from the main wellbore (known as multilateral completions). In addition, Smith Services Geotrack Whipstock System mills the casing exit and continues to drill several hundred feet of formation in a single trip, saving the customer time and reducing their overall drilling costs. The Company also provides mechanical, hydraulic and explosive pipe-cutting services to remove casing during well or platform abandonment.

Smith Services Completion Systems business specializes in providing fit-for-purpose liner hanger systems, liner cementing equipment, isolation packers, retrievable and permanent packers, and drillable bridge and frac plugs. Liner hangers allow strings of casing to be suspended within the wellbore without having to extend the string all the way to the surface and are also used to isolate production zones and formations. Most directional and multilateral wells include one or more hangers due to complex casing programs and need for zonal isolation. Using Smith Services Pocket SlipÔ liner hanger system, long or heavy liners can be suspended with minimal casing distortion and maximum flow-by area. Packers are mechanically or hydraulically actuated devices which lock into place at specified depths in the well and provide a seal between zones through expanding-element systems. The devices therefore create isolated zones within the wellbore to permit either specific formation production or allow for certain operations, such as cementing or acidizing, to take place without damaging the reservoir. The Smith Services IsofracÔ packer selectively isolates multiple zones in a single trip to reduce fracturing job time, while the Long ReachÔ packer facilitates successful liner deployment in vertical and long reach horizontal wellbores without excessive work string manipulation. In addition, Smith Services top drive cementing manifold eliminates cement contamination of top drive components by creating a flow path for cement that bypasses the drilling rig s top drive assembly.

Competition. Smith Services major competitors in the drilling, remedial, re-entry and fishing services markets are Weatherford International, Inc. (Weatherford), Baker Oil Tools (a division of Baker Hughes) and numerous small local

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companies. The main competitors in the liner hanger and packer markets are Baker Oil Tools, Weatherford and TIW Corporation. The main competitors in the drilling and fishing jar market and the fishing product and service market are Weatherford and National-Oilwell Varco. Competition in the drilling and completions sales, rental and services market is primarily based on performance, quality, reliability, service, price and response time and, in some cases, breadth of products.

Distribution Segment

Wilson

Products and Services. Wilson is a supply-chain management company which provides products and services to the energy, refining, petrochemical, power generation and mining industries. Wilson operates an extensive network of supply branches, service centers and sales offices through which it markets pipe, valves and fittings as well as mill, safety and other maintenance products, predominately in the United States and Canada. In addition, Wilson provides warehouse management, vendor integration and various surplus and inventory management services. The majority of Wilson s operations are focused on North American distribution of maintenance, repair and operating supplies and equipment with the remainder associated with line pipe and automated valve products (including valve, actuator and control packages).

Approximately 70 percent of Wilson s 2005 revenues were generated in the energy sector, which includes exploration and production companies and companies with operations in the petroleum industry s pipeline sector. The remainder related to sales in the downstream and industrial market, including refineries, petrochemical and power generation plants and other energy-focused operations. Approximately 25 percent of Wilson s 2005 revenues were reported in Canada, attributable to the CE Franklin Ltd. operations, a publicly-traded distribution business in which the Company owns the majority of the outstanding common stock.

Competition. Wilson s competitors in its energy sector operations include National-Oilwell Varco, Redman Pipe and Supply Company and a significant number of smaller, locally based operations. Wilson s competitors in the downstream and industrial market include Hagemeyer NV, Ferguson Enterprises, Inc., McJunkin Corporation and W.W. Grainger, Inc. The distribution market that Wilson participates in is highly competitive. Generally, competition involves numerous factors, including price, experience, customer service and equipment availability.

Non-U.S. Operations

Sales to oil and gas exploration and production markets outside the United States are a key strategic focus of Smith s management. The Company markets its products and services through subsidiaries, joint ventures and sales agents located in virtually all petroleum-producing areas of the world, including Canada, Europe/Africa, the Middle East, Latin America and the Far East. Approximately 55 percent, 55 percent and 56 percent of the Company s revenues in 2005, 2004 and 2003, respectively, were derived from equipment or services sold or provided outside the United States. The Company s Distribution operations constitute a significant portion of the consolidated revenue base and are concentrated in North America which serves to distort the geographic revenue mix of the Company s Oilfield segment operations. Excluding the impact of the Distribution operations, approximately 65 percent of the Company s revenues were generated in non-U.S. markets for each of the 2005, 2004 and 2003 fiscal years.

Historically, drilling activity outside the United States has been less volatile than U.S. based activity as the high cost exploration and production programs outside the United States are generally undertaken by major oil companies, consortiums and national oil companies. These entities operate under longer-term strategic priorities than do the independent drilling operators that are more common in the U.S. market.

Sales and Distribution

Sales and service efforts are directed to end users in the exploration and production industry, including major and independent oil companies, national oil companies and independent drilling contractors. The Company s products and services are primarily marketed through the direct sales force of each business unit. In certain non-U.S. markets where direct sales efforts are not practicable, the Company utilizes independent sales agents, distributors or joint ventures.

Smith maintains field service centers, which function as repair and maintenance facilities for rental tools, operations for remedial and completion services and a base for the Company s global sales force, in all major oil and gas producing regions of the world. The location of these service centers near the Company s customers is an important factor in maintaining favorable customer relations.

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Manufacturing

The Company s manufacturing operations, along with quality control support, are designed to ensure that all products and services marketed by the Company will meet standards of performance and reliability consistent with the Company s reputation in the industry.

Management believes that it generally has sufficient internal manufacturing capacity to meet anticipated demand for its products and services. During periods of peak demand, certain business units utilize outside resources to provide additional manufacturing capacity.

