



*A World of Opportunity*

## Best-in-Class



**Strategy** The Baker Hughes Strategic Framework has guided our pursuit of growth opportunities in a strong market. Our Best-in-Class divisions focus on being leaders in their selected product lines. We have achieved financial flexibility, so we have the resources to invest in growth. And we have accelerated our efforts to establish strong positions in geographic markets with the highest potential for growth.



**Technology** Baker Hughes is a technology leader in drilling, formation evaluation, completion and production. We continue to increase our investment in new technology development and have successfully introduced new technology to differentiate ourselves in a competitive market. Our world-class manufacturing capabilities enable us to deliver extremely reliable equipment for demanding wells and hostile production environments.



**Diversity** To be a global company, Baker Hughes is building a diverse workforce that includes men and women from the more than 90 countries where we operate. Such diversity will enable us to understand local cultures and provide service that creates value for customers around the world. Baker Hughes recruiting programs reach students from universities on five continents and our development programs provide opportunities for them to advance their careers.

# A World of Opportunity

## **Baker Hughes Incorporated**

Baker Hughes provides the worldwide oil and natural gas industry products and services for drilling, formation evaluation, completion and production.

Baker Hughes is the only major oilfield service company structured around strong product-line divisions that are focused on Best-in-Class products and services. Our divisions are organized in two segments, which share common opportunities in developing and delivering technology solutions during distinct phases of oil and gas development.

## **Drilling & Evaluation**

Drilling & Evaluation includes divisions that apply their products and services primarily during the drilling process to improve efficiency, reduce risk and acquire accurate information. The segment includes Baker Atlas, Baker Hughes Drilling Fluids, Hughes Christensen and INTEQ.

## **Completion & Production**

Completion & Production includes divisions that apply their products and services primarily during the well completion, field production, transportation and refining processes. The segment includes Baker Oil Tools, Baker Petrolite, Centrilit, and the Production Optimization business unit.



## **North America**

*Baker Hughes benefited from growing activity to produce natural gas from onshore fields in the U.S. and Canada. Business increased in the Gulf of Mexico for the year, despite the impact of two major hurricanes.*



## **Latin America**

*During 2005, Baker Hughes installed intelligent well systems in Ecuador, gained drilling fluids business in Colombia, and introduced advanced drilling systems in Brazil, while remaining a leading service provider in Venezuela.*

## **Baker Atlas**

Baker Atlas provides wireline-conveyed well logging, data analysis and perforating services for formation evaluation, production and reservoir management. Baker Atlas has a strong reputation for data accuracy, superior well-site execution, and people-oriented service. Baker Atlas is a technology leader in wellbore imaging, wireline formation testing, and magnetic resonance logging, and in acquiring data in high pressure high temperature wells.

## **Baker Hughes Drilling Fluids**

Baker Hughes Drilling Fluids provides fluids systems and services that help optimize the drilling and completion processes, maximize hydrocarbon production and manage drilling waste, even in demanding deepwater, high temperature and hostile environments. With its PERFORMAX™ high performance water base mud system, Baker Hughes Drilling Fluids is a leader in meeting requirements for operational efficiency and environmental compliance.

## **INTEQ**

INTEQ provides directional drilling, measurement-while-drilling (MWD), logging-while-drilling (LWD), and wellsite information services. INTEQ's AutoTrak® rotary closed loop drilling system has set the standard for horizontal, extended reach, designer profile and geosteering applications. Other recent drilling technology innovations include the VertiTrak® vertical drilling system and the X-Treme® downhole motor. Advanced LWD capabilities include resistivity, density, porosity, acoustic, pressure and magnetic resonance measurements.

## **Hughes Christensen**

Hughes Christensen provides Tricone® and PDC drill bits, ream-while-drilling tools and drilling optimization services. Hughes Christensen engineers work in Design Application and Research Teams to match the right bit to the formation for optimum drilling performance. Recent technology innovations from Hughes Christensen include Genesis® PDC bits, UltraMax® metal-sealed Tricone® bits and HedgeHog™ impregnated diamond bits.

## Keys to Success

- People contributing to their full potential.
- Delivering unmatched value to our customers.
- Being cost-efficient in everything we do.
- Employing our resources effectively.

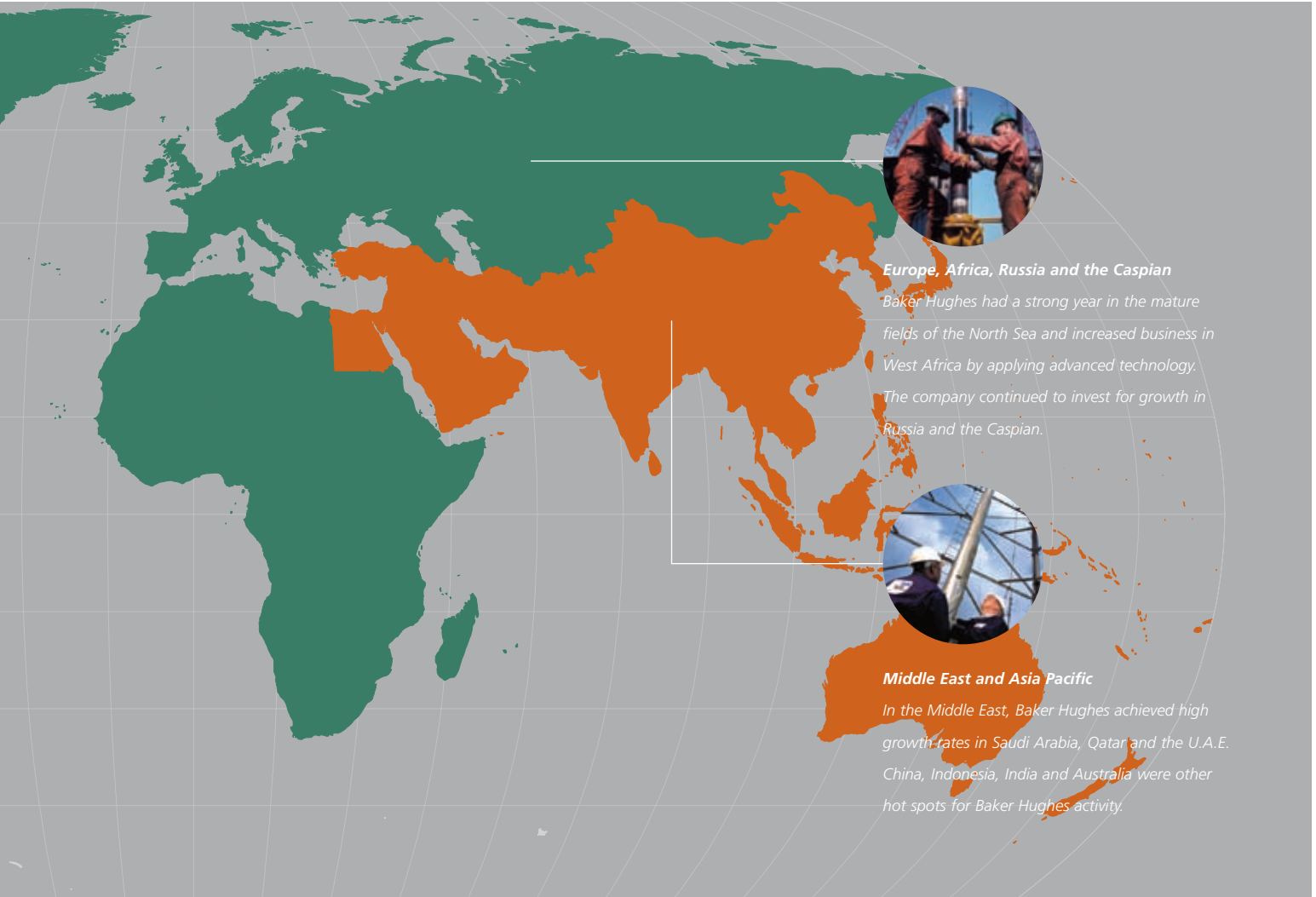
## Our Core Values

**Integrity** – We believe integrity is the foundation of our individual and corporate actions. We are accountable for our actions, successes and failures.

**Teamwork** – We believe teamwork leverages our individual strengths. We willingly share our resources as we work toward common goals.

**Performance** – We believe performance excellence will differentiate us from our competitors. We work hard, celebrate our successes and learn from our failures.

**Learning** – We believe a learning environment is the way to achieve the full potential of each individual and the company.



### Baker Oil Tools

Baker Oil Tools provides completion and intervention solutions that help manage cost and risk while optimizing production. Baker Oil Tools is the world's premier completion and wellbore intervention supplier. The division has a comprehensive line of completion systems, which maximize performance and safety from the sand face to the surface. Wellbore intervention solutions address issues ranging from temporary well abandonment and fishing to casing exits, wellbore cleaning, and isolation, remediation and stimulation operations.

### Baker Petrolite

Baker Petrolite provides chemical technology solutions for hydrocarbon production, transportation and processing, and also delivers pipeline integrity services. Baker Petrolite is a leader in oil/water separation technology and in solutions to control corrosion, deposition, bacteria and H<sub>2</sub>S in producing wells and production facilities. To serve refinery and petrochemical customers, Baker Petrolite provides chemicals and technical support to enhance plant processes, improve productivity, manage water treatment, and resolve environmental issues.

### Centrilift

Centrilift provides artificial lift systems, including electric submersible pumps (ESP) and progressive cavity pump systems, as well as specific engineering, project management and well monitoring services. Centrilift has expanded the applications for ESP systems to harsh downhole environments such as high gas to oil ratio, heavy oil, high temperatures and abrasive laden fluids. New systems also address the needs of coalbed methane and subsea production.

### Production Optimization

Baker Hughes formed its Production Optimization business unit to provide technology and services that help maximize recovery from both new and mature fields. The unit provides production optimization services centered on the well bore, including permanent monitoring, chemical automation, intelligent production systems, and consulting services. The unit integrates technologies from the recently acquired QuantX Wellbore Instrumentation, Luna Energy and Nova Technology businesses and from Baker Oil Tools, Centrilift and Baker Petrolite.

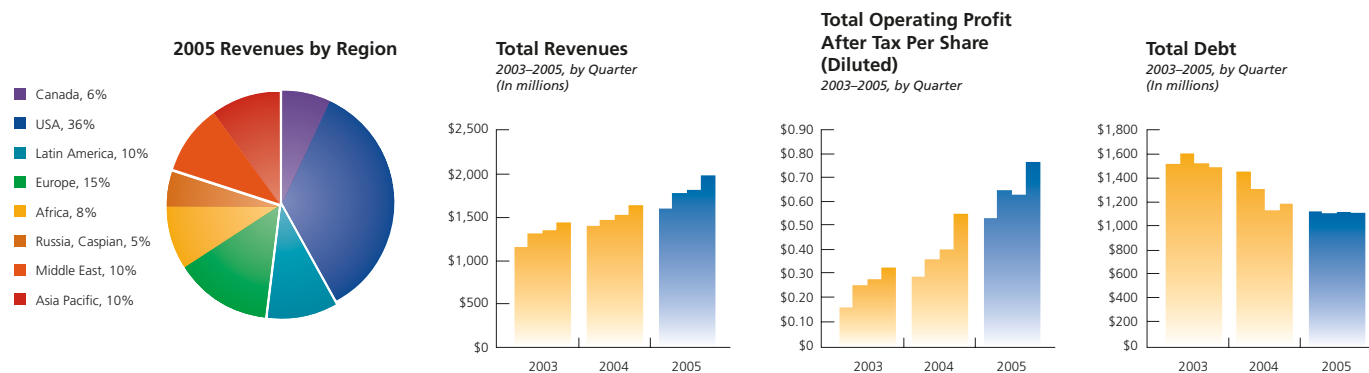
# Selected Financial Highlights

(In millions, except per share amounts)	Year Ended December 31,				
	2005 <sup>(1)</sup>	2004 <sup>(1)</sup>	2003 <sup>(1)</sup>	2002 <sup>(1)</sup>	2001 <sup>(1)</sup>
Revenues	\$ 7,185.5	\$ 6,079.6	\$ 5,233.3	\$ 4,843.5	\$ 4,980.5
Operating income	1,233.4	816.4	557.0	559.5	719.7
Income from continuing operations	874.4	525.3	175.8	226.0	429.2
Income before extraordinary loss and cumulative effect of accounting change	879.3	528.6	134.5	211.4	438.7
Net income	878.4	528.6	128.9	168.9	438.0
Per share of common stock:					
Income from continuing operations					
Basic	2.58	1.57	0.52	0.67	1.28
Diluted	2.56	1.57	0.52	0.67	1.27
Net income					
Basic	2.59	1.58	0.38	0.50	1.31
Diluted	2.57	1.58	0.38	0.50	1.30
Number of shares:					
Outstanding at year end	341.5	336.6	332.0	335.8	336.0
Average during year	339.4	333.8	334.9	336.8	335.6
Income from continuing operations	\$ 874.4	\$ 525.3	\$ 175.8	\$ 226.0	\$ 429.2
Non-operational items, net of tax <sup>(2)</sup>	—	—	150.1	86.8	4.8
Operating profit after tax <sup>(3)</sup>	\$ 874.4	\$ 525.3	\$ 325.9	\$ 312.8	\$ 434.0
Per share of common stock:					
Operating profit after tax					
Basic	\$ 2.58	\$ 1.57	\$ 0.97	\$ 0.93	\$ 1.29
Diluted	2.56	1.57	0.97	0.93	1.29
Working capital	\$ 2,479.4	\$ 1,738.3	\$ 1,210.5	\$ 1,498.6	\$ 1,661.6
Total assets	7,807.4	6,821.3	6,416.5	6,499.7	6,676.2
Total debt	1,087.9	1,162.3	1,484.4	1,547.8	1,694.6
Stockholders' equity	4,697.8	3,895.4	3,350.4	3,397.2	3,327.8
Total debt/equity ratio	23%	30%	44%	46%	51%
Number of employees (thousands)	29.1	26.9	26.5	25.7	25.2

<sup>(1)</sup> Excludes the results of our oil producing operations in West Africa, EIMCO Process Equipment, BIRD Machine, Baker Hughes Mining Tools, and Baker SPD, all discontinued businesses.

<sup>(2)</sup> Includes restructuring charges and reversals, impairment of investment in affiliate, and gain (loss) on disposal of assets. Additional information for each item can be found on our website at [www.bakerhughes.com/investor](http://www.bakerhughes.com/investor).

<sup>(3)</sup> Operating profit after tax is a non-GAAP measure comprised of income from continuing operations excluding the impact of certain non-operational items. We believe that operating profit after tax is useful to investors because it is a consistent measure of the underlying results of our business. Furthermore, management uses operating profit internally as a measure of the performance of the company's operations.



# To Our Stockholders

I am pleased to report that 2005 was an outstanding year for Baker Hughes with record revenues and profits and exceptional growth in the price of our common stock. As worldwide energy production capacity barely kept pace with growing demand, drilling and production activity continued to increase. With our Strategic Framework in place, Baker Hughes took advantage of opportunities in this active market. We built on our strength in North America while accelerating our growth in the Eastern Hemisphere. Our divisions continued to focus on Best-in-Class products and services, and they introduced new, differentiating technologies that created value for customers and contributed to strong financial results for the year.

## Our People Delivered Results

Our more than 29,000 Baker Hughes employees deserve the credit for helping deliver such outstanding results in 2005. Through dedication and hard work, our people achieved record productivity and maintained high standards of safety, quality and service. Our employees made the most of limited resources, and many of them worked extra hours and spent long rotations away from home. I thank our employees for their significant contributions during the year.

## Record Performance

Baker Hughes achieved record revenues and profits, as growth exceeded increases in the rig count. In last year's report, we projected that drilling activity would increase by 9–11% in 2005. In fact,

Baker Hughes revenues grew 18% and earnings per diluted share were up 63%, as the average worldwide active rig count increased by 15%.

Revenues were \$7.2 billion compared to \$6.1 billion in 2004. Income from continuing operations was \$874 million in 2005, up 66% from \$525 million in 2004. Our oilfield pre-tax operating margin, excluding the WesternGeco joint venture, reached an all time high of 20% in 2005, up from 17% in the prior year, the result of higher demand, greater productivity and stronger pricing.

## Two Segments, Regional Alignment

During 2005, two positive steps aligned our organization to pursue growth opportunities.

First, we created two business segments by forming the Drilling and Evaluation segment (comprised of Hughes Christensen, INTEQ, Baker Atlas and Baker Hughes Drilling Fluids) and the Completion and Production segment (comprised of Baker Oil Tools, Centrilift, Baker Petro-lite and our new Production Optimization business unit).

These two segments are organized around customer needs during distinct phases of oil and gas development. Within each segment, our divisions will focus on cross-divisional opportunities, sharpen their focus on customer relationships, develop Best-in-Class technologies, and work together to promote excellence in manufacturing and operations. The segment management will focus on the distinct strategic, technical and capital challenges faced within each segment.

*With our Strategic Framework in place, Baker Hughes took advantage of opportunities in this active market. We built on our strength in North America while accelerating our growth in the Eastern Hemisphere. Our divisions continued to focus on Best-in-Class products and services, and they introduced new, differentiating technologies that created value for customers and contributed to strong financial results for the year.*



Chad C. Deaton,  
Chairman and CEO

Next, we aligned our global operations into four regions – North America; Latin America; Europe, Africa, Russia and the Caspian; and Middle East and Asia Pacific. Each division now has a vice president located in each region, who reports to the division president and is a member of a regional management council. We made this change to facilitate and strengthen our operations in all parts of the world, not only in business activity, but in the makeup of the company, with the goal of accelerating the development of an indigenized management team.

The realigned organization – with two business segments and a consistent regional structure – supports our long-term strategy. It complements our Best-in-Class product-line focus while placing decision-makers closer to our global customers – particularly the national oil companies – in areas with the highest potential for growth.

### **Growth in All Regions**

Our customers around the globe increased their exploration, development and production activity in 2005, and Baker Hughes revenues grew in all four of our operating regions.

### **North America**

North American revenue increased 21% in 2005 compared to 2004. The average North American rig count was up 18% for the year, driven by an increase in land rigs, primarily drilling for natural gas. Horizontal drilling activity in North America also increased substantially compared to 2004, and the Canadian rig count ended the year at historically high levels. As a result, Baker Petrolite, Centrilift, Hughes Christensen, Baker Oil Tools and INTEQ all achieved record land-based revenue.

The average U.S. offshore rig count was down 4% in 2005, largely due to the year's disastrous hurricane season. In the third quarter, Hurricane Dennis disrupted offshore activity, and Hurricanes Katrina and Rita caused extensive damage to our customers' offshore drilling and production facilities. While the storms had a negative impact on third-quarter results – especially for Baker Atlas, Baker Hughes Drilling Fluids, and Baker Oil Tools – Baker Hughes offshore U.S. revenues increased 12% for the year compared to 2004.

### **Latin America**

Baker Hughes revenue in Latin America increased 15% in 2005 compared to 2004, while the average rig count in the region was up by 9%. Gains were most significant in Ecuador, where Baker Oil Tools and Centrilift installed intelligent well systems and Baker Hughes Drilling Fluids conducted major projects; in Brazil, where Baker Atlas conducted deepwater logging services and INTEQ introduced advanced drilling systems; and in Argentina, where Centrilift won new ESP contracts and Hughes Christensen set drilling records.