Raw Materials

Through its company-owned mines in and outside the United States, M-I SWACO has the capability to produce a large portion of its requirements for barite and bentonite, which are typically added to engineered fluid systems. Barite reserves are mined in the United States, the United Kingdom and Morocco. Bentonite is produced from ore deposits in the United States. Mining exploration activities continue worldwide to locate and evaluate ore bodies to ensure deposits are readily available for production when market conditions dictate. In addition to its own production, M-I SWACO purchases the majority of its worldwide barite requirement from suppliers outside the United States, mainly the People s Republic of China, India and Morocco.

The Company purchases a variety of raw materials for its Smith Technologies and Smith Services units, including alloy and stainless steel bars, tungsten carbide inserts and forgings. Generally, the Company is not dependent on any single source of supply for any of its raw materials or purchased components, and believes that numerous alternative supply sources are available for all such materials. The Company does not expect any interruption in supply, but there can be no assurance that there will be no price or supply issues over the long-term. The Company produces polycrystalline diamond materials in Provo, Utah and Scurelle, Italy for utilization in various Company products as well as direct customer sales.

Product Development, Engineering and Patents

The Company s business units maintain product development and engineering departments whose activities are focused on improving existing products and services and developing new technologies to meet customer demands for improved drilling performance and environmental-based solutions for drilling and completion operations. The Company s primary research facilities are located in Houston, Texas; Stavanger, Norway; Aberdeen, Scotland; and Florence, Kentucky.

The Company also maintains a drill bit database which records the performance of drill bits over the last 20 years, including those manufactured by competitors. This database gives the Company the ability to monitor, among other things, drill bit failures and performance improvements related to product development. The Company believes this proprietary database gives it a competitive advantage in the drill bit business.

The Company has historically invested significant resources in research and engineering in order to provide customers with broader product lines and technologically-advanced products and services. The Company s expenditures for research and engineering activities are attributable to the Company s Oilfield Products and Services segment and totaled $73.6 million in 2005, $67.2 million in 2004 and $55.6 million in 2003. In 2005, research and engineering expenditures approximated 1.8 percent of the Company s Oilfield Products and Services segment revenues.

Although the Company has over 2,900 issued and pending patents and regards its patents and patent applications as important in the operation of its business, it does not believe that any significant portion of its business is materially dependent upon any single patent.

Employees

At December 31, 2005, the Company had 14,697 full-time employees throughout the world. Most of the Company s employees in the United States are not covered by collective bargaining agreements except in certain U.S. mining operations of M-I SWACO and several distribution locations of Wilson. The Company considers its labor relations to be satisfactory.

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Officers of the Registrant

The names and ages of all officers of the Company, all positions and offices with the Company presently held by each person named and their business experience are stated below. Positions, unless otherwise specified, are with the Company.

Name, Age and Positions	Principal Current Occupation and Other Significant Positions Held
Doug Rock (59) Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer	Chairman of the Board since February 1991, elected Chief Executive Officer in March 1989 and served as President and Chief Operating Officer since December 1987. Held various positions since joining the Company in June 1974, served as President of the Company s Drilco Division beginning April 1982 and was named President of the Company s Smith Tool Division in July 1985.
Loren K. Carroll (62) Executive Vice President of the Company, President and Chief Executive Officer of M-I SWACO	President and Chief Executive Officer of M-I SWACO since March 1994, Executive Vice President since October 1992 and member of the Board of Directors since November 1987. Joined Company in December 1984 as Vice President and Chief Financial Officer and served in that capacity until March 1989. Rejoined the Company in October 1992 as Executive Vice President and Chief Financial Officer.
Richard E. Chandler, Jr. (49) Senior Vice President, General Counsel and Secretary	Senior Vice President and Secretary since January 2006 and served as General Counsel since August 2005. Joined predecessor to M-I SWACO in December 1986 as Vice President, General Counsel and Secretary. Named Senior Vice President Administration, General Counsel and Secretary of M-I SWACO in January 2004.
Margaret K. Dorman (42) Senior Vice President, Chief Financial Officer and Treasurer	Senior Vice President, Chief Financial Officer and Treasurer since June 1999. Joined Company as Director of Financial Reporting in December 1995 and named Vice President, Controller and Assistant Treasurer in February 1998.
Bryan L. Dudman (49) President, Smith Services	President, Smith Services since January 2006. Held various positions since joining the Company in January 1979. Named Senior Vice President World Wide Operations of the Company s Smith Tool Division in March 1993 and Senior Vice President Western Hemisphere Operations of M-I SWACO in May 1994.
John J. Kennedy (53) President and Chief Executive Officer, Wilson	President and Chief Executive Officer, Wilson since June 1999. Joined Company as Treasury Manager in November 1986, named Treasury Director - International Operations in November 1987 and served as Treasurer beginning May 1991. Elected Vice President, Chief Accounting Officer and Treasurer in March 1994 and named Senior Vice President, Chief Financial Officer and Treasurer in April 1997.
Michael D. Pearce (58) President, Smith Technologies	President, Smith Technologies since May 2005. Joined Company as Vice President Sales of the Company s GeoDiamond Division in April 1995 and named Vice President Sales of Smith Technologies in August 1998.
Neal S. Sutton (60) Senior Vice President Law	Senior Vice President Law since January 2006. Joined Company as Vice President, Secretary and General Counsel in January 1991, named Vice President Administration in March 1992 and Senior Vice President Administration, General

	Counsel and Secretary in December 1994.
Malcolm W. Anderson (58) Vice President, Human Resources	Vice President, Human Resources since May 2004. Vice President Human Resources of Hewlett Packard from January 2001 to April 2004. Vice President Human Resources of Weatherford International Ltd. from April 1996 to December 2000.
Peter J. Pintar (47) Vice President, Corporate Strategy and Development	Vice President Corporate Strategy and Development since September 2005. Held various positions at DTE Energy Company between October 1997 and August 2005, including Director Corporate Development, Managing Director Venture Capital Investments, and Director Investor Relations.
David R. Cobb (40) Vice President and Controller	Vice President and Controller since July 2002. Joined Company as Assistant Controller in October 2001. Assistant Treasurer, Kent Electronics Corporation from April 1997 to September 2001.
Geri D. Wilde (55) Vice President, Taxes and Assistant Treasurer	Vice President, Taxes since February 1998. Joined Company as Manager of Taxes and Payroll of M-I SWACO in December 1986 and named Director of Taxes and Assistant Treasurer in April 1997.