### **Europe, Africa, Russia and the Caspian**

Revenues from Europe, Africa, Russia and the Caspian were up 14% in 2005 compared to 2004. Revenues from INTEQ, Baker Atlas and Hughes Christensen were up broadly throughout the region. In the North Sea, several divisions combined their capabilities to deliver technically complex wells for customers in the U.K., Norwegian and Danish sectors. Hughes Christensen benefited from export sales into Russia and the Caspian area. Revenues in Africa increased, based on strong activity in Angola, Nigeria, Algeria, and Mauritania. Although our business in

*Demand for energy is growing rapidly, paced by economic growth in developing Asia and China in particular. At the same time, producers are struggling to meet demand and rebuild excess production capacity. With very little excess capacity, energy prices will remain high and volatile, driving investment in new field development in the Middle East, Russia and West Africa.*

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*This Annual Report to Stockholders, including the letter to stockholders from Chairman Chad C. Deaton, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words "will," "expect," "should," "scheduled," "plan," "aim," "ensure," "believe," "promise," "anticipate," "could" and similar expressions are intended to identify forward-looking statements. Baker Hughes' expectations regarding these matters are only its forecasts. These forecasts may be substantially different from actual results, which are affected by many factors, including those listed in "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in Items 1A and 7 of the Annual Report on Form 10-K of Baker Hughes Incorporated for its year ended December 31, 2005. The use of "Baker Hughes," "our," "we" and similar terms are not intended to describe or imply particular corporate organizations or relationships.*

Russia was negatively impacted in 2005 by the nationalization of Yukos, we remain committed to expanding our presence in this important market.

### Middle East and Asia Pacific

Middle East and Asia Pacific revenues were up 20% in 2005 compared to 2004, driven by impressive gains in the Middle East. In Saudi Arabia, the company provided a full range of drilling and completion technology to support an aggressive horizontal well program. In Kuwait, Baker Atlas introduced the latest formation evaluation technology, including the new Magnetic Resonance Explorer<sup>SM</sup> and Earth Imager<sup>SM</sup> services. In Qatar, Baker Hughes provided drilling systems, formation evaluation services, fluids, and completion systems for the country's high-volume gas wells.

In China, INTEQ, Hughes Christensen, Baker Oil Tools and Centrilift contributed to successful multi-well offshore development projects for two Western operators in Bohai Bay. In addition, INTEQ introduced its VertiTrak<sup>®</sup> vertical drilling service to drill an onshore well for a Chinese oil company in the challenging geology of Northwest China.

### Drilling and Evaluation Highlights

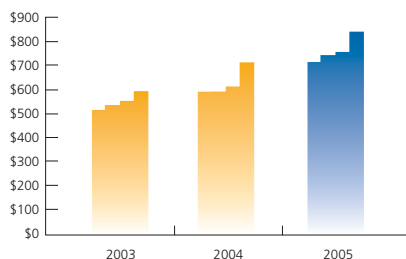
During its first full year as a stand-alone division, **Baker Hughes Drilling Fluids** benefited from its product line focus, increasing revenues by 19% to reach record levels and obtained a double digit

operating margin in the fourth quarter. Baker Hughes Drilling Fluids achieved this growth despite severe disruption of its Gulf of Mexico operations by the hurricanes during the year. The division continued to deploy its PERFORMAX<sup>™</sup> high performance water-based mud system as an alternative to emulsion mud systems in Saudi Arabia, Australia, Brazil, the Caspian Sea and the Gulf of Mexico. In addition, the division expanded its Fluids Environmental Services operation with a new facility in Louisiana.

**Hughes Christensen** sales grew 33% in 2005, achieving another record year in both revenues and profits. In 2005, Hughes Christensen continued to gain diamond bit market share by introducing technical enhancements to its Genesis<sup>®</sup> product line. The division's diamond bit rental business benefited from increases in gas-directed drilling in the United States and Canada. Hughes Christensen maintained its leadership in Tricone<sup>®</sup> drill bit technology by introducing three new lines for specific applications. *World Oil* Magazine presented Hughes Christensen with the year's "Best Drilling Technology Award" for its EZ-Case<sup>™</sup> casing bit system.

**INTEQ** increased sales 21% and achieved record revenues and profitability in 2005, with strong activity in all regions. The division deployed its AutoTrak<sup>®</sup> and VertiTrak<sup>®</sup> drilling systems and X-Treme<sup>®</sup> motors into more geographic markets during the year. INTEQ also focused on

**North America Revenues**  
2003-2005, by Quarter  
(In millions)





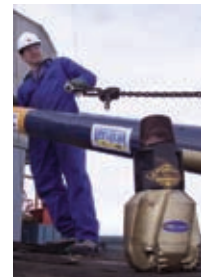


## North America



*Baker Hughes leveraged its traditional strength in North America by supporting increased natural gas development. Baker Hughes technology enabled customers to perform horizontal drilling and completion in Texas' Barnett Shale play, drill vertically through the faulted zones of the Canadian foothills, and dewater both conventional gas and coalbed methane wells in the Rocky Mountains.*

*In North America, advancements from Centrillift have extended the range of ESP systems to wells with harsh downhole conditions. Chemical automation systems offered by Production Optimization improved operating efficiency in remote fields. The VertiTak<sup>®</sup> system and Genesis<sup>®</sup> PDC bits enabled efficient vertical drilling in Canada and Oklahoma.*



## Latin America

*Baker Hughes increased its presence in Latin America with growing activity in Brazil, Ecuador, Colombia, and Argentina. In Brazil, Baker Hughes technology enabled drilling and completion of complex horizontal wells in deepwater fields. In Ecuador, the company installed its fourth Intelligent Well System, and supplied drilling fluids for a 30-well campaign.*



*In Latin America, Baker Hughes Drilling Fluids delivered innovative mud systems from Colombia to Argentina. Baker Atlas provided advanced logging services for deepwater wells in Brazil. Baker Hughes divisions combined drilling, evaluation and completion technologies to achieve high performance on land development projects in Venezuela, Ecuador, Colombia and Bolivia.*



enhancing its Logging-While-Drilling (LWD) product line by introducing new deep-reading resistivity technology, improving its imaging capability, and deploying more TesTrak™ formation pressure testing systems.

**Baker Atlas** revenues grew 17% (20% excluding a one-time intellectual property licensing fee in the fourth quarter of 2004) during another record year, in which the division differentiated itself with new technology and high-quality service. The division deployed its new Magnetic Resonance Explorer<sup>SM</sup> and Earth Imager<sup>SM</sup> services to key offshore markets like Brazil, West Africa and the Caspian Sea. Baker Atlas continued to build on its industry-leading Reservoir Characterization Instrument® service with new “mini-drill stem test” capabilities and data processing services.

#### Completion and Production Highlights

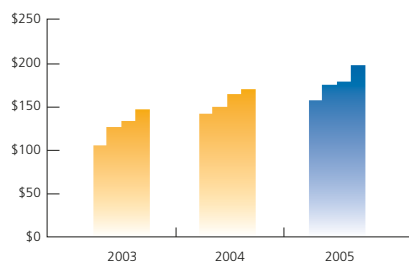
**Baker Oil Tools** revenues increased 15% with strong performance in the Gulf of Mexico, Egypt, Saudi Arabia, Qatar and West Africa. Demand for intelligent well systems increased during the year, and Baker Oil Tools installed new systems in Ecuador and off Eastern Canada’s Sable Island. The division installed more EQUALIZER™ horizontal well production systems in Norway, where more than 16,000 units are in place, and built a strong track record in Saudi Arabia, where EQUALIZER™ equipment

is producing from nearly 20 miles of completion screen.

**Centrilift** revenues grew 8% in 2005, surpassing performance in 2004 that had included significant electrical submersible pump (ESP) system sales in Russia. The division had major installations come on line in China’s Bohai Bay during the year. Full-scale operations at new repair facilities in Siberia and Dubai also began in 2005. Centrilift introduced technical innovations to improve ESP performance in high gas content wells and in steam-flooded heavy oil fields. Centrilift also became a major supplier of ESP systems for dewatering wells to produce gas from coalbed methane fields.

**Baker Petrolite** revenues increased 17%, with growth in both upstream and downstream product lines. The oilfield chemical business grew worldwide as customers strived to optimize mature field production. Growth areas in North America included chemicals to treat heavy oil in Canada and to control corrosion and remove fluid from gas wells in the Rocky Mountains. Baker Petrolite also expanded international oilfield markets in Brazil, West Africa and the Middle East. Baker Petrolite’s downstream business also grew through sales of products and services to help refineries process “opportunity” crude oils and operate more reliably and more efficiently. The division also had strong demand for its FLO® drag reducing agents, particularly in Eastern Hemisphere

**Latin America Revenues**  
2003–2005, by Quarter  
(In millions)



markets with limited pipeline capacity. The division's pipeline integrity business expanded its base of operations to provide engineering, cleaning and inspection services to customers in Europe and Latin America.

### Investing in Growth

We believe the next two to three years offer the prospect for significant growth for Baker Hughes. We are investing in equipment, people, and technology to take advantage of this market.

With strong demand and a robust pricing environment, Baker Hughes increased its capital budget for rental tools and related equipment to \$478 million in 2005 from \$348 million in 2004. We expect to increase capital spending in 2006 to \$750 million – \$780 million.

To address the need for additional skilled personnel, Baker Hughes is focused on hiring, training and retaining new employees. We have broadened our college recruiting program to attract graduates from leading technical universities in all the regions where we operate around the world. In 2006, we will enhance our development program for young engineers to train them in various Baker Hughes technologies and prepare them for future management roles.

We are building a new training center in Dubai that will begin providing a full range of training opportunities for employees from the Middle East and other areas of the Eastern Hemisphere beginning in 2007.

Baker Hughes remains committed to aggressive technology investment. Research and Engineering budgets totaled \$300 million in 2005, up 10% from 2004. More than 60% of these efforts were directed at developing new products. In 2006, we plan to increase our investment in technology.

In June 2005, the Baker Atlas Russian Science Center began operation in Novosibirsk, Siberia. Approximately 25 Russian scientists now work at this facility, performing advanced research in the geosciences.

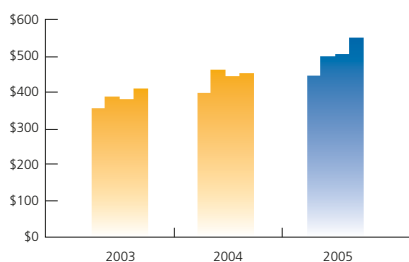
In December 2005, we approved plans to build a new Center for Innovative Technology in Houston, where research engineers from our Completion and Production segment can concentrate on new technologies. We expect this center to accelerate development of new, innovative products and services that bring high value to our customers.

Baker Hughes also has actively pursued new technology capabilities through acquisitions.

In late 2005, we acquired Zeroth Technology Limited, which has developed proprietary expandable metal-to-metal sealing technology for packers and coiled tubing operations. This product line will enhance Baker Oil Tools' well intervention capabilities.

In 2004, we purchased the remaining interest in the Luna Energy fiber optic venture from Luna Technologies and in 2005 we acquired the remaining interest in the QuantX Wellbore Instrumentation venture from Expro International. In early

**Europe, Africa, Russia and Caspian Revenues**  
2003–2005, by Quarter  
(In millions)



## Europe, Africa, Russia and the Caspian

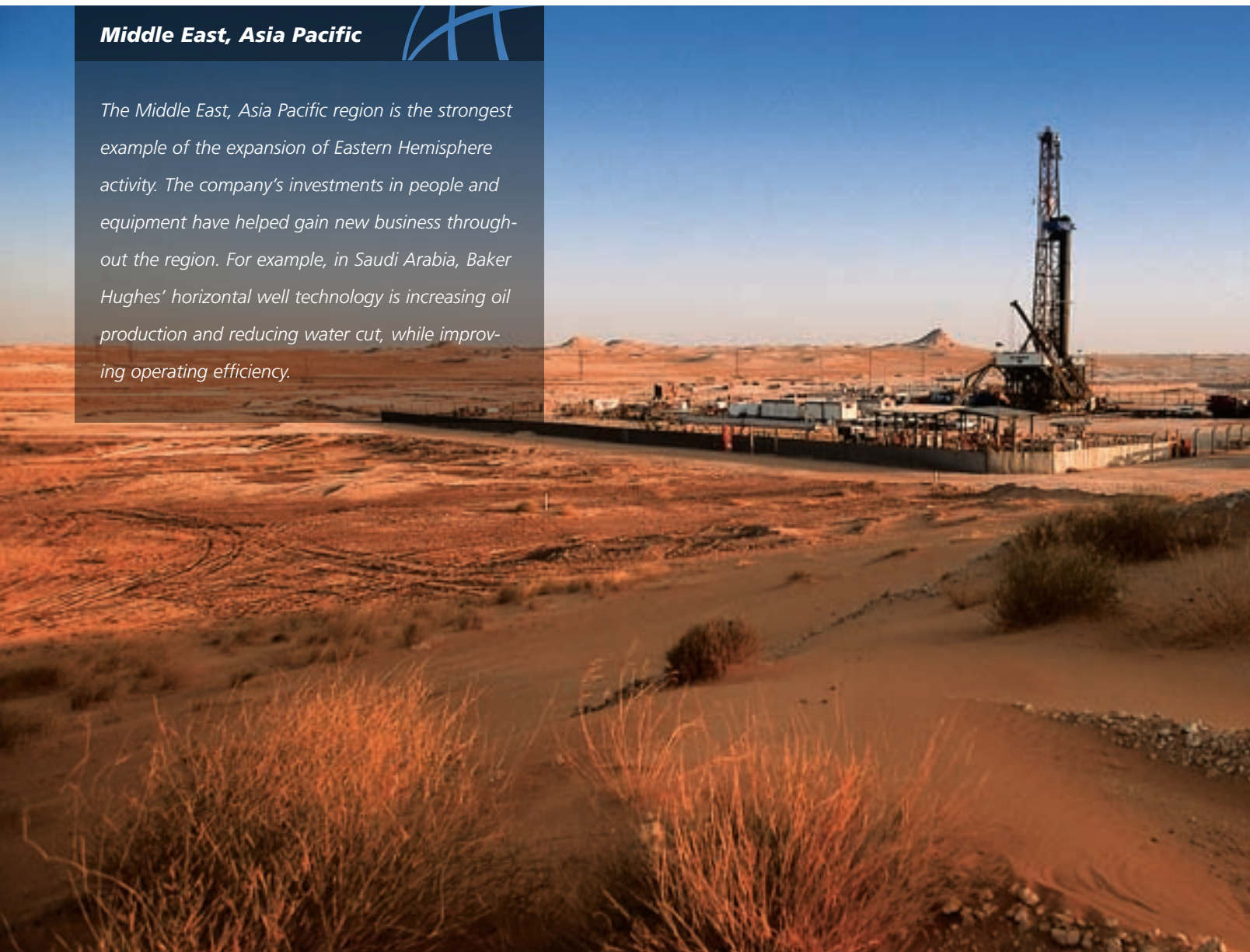
With high oil and gas prices, Baker Hughes gained opportunities by helping improve production from the North Sea's aging fields. The company also participated in major offshore projects along the West African coast, and pursued new business in the Caspian Sea region. Notable Russian successes included record extended reach drilling from Sakhalin Island and the opening of a research center in Siberia.

*Centrilift set ESP run-life records and began full-scale operation at its new repair facility in Siberia. In the Caspian Sea, Baker Atlas introduced advanced logging services. INTEQ and Hughes Christensen combined drilling systems, formation evaluation and PDC bit technologies to deliver complex wells in the North Sea, West Africa, Russia and the Caspian.*



## Middle East, Asia Pacific

The Middle East, Asia Pacific region is the strongest example of the expansion of Eastern Hemisphere activity. The company's investments in people and equipment have helped gain new business throughout the region. For example, in Saudi Arabia, Baker Hughes' horizontal well technology is increasing oil production and reducing water cut, while improving operating efficiency.



*Baker Hughes employees delivered quality drilling, formation evaluation and completion services throughout the Middle East, Asia Pacific region. Baker Hughes divisions teamed to conduct multi-well horizontal drilling and completion projects in China, India, Indonesia and the U.A.E. Centrifluff pumping systems contributed to production efficiency in Kuwait, Oman, China and Australia.*



2006, we acquired Nova Technology Corporation, a supplier of monitoring and chemical injection systems for subsea wells. All three of these technology units are part of our new Production Optimization business unit.

Baker Hughes formed Production Optimization in 2005 to meet the industry's need for efficient technologies that maximize recovery from both new and mature fields. The business unit will combine existing Baker Hughes product lines with recently acquired and newly developed products. The unit's goal is to provide intelligent production systems that monitor well performance and optimize hydrocarbon flow over the well's life.

#### Financial Flexibility

Maintaining financial flexibility remains a key strategy at Baker Hughes.

We have achieved financial flexibility by applying our Baker Value Added (BVA) metric to assure that our investments achieve an adequate return. While we will continue to use BVA as a key factor in allocating capital, we are now in a strong position to make longer-term investments in new technologies and expand our presence in geographic markets where we are under-represented.

With strong revenues and healthy cash flow, Baker Hughes continued to improve its balance sheet. During the year, we added \$455 million in cash and short-term investments and reduced net debt to \$314 million.

We also continued to focus on return to stockholders with a dividend increase and a stock repurchase program. In November 2005, the Board of Directors approved an increase in the regular quarterly dividend to \$0.13 per share from \$0.115 per share. This was our first dividend increase since the formation of Baker Hughes in 1987. In 2005, the company repurchased approximately 1.7 million shares at a cost of \$99 million. The company has authorization remaining to purchase approximately \$401 million in stock.

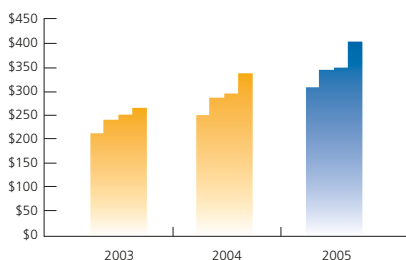
#### Hurricane Response

The two major hurricanes that hit the Gulf Coast in 2005 had a devastating affect on thousands of people from Mississippi to Texas. More than 700 employees and their families were seriously affected, many losing their homes. Baker Hughes employees from around the world responded by donating money, supplies and time to provide relief. The company matched the significant financial contributions made by employees and made a substantial donation to the American Red Cross. I am extremely proud of our people. Their generosity made a significant positive impact on the lives of fellow employees who were affected by the storm.

#### Steve Finley Retires

At the end of March 2006 Steve Finley, Senior Vice President – Finance & Administration and Chief Financial Officer, will

**Middle East, Asia Pacific Region Revenues**  
2003–2005, by Quarter  
(In millions)



retire from the company after 24 years with Baker Hughes. Steve has managed the implementation of our Baker Value Added metric, the development of our shared service organization and our implementation of the Sarbanes-Oxley Act. We will miss Steve's experience, steady hand and thought-provoking leadership and wish him all the best in his retirement.