All officers of the Company are elected annually by the Board of Directors. They hold office until their successors are elected and qualified. There are no family relationships between the officers of the Company.

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Item 1A. *Risk Factors*

This document contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, concerning, among other things, our outlook, financial projections and business strategies. These forward-looking statements are identified by their use of terms such as anticipate, believe, could, estimate, expect, , expected , project and similar terms. These statements are based on certain assumptions and analyses that we believe are reasonable under the circumstances. However, our assumptions could prove to be incorrect. Furthermore, such statements are subject to risks and uncertainties, many of which are beyond the control of the Company, that could cause actual results to differ materially from expected results. You should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

With this in mind, you should consider the risks discussed elsewhere in this report and other documents we file with the SEC from time to time and the following important factors that could cause our actual results to differ materially from those expressed in any forward-looking statement made by us or on our behalf.

We are dependent on the level of oil and natural gas exploration and development activities.

Demand for our products and services is dependent upon the level of oil and natural gas exploration and development activities. The level of worldwide oil and natural gas development activities is primarily influenced by the price of oil and natural gas, as well as price expectations. In addition to oil and natural gas prices, the following factors impact exploration and development activity and may lead to significant changes in worldwide activity levels:

- Overall level of global economic growth and activity;
- Actual and perceived changes in the supply and demand for oil and natural gas;
- Political stability and policies of oil-producing countries;
- Finding and development costs of operators;
- Decline and depletion rates for oil and natural gas wells; and
- Seasonal weather conditions that temporarily curtail drilling operations.

Changes in any of these factors could adversely impact our financial condition or results of operations.

There are certain risks associated with conducting business in markets outside of North America.

We are a multinational oilfield service company and generate the majority of our Oilfield segment revenues in markets outside of North America. Changes in conditions within certain countries that have historically experienced a high degree of political and/or economic instability could adversely impact our financial condition or results of operations. Additional risks inherent in our non-North American business activities include:

- Changes in political and economic conditions in the countries in which we operate, including civil uprisings, riots and terrorist acts;
- Unexpected changes in regulatory requirements;
- Fluctuations in currency exchange rates and the value of the U.S. dollar;
- Restrictions on repatriation of earnings or expropriation of property without fair compensation;
- Governmental actions that result in the deprivation of contract rights; and
- Governmental sanctions.

We operate in a highly technical and competitive environment.

We operate in a highly-competitive business environment. Accordingly, demand for our products and services is largely dependent on our ability to provide leading-edge, technology-based solutions that reduce the operator s overall cost of developing energy assets. If competitive or other market conditions impact our ability to continue providing superior-performing product offerings, our financial condition or results of operations could be adversely impacted.

Our businesses are subject to a variety of governmental regulations.

We are exposed to a variety of federal, state, local and international laws and regulations relating to environmental, health and safety, export control, currency exchange, labor and employment and taxation matters. These laws and regulations are complex, change frequently and have tended to become more stringent over time. In the event the scope of these laws and regulations expand in the future, the incremental cost of compliance could adversely impact our financial condition or results of operations.

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Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

The principal facilities and properties utilized by the Company at December 31, 2005 are shown in the table below. Generally, the facilities and properties are owned by the Company.

Location	Principal Products Processed or Manufactured	Land (Acres)	Approx. Bldg. Space(sq.ft.)
Oilfield Products and Services Segment:			
Houston, Texas	Tubulars, surface and downhole tools, remedial products, liner hangers, diamond drill bits, turbodrills, drilling and fishing jars and fishing tool equipment	88	850,000
Houston, Texas	M-I SWACO corporate headquarters and research center	18	223,000
Ponca City, Oklahoma	Three-cone drill bits	15	207,000
Florence, Kentucky	Separator units, mill units, parts, screens and motors	15	145,000
Aberdeen, Scotland	Downhole tools and remedial products	10	132,000
Greybull, Wyoming	Bentonite mine and processing	8,394	110,000
Tulsa, Oklahoma	Oilfield and industrial screening products	7	95,000
Saline di Volterra, Italy	Three-cone drill bits	11	92,000
Edinburgh, Scotland	Wire cloth and oilfield screening products	3	91,400
Aberdeen, Scotland	Downhole tools	10	91,000
Karmoy, Norway	Barite and bentonite processing	5	51,000
Greystone, Nevada	Barite mine and processing	268	50,000
Battle Mountain, Nevada	Barite processing	23	43,000
Provo, Utah	Synthetic diamond materials	4	43,000
Nisku, Canada	Tubulars and drill collars	10	42,000
Zelmou, Morocco	Barite mine	3,954	41,000
Zavalla, Texas	Drilling fluid chemical products	33	36,000
Nivellas, Belgium	Separator units, mill units, parts, screens and motors	5	32,000
Scurelle, Italy	Diamond drill bits and synthetic diamond materials	4	31,000
Amelia, Louisiana	Barite processing	26	25,000
Port Fouchon, Louisiana	Drilling fluid storage, processing and distribution	11	24,600
Spruce Grove, Canada	Drilling fluid processing	3	24,000
Berra, Italy	Solids control equipment	2	24,000
Salzweld, Germany	Drilling fluid processing	2	23,000
Galveston, Texas	Barite processing	6	21,000
Macon, Georgia	Separator units and screens	1	18,000
Aberdeen, Scotland	Barite and bentonite processing	2	12,000
Foss/Aberfeldy, Scotland	Barite mine and processing	102	10,000
Grand Prairie, Canada	Fishing and remedial services	2	9,000
Mountain Springs, Nevada	Barite mine	900	
Distribution Segment:			
Houston, Texas	Pipe, valves and fittings	11	198,000
Trainer, Pennsylvania	Pipe, valves and fittings	3	23,000
Tampa, Florida	Pipe, valves and fittings	4	16,000

The Company considers its mines and manufacturing and processing facilities to be in good condition and adequately maintained. The Company also believes its facilities are suitable for their present and intended purposes and are generally adequate for the Company s current and anticipated level of operations.

The Company s Corporate headquarters is located in a leased office building in Houston, Texas. The Company leases various other administrative and sales offices, as well as warehouses and service centers in the United States and other countries in which it conducts business. The Company believes that it will be able to renew and extend its property leases on terms satisfactory to the Company or, if necessary, locate substitute facilities on acceptable terms.

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Item 3. ***Legal Proceedings***

Information relating to various commitments and contingencies, including legal proceedings, is described in Note 2 and Note 16 of the Consolidated Financial Statements included elsewhere in this report on Form 10-K and is incorporated herein by reference.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

PART II

Item 5. ***Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

The common stock of the Company is traded on the New York Stock Exchange and the Pacific Stock Exchange. The following are the high and low sale prices for the Company s common stock as reported on the New York Stock Exchange Composite Tape for the periods indicated, and adjusted for the two-for-one stock split effective August 24, 2005.

	2004 Common Stock				2005 Common Stock			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
High	$27.36	$28.88	$30.71	$31.25	$32.77	$32.06	$35.23	$39.59
Low	$20.14	$24.03	$26.09	$26.99	$25.96	$27.92	$31.91	$29.61

On March 6, 2006, the Company had 1,965 common stock holders of record and the last reported closing price on the New York Stock Exchange Composite Tape was $38.12.

Stock Repurchases

In October 2005, the Company completed a previously announced share repurchase program. On October 20, 2005, the Board of Directors approved a new repurchase program that allows for the purchase of up to 20 million shares of the Company s common stock, subject to regulatory issues, market considerations and other relevant factors. During the fourth quarter of 2005, the Company repurchased 0.3 million shares of common stock under the programs at an aggregate cost of $9.6 million. The acquired shares have been added to the Company s treasury stock holdings and may be used in the future for acquisitions or other corporate purposes.

The following table summarizes the Company s repurchase activity for the three months ended December 31, 2005:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Number of Shares that May Yet Be Purchased Under the Programs
October 1 31	225,000	$30.25	225,000	19,997,200
November 1 30				19,997,200
December 1 31	76,000	$36.64	76,000	19,921,200
4th Quarter 2005	301,000	$31.86	301,000	19,921,200

Dividend Program

On February 2, 2005, the Company s Board of Directors approved a cash dividend program for stockholders and declared a quarterly cash dividend of $0.06 per share, after adjusting for the August 2005 stock dividend. The Board of Directors declared dividends of $48.4 million and distributed cash dividends of $36.4 million during 2005. On March 1, 2006, the Company s Board of Directors approved an increase in the quarterly cash dividend to $0.08 per share, beginning with the distribution payable April 14, 2006 to stockholders of record on March 15, 2006. The level of future dividend payments will be at the discretion of the Board of Directors and will depend upon the Company s financial condition, earnings and cash flow from operations, the level of its capital expenditures, compliance with certain debt covenants, its future business prospects and other factors that the Board of Directors deems relevant.

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Item 6. *Selected Financial Data*

	For the Years Ended December 31,				
	2005	2004[a]	2003	2002	2001
	(In thousands, except per share data)				
Statements of Operations Data:					
Revenues	$5,579,003	$4,419,015	$3,594,828	$3,170,080	$3,551,209
Gross profit	1,685,138	1,351,939	1,075,931	918,302	1,045,804
Operating income	670,561	438,764	328,747	256,148	371,510
Income before cumulative effect of change in accounting principle	302,305	182,451	124,634	93,189	152,145
Earnings per share before cumulative effect of change in accounting principle diluted basis[b]	1.48	0.89	0.62	0.47	0.76
Balance Sheet Data:					
Total assets	$4,059,914	$3,506,778	$3,097,047	$2,749,545	$2,735,828
Long-term debt	610,857	387,798	488,548	441,967	538,842
Total stockholders equity	1,578,505	1,400,811	1,235,776	1,063,535	949,159
Cash dividends declared per common share[c]	0.24				

The Selected Financial Data above should be read together with the Notes to Consolidated Financial Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-K in order to understand factors, such as changes in the method of accounting for goodwill, business combinations completed during 2005, 2004 and 2003, and unusual items, which may affect the comparability of the Selected Financial Data.

(a) In 2004, the Company recognized a $31.4 million, or $0.10 per share, patent litigation-related charge.
(b) All fiscal years prior to 2005 have been restated for the impact of a two-for-one stock dividend distributed on August 24, 2005.
(c) On February 2, 2005, the Company s Board of Directors approved a cash dividend program for stockholders and declared a quarterly cash dividend of $0.06 per share, after adjusting for the August 2005 stock dividend. The Board of Directors declared dividends of $48.4 million and distributed cash dividends of $36.4 million during 2005. On March 1, 2006, the Company s Board of Directors approved an increase in the quarterly cash dividend to $0.08 per share, beginning with the distribution payable April 14, 2006 to stockholders of record on March 15, 2006.

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

General

The following Management s Discussion and Analysis of Financial Condition and Results of Operations is provided to assist readers in understanding the Company s financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-K. This discussion includes forward-looking statements that are subject to risks and uncertainties. Actual results may differ materially from the statements we make in this section due to a number of factors that are discussed beginning on page 9.