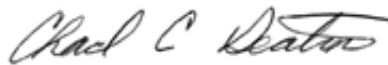
### Outlook

We agree with many industry experts that the current growth cycle is different from earlier market cycles. Demand for energy is growing rapidly, paced by economic growth in developing Asia and China in particular. At the same time, producers are struggling to meet demand and rebuild excess production capacity. With very little excess capacity, energy prices will remain high and volatile driving investment in new field development in the Middle East, Russia and West Africa. At the same time, oil and gas companies in North America and the North Sea are investing in mature fields and in gas fields

that could not be produced economically at lower commodity prices.

Worldwide, we expect our customers' exploration and production budgets to increase 17–21% in 2006. High activity levels are expected to continue for the next several years. In a sustained market like this one, Baker Hughes has a world of opportunities.

As we move ahead, Baker Hughes will grow by building on its strengths. We will continue to be the Best-in-Class company comprised of product-line focused divisions. Baker Hughes will be recognized increasingly as a technology innovator. We will live and work within a High Performance Culture based on our Core Values. And we will become an even more global company, with a diverse workforce and career opportunities for employees around the world.



Chad C. Deaton  
Chairman and Chief Executive Officer



Alan R. Crain, Jr., V.P. and General Counsel; James R. Clark, President and COO; Chad C. Deaton, Chairman and CEO; G. Stephen Finley, Sr. V.P. – Finance and Administration and CFO; and Greg Nakanishi, V.P. Human Resources.



# Baker Hughes Incorporated

## Notice of Annual Meeting of Stockholders

April 27, 2006

### TO THE STOCKHOLDERS OF BAKER HUGHES INCORPORATED:

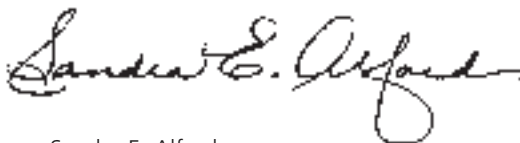
The Annual Meeting of the Stockholders of Baker Hughes Incorporated ("Company" or "Baker Hughes") will be held at the offices of the Company, 3900 Essex Lane, Suite 210, Houston, Texas on Thursday, April 27, 2006, at 9:00 a.m., Central Daylight Time, for the purpose of considering and voting on:

1. Election of eleven directors;
2. Ratification of Deloitte & Touche LLP as the Company's Independent Auditor for Fiscal Year 2006;
3. Approval of the Performance Criteria for Awards under the Annual Incentive Compensation Plan;
4. Stockholder Proposal No. 1 regarding voting under the Company's Delaware Charter; and
5. Such other business as may properly come before the meeting and any reconvened meeting after an adjournment thereof.

The Board of Directors has fixed March 1, 2006 as the record date for determining the stockholders of the Company entitled to notice of, and to vote at, the meeting and any reconvened meeting after an adjournment thereof, and only holders of Common Stock of the Company of record at the close of business on that date will be entitled to notice of, and to vote at, that meeting or a reconvened meeting after an adjournment.

You are invited to attend the meeting in person. Whether or not you plan to attend the meeting personally, please complete, sign and date the enclosed proxy, and return it as soon as possible in the enclosed postage prepaid envelope. You may revoke your proxy any time prior to its exercise, and you may attend the meeting and vote in person, even if you have previously returned your proxy. In some cases, you may be able to exercise your proxy by telephone or by the Internet. Please refer to the Proxy Statement for further information on telephone and Internet voting.

By order of the Board of Directors,



Sandra E. Alford  
Corporate Secretary

Houston, Texas  
March 15, 2006

**TO ASSURE YOUR REPRESENTATION AT THE MEETING, PLEASE SIGN, DATE AND RETURN YOUR PROXY AS PROMPTLY AS POSSIBLE. AN ENVELOPE, WHICH REQUIRES NO POSTAGE IF MAILED IN THE UNITED STATES, IS ENCLOSED FOR THIS PURPOSE.**

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## PROXY STATEMENT

This Proxy Statement is furnished in connection with the solicitation of proxies by the Board of Directors of Baker Hughes Incorporated, a Delaware corporation (“Company,” “Baker Hughes,” “we,” “us” and “our”), to be voted at the Annual Meeting of Stockholders scheduled to be held on Thursday, April 27, 2006 and at any and all reconvened meetings after adjournments thereof.

Solicitation of proxies by mail is expected to commence on or about March 15, 2006 (the approximate date this Proxy Statement and accompanying proxy were first sent to security holders). The Company will bear the cost of the solicitation. In addition to solicitation by mail, certain of the directors, officers and regular employees of the Company may, without extra compensation, solicit proxies by telephone, facsimile and personal interview. The Company will make arrangements with brokerage houses, custodians, nominees and other fiduciaries to send proxy material to their principals, and the Company will reimburse them for postage and clerical expenses. The Company has retained Mellon Investor Services LLC, Baker Hughes’ transfer agent and registrar, to assist in the solicitation of proxies from stockholders of the Company for an anticipated fee of \$9,500, plus out-of-pocket expenses.

Stockholders with shares registered in their names with Mellon Investor Services LLC may authorize a proxy by the Internet at the following Internet address: <http://www.eproxy.com/bhi>, or telephonically by calling Mellon Investor Services LLC at 1-800-435-6710. Proxies submitted through Mellon Investor Services LLC by the Internet or telephone must be received by 11:59 p.m. Eastern time (10:59 p.m. Central time) on April 26, 2006. The giving of a proxy will not affect your right to vote in person if you decide to attend the meeting.

A number of banks and brokerage firms participate in a program that also permits stockholders to direct their vote by the Internet or telephone. This option is separate from that offered by Mellon Investor Services LLC and will be reflected on the voting form from a bank or brokerage firm that accompanies this Proxy Statement. If your shares are held in an account at a bank or brokerage firm that participates in such a program, you may direct the vote of these shares by the Internet or telephone by following the instructions on the voting

form enclosed with the proxy from the bank or brokerage firm. Votes directed by the Internet or telephone through such a program must be received by Mellon Investor Services LLC by 11:59 p.m. Eastern time (10:59 p.m. Central time) on April 26, 2006. Directing the voting of your shares will not affect your right to vote in person if you decide to attend the meeting; however, you must first request a proxy either on the Internet or the voting form that accompanies this Proxy Statement. Requesting a proxy prior to the deadlines described above will automatically cancel any voting directions you have previously given by the Internet or by telephone with respect to your shares.

The Internet and telephone proxy procedures are designed to authenticate stockholders’ identities, to allow stockholders to give their proxy instructions and to confirm that those instructions have been properly recorded. Stockholders authorizing proxies or directing the voting of shares by the Internet should understand that there may be costs associated with electronic access, such as usage charges from access providers and telephone companies, and those costs must be borne by the stockholder.

**Shares for which proxies have been executed will be voted as specified in the proxies. If no specification is made, the shares will be voted FOR the election of nominees listed herein as directors, FOR ratification of Deloitte & Touche LLP as the Company’s Independent Auditor for fiscal year 2006, FOR approval of the performance criteria for awards under the Annual Incentive Compensation Plan and AGAINST Stockholder Proposal No. 1.**

Proxies may be revoked at any time prior to the exercise thereof by filing with the Corporate Secretary, at the Company’s executive offices, a written revocation or a duly executed proxy bearing a later date. The executive offices of the Company are located at 3900 Essex Lane, Houston, Texas 77027-5177. For a period of at least ten days prior to the Annual Meeting of Stockholders, a complete list of stockholders entitled to vote at the Annual Meeting will be available for inspection during ordinary business hours at the Company’s executive offices by stockholders of record for proper purposes.

## VOTING SECURITIES

The securities of the Company entitled to be voted at the Annual Meeting consist of shares of its Common Stock, par value \$1 per share ("Common Stock"), of which 342,449,488 shares were issued and outstanding at the close of business on March 1, 2006. Only stockholders of record at the close of business on that date will be entitled to vote at the meeting. Each share of Common Stock entitles the holder thereof to one vote on each matter to be considered at the meeting.

Assuming a quorum is present at the Annual Meeting, either in person or represented by proxy, (i) the eleven nominees receiving the greatest number of votes cast by the holders of the Common Stock entitled to vote on the matter will be elected as directors; and (ii) the affirmative vote of the holders of a majority of the shares of Common Stock present in person or represented by proxy at the Annual Meeting and entitled to vote on the matter is required for the approval of the ratification of Deloitte & Touche LLP as the Company's Independent Auditor for fiscal year 2006, the approval of the performance criteria for awards under the Annual Incentive Compensation Plan, and for the approval of Stockholder Proposal No. 1. There will be no cumulative voting in the election of directors. Under Delaware law, abstentions are treated as present and entitled to vote and thus, will be counted in determining whether a quorum is present and will have the effect of a vote against a matter, except for the election of directors in which case an abstention will have no effect. Shares held by brokers or nominees for which instructions have not been received from the beneficial owners or persons entitled to vote and for which the broker or nominee does not have discretionary power to vote on a particular matter (called "broker non-votes"), will be considered present for quorum purposes but not considered entitled to vote on that matter. Accordingly, broker non-votes will not have any impact on the vote on a matter.

Under the rules of the New York Stock Exchange ("NYSE") in effect at the time this Proxy Statement was issued, if you hold your shares through a broker, your broker is permitted to vote your shares on the election of directors, the ratification of the Independent Auditor and the approval of the performance criteria for awards under the Annual Incentive Compensation Plan even if the broker does not receive instructions from you. Your shares will only be voted with respect to Stockholder Proposal No. 1 if you have provided specific voting instructions to your broker.

The following table sets forth information about the holders of the Common Stock known to the Company on February 28, 2006 to own beneficially 5% or more of the Common Stock, based on filings by the holders with the Securities and Exchange Commission ("SEC"). For the purposes of this Proxy Statement, beneficial ownership of securities is defined in accordance with the rules of the SEC to mean generally the power to vote or dispose of securities regardless of any economic interest therein.

Name and Address	Shares	Percent
1. Capital Research and Management Company 333 South Hope Street Los Angeles, California 90071	43,307,900	12.7%
2. FMR Corp. 82 Devonshire Street Boston, Massachusetts 02109	26,415,890	7.8%
3. Dodge & Cox Management Company One Sansome Street, 35th Floor San Francisco, California 94104	19,210,112	5.6%
4. Barclays Global Investors, N.A. 45 Fremont Street San Francisco, California 94105	17,916,953	5.3%

**PROPOSAL NO. 1**  
**ELECTION OF DIRECTORS**

Eleven directors will be elected at the Annual Meeting of Stockholders to serve for one-year terms expiring at the Annual Meeting of Stockholders expected to be held in April 2007.

The following table sets forth each nominee director's name, all positions with the Company held by the nominee, the nominee's principal occupation, age and year in which the nominee first became a director of the Company. Each nominee director has agreed to serve if elected.

<b>Nominees</b>	<b>Principal Occupation</b>	<b>Age</b>	<b>Director Since</b>
Larry D. Brady	Chairman of the Board and Chief Executive Officer of Intermec, Inc. (industrial technologies). Mr. Brady has served as Chairman of Intermec since 2001 and as Chief Executive Officer since 2000. He served as President of Intermec, Inc. from 1999 to 2001 and as Chief Operating Officer from 1999 to 2000. Mr. Brady served as President of FMC Corporation from 1993 to 1999. He served as a Vice President of FMC from 1984 to 1989, as Executive Vice President from 1989 to 1999 and was a director from 1989 to 1999. Mr. Brady is a director of Pactiv Corporation and a member of the Advisory Board of Northwestern University's Kellogg School of Management.	63	2004
Clarence P. Cazalot, Jr.	President and Chief Executive Officer and Director since 2002 of Marathon Oil Corporation, formerly known as USX Corporation (diversified petroleum), and he is also a member of the Board of Managers of Marathon Ashland Petroleum LLC. He served as Vice Chairman of USX Corporation and President of Marathon Oil Company from 2000 to 2001. Mr. Cazalot was with Texaco Inc. from 1972 to 2000, and while at Texaco served in the following executive positions: President of Worldwide Production Operations of Texaco Inc. from 1999 to 2000; President of International Production and Chairman of London-based Texaco Ltd. from 1998 to 1999; President of International Marketing and Manufacturing from 1997 to 1998; President of Texaco Exploration and Production Inc. from 1994 to 1996; and President of Texaco's Latin America/West Africa Division from 1992 to 1994. In 1992, he was named Vice President, Texaco Inc. He is a director and Executive Committee member of both the U.S. Saudi Arabian Business Council and the American Petroleum Institute.	55	2002
Chad C. Deaton	Chairman of the Board and Chief Executive Officer of Baker Hughes since October 2004. Mr. Deaton was President and Chief Executive Officer of Hanover Compressor Company (compression services) from 2002 through October 2004. He was a Senior Advisor to Schlumberger Oilfield Services (oilfield services) from 1999 to September 2001 and was an Executive Vice President from 1998 to 1999. Mr. Deaton is a director of CARBO Ceramics, Inc. and Ariel Corporation. He is also a director of Junior Achievement of Southeast Texas, Houston Achievement Place and Greater Houston Partnership.	53	2004
Edward P. Djerejian	Director of the James A. Baker III Institute for Public Policy at Rice University since 1994. Ambassador Djerejian served as U.S. Ambassador to Israel from 1993 to 1994. He served as Assistant Secretary of State for Near Eastern Affairs from 1991 to 1993. Ambassador Djerejian also served as U.S. Ambassador to the Syrian Arab Republic from 1988 to 1991, as Deputy Assistant Secretary of Near Eastern and South Asian Affairs from 1986 to 1988 and as Special Assistant to the President and Deputy Press Secretary for Foreign Affairs from 1985 to 1986. He is a director of Global Industries, Ltd. and Occidental Petroleum.	66	2001
Anthony G. Fernandes	Former Chairman, President and Chief Executive Officer of Phillip Services Corporation (diversified industrial services provider) from August 1999 to April 2002. He was Executive Vice President of ARCO (Atlantic Richfield Company) from 1994 to 1999, President of ARCO Coal, a subsidiary of ARCO, from 1990 to 1994 and Corporate Controller of ARCO from 1987 to 1990. Mr. Fernandes serves on the Boards of Black & Veatch, Cytec Industries and Tower Automotive.	60	2001

<b>Nominees (cont'd.)</b>	<b>Principal Occupation</b>	<b>Age</b>	<b>Director Since</b>
Claire W. Gargalli	Former Vice Chairman, Diversified Search and Diversified Health Search Companies (executive search consultants) from 1990 to 1998. Ms. Gargalli served as President and Chief Operating Officer of Equimark from 1984 to 1990. During that period, she also served as Chairman and Chief Executive Officer of Equimark's two principal subsidiaries, Equibank and Liberty Bank. Ms. Gargalli is a director of Praxair, Inc., Intermec, Inc. and Virginia National Bank. She is also a trustee emeritus of Carnegie Mellon University and Middlebury College.	63	1998
James A. Lash	First Selectman, Greenwich, Connecticut (city government) since 2003 and Chairman of Manchester Principal LLC and its predecessor company (high technology venture capital firm) since 1982. Mr. Lash also served as Chairman and Chief Executive Officer of Reading Tube Corporation from 1982 to 1996. Mr. Lash is a director of Ivy Animal Health, Inc., City Center 55th Street Foundation, Inc. and the East West Institute.	61	2002
James F. McCall	Former Executive Director of the American Society of Military Comptrollers from 1991 to 2004. He was Lieutenant General and Comptroller of the U.S. Army from 1988 until 1991, when he retired. General McCall was commissioned as 2nd Lieutenant of Infantry in 1958 and was selected into the Army's Comptroller/Financial Management career field in 1970. General McCall is Chairman of the Board of Enterprise Bancorp Inc. and former Vice Chairman of the Board of Directors of the American Refugee Committee.	71	1996
J. Larry Nichols	Chairman of the Board and Chief Executive Officer of Devon Energy Corporation (independent energy company). Mr. Nichols has served as Chairman of Devon Energy Corporation since 2000, as Chief Executive Officer since 1980 and was President from 1976 until May 2003. Mr. Nichols serves as a director of several trade associations relevant to the oil and gas exploration and production business.	63	2001
H. John Riley, Jr.	Former Chairman of the Board of Cooper Industries, Ltd. (diversified manufacturer) from May 1996 to February 2006. He was Chief Executive Officer of Cooper Industries from 1995 to 2005. He was Executive Vice President, Operations of Cooper Industries from 1982 to 1992, Chief Operating Officer from 1992 to 1995 and President from 1992 to 2004. Mr. Riley is a director of The Allstate Corporation. Mr. Riley also serves as a director of Junior Achievement of Southeast Texas, Central Houston, Inc. and as a trustee of the Museum of Fine Arts, Houston and Syracuse University.	65	1997
Charles L. Watson	Chairman of Eagle Energy Partners (energy marketing), Chairman of Wincrest Ventures, L.P. (private investments) since January 1998 and Founding Partner of Caldwell Watson Real Estate Group, Inc. since 1994. Former Chairman and Chief Executive Officer of Dynegy Inc. (diversified energy) from 1989 to 2002. Mr. Watson was elected Chairman and Chief Executive Officer of NGC Corporation, the predecessor of Dynegy, in 1989. Mr. Watson serves on the National Petroleum Council and the Governor's Business Council. He is a founding member of the Natural Gas Council. Mr. Watson is also a board member of Theatre Under the Stars, Hobby Center for the Performing Arts, Central Houston, Inc., Baylor College of Medicine and Angeleno Investors, L.P.	56	1998

Any nominee for director who receives a "withhold" vote representing a majority of the votes cast for his or her election would be required to submit a letter of resignation to the Board's Governance Committee. The Governance Committee would recommend to the Board whether or not the resignation should be accepted. Pursuant to the Company's Bylaws, in case of a vacancy on the Board of Directors, a majority of the remaining directors will appoint a successor, and the director so appointed will hold office until the next annual meeting or until his or her successor is elected and qualified or until his or her earlier death, retirement, resignation or removal.

## CORPORATE GOVERNANCE

The Company's Board of Directors believes the purpose of corporate governance is to maximize stockholder value in a manner consistent with legal requirements and the highest standards of integrity. The Board has adopted and adheres to corporate governance practices, which practices the Board and management believe promote this purpose, are sound and represent best practices. The Board continually reviews these governance practices, Delaware law (the state in which the Company is incorporated), the rules and listing standards of the NYSE and SEC regulations, as well as best practices suggested by recognized governance authorities. The Board has established the Company's Corporate Governance Guidelines ("Governance Guidelines") as the principles of conduct of the Company's business affairs to benefit its stockholders, which guidelines conform to the NYSE corporate governance listing standards and SEC rules. The Governance Guidelines are posted under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to the Company's Corporate Secretary.