Company Products and Operations

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, oilfield production chemicals, three-cone and diamond drill bits, turbine products, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply chain management solutions through an extensive North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

The Company s operations are largely driven by the level of exploration and production (E&P) spending in major energy-producing regions around the world and the depth and complexity of these projects. Although E&P spending is significantly influenced by the market price of oil and natural gas, it may also be affected by supply and demand fundamentals, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, the financial condition of independent E&P companies and the overall level of global economic growth and activity. In addition, approximately 10 percent of the Company s consolidated revenues relate to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely impacted by the general condition of the U.S. economy.

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with approximately 85 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although over half of the Company s consolidated revenues were generated in North America during 2005, Smith s profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately 30 percent of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company s Oilfield segment operations. Excluding the impact of the Distribution operations, 57 percent of the Company s 2005 revenues were generated in markets outside of North America.

Business Outlook

The Company s business is highly dependent on the general economic environment in the United States and other major world economies, which impact energy consumption and the resulting demand for our products and services. In 2005, the average worldwide rig count grew 15 percent over the prior year period, as higher commodity prices influenced increased natural-gas focused drilling activity. The Company expects to see modest growth in exploration and production spending in 2006, supported by commodity prices, which remain economically viable despite recent declines from the record high prices set in late 2005. Although there are a number of factors which could influence forecasted exploration and production spending, a significant decline in commodity prices, particularly natural gas, or deterioration in the global economic environment could adversely impact worldwide drilling activity and demand for our products and services.

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Results of Operations

Segment Discussion

The Company markets its products and services throughout the world through four business units which are aggregated into two reportable segments. The Oilfield Products and Services segment consists of three business units: M-I SWACO, Smith Technologies and Smith Services. The Distribution segment includes the Wilson business unit. The revenue discussion below has been summarized by business unit in order to provide additional information in analyzing the Company s operations.

	For the Years Ended December 31,					
	2005		2004		2003	
Financial Data: *(dollars in thousands)*	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Revenues:						
M-I SWACO	$ 2,682,511	48	$ 2,231,884	50	$ 1,865,851	52
Smith Technologies	601,821	11	511,410	12	403,261	11
Smith Services	694,667	12	493,045	11	409,162	11
Oilfield Products and Services	3,978,999	71	3,236,339	73	2,678,274	74
Wilson	1,600,004	29	1,182,676	27	916,554	26
Total	$ 5,579,003	100	$ 4,419,015	100	$ 3,594,828	100
Geographic Revenues:						
United States:						
Oilfield Products and Services	$ 1,393,564	25	$ 1,128,294	26	$ 925,148	26
Distribution	1,127,142	20	854,173	19	667,095	18
Total United States	2,520,706	45	1,982,467	45	1,592,243	44
Canada:						
Oilfield Products and Services	313,912	6	225,629	5	171,653	5
Distribution	399,653	7	261,923	6	191,221	5
Total Canada	713,565	13	487,552	11	362,874	10
Non-North America:						
Oilfield Products and Services	2,271,523	41	1,882,416	43	1,581,483	44
Distribution	73,209	1	66,580	1	58,228	2
Total Non-North America	2,344,732	42	1,948,996	44	1,639,711	46
Total Revenue	$ 5,579,003	100	$ 4,419,015	100	$ 3,594,828	100
Operating Income:						
Oilfield Products and Services	$ 625,384	16	$ 423,648	13	$ 343,486	13
Distribution	64,714	4	26,513	2	(7,897)	
General Corporate	(19,537)	*	(11,397)	*	(6,842)	*

Total	$ 670,561	12	$ 438,764	10	$ 328,747	9
Market Data:						
Average Worldwide Rig Count: [1]						
United States	1,666	50	1,417	49	1,216	47
Canada	408	12	348	12	339	13
Non-North America	1,271	38	1,145	39	1,050	40
Total	3,345	100	2,910	100	2,605	100
Onshore	2,833	85	2,443	84	2,143	82
Offshore	512	15	467	16	462	18
Total	3,345	100	2,910	100	2,605	100
Average Commodity Prices:						
Crude Oil ($/Bbl)[2]	$ 56.59		$ 41.51		$ 31.06	
Natural Gas ($/mcf)[3]	8.89		5.90		5.49	

(1) *Source: M-I SWACO.*

(2) *Average daily West Texas Intermediate (WTI) spot closing prices.*

(3) *Average daily Henry Hub, Louisiana spot closing prices.*

* *not meaningful*

Oilfield Products and Services Segment

Revenues

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by exploration and production spending in markets outside of North America, which contributes approximately two-thirds of the unit s revenues, and by its exposure to the U.S. offshore market, which constitutes nine percent of the revenue base. U.S. offshore drilling programs, which account for approximately three percent of the worldwide rig count, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. For the year ended December 31, 2005, M-I SWACO reported revenues of $2.7 billion, an increase of 20 percent over the prior year period. Over 60 percent of the business growth was generated in the Eastern Hemisphere influenced by an 11 percent increase in corresponding activity levels and the impact of new contract awards. Increased exploration and production spending in the North American market, driven by the significant increase in the number of land-based drilling programs and, to a lesser extent, the impact of price increases initiated throughout 2005 also contributed to the year-over-year revenue improvement. M-I SWACO s revenues totaled $2.2 billion for the year ended December 31, 2004. The majority of the revenue increase was generated in markets outside of North America, where revenues grew 21 percent largely due to the underlying activity level increase of nine percent. Although increased investment by exploration and production companies in Latin America and the Middle East contributed to the improvement, new contract awards and increased customer demand for waste management product offerings in several major Europe/Africa markets also had a favorable impact. Approximately one-third of the year-over-year revenue growth was reported in North America, as increased customer spending related to land-based projects more than offset the impact of reduced drilling activity in the higher-margin U.S. offshore market.

Smith Technologies designs, manufactures and sells three-cone drill bits, diamond drill bits and turbines for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations typically correlate more closely to the rig count than any of the Company s other businesses. Moreover, Smith Technologies generally has the highest North American revenue exposure of the Oilfield segment units. For the year ended December 31, 2005, Smith Technologies reported revenues of $601.8 million, an increase of 18 percent over the prior year. The year-over-year revenue growth resulted from increased unit sales and rentals of diamond drill bits, as technological advancements in fixed cutter drill bit manufacturing and design has influenced a shift from roller-cone toward diamond drill bit product offerings. To a lesser extent, the impact of higher unit pricing and continued demand for turbine products contributed to the year-over-year revenue improvement. Smith Technologies reported revenues of $511.4 million for the year ended December 31, 2004, a 27 percent increase over the prior year level. Approximately three-quarters of the revenue growth was reported in North America, as increased activity levels impacted demand for diamond bit rentals. Additionally, increased market penetration resulting from new product designs and, to a lesser extent, improved product pricing also contributed to the revenue variance.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Smith Services core business volumes are more evenly distributed between North America and the international markets and are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. For the year ended December 31, 2005, Smith Services reported revenues of $694.7 million, a 41 percent increase from the prior year. Excluding the effect of acquired operations, revenues increased 34 percent influenced by higher worldwide exploration and production spending levels. The majority of the base revenue growth was generated in North America, as increased activity levels impacted tubular product sales, which were twice the level reported in the prior year. Approximately one-third of the year-over-year base revenue growth was reported in markets outside of North America, driven by strong demand for remedial product and service lines in the Middle East and North Sea markets. Smith Services reported revenues of $493.0 million for the year ended December 31, 2004, a 21 percent increase over the amount reported in 2003. Approximately three-quarters of the revenue improvement was generated in the North American market, influenced by higher activity levels, increased demand for tubular products and, to a lesser extent, incremental revenues from acquired operations.

Operating Income

Operating income for the Oilfield Products and Services segment was $625.4 million, or 15.7 percent of revenues, for the year ended December 31, 2005. The year-over-year comparison was impacted by litigation-related charges, including $5.6 million and $31.4 million in 2005 and 2004, respectively. Excluding the impact of these charges, segment operating margins increased 1.8 percentage points above the prior year level. The year-over-year operating margin expansion primarily reflects reduced operating expenses as a percentage of revenues associated with improved fixed cost coverage in the sales and administrative functions. Gross margins improved slightly reflecting the impact of increased fixed cost absorption in the segment s manufacturing operations and higher unit pricing, partially offset by a combination of an unfavorable shift in business mix and rising commodity costs. Fiscal 2005 operating income increased $175.9 million over the prior year, net of the litigation-related charges. The growth in operating income was attributable to the impact of a 23 percent increase in business volumes on gross profit, partially offset by higher variable-based operating expenses, including investment in personnel and infrastructure to support the expanding business operations. For the year ended December 31, 2004, Oilfield operating income was $423.6 million, or 13.1 percent of revenues. Excluding the impact of the litigation-related charge recorded during 2004, segment operating margins improved 1.3 percentage points over the prior year due to gross margin expansion and, to a lesser extent, reduced operating expenses as a percentage of revenues. The gross margin improvement largely reflects increased fixed cost absorption in the Company s manufacturing operations and, to a lesser extent, the impact of price increases introduced in the drilling fluid and drill bit operations. Fiscal 2004 operating income, net of the litigation charge, increased $111.6 million over the 2003 level attributable to the impact of higher revenue volumes on gross profit, partially offset by growth in variable-based operating expenses associated with the expanding business base.

Distribution Segment

Revenues

Wilson markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company s operations with approximately 95 percent of Wilson s 2005 revenues generated in those markets. Moreover, approximately 30 percent of Wilson s revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. For the year ended December 31, 2005, Wilson reported revenues of $1.6 billion, 35 percent above the prior year. Approximately three-quarters of the revenue growth was generated in the upstream energy operations reflecting higher spending by exploration and production companies associated with increased North American drilling and completion activity, the impact of new contract awards and strong demand for tubular products. Industrial and downstream sales volumes grew 17 percent, influenced by increased spending levels for line pipe and maintenance and repair projects primarily in the engineering and construction and petrochemical customer base. Wilson reported revenues totaling $1.2 billion for the year ended December 31, 2004, an increase of 29 percent from the 2003 fiscal year. Two-thirds of the revenue improvement was reported in Wilson s upstream energy segment, attributable to higher North American activity levels, increased demand for tubular products and new contract awards.

Operating Income

Operating income for the Distribution segment was $64.7 million, or four percent of revenues, for the year ended December 31, 2005. Distribution operating results increased $38.2 million over the amount reported in 2004, equating to incremental operating income of nine percent of revenues. Incremental operating income was driven by the energy sector operations reflecting increased coverage of fixed sales and administrative costs. The lower expense ratio more than offset deterioration in gross profit margins associated with increased tubular product costs and a higher mix of project and export orders, which typically generate lower comparable margins. For the year ended December 31, 2004, operating income for the Distribution segment was $26.5 million, or 2.2 percent of revenues. Excluding a charge recorded in the prior year, segment operating income increased $29.8 million above the amount reported in 2003, equating to incremental operating income of 11 percent of revenues. Incremental operating income was influenced by year-over-year improvement reported in both the energy and industrial sector operations attributable to increased coverage of fixed sales and administrative costs and, to a lesser extent, the impact of favorable pricing driven by a competitive market for tubular products.