### Board of Directors

During the fiscal year ended December 31, 2005 the Board of Directors held ten meetings, and each director attended at least 75% of the total number of meetings of the Company's Board of Directors and respective Committees on which he or she served. During fiscal year 2005, each non-employee director was paid an annual retainer of \$60,000. The Audit/Ethics Committee Chairman received an additional annual retainer of \$20,000. Each of the other non-employee Committee Chairmen received an additional annual retainer of \$15,000. Each of the members of the Audit/Ethics Committee, excluding the Chairman, received an additional annual retainer of \$10,000. Each of the members, excluding the Chairmen, of the Compensation, Finance and Governance Committees received an additional annual retainer of \$5,000. Each non-employee director also received annual non-retainer equity in a total amount of \$70,000, in the form of restricted shares of the Company's Common Stock with \$35,000 issued in each of January and July of 2005. The restricted stock vested on February 24, 2006. The Company previously provided benefits under a Directors Retirement Plan, which plan remains in effect until all benefits accrued thereunder are paid in accordance with the current terms and conditions of that Plan. No additional benefits have been accrued under the Plan since December 31, 2001.

Effective as of January 1, 2006 each non-employee director is paid an annual retainer of \$60,000. The Audit/Ethics Committee Chairman receives an additional annual retainer of \$20,000. Each of the other non-employee Committee Chairmen receives an additional annual retainer of \$15,000. Each of the members of the Audit/Ethics Committee, excluding the Chairman, receives an additional annual retainer of \$10,000. Each of the members, excluding the Chairmen, of the Compensation, Finance and Governance Committees receives an additional annual retainer of \$5,000. Each non-employee

director also receives annual non-retainer equity in a total amount of \$150,000, in the form of (i) restricted shares of the Company's Common Stock with a value of \$100,000 issued in January of each year that will generally vest one-third on each of January 25, 2007, 2008 and 2009, respectively (however, the restricted shares will become fully vested on the annual meeting of stockholders next following the date the non-employee director attains the age of 72); and (ii) options to acquire the Company's Common Stock with a value of \$25,000 issued in each of January and July. The options will vest one-third each year beginning on the first anniversary date of the grant of the option.

### Director Independence

All members of the Board of Directors, other than the Chairman and Chief Executive Officer, Mr. Deaton, satisfy the independence requirements of the NYSE. In addition, the Board has adopted a "Policy for Director Independence, Audit/Ethics Committee Members and Audit Committee Financial Expert" included as Exhibit C to the Governance Guidelines and attached as Annex A to this Proxy Statement. Such Policy supplements the NYSE independence requirements. Directors who meet these standards are considered to be "independent." The Board has determined that all the nominees for election at this Annual Meeting, other than Mr. Deaton, meet these standards.

### Regularly Scheduled Executive

#### Sessions of Non-Management Directors

Pursuant to the Governance Guidelines, executive sessions of independent non-employee directors are held at every regularly scheduled meeting of the Board of Directors. The Governance Committee reviews and recommends to the Board a director to serve as Lead Director during executive sessions. Currently, Mr. Riley serves as the Lead Director during the executive sessions of independent non-employee directors.

### Committees of the Board

The Board of Directors has, in addition to other committees, an Audit/Ethics Committee, a Compensation Committee and a Governance Committee. The Audit/Ethics Committee, Compensation Committee and Governance Committee are comprised solely of independent directors in accordance with NYSE corporate governance listing standards. The Board of Directors adopted charters for the Audit/Ethics, Compensation and Governance Committees that comply with the requirements of the NYSE standards, applicable provisions of the Sarbanes-Oxley Act of 2002 ("SOX") and SEC rules. Each of the charters has been posted and is available for public viewing under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to the Company's Corporate Secretary.

**Audit/Ethics Committee.** The Audit/Ethics Committee, which is comprised of Messrs. McCall (Chairman), Cazalot, Fernandes, Lash and Nichols, held eight meetings during fiscal year 2005. The Board of Directors has determined that the Audit/Ethics Committee members meet the NYSE standards for independence and the Company's "Policy for Director Independence, Audit/Ethics Committee Members and Audit Committee Financial Expert." The Audit/Ethics Committee Charter is attached as Annex B to this Proxy Statement and can be accessed electronically under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com). The General Auditor and the Corporate internal audit function report directly to the Audit/Ethics Committee. The Company's Corporate Audit Department sends written reports quarterly to the Audit/Ethics Committee on its audit findings and the status of its internal audit projects. The Audit/Ethics Committee provides assistance to the Board of Directors in overseeing matters relating to the accounting and reporting practices of the Company, the adequacy of the Company's disclosure controls and internal controls, the quality and integrity of the quarterly and annual financial statements of the Company, the performance of the Company's internal audit function, the review and pre-approval of the current year audit and non-audit fees and the Company's risk analysis and risk management procedures. In addition, the Audit/Ethics Committee oversees the Company's compliance programs relating to legal and regulatory requirements. The Audit/Ethics Committee has developed "Procedures for the Receipt, Retention and Treatment of Complaints" to address complaints received by the Company regarding accounting, internal controls or auditing matters. Such procedures are included as Exhibit F to the Governance Guidelines. The Governance Guidelines are posted under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to the Company's Corporate Secretary.

The Audit/Ethics Committee also is responsible for the selection and hiring of the Company's independent auditor. To promote independence of the audit, the Committee consults separately and jointly with the independent auditor, the internal auditors and management.

The Board has reviewed the experience of the members of the Audit/Ethics Committee and has found that all five members of the Committee meet the qualifications to be an "audit committee financial expert" under the SEC rules issued pursuant to SOX. In addition, the Board has designated Anthony G. Fernandes as the member of the Committee who serves as the "audit committee financial expert" of the Company's Audit/Ethics Committee.

**Compensation Committee.** The Compensation Committee, which is comprised of Messrs. Riley (Chairman), Brady, Djerejian, Watson and Ms. Gargalli, held six meetings during fiscal year 2005. The Board of Directors has determined that the Compensation Committee members meet the NYSE standards for independence as contained in the Company's "Policy for Director Independence, Audit/Ethics Committee Members and Audit Committee Financial Expert." The Compensation Committee Charter can be accessed electronically under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com). The functions performed by the Compensation Committee include reviewing and approving Baker Hughes' executive salary and bonus structure; reviewing Baker Hughes' stock option plans (and making grants thereunder), employee retirement income plans, the employee thrift plan and the employee stock purchase plan; setting bonus goals; approving salary and bonus awards to key executives; recommending incentive compensation and stock award plans for approval by stockholders; and reviewing management succession plans.

**Governance Committee.** The Governance Committee, which is comprised of Messrs. Cazalot (Chairman), Djerejian, McCall, Riley and Watson, held three meetings during fiscal year 2005. The Board of Directors has determined that the Governance Committee members meet the NYSE standards for independence as well as those contained in the Company's "Policy for Director Independence, Audit/Ethics Committee Members and Audit Committee Financial Expert." A current copy of the Governance Committee Charter can be accessed electronically under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com). The functions performed by the Governance Committee include overseeing the Company's corporate governance affairs and monitoring compliance with the Governance Guidelines. In addition, the Governance Committee nominates candidates for the Board of Directors, selects candidates to fill vacancies on the Board, reviews the structure and composition of the Board, considers the qualifications required for continuing Board service and recommends directors' fees.



The Governance Committee has implemented policies regarding Board membership. The Governance Committee will consider candidates based upon the size and existing composition of the Board, the number and qualifications of candidates, the benefit of continuity on the Board and the relevance of the candidate's background and experience to issues facing the Company. The criteria used for selecting directors are described in the Company's "Guidelines for Membership on the Board of Directors," included as Exhibit A to the Governance Guidelines, which are attached as Annex C to this Proxy Statement. In addition, the Company has established a formal process for the selection of candidates, as described in the Company's "Selection Process for New Board of Directors Candidates" included as Exhibit B to the Governance Guidelines which are attached as Annex D to this Proxy Statement, and candidates are evaluated based on their background, experience and other relevant factors as described in the Guidelines for Membership on the Board of Directors. The Board or the Governance Committee will evaluate candidates properly proposed by stockholders in the same manner as all other candidates.

The Governance Committee has established, in accordance with the Company's Bylaws regarding stockholder nominees, a policy that it will consider director candidates recommended by stockholders. Recommendations that stockholders desire to make should be submitted between October 16, 2006 and November 15, 2006 in accordance with the Company's Bylaws and "Policy and Submission Procedures for Stockholder Recommended Director Candidates" included as Exhibit D to the Governance Guidelines, which are posted under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to: Chairman, Governance Committee of the Board of Directors, P.O. Box 4740, Houston, Texas 77210-4740, or to the Corporate Secretary c/o Baker Hughes Incorporated, 3900 Essex Lane, Suite 1200, Houston, Texas 77027-5177 and should be accompanied by substantially the same types of information as are required under the Company's Bylaws for stockholder nominees.

Each of the current nominees for director listed under the caption "Election of Directors" is an existing director standing for re-election. The Company has not paid any fee to a third party to identify or evaluate or to assist in identifying or evaluating such nominees. In connection with the 2006 Annual Meeting, the Governance Committee did not receive any recommendation for a nominee proposed from any stockholder or group of stockholders.

### **Stockholder Communications with the Board of Directors**

The Company's Annual Meeting provides an opportunity each year for stockholders to ask questions of or otherwise communicate directly with members of the Company's Board of Directors on matters relevant to the Company. In accordance with the Company's "Annual Meeting Director Attendance Policy," which has been incorporated into the Governance Guidelines, all directors and nominees for election as directors are requested and encouraged to personally attend the Company's Annual Meeting. Ten of the Company's director nominees attended the Company's 2005 Annual Meeting.

To provide the Company's stockholders and other interested parties with a direct and open line of communication to the Company's Board of Directors, a process has been established for communications with any member of the Board of Directors, including the Company's Lead Director, any of the Chairmen of the Company's Governance Committee, Audit/Ethics Committee, Compensation Committee, Finance Committee or with the non-employee directors as a group. Stockholders may communicate with any member of the Board, including the Company's Lead Director, the Chairman of any of the Company's Governance Committee, Audit/Ethics Committee, Compensation Committee, Finance Committee or with the non-employee directors of the Company as a group, by sending such written communication to the Corporate Secretary, c/o Baker Hughes Incorporated, 3900 Essex Lane, Suite 1200, Houston, TX 77027-5177. The procedures for "Stockholder Communications with the Board of Directors" (attached as Annex E to this Proxy Statement) are also included as Exhibit E to the Governance Guidelines and can be accessed electronically under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to the Company's Corporate Secretary.

### **Business Code of Conduct**

The Company has a Business Code of Conduct that applies to all officers, directors and employees, which includes the code of ethics for the Company's principal executive officer, principal financial officer, principal accounting officer or controller and all other persons performing similar functions within the meaning of the securities laws and regulations. Each of the Company's officers has certified compliance with the Company's Business Code of Conduct and the applicable NYSE and SOX provisions. The Company's Business Code of Conduct and Code of Ethical Conduct Certification are posted under the "About Baker Hughes" section of the Company's website at [www.bakerhughes.com](http://www.bakerhughes.com) and are also available upon request to the Company's Corporate Secretary.

## SECURITY OWNERSHIP OF MANAGEMENT

Set forth below is certain information with respect to beneficial ownership of the Common Stock as of March 1, 2006 by each director nominee, the persons named in the Summary Compensation Table below and the directors and executive officers as a group. The table includes transactions effected prior to the close of business on March 1, 2006.

Name	Shares Beneficially Owned			% of Class <sup>(1)</sup>
	Shares Owned as of 3/01/06	Shares Subject to Options Which Are or Will Become Exercisable Prior to 5/01/06	Total Beneficial Ownership	
Larry D. Brady	4,158 <sup>(2)</sup>	254	4,412	—
Clarence P. Cazalot, Jr.	5,749 <sup>(2)</sup>	1,981	7,730	—
Edward P. Djerejian	5,749 <sup>(2)</sup>	4,981	10,730	—
Anthony G. Fernandes	7,749 <sup>(2)</sup>	13,358	21,107	—
Claire W. Gargalli	15,283 <sup>(2)</sup>	10,381	25,664	—
James A. Lash	5,749 <sup>(2)</sup>	1,981	7,730	—
James F. McCall	8,749 <sup>(2)</sup>	1,981	10,730	—
J. Larry Nichols	5,749 <sup>(2)</sup>	4,981	10,730	—
H. John Riley, Jr.	16,749 <sup>(2)</sup>	4,981	21,730	—
Charles L. Watson	13,589 <sup>(2)</sup>	35,557	49,146	—
Chad C. Deaton	152,001 <sup>(3)</sup>	55,000	207,001	—
James R. Clark	100,593 <sup>(4)</sup>	68,500	169,093	—
G. Stephen Finley	132,479 <sup>(5)</sup>	—	132,479	—
Alan R. Crain, Jr.	32,547 <sup>(6)</sup>	—	32,547	—
Douglas J. Wall	50,987 <sup>(7)</sup>	52,475	103,462	—
All directors and executive officers as a group (26 persons)	726,931	471,793	1,198,724	—

<sup>(1)</sup> No percent of class is shown for holdings of less than 1%.

<sup>(2)</sup> Includes 1,332 shares issued as a restricted stock award on January 25, 2006, which award will vest one-third on each of January 25, 2007, 2008 and 2009, or, if earlier, on the date of the annual meeting of stockholders next following the date the non-employee director attains age 72.

<sup>(3)</sup> Includes 80,000, 33,900 and 25,395 shares issued as restricted stock awards on October 25, 2004, January 26, 2005 and January 25, 2006, respectively, which awards will vest 25 percent on each of October 25, 2006, 2007, 2008 and 2009, one-half on each of January 26, 2007 and 2008, respectively, and one-third on each of January 25, 2007, 2008 and 2009, respectively.

<sup>(4)</sup> Includes 40,000, 13,567 and 11,000 shares issued as restricted stock awards on October 27, 2004, January 26, 2005 and January 25, 2006, respectively, which awards will vest 25 percent on each of October 27, 2007 and October 27, 2008, with the remaining 50 percent vesting on October 27, 2009, one-half on each of January 26, 2007 and 2008, respectively, and one-third on each of January 25, 2007, 2008 and 2009, respectively. Also includes a one-time, stock-matching award of 25,000 shares of restricted stock issued on September 2, 2002, which award will vest on March 7, 2006.

<sup>(5)</sup> Includes 20,000 and 9,600 shares issued as restricted stock awards on October 23, 2002 and January 26, 2005, respectively, which awards are scheduled to vest on June 30, 2006, one-half on each of January 26, 2007 and 2008, respectively. However, Mr. Finley has announced his retirement from the Company effective March 31, 2006. In connection with his retirement, the Company has indicated that it will accelerate the vesting of Mr. Finley's 20,000 share restricted stock award to March 31, 2006, which was originally scheduled to vest on June 30, 2006 and the vesting of the remaining 9,600 shares of the 14,400 share restricted stock award to March 31, 2006, which was originally scheduled to vest on January 26, 2007 and 2008.

<sup>(6)</sup> Includes 10,000, 6,217 and 6,000 shares issued as restricted stock awards on April 28, 2004, January 26, 2005 and January 25, 2006, respectively, which awards will vest on April 28, 2008, one-half on each of January 26, 2007 and 2008, respectively, and one-third on each of January 25, 2007, 2008 and 2009, respectively.

<sup>(7)</sup> Includes 10,000, 3,167 and 4,356 shares issued as restricted stock awards on March 2, 2004, January 26, 2005 and January 25, 2006, respectively, which awards will vest on March 2, 2008, one-half on each of January 26, 2007 and 2008, respectively, and one-third on each of January 25, 2007, 2008 and 2009, respectively. Also includes 16,000 shares issued as a restricted stock award on February 28, 2005, which award will vest 25 percent on February 28, 2007 and 2008, with the remaining 50 percent vesting on February 28, 2009.

## CHARITABLE CONTRIBUTIONS

During the fiscal year ended December 31, 2005, the Company did not make any contributions to any charitable organization in which an independent director served as an executive officer, that exceeded the greater of \$1 million or 2% of the charitable organization's consolidated gross revenues.

## COMPLIANCE WITH SECTION 16(a) OF THE SECURITIES EXCHANGE ACT OF 1934

Section 16(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), requires executive officers, directors and persons who beneficially own more than 10% of the

Common Stock to file initial reports of ownership and reports of changes in ownership with the SEC and the NYSE. SEC regulations require executive officers, directors and greater than 10% beneficial owners to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of those forms furnished to the Company and written representations from the executive officers and directors, the Company believes its executive officers and directors complied with all applicable Section 16(a) filing requirements during the fiscal year ended December 31, 2005.

## EXECUTIVE COMPENSATION

### SUMMARY COMPENSATION TABLE

The following table sets forth the compensation earned by the Chief Executive Officer and the four most highly compensated executive officers of the Company for services rendered to the Company and its subsidiaries for the fiscal years ended December 31, 2005, 2004 and 2003. Bonuses are paid under the Company's applicable incentive compensation guidelines and are generally paid in the year following the year in which the bonus is earned.

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation Awards	
		Salary	Bonus	Other Annual Compensation <sup>(1)</sup>	Restricted Stock Awards	Securities Underlying Options (# Shares) <sup>(2)</sup>
Chad C. Deaton, Chairman of the Board and Chief Executive Officer <sup>(3)</sup>	2005	\$ 878,846	\$ 2,036,576 <sup>(4)</sup>	\$ 212,326	50,850 <sup>(5)</sup>	180,000
	2004	126,923	600,000	10,930	80,000 <sup>(6)</sup>	75,000
James R. Clark, President and Chief Operating Officer	2005	635,769	1,178,630 <sup>(7)</sup>	190,754	20,350 <sup>(5)</sup>	72,000
	2004	500,702	720,261	113,132	40,000 <sup>(8)</sup>	98,500
	2003	321,270	245,134	74,890	—	26,000
G. Stephen Finley, Senior Vice President – Finance and Administration and Chief Financial Officer <sup>(9)</sup>	2005	528,077	795,423	167,160	14,400 <sup>(5)</sup>	51,000
	2004	507,257	624,484	111,794	—	79,000
	2003	483,441	289,098	92,905	—	79,000
Alan R. Crain, Jr., Vice President and General Counsel	2005	418,077	581,293 <sup>(10)</sup>	128,639	9,325 <sup>(5)</sup>	33,000
	2004	402,385	419,164	90,269	10,000 <sup>(11)</sup>	55,000
	2003	386,346	195,491	77,212	—	54,500
Douglas J. Wall, Vice President and Group President, Completion and Production	2005	367,260	507,685 <sup>(12)</sup>	105,765	20,750 <sup>(5)(13)</sup>	23,150
	2004	330,250	374,834	69,145	10,000 <sup>(14)</sup>	28,000
	2003	311,812	198,411	58,844	—	25,000

(1) Other Annual Compensation includes Company contributions to the Baker Hughes Thrift Plan, the Baker Hughes Supplemental Retirement Plan, the Baker Hughes Pension Plan, life insurance premiums, perquisites and other compensation for the named executive officers. Amounts for fiscal year 2005 for the persons named above are as follows:

	Thrift	SRP	Pension	Life	Perquisites	Total
Chad C. Deaton	\$ 15,531	\$ 153,792	\$ 8,400	\$ 9,603	\$ 25,000	\$ 212,326
James R. Clark	12,246	144,288	8,400	5,820	20,000	190,754
G. Stephen Finley	16,800	115,907	8,400	6,053	20,000	167,160
Alan R. Crain, Jr.	15,531	79,936	8,400	4,772	20,000	128,639
Douglas J. Wall	16,800	58,501	8,400	3,899	18,165	105,765

(2) See Footnote (1) to table in "Stock Options Granted During 2005" below.