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Consolidated Discussion

For the periods indicated, the following table summarizes the consolidated results of operations of the Company and presents these results as a percentage of total revenues (dollars in thousands):

	For the Years Ended December 31,					
	2005		2004		2003	
	Amount	%	Amount	%	Amount	%
Revenues	$ 5,579,003	100	$ 4,419,015	100	$ 3,594,828	100
Gross profit	1,685,138	30	1,351,939	31	1,075,931	30
Operating expenses	1,014,577	18	913,175	21	747,184	21
Operating income	670,561	12	438,764	10	328,747	9
Interest expense	44,446	1	38,762	1	40,964	1
Interest income	(1,692)		(1,300)		(1,973)	
Income before income taxes, minority interests and cumulative effect of change in accounting principle	627,807	11	401,302	9	289,756	8
Income tax provision	202,743	4	129,721	3	93,334	3
Minority interests	122,759	2	89,130	2	71,788	2
Income before cumulative effect of change in accounting principle	302,305	5	182,451	4	124,634	3
Cumulative effect of change in accounting principle, net of tax and minority interests					(1,154)	
Net income	$ 302,305	5	$ 182,451	4	$ 123,480	3

2005 versus 2004

Consolidated revenues increased to $5.6 billion for the year ended December 31, 2005, 26 percent above the prior year period. The majority of the year-over-year dollar variance was reported in the Oilfield segment primarily attributable to higher worldwide drilling activity. On a geographic basis, two-thirds of the revenue improvement was generated in North America impacted by a combination of increased land-based drilling activity, strong demand for tubular products and improved pricing. Increased business volumes in markets outside North America also contributed to the year-over-year revenue variance, reflecting higher customer spending levels and the impact of new contract awards.

Gross profit totaled $1.7 billion, or 30 percent of revenues, less than one percentage point below the gross profit margins generated in the comparable prior year period. The modest decline in gross profit margins reflects an increased proportion of Distribution segment sales, which historically generate lower margins than the Oilfield operations. To a lesser extent, gross profit margin deterioration reported in the Distribution segment also contributed to the reduction in consolidated gross profit margins. On an absolute dollar basis, gross profit was $333.2 million above the prior year period primarily reflecting the increased sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased $101.4 million from the amount reported in the prior year. The year-over-year operating expense variance was impacted by litigation-related charges, including $5.6 million recorded in 2005 and $28.8 million recognized during 2004, related to the settlement, legal fees and other costs directly associated with a patent infringement case. Excluding the litigation-related charges, operating expenses increased $124.6 million on an absolute dollar basis, but decreased two percentage points from the prior year period, as a percentage of revenues. The majority of the absolute dollar increase was attributable to variable costs directly associated with the improved business volumes, including increased investment in personnel and infrastructure. To a lesser extent, increased employee profit-sharing amounts directly attributable to the reported profitability levels and stock-based compensation expense associated with restricted stock awards also contributed to the year-over-year operating expense growth.

Net interest expense, which represents interest expense less interest income, totaled $42.8 million in 2005. Net interest expense increased $5.3 million from the prior year reflecting higher average debt levels between the periods and, to a lesser extent, an increase in variable interest rates.

The effective tax rate approximated 32 percent, which was comparable to the level reported in the prior year, but below the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO s U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. The Company properly consolidates the pretax income related to the minority partner s share of U.S. partnership earnings but excludes the related tax provision.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests totaled $122.8 million in 2005, a $33.6 million increase from the prior year. The year-over-year increase primarily reflects the higher profitability of the M-I SWACO joint venture and, to a lesser extent, improved earnings reported by CE Franklin Ltd.

2004 versus 2003

Consolidated revenues increased to $4.4 billion for the year ended December 31, 2004, 23 percent above the prior year period. The majority of the year-over-year dollar variance was reported in the Oilfield segment attributable to a combination of higher activity levels, increased market penetration and, to a lesser extent, improved product pricing. On a geographic basis, two-thirds of the revenue improvement was reported in the Western Hemisphere as the impact of higher land-based drilling more than offset revenue reductions associated with activity declines experienced in the U.S. offshore market. Improved business volumes in the Eastern Hemisphere market also contributed to the year-over-year revenue variance, reflecting the higher number of exploration and production projects and the impact of new contract awards.

Gross profit totaled $1.4 billion, or 31 percent of revenues, one percentage point above the gross profit margins generated in the comparable prior year period. Although the margin expansion was largely driven by the impact of increased sales volumes on fixed manufacturing and service infrastructure costs, a shift in the business mix toward higher-margin product offerings and improved product pricing also had a favorable effect. On an absolute dollar basis, gross profit was $276.0 million above the prior year period primarily reflecting the increased sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased $166.0 million from the amount reported in the prior year. The operating expense growth was impacted by a $28.8 million litigation-related charge recognized during 2004 to reflect an estimated loss provision, legal fees and other costs directly associated with a patent infringement case. Excluding the charge, operating expenses, as a percentage of revenues, decreased one percentage point from the prior year period. Improved fixed cost coverage in the sales and administrative functions accounted for the majority of the operating expense percentage decline. The majority of the absolute dollar increase was attributable to variable-related costs associated with the improved business volumes, including investment in personnel and infrastructure to support the expanding business operations. To a lesser extent, increased employee profit-sharing amounts directly attributable to the reported profitability levels, increased medical and casualty insurance program costs and legal fees associated with defending patent infringement lawsuits also contributed to the year-over-year operating expense growth.

Net interest expense, which represents interest expense less interest income, totaled $37.5 million in 2004. Net interest expense decreased $1.5 million from the prior year reflecting lower average debt levels between the periods.

The effective tax rate approximated 32 percent, which was comparable to the level reported in the prior year, but below the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO s U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes.

The Company properly consolidates the pretax income related to the minority partner s share of U.S. partnership earnings but excludes the related tax provision.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests totaled $89.1 million in 2004, a $17.3 million increase from the prior year. The year-over-year increase primarily reflects the higher profitability of the M-I SWACO joint venture and, to a lesser extent, improved earnings reported by CE Franklin Ltd.

The cumulative effect of change in accounting principle included for 2003 represents the impact of the adoption of Statement of Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations.