(3) Mr. Deaton joined the Company on October 25, 2004 as Chairman of the Board and Chief Executive Officer.

(4) For 2005, Mr. Deaton earned a bonus of \$1,000,000 under the Company's Annual Incentive Compensation Plan, which will be paid in March 2006. In February 2006, he also was awarded an additional discretionary bonus of \$1,036,576, which will be paid in three installments, with \$757,692 paid in March 2006 and \$278,884 carried over and paid in two installments of \$139,442 in March 2007 and 2008, respectively, together with interest at an annual rate equal to the ten-year Treasury rate plus 25 basis points. Interest will be calculated as of January 15 of each year. The carryover or "banked" bonus will be paid only if Mr. Deaton is actively employed by the Company as of the date the bonus is paid.

(5) On January 26, 2005, Messrs. Deaton, Clark, Finley, Crain and Wall were awarded 50,850, 20,350, 14,400, 9,325 and 4,750 shares of restricted Common Stock valued at \$3,710,016, \$1,484,736, \$1,050,624, \$680,352, and \$346,560, respectively. See Footnotes (3-7) to the table under the caption "Security Ownership of Management" above. After January 26, 2005, Messrs. Deaton, Clark, Finley, Crain and Wall received the Company's ordinary dividend payment on the award on a quarterly basis. All of these awards vest one-third on each of January 26, 2006, 2007 and 2008. Upon his retirement, Mr. Finley will vest in all of these shares and all of his previously awarded 20,000 shares.

(6) On October 25, 2004, Mr. Deaton was awarded 80,000 shares of restricted Common Stock valued at \$3,471,200. See Footnote (3) to the table under the caption "Security Ownership of Management" above. After October 25, 2004, Mr. Deaton received the Company's ordinary dividend payment on the award on a quarterly basis. The 80,000-share award vests 25 percent on each of October 25, 2006, 2007, 2008 and 2009. At December 31, 2005, Mr. Deaton held 80,000 shares of restricted stock, valued at \$4,862,400, based upon the closing stock price of \$60.78 per share of Common Stock on the NYSE on December 30, 2005.

(7) For 2005, Mr. Clark earned a bonus of \$1,000,000 under the Company's Annual Incentive Compensation Plan, which will be paid in March 2006. In February 2006, he also was awarded an additional discretionary bonus of \$178,630, which will be paid in three installments, with \$17,231 paid in March 2006 and \$80,700 and \$80,699 paid in March 2007 and 2008, respectively, together with interest at an annual rate equal to the ten-year Treasury rate plus 25 basis points. Interest will be calculated as of January 15 of each year. The carryover or "banked" bonus will be paid only if Mr. Clark is actively employed by the Company as of the date the bonus is paid.

(8) On October 27, 2004, Mr. Clark was awarded 40,000 shares of restricted Common Stock valued at \$1,768,000. See Footnote (4) to the table under the caption "Security Ownership of Management" above. After October 27, 2004, Mr. Clark received the Company's ordinary dividend payment on the award on a quarterly basis. The 40,000-share award vests 25 percent on each of October 27, 2007 and 2008 with the remaining 50 percent vesting on October 27, 2009. At December 31, 2005, Mr. Clark held 40,000 shares of restricted stock, valued at \$2,431,200 based upon the closing stock price of \$60.78 per share of Common Stock on the NYSE on December 30, 2005.

(9) Mr. Finley has announced that he will retire from the Company on March 31, 2006. The Company has entered into an agreement with Mr. Finley regarding his retirement benefits and agreement to provide consulting services. See "Employment, Change in Control and Indemnification Agreements" below.

(10) For 2005, Mr. Crain earned a bonus of \$581,293, which will be paid in three installments, with \$501,692 paid in March 2006 and \$39,801 and \$39,800 carried over and paid in March 2007 and 2008, respectively, together with interest at an annual rate equal to the ten-year Treasury rate plus 25 basis points. Interest will be calculated as of January 15 of each year. Under the Company's incentive compensation guidelines, a carryover or "banked" bonus is paid to an employee if the employee is actively employed by the Company as of the date the bonus is paid and the employee remains eligible to participate in the plan that generated the bonus.

(11) On April 28, 2004, Mr. Crain was awarded 10,000 shares of restricted Common Stock valued at \$382,700. See Footnote (6) to the table under the caption "Security Ownership of Management" above. After April 28, 2004, Mr. Crain received the Company's ordinary dividend payment on the award on a quarterly basis. The 10,000-share award vests on April 28, 2008. At December 31, 2005, Mr. Crain held 10,000 shares of restricted stock, valued at \$607,800, based upon the closing stock price of \$60.78 per share of Common Stock on the NYSE on December 30, 2005.

(12) For 2005, Mr. Wall earned a bonus of \$507,685, which will be paid in three installments, with \$427,837 paid in March 2006 and \$79,848 carried over and paid in two installments of \$39,924 in March 2007 and 2008. For 2004, Mr. Wall earned a bonus of \$374,834, which will be paid in three installments, with \$330,250 paid in March 2005 and \$44,584 carried over and paid in two installments of \$22,292 in March 2006 and 2007, respectively, together with interest at an annual rate equal to the ten-year Treasury rate plus 25 basis points. Interest will be calculated as of January 15 of each year. Under the Company's incentive compensation guidelines, a carryover or "banked" bonus is paid to an employee if the employee is actively employed by the Company as of the date the bonus is paid and the employee remains eligible to participate in the plan that generated the bonus.

(13) On February 28, 2005, Mr. Wall was awarded 16,000 shares of restricted Common Stock valued at \$763,200. See Footnote (7) to the table under the caption "Security Ownership of Management" above. After February 28, 2005, Mr. Wall received the Company's ordinary dividend payment on the award on a quarterly basis. The 16,000-share award will vest 25 percent on February 28, 2007 and 2008, with the remaining 50 percent vesting on February 28, 2009. At December 30, 2005, Mr. Wall held 16,000 shares of restricted stock, valued at \$972,480, based upon the closing stock price of \$60.78 per share of Common Stock on the NYSE on December 30, 2005.

(14) On March 2, 2004, Mr. Wall was awarded 10,000 shares of restricted Common Stock valued at \$384,200. See Footnote (7) to the table under the caption "Security Ownership of Management" above. After March 2, 2004, Mr. Wall received the Company's ordinary dividend payment on the award on a quarterly basis. The 10,000-share award vests on March 2, 2008. At December 31, 2005, Mr. Wall held 10,000 shares of restricted stock, valued at \$607,800, based upon the closing stock price of \$60.78 per share of Common Stock on the NYSE on December 30, 2005.

## STOCK OPTIONS GRANTED DURING 2005

The following table sets forth certain information regarding stock options granted during fiscal year 2005 to the persons named in the Summary Compensation Table above. The theoretical values on the date of the grant of stock options granted in 2005 shown below are presented pursuant to SEC rules and are calculated using the Black-Scholes Model for pricing options. The theoretical values of options trading in the stock markets do not necessarily bear a relationship to the compensation cost to the Company or potential gain realized by an executive. The actual amount, if any, realized upon exercise of stock options will depend upon the market price of the Common Stock relative to the exercise price per share of the stock option at the time the stock option is exercised. There is no assurance that the theoretical values of stock options reflected in this table actually will be realized.

Name and Date of Option Grant	Options Granted	% of Total Options Granted to Employees	Exercise Price	Expiration Date	Grant Date Theoretical Value <sup>(1)</sup>
Chad C. Deaton					
01/26/2005	90,000	6.8%	\$ 42.60	01/26/2015	\$ 1,074,375
07/27/2005	90,000	6.8%	56.21	07/27/2015	1,540,602
James R. Clark					
01/26/2005	36,000	2.7%	42.60	01/26/2015	429,750
07/27/2005	36,000	2.7%	56.21	07/27/2015	616,241
G. Stephen Finley <sup>(2)</sup>					
01/26/2005	25,500	1.9%	42.60	01/26/2015	304,406
07/27/2005	25,500	1.9%	56.21	07/27/2015	436,504
Alan R. Crain, Jr.					
01/26/2005	16,500	1.2%	42.60	01/26/2015	196,969
07/27/2005	16,500	1.2%	56.21	07/27/2015	282,444
Douglas J. Wall					
01/26/2005	8,400	0.6%	42.60	01/26/2015	100,275
07/27/2005	14,750	1.1%	56.21	07/27/2015	252,488

<sup>(1)</sup> The theoretical values on the grant date are calculated under the Black-Scholes Model. The Black-Scholes Model is a mathematical formula used to value options traded on stock exchanges. This formula considers a number of factors to estimate the option's theoretical value, including the stock's historical volatility, the dividend rate, the expected life of the option and risk-free interest rates. The grant date theoretical value assumes a volatility of 35.04%, a dividend yield of 0.95%, a risk-free rate of return of 3.72% and an expected option life of 3.71 years.

<sup>(2)</sup> Upon Mr. Finley's retirement, all of his options will vest with a five-year exercise period from his retirement date.

**AGGREGATED OPTION EXERCISES DURING 2005  
AND OPTION VALUES AT DECEMBER 31, 2005**

The following table sets forth certain information regarding options the persons named in the Summary Compensation Table above exercised during 2005 and the options those persons held at December 31, 2005. The values of unexercised in-the-money stock options at December 31, 2005, shown below, are presented pursuant to SEC rules. The actual amount, if any, realized upon exercise of stock options will depend upon the market price of the Common Stock relative to the exercise price per share of the stock option at the time the stock option is exercised.

Name	Option Exercises		Unexercised Options at December 31, 2005			
	Shares Acquired on Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options		Value of Unexercised In-the-Money Options (\$) <sup>(1)</sup>	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Chad C. Deaton	–	\$ –	25,000	230,000	\$ 434,750	\$ 2,917,000
James R. Clark	57,832	918,101	39,333	185,668	1,220,377	2,581,750
G. Stephen Finley <sup>(2)</sup>	204,163	3,603,055	–	130,002	–	2,591,121
Alan R. Crain, Jr.	151,450	1,999,233	–	88,002	–	1,775,451
Douglas J. Wall	34,006	548,851	56,941	50,152	1,660,032	901,380

<sup>(1)</sup> Based on the closing price of the Common Stock of \$60.78 on December 30, 2005, the last trading day of 2005.

<sup>(2)</sup> Upon Mr. Finley's retirement, all of his options will vest.

**LONG-TERM INCENTIVE PLAN AWARDS GRANTED  
IN 2006 PERFORMANCE UNITS FOR 2006–2008**

Name	Number of Units Awarded <sup>(1)</sup>	Performance Period Payout	Estimated Future Payouts under Non-Stock Price-Based Plans		
			Threshold (\$ or #)	Target (\$ or #)	Maximum (\$ or #)
Chad C. Deaton	24,050	December 31, 2008	\$ 601,250	\$ 2,405,000	\$ 4,810,000
James R. Clark	10,000	December 31, 2008	250,000	1,000,000	2,000,000
G. Stephen Finley <sup>(2)</sup>	–	December 31, 2008	–	–	–
Alan R. Crain, Jr.	5,500	December 31, 2008	137,500	550,000	1,100,000
Douglas J. Wall	4,125	December 31, 2008	103,125	412,500	825,000

<sup>(1)</sup> Under the 2002 Director & Officer Long-Term Incentive Plan, each Performance Unit provides the individual an opportunity to earn a cash payment based upon the cumulative Baker Value Added (as that term has been defined by the Performance Unit Agreement) achieved by the Company for the three-year period beginning January 1, 2006 and ending December 31, 2008. Each unit awarded under the Performance Unit Agreement has a target value of \$100. However, the actual award payment will be within a range of \$25 per unit if a minimum cumulative BVA level is reached for the Performance Period up to \$200 per unit if a maximum cumulative BVA is met or exceeded for the Performance Period. If the minimum cumulative BVA level is not reached for the Performance Period, then the award pursuant to the Performance Unit Agreement shall lapse and be forfeited as of December 31, 2008. The Company will pay any amount payable to an individual pursuant to the Performance Unit Agreement to such individual on March 13, 2009, unless otherwise provided under the Terms and Conditions of the Performance Unit Agreement.

<sup>(2)</sup> Upon Mr. Finley's retirement, all of his awards will terminate without payment.

**LONG-TERM INCENTIVE PLAN AWARDS GRANTED IN 2005 AND 2004  
PERFORMANCE PLAN FOR 2005–2007 AND 2004–2006**

Name	For 2005–2007 Performance Period		For 2004–2006 Performance Period	
	Number of Target Shares <sup>(1)</sup>	Performance Period Payout	Number of Target Shares <sup>(1)</sup>	Performance Period Payout
Chad C. Deaton	31,000	December 31, 2007	17,000	December 31, 2006
James R. Clark	14,500	December 31, 2007	13,993	December 31, 2006
G. Stephen Finley <sup>(2)</sup>	8,500	December 31, 2007	7,774	December 31, 2006
Alan R. Crain, Jr.	5,000	December 31, 2007	4,664	December 31, 2006
Douglas J. Wall	3,250	December 31, 2007	3,109	December 31, 2006

<sup>(1)</sup> Under the Company's 2002 Director & Officer Long-Term Incentive Plan, individuals may be awarded target shares that subject to the terms and conditions of the plan may entitle the individual to receive shares of Common Stock. If (a) the Company's total shareholder return for the three-year period ending December 31, 2006 or December 31, 2007 (the "Performance Period"), equals or exceeds the median of the total shareholder returns of the Morgan Stanley Oil Services Index companies for the Performance Period, (b) a Change in Control of the Company has not occurred on or before December 31, 2006, or December 31, 2007 and (c) the executive remains in the active employ of the Company and/or one or more wholly-owned subsidiaries of the Company through the last day of the Performance Period, then the Company will issue to the executive that number of shares of Common Stock equal to (x) the number of shares of Common Stock set forth above as the "Number of Target Shares" for the executive's performance award, multiplied by (y) the applicable "Percentage Target Earned" factor specified in the table below. If (a) the Company's total shareholder return for the Performance Period is less than the median of the total shareholder returns of the Morgan Stanley Oil Services Index companies for the Performance Period, and (b) a Change in Control of the Company has not occurred on or before December 31, 2006, or December 31, 2007 then the award will lapse and be forfeited as of December 31, 2006 or December 31, 2007.

<sup>(2)</sup> Upon Mr. Finley's retirement, all of his awards will terminate without payment.

Percentile Rank of the Company's Total Shareholder Return for the Performance Period as Compared to the Total Shareholder Returns of All Morgan Stanley Oil Services Index Companies	2005–2007 Percentage Target Earned
96th Percentile or more	200%
88th Percentile or more, but less than 95th Percentile	150%
81th Percentile or more, but less than 87th Percentile	125%
74th Percentile or more, but less than 80th Percentile	100%
66th Percentile or more, but less than 73rd Percentile	75%
58th Percentile or more, but less than 65th Percentile	50%
50th Percentile or more, but less than 57th Percentile	25%
Less than 50th Percentile	0%

Percentile Rank of the Company's Total Shareholder Return for the Performance Period as Compared to the Total Shareholder Returns of All Morgan Stanley Oil Services Index Companies	2004–2006 Percentage Target Earned
95th Percentile or more	200%
85th Percentile or more, but less than 95th Percentile	150%
80th Percentile or more, but less than 85th Percentile	125%
70th Percentile or more, but less than 80th Percentile	100%
65th Percentile or more, but less than 70th Percentile	75%
55th Percentile or more, but less than 65th Percentile	50%
50th Percentile or more, but less than 55th Percentile	25%
Less than 50th Percentile	0%

## PENSION PLAN TABLE

Baker Hughes adopted the Baker Hughes Incorporated Pension Plan, effective January 1, 2002, to provide benefits to its U.S. employees. (Employees outside the U.S. are covered under different retirement plans.) Employees who are officers of the Company participate on the same basis as other eligible employees. The Pension Plan is a tax-qualified, defined benefit plan funded entirely by the Company. Under the provisions of the Pension Plan, a cash balance account is established for each participant. Company contributions are made quarterly to the accounts, and the contribution percentage is determined by the employee's age on the last day of the quarter and is applied to quarterly eligible compensation. In addition to the Company contributions, the cash balance accounts are credited with interest credits based on the balance in the account on the last day of the quarter, using the applicable interest rate provided under section 417(e)(3)(A)(ii)(III) of the Internal Revenue Code of 1986, as amended. The following are the quarterly contribution rates under the Pension Plan:

Age at End of Quarter	Percentage Contribution
Under age 35	2.0%
35 – 39	2.5%
40 – 44	3.0%
45 – 49	3.5%
50 and older	4.0%

An employee is fully vested in his or her Pension Plan account after five years of service. However, regardless of the number of years of service, an employee is fully vested if the employee retires from Baker Hughes at age 65 or later, or upon the employee's termination of employment due to the death of the employee. In addition, employees of Baker Hughes who were 55 years or older on January 1, 2002, had their prior years of service with Baker Hughes counted in the number of years of service. Employees who are fully vested are eligible for early retirement benefits starting at age 55. Pension Plan benefits in excess of \$1,000 may be paid in the form of a single lump sum, a single life annuity, or if an employee is married, a joint and 50% survivor annuity.

Estimated annual benefits payable upon retirement at normal retirement age (i.e., age 65) under the Baker Hughes Pension Plan to each executive named in this Proxy Statement are reflected in the following table. The retirement benefits in the table are calculated based on the assumptions that each executive officer named in the Summary Compensation Table will remain an employee until age 65 at the base salary shown in the Summary Compensation Table, with no pay increases, cash balances are credited at the rate of 4% per quarter, interest is credited quarterly using the applicable rate at August 1 of the preceding plan year, and the terms of the Pension Plan remain unchanged.

Named Officer	Approximate Years of Credited Service at Anticipated Retirement	Estimated Annual Benefits Payable at Anticipated Retirement
Chad C. Deaton	13	\$ 16,345.76
James R. Clark	13	15,491.97
G. Stephen Finley <sup>(1)</sup>	14	16,367.64
Alan R. Crain, Jr.	14	17,036.93
Douglas J. Wall	16	19,652.89

<sup>(1)</sup> Mr. Finley will not be fully vested upon his retirement and will not receive any benefit under the Pension Plan, but will receive his cash balance account under the prior pension plan and the pension portion of the Supplemental Retirement Plan.

In addition to the Pension Plan, the Company has a Supplemental Retirement Plan to provide covered executives with the total amount of retirement benefit they would have otherwise received under the Pension Plan but for legislated compensation ceilings in compliance with certain sections of the Internal Revenue Code, which limit retirement benefits payable under qualified plans. In accordance with these legislated ceilings, eligible compensation under the Pension Plan was limited to \$210,000 in 2005. The compensation limit is assumed, for purposes of determining estimated benefits shown in the above table, to increase in future years, based on estimated cost-of-living increases applicable to such limit. The ceiling may be adjusted in the future by regulations issued under the Internal Revenue Code. See Footnote (1) to the table under the caption "Summary Compensation Table."

## EMPLOYMENT, CHANGE IN CONTROL AND INDEMNIFICATION AGREEMENTS

### Employment Agreements

The Company has an employment agreement with Mr. Chad C. Deaton, dated as of October 25, 2004, which provides for the employment of Mr. Deaton for an initial two-year period ending October 25, 2006, with automatic one-year renewals unless either party provides a notice not to extend the employment agreement at least thirteen months prior to the then current expiration date. During the term of the employment agreement, Mr. Deaton is entitled to receive the following, all as established from time to time by the Board of Directors or the Compensation Committee:

- a base salary;
- the opportunity to earn annual cash bonuses in amounts that may vary from year to year and that are based upon achievement of performance goals;
- long-term incentives in the form of equity-based compensation no less favorable than awards made to other senior executives of the Company and that are commensurate with awards granted to CEOs of other public companies of a similar size to the Company; and
- benefits and perquisites that other officers and employees of the Company are entitled to receive.

Mr. Deaton's base salary is to be reviewed at least annually during the term of the employment agreement and may be increased (but not decreased) based upon his performance during the year.



Upon the termination of Mr. Deaton's employment due to his Disability (as defined in the employment agreement) or his death, he or his beneficiary is to be paid a lump sum in cash equal to one-half his then base salary for each year (prorated for partial years) during the remaining term of the employment agreement and a lump sum in cash equal to his expected value incentive bonus for the year of termination. Upon termination of Mr. Deaton's employment by him for Good Reason (as defined in the employment agreement) or by the Company without Cause (as defined in the employment agreement), he is entitled to:

- (i) a lump sum cash payment in an amount equal to two times his then base salary;
- (ii) a lump sum cash payment equal to the expected value of his incentive bonus for the year of termination, prorated to the date of termination;
- (iii) for the remainder of the term of the employment agreement, continuation of certain executive perquisites and medical insurance benefits; and
- (iv) for the remainder of the term of the employment agreement, continued employer contributions to the Company's Supplemental Retirement Plan.

However, the foregoing benefits are not payable if Mr. Deaton is entitled to benefits under his 2004 Change in Control Agreement discussed below.

If Mr. Deaton's employment is terminated by him for any reason other than a Good Reason (as defined in the employment agreement) or by the Company for Cause (as defined in the employment agreement), he is to receive only those vested benefits to which he is entitled under the terms of the employee benefit plans in which he is a participant as of the date of termination and a lump sum amount in cash equal to the sum of (i) his base salary through the date of termination; (ii) any compensation previously deferred by him (together with any accrued interest or earnings thereon) and any accrued vacation pay; and (iii) any other amounts due him as of the date of termination, in each case to the extent not theretofore paid.

During the term of the employment agreement and for a period of two years following termination of the employment agreement, Mr. Deaton is prohibited from (i) engaging in Competition (as defined in the employment agreement) with the Company and (ii) soliciting customers, employees and consultants of the Company. To the extent any provision is covered by both the employment agreement and the 2004 Change in Control Agreement described and defined below, the 2004 Change in Control Agreement provision so covered will supersede the employment agreement provision.

Mr. G. Stephen Finley has announced his retirement from the Company on March 31, 2006. In connection with Mr. Finley's retirement, Mr. Finley entered into a retirement and consulting agreement with the Company pursuant to which Mr. Finley has agreed to assist the Company as a consultant for twelve months commencing April 1, 2006 for a consulting fee of \$44,583.33 per month. During the term of the agreement Mr. Finley has agreed to maintain confidentiality and not to compete with the Company. In addition, effective March 31, 2006, all of Mr. Finley's current and outstanding

stock options and shares of restricted stock will vest, and he will be entitled to a bonus payment for years 2005 and 2006.

### **Change in Control Agreements**

In addition to the employment agreements described above, the Company has entered into change in control agreements ("2004 Change in Control Agreements") with Messrs. Chad C. Deaton, G. Stephen Finley, James R. Clark, Alan R. Crain, Jr. and Douglas J. Wall ("Named Officers"), as well as nine other officers of the Company. The 2004 Change in Control Agreements provide for payment of certain benefits to these officers as a result of termination of employment following, or in connection with, a Change in Control of the Company. The initial term of the 2004 Change in Control Agreement for Mr. Deaton expires on October 25, 2007. The 2004 Change in Control Agreements for the remaining Named Officers were effective as of January 1, 2006, and the initial term will expire December 31, 2007. After the expiration of the initial term, the 2004 Change in Control Agreements will be automatically extended for successive two-year periods beginning on the day immediately following the expiration date, unless, not later than 18 months prior to the expiration date or applicable renewal date, the Company shall give notice to the Named Officer that the term of the 2004 Change in Control Agreements will not be extended.

Pursuant to the 2004 Change in Control Agreements, the Company pays severance benefits to an officer if the officer's employment is terminated following, or in connection with, a Change in Control and during the term unless:

- (i) the Named Officer resigns without Good Reason (as defined in the 2004 Change in Control Agreements);
- (ii) the Company terminates the employment of the Named Officer for Cause (as defined in the 2004 Change in Control Agreements); or
- (iii) the employment of the Named Officer is terminated by reason of death or Disability (as defined in the 2004 Change in Control Agreements).

If the Named Officer meets the criteria for payment of severance benefits due to termination of employment following a Change in Control during the term as described above, in addition to any benefits he is due under the Company's employee benefit plans and equity and incentive compensation plans, he will receive the following benefits:

- (a) a lump sum payment equal to three (3) times the Named Officer's annual base salary in effect immediately prior to (i) the first event or circumstance constituting Good Reason for his resignation, (ii) the Change of Control, or (iii) the Named Officer's termination of employment, whichever is greatest (his "Highest Base Salary");
- (b) a lump sum payment equal to the Named Officer's expected value target percentage for his incentive bonus under the Company's Annual Incentive Plan for the year in which he terminates employment multiplied by his Highest Base Salary, prorated based upon the number of days of his service during the performance period (reduced by any payments received by the Named Officer under the Company's Annual

Incentive Compensation Plan, as amended, in connection with the Change in Control if the Named Officer's termination of employment occurs during the same calendar year in which the Change in Control occurs);

- (c) a lump sum payment equal to Named Officer's expected value target percentage under his bonus for the year in which he terminates employment multiplied by his Highest Base Salary and multiplied by three (3);
- (d) continuation of accident and health insurance benefits for an additional three (3) years;
- (e) a lump sum payment equal to the sum of (i) the cost of the Named Officer's perquisites in effect prior to his termination of employment for the remainder of the calendar year and (ii) the cost of the Named Officer's perquisites in effect prior to his termination of employment for an additional three (3) years;
- (f) a lump sum payment equal to the undiscounted value of the benefits the Named Officer would have received had he continued to participate in the Company's thrift and supplemental retirement and pension plans for an additional three (3) years, assuming for this purpose that:
  - (1) the Named Officer's compensation during that three-year period remained at the levels used for calculating the severance payment described in paragraphs (a) and (c) above, and
  - (2) the Named Officer's contributions to and accruals under those plans remained at the levels in effect as of the date of the Change in Control or the date of termination, whichever is greater;
- (g) eligibility for the Company's retiree medical program if the Named Officer would have become entitled to participate in that program had he remained employed for an additional three (3) years;
- (h) a lump sum payment equivalent to thirty-six (36) multiplied by the monthly basic life insurance premium applicable to the Named Officer's basic life insurance coverage on the date of termination;
- (i) outplacement services for a period of three (3) years or, if earlier, until the Named Officer's acceptance of an offer of employment or in lieu of outplacement services, the Named Officer may elect to receive a cash payment of \$30,000; and
- (j) an additional amount (a "gross-up" payment) in respect of excise taxes that may be imposed under the "golden parachute" rules on payments and benefits received in connection with the Change in Control. The gross-up payment would make the officer whole for excise taxes (and for all taxes on the gross-up payment) in respect of payments and benefits received pursuant to all the Company's plans, agreements and arrangements (including for example, acceleration of vesting of equity awards).

In addition to the above, the 2004 Change in Control Agreements provide for full vesting of all stock options and other equity incentive awards upon the occurrence of a Change in Control.

Pursuant to the 2004 Change in Control Agreements, a "Change in Control" is deemed to occur if:

- (i) the individuals who are Incumbent Directors (as defined in the 2004 Change in Control Agreements) cease for any reason to constitute a majority of the members of the Board;
- (ii) the consummation of a merger of the Company or an affiliate of the Company with another entity, unless the individuals and entities who were the beneficial owners of the voting securities of the Company outstanding immediately prior to such merger own, directly or indirectly, at least 50 percent of the combined voting power of the voting securities of the Company, the surviving entity or the parent of the surviving entity outstanding immediately after such merger;
- (iii) any person, other than a Specified Owner (as defined in the 2004 Change in Control Agreements), becomes a beneficial owner, directly or indirectly, of securities of the Company representing 30 percent or more of the combined voting power of the Company's then outstanding voting securities;
- (iv) a sale, transfer, lease or other disposition of all or substantially all of the Company's Assets (as defined in the 2004 Change in Control Agreements) is consummated (an "Asset Sale"), unless:
  - (a) the individuals and entities who were the beneficial owners of the voting securities of the Company immediately prior to such Asset Sale own, directly or indirectly, 50 percent or more of the combined voting power of the voting securities of the entity that acquires such Assets in such Asset Sale or its parent immediately after such Asset Sale in substantially the same proportions as their ownership of the Company's voting securities immediately prior to such Asset Sale; or
  - (b) the individuals who comprise the Board immediately prior to such Asset Sale constitute a majority of the board of directors or other governing body of either the entity that acquired such Assets in such Asset Sale or its parent (or a majority plus one member where such board or other governing body is comprised of an odd number of directors); or
- (v) the stockholders of the Company approve a plan of complete liquidation or dissolution of the Company.

### **Indemnification Agreements**

The Company has entered into an indemnification agreement with each of its directors and executive officers. These agreements provide for the Company to, among other things, indemnify such persons against certain liabilities that may arise by reason of their status or service as directors or officers, to advance their expenses incurred as a result of a proceeding as to which they may be indemnified and to cover such person under any directors' and officers' liability insurance policy the Company chooses, in its discretion, to maintain. These indemnification agreements are intended to provide indemnification rights to the fullest extent permitted under applicable indemnification rights statutes in the State of Delaware and shall be in addition to any other rights the indemnitee may have under the Company's Restated Certificate of Incorporation, Bylaws and applicable law.

## COMPENSATION COMMITTEE REPORT

### To Our Stockholders

This report is provided in accordance with SEC rules to inform the Company's stockholders of the Compensation Committee's compensation policies for executive officers and the rationale for compensation paid to the Chief Executive Officer of the Company.

The Compensation Committee consists of five non-employee, independent directors (as defined in Annex A to this Proxy Statement) who have no "interlocking" relationships (as defined by the SEC). The Compensation Committee's overall goal is to develop executive compensation policies that support the Company's strategic business objectives and consider current competitive market practices. The Compensation Committee reviews and approves the design of, assesses the effectiveness of and oversees executive compensation programs and other matters. The Compensation Committee also reviews and approves all compensation and incentive programs for senior executives and evaluates CEO performance.

### Compensation Philosophy

The Company's primary business objective is to maximize stockholder value over the long-term. The Company has developed a comprehensive business strategy that emphasizes financial and organizational performance and continuing market leadership and Best-in-Class products and services.

The following compensation policies are intended to facilitate the achievement of the Company's business strategies:

- Drive and reward strong business performance which supports the Company's core values and creates value for stockholders and competitive compensation for executives.
- Provide senior executives a significant percentage of total pay that is at-risk compensation to ensure management is focused on the long-term interests of stockholders while balancing short- and long-term business goals.
- Encourage executives to maintain significant stock holdings to align interests with those of stockholders and require senior executive officers to own from two to five times their base salary in Company Common Stock.
- Design competitive total compensation and rewards which enhance the Company's ability to attract and retain knowledgeable and experienced executives.
- Target compensation and incentive levels that reflect competitive market practices.

An independent compensation consultant provides competitive market data which includes current compensation and benefit trends. The consultant reviews and provides survey data to the Committee to compare the Company's executive compensation with compensation levels at companies in peer and general industry groups. The Compensation Committee reviews and approves the selection of companies used for compensation comparison purposes.

The companies in the S&P 500 Oil and Gas Equipment and Services Index in the Performance Graph included in this Proxy Statement are included in the group of companies used by the

Company for compensation comparisons. The Committee believes the Company's market for both compensation comparison and executive talent purposes consists of companies with national and international business operations and similar sales volumes, employment levels and operations in comparable lines of business.

The key components of the executive compensation program are base salary, annual and long-term incentives and benefits. All executive officers are also entitled to participate in the Company's executive benefit and perquisite plans.

The Compensation Committee regularly reviews all elements of an executive's total compensation package. Total compensation opportunity is targeted between the 50th and 75th percentile based on performance. Executives can be rewarded at the upper end of the range based on individual or company performance, as well as the executive's experience and expertise.

Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code") places a limit of \$1,000,000 on the amount of compensation that may be deducted by the Company in any year with respect to the Company's Chief Executive Officer and its four other highest paid executive officers, unless the compensation is performance-based compensation as described in Section 162(m) and the related regulations. The Company has qualified certain compensation paid to executive officers for deductibility under Section 162(m), including certain compensation expense related to options granted pursuant to the Company's 1993 Stock Option Plan, and certain options and other long-term performance-based stock or cash awards granted pursuant to the Company's Long-Term Incentive Plan and the Baker Hughes Incorporated 2002 Director & Officer Long-Term Incentive Plan. The Company may from time to time pay compensation to its executive officers that may not be deductible including discretionary bonuses, or other types of compensation, outside of the Baker Hughes Incorporated Annual Incentive Compensation Plan as amended and restated.

### Base Salaries

Executive base salaries are targeted at median levels of the peer and general industry group. Base salaries are determined by evaluating an executive's level of responsibility and experience, company-wide performance and internal and external equity.

After evaluating the competitive market data, increases to base salaries, if any, are driven primarily by individual performance. Individual performance considers the executive's efforts in achieving business results; promoting the Company's core values and keys to success; continuing educational and management training; improving product quality; developing relationships with customers, suppliers and employees; and demonstrating leadership abilities among co-workers.

In setting the base salary of Mr. Deaton for fiscal year 2005, the Compensation Committee reviewed the compensation of chief executive officers from a group of comparator companies and with comparable levels of experience. Based on

this evaluation and analysis by outside advisors, the Compensation Committee established a base salary of \$925,000 for Mr. Deaton. Mr. Deaton's salary will be reviewed on an ongoing basis using comparable data. In the future, the Compensation Committee expects to also consider a review of Mr. Deaton's performance, including a review of the Company's financial performance during the previous fiscal year with respect to revenue growth, expense control, net income and earnings per share in setting Mr. Deaton's salary. Members of the Board of Directors that are not part of the Compensation Committee will also be given the opportunity to review Mr. Deaton's performance each year and provide input to the Compensation Committee with respect to both past performance and performance goals and objectives for the upcoming year.

### **Annual Incentives**

The 1995 Employee Annual Incentive Compensation Plan, as amended and restated (the "Restated Plan"), provides executives with the opportunity to earn cash bonuses based on the achievement of specific Company-wide, business unit and individual performance goals.

Each year, the Compensation Committee establishes specific goals relating to each executive's bonus opportunity. Executives are assigned threshold, target and overachievement bonus levels based on a percentage of their base salary. The percentages have been established based on competitive practices of the comparator group. Executives earn bonuses based on achievements of the extent to which pre-established goals are achieved. Bonus awards may be adjusted to differentiate performance among executives. However, no bonus is paid unless predetermined threshold performance levels are reached. If overachievement status is reached and surpassed, bonus awards earned over this level are paid to the executive over a two-year period.

Performance goals are approved each year by the Compensation Committee and are based upon financial and/or strategic objectives of the Company. During fiscal year 2005, the corporate objective was based on (i) earnings per share and (ii) Baker Value Added, a Company metric that measures our operating profit after tax less the cost of capital employed as a measure of the value we create for our stockholders. Baker Value Added integrates the profit and loss results and balance sheet investments of the Company by assuring that the cost of any capital used to earn those profits is fully taken into account. Where executives have business unit responsibilities, a portion of the goal may be based on financial performance measures that support business unit performance. This portion varies with the position of each individual and the particular objectives of the Company.

Performance targets are established by the Compensation Committee at levels that are achievable, but require above-average performance from each executive. Target bonus awards range from 45% to 100% of base salary.

Each of the named executive officers received an annual bonus based on their contribution to the 2005 financial performance.

The Restated Plan was amended and restated in January 2006. Under the Restated Plan, the maximum annual award is increased from \$1,000,000 to \$4,000,000, specific provisions are included to provide for the deferral of payment of any award earned over the overachievement level set by the Committee and other amendments made to comply with the American Jobs Creation Act. The performance criteria under the Restated Plan is being submitted to the stockholders for approval in order to continue the qualification of the Restated Plan as generally providing for qualified performance-based compensation under Section 162(m) of the Internal Revenue Code of 1986, as amended. A copy of the Restated Plan is attached as Annex F to this Proxy Statement.

In addition to the bonus of \$1,000,000 each earned under the Restated Plan for fiscal year 2005 performance, in February 2006 Mr. Deaton and Mr. Clark each were awarded an additional discretionary bonus of \$1,036,576 and \$178,630, respectively, outside of the Restated Plan. The additional discretionary bonus was paid in recognition of the efforts of Mr. Deaton and Mr. Clark during fiscal year 2005 and their contributions to the financial results of the Company during that period. A portion of the additional discretionary bonus paid to Mr. Deaton and Mr. Clark will be paid in 2007 and 2008.

### **Long-Term Incentives**

Long-term incentives comprise the largest portion of an executive's total compensation package, supporting the Company's commitment to provide a total compensation package that favors at-risk pay. The Compensation Committee's objective is to provide executives with long-term incentive award opportunities that are consistent with grants made within the comparator groups.

Long-term incentive award guidelines are determined using competitive market references for each executive position and the individual performance of each executive. Long-term incentives are provided pursuant to the Company's long-term incentive plans.

The Committee determined that, beginning in 2005, equity awards would be made in shares of restricted stock (or restricted stock units in some jurisdictions) in addition to fixed-price stock options. Restricted stock awards or units (collectively, "restricted stock") generally vest pro rata over three years after the date of the award.

Stock options are granted at an option price equal to the fair market value of the Common Stock on the date prior to the date of grant. Vesting for stock options is generally pro rata over three years after the date of grant. Stock options have value if the stock price appreciates after the date the options are granted.

The Compensation Committee determines the total stock options and restricted stock that will be made available to the Company's executives, as well as the size of individual grants for each senior executive. The amounts vary each year and are based upon what the Compensation Committee believes is appropriate after consideration of the data provided by the independent compensation consultant as well as the executive's total compensation package.

In fiscal year 2005, the Compensation Committee awarded grants of stock options and restricted stock to certain of the Company's senior executives, including Messrs. Deaton, Clark, Finley, Crain and Wall to furnish an incentive for top performance for the mutual benefit of the employees, the Company and stockholders. In addition, in 2005 Mr. Wall received an award of 16,000 restricted shares of Common Stock. Mr. Wall's award vests 25 percent on each of February 28, 2007 and 2008 with the remaining 50 percent vesting on February 28, 2009.

In 2002, the Compensation Committee and the Company's Board of Directors approved, subject to stockholder approval, the Baker Hughes Incorporated 2002 Director & Officer Long-Term Incentive Plan (the "2002 D&O Plan") for performance-related awards for senior executives in order to maintain a strong link to stockholders and to provide a more balanced long-term incentive program. The Company's stockholders approved this plan in April 2002.

In 2005, the Compensation Committee approved performance-related awards for senior executives under the 2002 D&O Plan. If the Company's total shareholder return for the three-year period ending December 31, 2007 equals or exceeds the median of the total shareholder returns of the Morgan Stanley Oil Services Index companies (28 comparators) for the period, the Company will issue shares of Common Stock equal to the participant's number of target shares of Common Stock for the performance award multiplied by the applicable percentage target earned factor for the Morgan Stanley Oil Services Index companies.

In June 2005, the Committee entered into an engagement with a separate independent executive compensation consultant for the purpose of reviewing the Company's long-term incentive compensation program. The Committee received and reviewed the recommendations from the consultant in December 2005, which the Committee has taken into consideration in its overall compensation program. Based upon the advice of the consultant, the mix of long-term incentives to award executives in 2006 will include stock options, restricted stock and performance units. Performance units will be paid in cash and are based on a cumulative Baker Value Added target over a three-year period.

Performance unit targets for Baker Value Added were established by the Compensation Committee with assistance from an independent consultant. Executives were assigned entry level, expected value and overachievement levels of the Baker Value Added metric. No payout shall be made unless predetermined threshold performance levels are reached. If the overachievement level is surpassed, resulting payouts will be capped at the amount payable for the overachievement level.

## Summary

The Compensation Committee believes the executive compensation program provides a competitive total compensation opportunity with a significant performance orientation. The annual incentive plan is designed to evaluate and reward achievement of specific objectives that drive the success of the Company. The long-term incentive awards link executives directly to stockholders and reward the Company's executives for continuing positive stock performance on an absolute and relative basis.

H. John Riley, Jr. (Chairman)  
Larry D. Brady  
Edward P. Djerejian  
Claire W. Gargalli  
Charles L. Watson

## COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

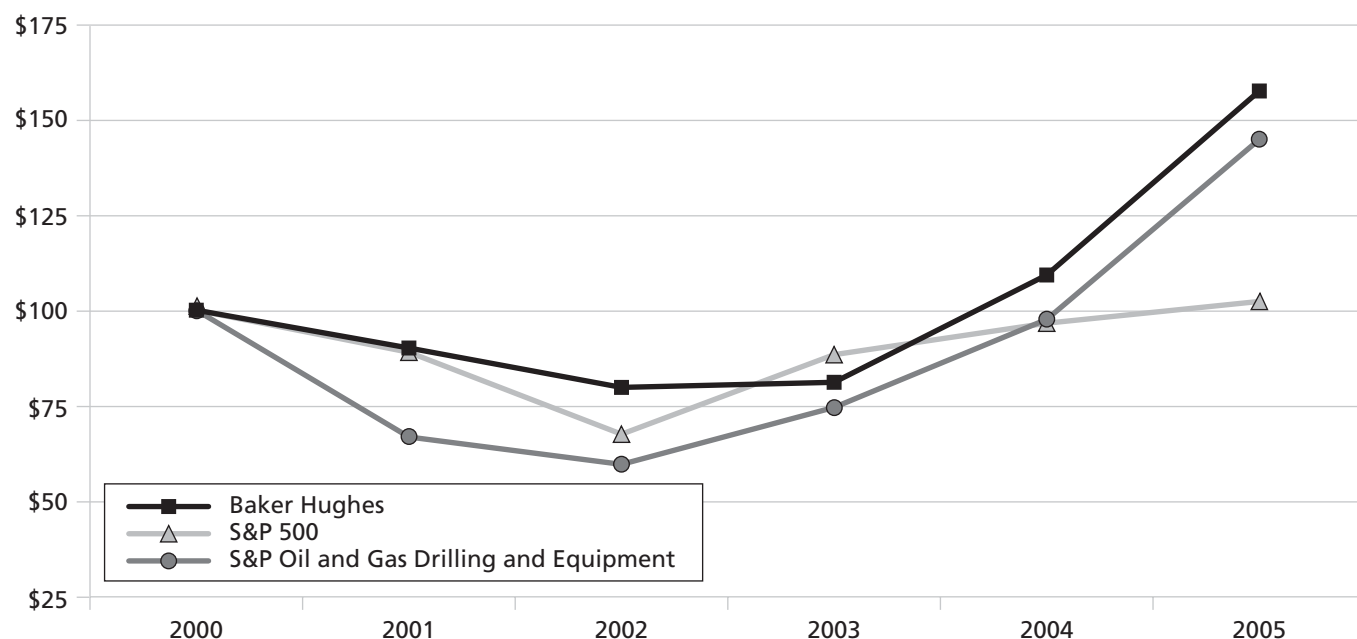
The Company's Compensation Committee consists of Messrs. Riley, Brady, Djerejian and Watson and Ms. Gargalli, all of whom are non-employee directors. None of the Compensation Committee members has served as an officer of the Company, and none of the Company's executive officers has served as a member of a compensation committee or board of directors of any other entity, which has an executive officer serving as a member of the Company's Board of Directors.

## CORPORATE PERFORMANCE GRAPH

The following graph compares the yearly percentage change in the Company's cumulative total stockholder return on its Common Stock (assuming reinvestment of dividends into Common Stock at the date of payment) with the cumulative total return on the published Standard & Poor's 500 Stock Index and the cumulative total return on Standard & Poor's 500 Oil and Gas Equipment and Services Index over the preceding five-year period. The following graph is presented pursuant to SEC rules. The Company believes that while total stockholder return is an important corporate performance indicator, it is subject to the vagaries of the market. In addition to the creation of stockholder value, the Company's executive compensation program is based on financial and strategic results and the other factors set forth and discussed above in the "Compensation Committee Report."

### Comparison of Five-Year Cumulative Total Return\*

#### Baker Hughes Incorporated; S&P 500 Index and S&P 500 Oil and Gas Equipment and Services Index



	2000	2001	2002	2003	2004	2005
Baker Hughes	\$ 100.00	\$ 88.85	\$ 79.60	\$ 80.77	\$ 108.46	\$ 155.94
S&P 500	100.00	88.11	68.64	88.33	97.94	102.75
S&P Oil and Gas Drilling and Equipment	100.00	66.56	58.92	73.50	96.91	143.98

\* Total return assumes reinvestment of dividends on a quarterly basis.

The comparison of total return on investment (change in year-end stock price plus reinvested dividends) assumes that \$100 was invested on December 31, 1999 in Baker Hughes Common Stock, the S&P 500 Index and the S&P 500 Oil and Gas Equipment and Services Index.

### AUDIT/ETHICS COMMITTEE REPORT

The Audit/Ethics Committee is comprised of five members, each of whom is independent, as defined by the standards of the NYSE, the rules of the SEC, and under the Company's Policy for Director Independence (attached as Annex A to this Proxy Statement). Under the Charter of the Audit/Ethics Committee (attached as Annex B to this Proxy Statement), the Audit/Ethics Committee assists the Board of Directors in overseeing matters relating to the accounting and reporting practices of the Company, the adequacy of the Company's disclosure controls and internal controls, the quality and integrity of the quarterly and annual financial statements of the Company, the performance of the Company's internal audit function and the review and pre-approval of the current year audit and non-audit fees with the Company's independent auditor. The Audit/Ethics Committee also oversees the Company's policies with respect to risk assessment and risk management and compliance programs relating to legal and regulatory requirements.

During the year ended December 31, 2005, the Audit/Ethics Committee held eight meetings and otherwise met and communicated with management and with Deloitte & Touche LLP, the Company's Independent Auditor for 2005. Deloitte & Touche discussed with the Audit/Ethics Committee various matters under applicable auditing standards, including information regarding the scope and results of the audit and other matters required to be discussed by the Statement on Auditing Standards No. 61, as amended, "Communication with Audit Committees." The Audit/Ethics Committee also discussed with Deloitte & Touche its independence from the Company and received the written disclosures and the letter from Deloitte & Touche concerning independence as required by the Independence Standards Board Standard No. 1, "Independence Discussions with Audit Committees." The Audit/Ethics Committee also reviewed the provision of services by Deloitte & Touche not related to the audit of the Company's financial statements and not related to the review of the Company's interim financial statements as it pertains to the independence of Deloitte & Touche. Deloitte & Touche also periodically reported the progress of its audit of management's assessment of the Company's internal control over financial reporting.

The Audit/Ethics Committee reviewed and discussed with management the Company's financial results prior to the release of earnings. In addition, the Audit/Ethics Committee reviewed and discussed with management, the Company's internal auditors and Deloitte & Touche the interim financial information included in the March 31, 2005, June 30, 2005 and September 30, 2005 Form 10-Qs prior to their being filed with the SEC. The Audit/Ethics Committee also reviewed and discussed the Company's audited financial statements for the year ended December 31, 2005 with management, the Company's internal auditors and Deloitte & Touche. Deloitte & Touche informed the Audit/Ethics Committee that the Company's audited financial statements are presented fairly in conformity with generally accepted accounting principles. The Audit/Ethics Committee also monitored and reviewed the Company's procedures and policies relating to the requirements of Section 404 of the Sarbanes-Oxley Act and related regulations.

Based on the review and discussions referred to above, and such other matters deemed relevant and appropriate by the Audit/Ethics Committee, the Audit/Ethics Committee recommended to the Board of Directors, and the Board has approved, that the financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

James F. McCall (Chairman)  
 Clarence P. Cazalot, Jr.  
 Anthony G. Fernandes  
 James A. Lash  
 J. Larry Nichols

**PROPOSAL NO. 2  
 RATIFICATION OF INDEPENDENT AUDITOR**

The Audit/Ethics Committee has selected the firm of Deloitte & Touche LLP as our Independent Auditor to audit the Company's books and accounts for the year ending December 31, 2006. Deloitte & Touche served as our Independent Auditor for fiscal year 2005. While the Audit/Ethics Committee is responsible for the appointment, compensation, retention, termination and oversight of the independent auditor, we are requesting, as a matter of good corporate governance, that the stockholders ratify the appointment of Deloitte & Touche as our principal Independent Auditor. If the stockholders fail to ratify the selection, the Audit/Ethics Committee will reconsider whether to retain Deloitte & Touche and may retain that firm or another without re-submitting the matter to our stockholders. Even if the appointment is ratified, the Audit/Ethics Committee may, in its discretion, direct the appointment of a different independent auditor at anytime during the year if it determines that such change would be in the Company's best interests and in the best interests of our stockholders.

Deloitte & Touche's representatives will be present at the Annual Meeting and will have an opportunity to make a statement, if they so desire, as well as to respond to appropriate questions asked by our stockholders.

**Recommendation of the Board of Directors**

**Your Board of Directors recommends a vote "FOR" ratification of the selection of Deloitte & Touche LLP as the Company's Independent Auditor for 2006.**

**FEES PAID TO DELOITTE & TOUCHE LLP**

Deloitte & Touche LLP, the member firms of Deloitte Touche Tohmatsu and their respective affiliates (collectively, "Deloitte Entities") billed or will bill the Company or its subsidiaries for the aggregate fees set forth in the table below for services provided during 2005 and 2004. These amounts include fees paid or to be paid by the Company for (i) professional services rendered for the audit of the Company's annual financial statements and review of quarterly financial statements, audit services related to Management's Report on Internal Control over Financial Reporting and audit services related to the effectiveness of the Company's internal control over financial reporting, (ii) assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements, (iii) professional services rendered for tax compliance, tax advice, and tax planning and (iv) products and services provided by Deloitte Entities.

	2005 <i>(in millions)</i>	2004 <i>(in millions)</i>
Audit fees	\$ 11.0	\$ 10.6
Audit-related fees	0.0	0.2
Tax fees	1.0	1.1
Total	\$ 12.0	\$ 11.9

Audit fees include fees related to the audit of the Company's annual financial statements, review of quarterly financial statements, audit of Management's Report on Internal Controls as required by Section 404 of SOX and audit services related to the effectiveness of the Company's internal control over financial reporting.

Audit-related fees for 2004 relate primarily to non-audit assistance with regulatory filings and related matters, assistance with an internal control assessment program, non-audit work related to the implementation of Section 404 of SOX, training services and miscellaneous other minor services.

Tax fees are primarily for the preparation of income, payroll, value added and various other miscellaneous tax returns in 29 of the more than 90 countries where the Company operates. The Company also incurs local country tax advisory services in these countries. Examples of these kinds of services are assistance with audits by the local country tax authorities, acquisition and disposition advice, consultation regarding changes in legislation or rulings and advice on the tax effect of other structuring and operational matters.

In addition to the above services and fees, Deloitte Entities provide audit and other services to various Company sponsored employee benefit plans which fees are incurred by and paid by the respective plans. Fees paid to Deloitte Entities for these services totaled approximately \$0.3 million in 2005 and \$0.2 million in 2004.

## Pre-Approval Policies and Procedures

The Audit/Ethics Committee has adopted guidelines for the pre-approval of audit and permitted non-audit services by the Company's Independent Auditor. The Audit/Ethics Committee will consider annually and, if appropriate, approve the provision of audit services by its Independent Auditor and consider and, if appropriate, pre-approve the provision of certain defined audit and non-audit services. The Audit/Ethics Committee will also consider on a case-by-case basis and, if appropriate, approve specific engagements that are not otherwise pre-approved. The "Guidelines for Pre-Approval of Audit and Non-Audit Fees of the Independent Auditor" adopted by the Audit/Ethics Committee on January 27, 2004 is attached as Annex G to this Proxy Statement. Any proposed engagement with estimated non-audit fees of \$15,000 or more that does not fit within the definition of a pre-approved service are presented to the Chairman of the Audit/Ethics Committee for pre-approval. The Chairman of the Audit/Ethics Committee will report any specific approval of services at its next regular meeting. The Audit/Ethics Committee will review a summary report detailing all services being provided to the Company by its Independent Auditor. All of the fees and services described above under "audit fees," "audit-related fees" and "tax fees" were approved under the Guidelines for Pre-Approval of Audit and Non-Audit Fees of the Independent Auditor and pursuant to Section 202 of SOX.

## PROPOSAL NO. 3 APPROVAL OF THE PERFORMANCE CRITERIA FOR AWARDS UNDER THE BAKER HUGHES INCORPORATED ANNUAL INCENTIVE COMPENSATION PLAN

### Background

The Company's stockholders are being asked to approve the performance criteria that may apply to annual performance bonuses granted under the Baker Hughes Incorporated 1995 Employee Annual Incentive Compensation Plan, as amended and restated in January 2006 (the "Restated Plan"). This approval is necessary to generally preserve the Company's federal income tax deduction for performance-based compensation paid to certain executive officers under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code").

In 1995 the Board of Directors adopted, and the stockholders approved, the Restated Plan, which prior to the current amendment and restatement provided for cash bonuses for key employees of the Company and its affiliates based upon the achievement of performance goals for the year. The performance criteria for bonuses under the Restated Plan were subsequently approved at the 2001 stockholders meeting in order to continue the qualification of the Restated Plan under Section 162(m) of the Code.

The Restated Plan provides officers of the Company with performance incentives that are designed to align the interests of the officers, currently approximately 25, with those of the Company's stockholders.

The Restated Plan is administered by the Compensation Committee of the Company's Board of Directors (the "Compensation Committee"), which is composed of non-employee independent directors. The Compensation Committee has exclusive authority to (i) select the participants each year, (ii) establish award opportunities for each participant, (iii) establish the performance goals for each participant, and (iv) determine the extent to which the performance goals have been attained.

### Section 162(m) of the Code

Section 162(m) of the Code imposes an annual deduction limit of \$1,000,000 on the amount of compensation paid to each of the chief executive officer and the four other highest compensated officers. The deduction limit does not apply to performance-based compensation that satisfies the requirements of Section 162(m) of the Code. The requirements of Section 162(m) of the Code for performance-based compensation include stockholder approval of the material terms of the performance goals under which the compensation is paid. The material terms include (1) the employees eligible to receive compensation upon attainment of a goal, (2) the business criteria on which the goals may be based, and (3) the maximum amount payable to an employee upon attainment of a goal. Although the Company's stockholders previously approved the performance criteria under the Restated Plan, Section 162(m) requires that performance criteria under plans such as the Restated Plan be approved by the Company's stockholders every five years in order to meet the performance-based compensation exception to the limitation on deductions. The stockholder approval of the performance criteria under the Restated Plan serves the purpose of ensuring the tax deductibility of any awards under the Restated Plan.

### Performance Criteria

The following summary of the material features of the performance criteria for awards under the Restated Plan is qualified by reference to the copy of the Restated Plan which is attached as Annex F to this Proxy Statement.

Performance bonuses may be granted under the Restated Plan to key employees of the Company and its affiliates who are in a position to significantly contribute to the growth and profitability of the Company and/or its affiliates.

Under the Restated Plan, performance bonuses are subject to the satisfaction of one or more performance goals during the applicable calendar year performance period. Performance goals for awards will be determined by the Compensation Committee and will be designed to support the Company's business strategy and align participants' interests with stockholder interests. Performance goals will be based on one or more of the following business criteria: Profit After Tax (as defined in the Restated Plan), Baker Value Added (as defined in the Restated Plan), earnings per share, total shareholder return, cash return on capitalization, increased revenue, revenue ratios, net income, stock price, market share, return on equity, return on assets, return on capital, return on capital compared to cost of capital, return on capital employed,



return on invested capital, shareholder value, net cash flow, operating income, earnings before interest and taxes, cash flow, cash flow from operations, cost reductions, and cost ratios. In the case of a participant other than a covered employee (within the meaning of Section 162(m) of the Code), up to 25 percent of his or her expected value bonus opportunity may be based on nonfinancial, subjective performance goals.

Achievement of the goals may be measured:

- individually, alternatively, or in any combination;
- with respect to the Company, one or more business units, or any combination of the foregoing;
- on an absolute basis, or relative to a target, to a designated comparison group, to results in other periods, or to other external measures; and
- including or excluding items determined to be extraordinary, unusual in nature, infrequent in occurrence, related to the acquisition or disposal of a business, or related to a change in accounting principle, in each case based on Opinion No. 30 of the Accounting Principles Board (APB Opinion No. 30), or other applicable accounting rules, or consistent with the Company's policies and practices for measuring the achievement of performance goals on the date the Committee establishes the goals.

The Compensation Committee may, in its discretion, decrease the amount payable under any award. The Compensation Committee may, in its discretion, increase the amount payable under an award to a participant who is not a covered employee (as defined in Section 162(m) of the Code). The Compensation Committee may not increase the amount payable under an award to a participant who is a covered employee (as defined in Section 162(m) of the Code).

Under the Restated Plan, effective with the 2006 annual performance period, the maximum annual performance bonus that may be granted under the Restated Plan is \$4,000,000.

No performance bonuses will be paid under the Restated Plan for the 2006 performance period or subsequent annual performance periods unless the Company's stockholders approve this Proposal No. 3. For further information regarding compensation to executive officers and this Restated Plan see "Compensation Committee Report."

For equity compensation plan information, see Pages 70 through 72 in the Form 10-K attached to this Proxy Statement.

### **Recommendation of the Board of Directors**

**Your Board of Directors recommends a vote "FOR" approval of the performance criteria for performance bonuses under the Restated Plan.** If you do not vote against or abstain from voting on the proposal, your proxy will be voted "FOR" approval of the proposal. Abstentions will be counted as shares entitled to vote on the proposal and will have the same effect as a vote "AGAINST" the proposal. A broker non-vote will be counted for purposes of establishing a quorum, but will not be treated as a share entitled to vote on the proposal. This will have the effect of reducing the absolute number of shares necessary to approve the proposal.

## **STOCKHOLDER PROPOSAL NO. 1 REGARDING VOTING UNDER THE COMPANY'S DELAWARE CHARTER**

### **The Board of Directors Unanimously Recommends a Vote AGAINST This Proposal**

The following proposal was submitted to Baker Hughes by Nick Rossi (with an address of P.O. Box 249, Boonville, California 95415 and a legal proxy to Mr. John Chevedden and/or his designee, with an address of 2215 Nelson Ave., No. 205, Redondo Beach, CA 90278) who is the owner of 1,000 shares of the Company's Common Stock, and is included in this Proxy Statement in compliance with SEC rules and regulations. The proposed resolution and supporting statement, for which the Board of Directors and the Company accept no responsibility, are set forth below.

### **Shareholder Proposal and Supporting Statement:**

#### **1 – Adopt Simple Majority Vote**

RESOLVED: Shareholders recommend that our Board of Directors take each step necessary for a simple majority vote to apply on each issue that can be subject to shareholder vote to the greatest extent possible.

Nick Rossi, P.O. Box 249, Boonville, Calif. 95415 submitted this proposal.

#### **75% yes-vote**

This topic won a 75% yes-vote average at 7 major companies in 2004. The Council of Institutional Investors [www.cii.org](http://www.cii.org) formally recommends adoption of this proposal topic.

### **End Potential Frustration of the Shareholder Majority**

Our current rule allows a small minority to frustrate the will of our shareholder majority. For example, in requiring a 75% vote to make key governance changes, if 74% vote yes and only 1% vote no – only 1% could force their will on the overwhelming 74% majority.

This proposal does not address a majority vote standard in director elections which is gaining increased support as a separate topic.

### **Progress Begins with One Step**

It is important to take a step forward in corporate governance and adopt the above RESOLVED statement since our 2005 governance standards were not impeccable. For instance in 2005 it was reported (and certain corresponding concerns are noted):

- We had no Independent Chairman – Independent oversight concern.
- An awesome 75% shareholder vote was required to make certain key changes – Entrenchment concern.
- Cumulative voting was not permitted.
- Poison Pill: In response to a 2003 shareholder proposal, Baker Hughes adopted a policy requiring poison pill shareholder approval, but allowing the board to override the policy and adopt a pill anyway without shareholder approval. According to The Corporate Library, an independent

investment research firm in Portland, Maine, this “override” provision undermines the shareholder approval requirement.

- In May 2005 our Board made it more difficult for shareholders to fill vacancies on the board.

### One Step Forward

The above practices reinforce the reason to take one step forward and adopt simple majority vote.

#### **Adopt Simple Majority Vote**

**Yes on 1**

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### Statement of the Board of Directors and Management in Opposition to Stockholder Proposal No. 1

Your Board of Directors is committed to the long-term best interests of all stockholders. A simple majority vote requirement already applies to most corporate matters involving the Company. The Board believes the Company’s existing use of a higher voting requirement in specific situations is prudent and appropriately limited in scope. Our Restated Certificate of Incorporation (“Certificate”) and Bylaws require a higher stockholder voting threshold only for fundamental corporate matters involving certain (i) business combinations, (ii) amendments to our Certificate and (iii) amendments to our Bylaws. We strongly believe that these voting requirements accord with good governance and serve the best interests of all stockholders. The Company disagrees with many of the statements included in the proposal, including statements regarding the Company’s corporate governance practices. The Company has been named in *Institutional Investor* magazine’s inaugural ranking of America’s most shareholder-friendly companies. In addition, the Company has received high governance ratings from Institutional Shareholder Services, Governance Metrics and The Corporate Library.

The Certificate requires approval of at least 75% of the outstanding shares of voting stock, including the affirmative vote of the holders of not less than 66⅔% of the outstanding shares of voting stock not owned by a related person, for the authorization of any business combination between the Company and a related person. The 75% voting requirement is not applicable if certain procedural and other requirements are met. This protects stockholders against self-interested actions by one or a few large stockholders. The Company’s charter documents also require approval of at least 75% of all shares of stock of the Company entitled to vote in the election of directors before changes to certain provisions of the Certificate and certain amendments to the Company’s Bylaws can be made, including stockholder amendments to the Bylaws, stockholder meetings, director liability, Board structure, certain business combinations and cumulative voting. These voting requirements do not preclude changes to these corporate governance provisions, but ensure that fundamental changes can only be made with a broad consensus of stockholders. As outlined in the Corporate Governance section of this Proxy Statement, the Company’s governance policies and practices comply with best governance practices and all requirements of the NYSE and SEC corporate governance standards.

Your Board believes that the voting provisions as currently contained in the Certificate and Bylaws are necessary to preserve the fundamental framework of the Company’s governance structure. The Company’s prudent and limited use of such voting requirements has and continues to effectively safeguard the best interests of our stockholders, and we therefore recommend a vote against this Proposal.

### Recommendation of the Board of Directors

**Your Board of Directors recommends a vote “AGAINST” approval of Stockholder Proposal No. 1 on majority voting.**

### ANNUAL REPORT

The 2005 Annual Report on Form 10-K of the Company, which includes audited financial statements for the fiscal year ended December 31, 2005, accompanies this Proxy Statement; however, that report is not part of the proxy soliciting information.

### INCORPORATION BY REFERENCE

To the extent that this Proxy Statement is incorporated by reference into any other filing by Baker Hughes under the Securities Act of 1933, as amended, or the Exchange Act, the sections of this Proxy Statement entitled “Compensation Committee Report,” “Audit/Ethics Committee Report” (to the extent permitted by the rules of the SEC) and “Corporate Performance Graph,” as well as the annexes to this Proxy Statement, will not be deemed incorporated unless specifically provided otherwise in such filing. Information contained on or connected to our website is not incorporated by reference into this Proxy Statement and should not be considered part of this Proxy Statement or any other filing that we make with the SEC.

### STOCKHOLDER PROPOSALS

Proposals of stockholders intended to be presented at the 2007 Annual Meeting must be received by the Company by November 15, 2006 to be properly brought before the 2007 Annual Meeting and to be considered for inclusion in the Proxy Statement and form of proxy relating to that meeting. Such proposals should be mailed to the Corporate Secretary, c/o Baker Hughes Incorporated 3900 Essex Lane, Suite 1200, Houston, Texas 77027-5177. Nominations of directors by stockholders must be received by the Chairman of the Governance Committee of the Company’s Board of Directors, P.O. Box 4740, Houston, Texas 77210-4740 or the Corporate Secretary, c/o Baker Hughes Incorporated 3900 Essex Lane, Suite 1200, Houston, Texas 77027-5177 between October 16, 2006 and November 15, 2006 to be properly nominated before the 2007 Annual Meeting, although the Company is not required to include such nominees in its Proxy Statement.

### OTHER MATTERS

The Board of Directors knows of no other matter to be presented at the Annual Meeting. If any additional matter should be presented properly, it is intended that the enclosed proxy will be voted in accordance with the discretion of the persons named in the proxy.

## ANNEX A

### BAKER HUGHES INCORPORATED POLICY FOR DIRECTOR INDEPENDENCE, AUDIT/ETHICS COMMITTEE MEMBERS AND AUDIT COMMITTEE FINANCIAL EXPERT

#### INDEPENDENCE

##### **I. Introduction**

A member of the Board of Directors ("Board") of Baker Hughes Incorporated ("Company") shall be deemed independent pursuant to this Policy of the Board, only if the Board affirmatively determines that (1) such director meets the standards set forth in Section II below, and (2) the director has no material relationship with the Company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company). In making its determination, the Board shall broadly consider all relevant facts and circumstances. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.

Each director of the Company's Audit/Ethics Committee, Governance Committee and Compensation Committee must be independent. A director who is a member of the Company's Audit/Ethics Committee is also required to meet the criteria set forth below in Section III. These standards shall be implemented by the Governance Committee with such modifications as it deems appropriate.

##### **II. Standards for Director Independence**

1. A director who is an employee, or whose immediate family member is an executive officer, of the Company is not independent until three years after the end of such employment relationship. Employment as an interim Chairman or CEO shall not disqualify a director from being considered independent following that employment.
2. A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than \$100,000 per year in such compensation. Compensation received by a director for former service as an interim Chairman or CEO need not be considered in determining independence under this test. Compensation received by an immediate family member for service as a non-executive employee of the Company need not be considered in determining independence under this test.
3. A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the Company is not "independent"

until three years after the end of the affiliation or the employment or auditing relationship.

4. A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the Company's present executives serve on that company's compensation committee is not "independent" until three years after the end of such service or the employment relationship.
5. A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the Company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of the consolidated gross revenues of such other company employing such executive officer or employee, is not "independent" until three years after falling below such threshold.<sup>1</sup>
6. The three-year period referred to in paragraphs II.1 through II.5 above will be applied consistent with the New York Stock Exchange's ("NYSE") transition rules, which permit a one-year look-back period until November 4, 2004. Accordingly, until November 4, 2004, a one-year period, rather than a three-year period, shall apply to the determination of independence and the application of paragraphs II.1 through II.5 above.

##### **III. Standards for Audit/Ethics Committee Members**

1. A director who is a member of the Audit/Ethics Committee other than in his or her capacity as a member of the Audit/Ethics Committee, the Board, or any other Board committee, may not accept directly or indirectly any consulting, advisory, or other compensatory fee from the Company or any subsidiary thereof, provided that, unless the rules of the NYSE provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the Company (provided that such compensation is not contingent in any way on continued service).  
Indirect acceptance of compensatory payments includes: (1) payments to spouses, minor children or stepchildren, or children or stepchildren sharing a household with the member; or (2) payments accepted by an entity in which such member is a partner, member, officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position and which provides accounting, consulting, legal, investment banking or financial advisory services to the Company.
2. A director, who is a member of the Audit/Ethics Committee may not, other than in his or her capacity as a member of the Audit/Ethics Committee, the Board, or any other Board committee, be an affiliated person of the Company or any subsidiary thereof.
3. A member of the Audit/Ethics Committee may not simultaneously serve on the audit committees of more than two other public companies in addition to the Company.

#### IV. Definitions

An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's household. When considering the application of the three year period referred to in each of paragraphs II.1 through II.5 above, the Company need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.

The "Company" includes any subsidiary in a consolidated group with the Company.

#### **AUDIT/ETHICS COMMITTEE FINANCIAL EXPERT QUALIFICATIONS**

The Company believes that it is desirable that one or more members of the Audit/Ethics Committee possess such qualities and skills such that they qualify as an Audit Committee Financial Expert as defined by the Securities and Exchange Commission ("SEC").

1. The SEC rules define an Audit Committee Financial Expert as a director who has the following attributes:
  - (a) An understanding of generally accepted accounting principles and financial statements;
  - (b) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
  - (c) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
  - (d) An understanding of internal controls and procedures for financial reporting; and
  - (e) An understanding of audit committee functions.

2. Under SEC rules, a director must have acquired such attributes through any one or more of the following:
  - (a) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
  - (b) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
  - (c) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
  - (d) Other relevant experience.

<sup>1</sup> In applying this test, both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the Company and the director or immediate family member's current employer; the Company need to consider former employment of the director or immediate family member. Charitable organizations shall not be considered "companies" for purposes of this test provided however that the company shall disclose in its annual proxy statement any charitable contributions made by the Company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year exceeded the greater of \$1 million, or 2% of such charitable organization's consolidated gross revenues.

## ANNEX B

### BAKER HUGHES INCORPORATED CHARTER OF THE AUDIT/ETHICS COMMITTEE OF THE BOARD OF DIRECTORS

(as amended and restated October 26, 2005)

The Board of Directors of Baker Hughes Incorporated (the "Company") has heretofore constituted and established an Audit/Ethics Committee (the "Committee") with authority, responsibility and specific duties as described in this Charter. It is intended that this Charter and the composition of the Committee comply with the rules of the New York Stock Exchange (the "NYSE"). This document replaces and supersedes in its entirety the previous Charter of the Committee adopted by the Board of Directors of the Company.

#### **Purpose**

The Committee's purpose is to assist the Board of Directors with oversight of: (i) the integrity of the Company's financial statements and financial reporting system, (ii) the Company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence and performance and (iv) the performance of the Company's internal audit function and independent auditors. The Committee shall also prepare the report of the Committee to be included in the Company's annual proxy statement, carry out the duties and responsibilities set forth in this Charter and conduct an annual self-evaluation.

#### **Composition**

The Committee and Chairman of the Committee shall be elected annually by the Board of Directors and are subject to removal pursuant to the terms of the Company's Bylaws. The Committee shall be comprised of not less than three non-employee Directors who are (i) independent (as defined by Section 10A(m)(3) of the Securities Exchange Act of 1934 and the regulations thereunder and the NYSE) and (ii) financially literate (as interpreted by the Board of Directors in its business judgment). Such Committee members may not simultaneously serve on the audit committee of more than three public companies. At least one member of the Committee shall have accounting or related financial management expertise and at least one member of the Committee shall be an "audit committee financial expert," as defined by the Securities and Exchange Commission ("SEC"). The audit committee financial expert must have: an understanding of GAAP and financial statements; experience in the (a) preparation, auditing, analyzing or evaluating of financial statements of generally comparable issuers and (b) application of such principles in connection with the accounting for estimates, accruals and reserves; an understanding of internal accounting controls and procedures for financial reporting; and an understanding of audit committee functions. The Committee may, if appropriate, delegate its authority to subcommittees.

#### **Principal Responsibilities**

The principal responsibilities of the Committee are: (i) to provide assistance to the Board of Directors in fulfilling its responsibility in matters relating to the accounting and reporting practices of the Company, the adequacy of the Company's internal controls over financial reporting and disclosure controls and procedures and the quality and integrity of the financial statements of the Company; and (ii) to oversee the Company's compliance programs. The independent auditor is ultimately accountable to the Board of Directors and the Committee, as representatives of the Company's stockholders, and shall report directly to the Committee; and the Committee has the ultimate authority and direct responsibility to select, appoint, evaluate, compensate and oversee the work, and, if necessary, terminate and replace the independent auditor (subject, if applicable, to stockholder ratification). The Committee shall have authority to conduct or authorize investigations into any matters within its scope of responsibilities.

The Committee shall have the authority to engage independent counsel and other advisors, as the Committee deems necessary to carry out its duties. The Committee shall have the sole authority to approve the fees paid to any independent advisor retained by the Committee, and the Company shall provide funding for such payments. In addition, the Company must provide funding for ordinary administrative expenses of the Committee that are necessary or appropriate in carrying out its duties.

The Committee shall review the composition, expertise and availability of the Committee members on an annual basis. The Committee shall also perform a self-evaluation of the Committee and its activities on an annual basis.

The Committee shall meet in executive session at each regularly scheduled meeting, including separate, private meetings with the independent auditors, internal auditors, general counsel and compliance officer.

This Charter is intended to be flexible so that the Committee is able to meet changing conditions. The Committee is authorized to take such further actions as are consistent with the following described responsibilities and to perform such other actions as applicable law, the NYSE, the Company's charter documents and/or the Board of Directors may require. To that end, the Committee shall review and reassess the adequacy of this Charter annually. Any proposed changes shall be put before the Board of Directors for its approval.

With regard to its audit responsibilities, the Committee shall:

- (1) Receive and review reports from the independent auditors pursuant to the Sarbanes-Oxley Act of 2002 ("SOX") and, on an annual basis, formal written reports from the independent auditors regarding the auditors' independence required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), giving consideration to the range of audit and non-audit services performed by them and all their relationships with the Company, as well as a report describing the

- (i) independent auditors' internal quality-control procedures; and (ii) material issues raised by the most recent internal quality-control review or Public Company Accounting Oversight Board review, of the independent auditors, or by any inquiry or investigation by governmental professional authorities, within the preceding five years, respecting one or more independent audits carried out by the auditors, and any steps taken to deal with such issues. Conduct an active discussion with the independent auditors with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditors; and, select the independent auditors to be employed or discharged by the Company. Review competence of partners and managers of the independent auditors who lead the audit as well as possible rotation of the independent auditors. The Committee shall establish hiring policies for the Company of employees or former employees of the independent auditors in accordance with the NYSE rules, SOX and as specified by the SEC and review and discuss with management and the independent auditors any proposals for hiring any key member of the independent auditors' team.
- (2) Prior to commencement of the annual audit, review with management, the internal auditors and the independent auditors the proposed scope of the audit plan and fees, including the areas of business to be examined, the personnel to be assigned to the audit, the procedures to be followed, special areas to be investigated, as well as the program for integration of the independent and internal audit efforts.
  - (3) Review policies and procedures for the engagement of the independent auditors to provide audit and non-audit services, giving due consideration to whether the independent auditor's performance of non-audit services is compatible with the auditor's independence and review and pre-approve all audit and non-audit fees for such services, subject to the de minimus exception under the Sarbanes-Oxley Act. With the exception of the annual audit, the Committee may delegate to a member of the Committee the authority to pre-approve all audit and non-audit services with any such decision presented to the full Committee at the next scheduled meeting.
  - (4) Review with management and independent auditors the accounting and reporting policies and procedures that may be viewed as critical, any improvements, questions of choice and material changes in accounting policies and procedures, including interim accounting, as well as significant accounting, auditing and SEC pronouncements.
  - (5) Review with management and the independent auditors any financial reporting and disclosure issues, including material correcting adjustments and off-balance sheet financings and relationships, if any, discuss significant judgment matters made in connection with the preparation of the Company's financial statements and ascertain that any significant disagreements among them have been satisfactorily resolved, and ascertain that no restrictions were placed by management on implementation of the independent or internal auditors' examinations. Regularly scheduled executive sessions will be held for this purpose.
- Review with management, the internal auditors and the independent auditors the results of the annual audit prior to release of the audited financial statements in the Company's annual report on Form 10-K filed with the SEC, including a review of the MD&A section; quarterly financial statements prior to release in the Company's quarterly report on Form 10-Q filed with the SEC, including a review of the MD&A section; and have management review the Company's financial results with the Board of Directors.
- (6) Establish guidelines with respect to earnings releases and financial information and earnings guidance provided to analysts and rating agencies. The Committee may request a prior review of any annual or quarterly earnings release or earnings guidance and delegate to the Chairman of the Committee the authority to review any such earnings releases and guidance.
  - (7