Liquidity and Capital Resources

General

At December 31, 2005, cash and cash equivalents equaled $62.5 million. During 2005, the Company generated $219.5 million of cash flows from operations, which is $37.3 million above the amount reported in 2004. The improvement was attributable to increased profitability levels experienced by the Company, partially offset by higher working capital investment, particularly receivables, associated with the continued increase in worldwide drilling activity.

In 2005, cash flows used in investing activities totaled $212.3 million, consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisitions. The Company invested $151.4 million in property, plant and equipment, net of cash proceeds arising from certain asset disposals. Acquisition funding, which primarily related to the purchase of the Tubular Technology Inc. and Nunez Oil Field Pipe Ltd. operations resulted in cash outflows of $81.3 million in 2005.

Projected net capital expenditures for 2006 are expected to approximate $190 million, with the year-over-year increase driven by the inclusion of approximately $30 million of non-recurring facility-related investment. The majority of the 2006 capital spending is expected to consist of spending for routine additions of rental tool and manufacturing equipment to support the Company s operations and maintenance of the Company s capital equipment base.

Cash flows provided by financing activities totaled $2.4 million in 2005. Operating cash flow was sufficient to fund investing activities; however, amounts required to finance repurchases under the Company s stock buyback program and dividend payments resulted in $144.7 million of incremental borrowings under existing credit facilities.

The Company s primary internal source of liquidity is cash flow generated from operations. Cash flow generated by operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of December 31, 2005, the Company had $162.8 million of capacity available under its U.S. revolving credit facilities for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At year-end, the Company had available borrowing capacity of $76.9 million under the non-U.S. borrowing facilities.

The Company s external sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets. The Company s overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of year-end, the Company was well within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes funds generated by operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future.

During 2005, the Company s Board of Directors approved a cash dividend program for stockholders. On March 1, 2006, the Company s Board of Directors increased the quarterly cash dividend to $0.08 per share. The projected annual payout of approximately $65 million is expected to be funded with cash flows from operations and, if necessary, amounts available under existing credit facilities. The level of future dividend payments will be at the discretion of the Company s Board of Directors and will depend upon the Company s financial condition, earnings, cash flows, compliance with certain debt covenants and other relevant factors.

In October 2005, the Company completed a previously announced share repurchase program. On October 20, 2005, the Board of Directors approved a new repurchase program that allows for the purchase of up to 20 million shares of the Company s common stock, subject to regulatory issues, market considerations and other relevant factors. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

In February 2006, M-I SWACO acquired Norwegian-based Epcon Offshore AS for cash consideration of $46.4 million. The transaction was initially funded with borrowings under an expanded local credit facility and will be refinanced with a four-year term note during the first half of 2006. Management continues to evaluate opportunities to acquire products or businesses complementary to the Company s operations. Additional acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

The Company believes that it has sufficient existing manufacturing capacity to meet current demand for its products and services. Additionally, although inflation has had a modest impact on the Company s financial results in the three most recent fiscal years, the Company experienced sizable increases in transportation costs, as well as, petrochemical, steel and other commodity prices during 2005. These costs, however, do not comprise a significant portion of the Company s overall cost structure and the Company has generally been able to offset most of these costs through productivity gains and price increases.

The Company has not engaged in off-balance sheet financing arrangements through special purpose entities, and the consolidation of the Company s minority ownership positions would not result in an increase in reported leverage ratios. The Company has no contractual arrangements in place that could result in the issuance of additional shares of the Company s common stock at a future date other than the Company s stock-based compensation program, which is discussed in Note 1, Summary of Significant Accounting Policies, and Note 14, Long-Term Incentive Compensation.

Contractual Obligations, Commitments and Contingencies

Contractual Obligations

The following table summarizes the Company s debt maturities, estimated interest on fixed rate long-term debt and future minimum payments under non-cancelable operating leases having initial terms in excess of one year as of December 31, 2005 (in thousands):

		Amount of Commitment Expiration per Period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Debt maturities	$ 744,507	$ 133,650	$ 158,234	$ 232,734	$ 219,889
Interest on fixed rate long-term debt	97,411	26,284	38,333	29,700	3,094
Operating lease commitments	179,769	46,883	60,934	28,682	43,270
Total	$ 1,021,687	$ 206,817	$ 257,501	$ 291,116	$ 266,253

In the normal course of business, the Company enters into lease agreements with cancellation provisions as well as agreements with initial terms of less than one year. The costs related to these leases have been reflected in rent expense, which totaled $102.1 million in 2005, but have been appropriately excluded from the future minimum payments presented in the table above. Amounts related to commitments under capital lease agreements, as well as pension and other postretirement obligations, were immaterial for the periods presented.

Standby Letters of Credit

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies which reinsure certain liability coverages of the Company s insurance captive. Excluding the impact of these instruments, for which $19.5 million of related liabilities are reflected in the accompanying consolidated balance sheet, the Company was contingently liable for approximately $49.8 million of standby letters of credit and bid, performance and surety bonds at December 31, 2005. Management does not expect any material amounts to be drawn on these instruments.

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Insurance

The Company maintains insurance coverage for various aspects of its business and operations. The Company has elected to retain a portion of losses that occur through the use of deductibles and retentions under its insurance programs. Amounts in excess of the self-insured retention levels are fully insured to limits believed appropriate for the Company s operations. Self-insurance accruals are based on claims filed and an estimate for claims incurred but not reported. While management believes that amounts accrued in the accompanying consolidated financial statements are adequate for expected liabilities arising from the Company s portion of losses, estimates of these liabilities may change as circumstances develop.

Litigation

Rose Dove Egle v. John M. Egle, et al.

In April 1997, the Company acquired all of the equity interests in Tri-Tech Fishing Services, L.L.C. (Tri-Tech) in exchange for cash consideration of approximately $20.4 million (the Transaction).

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled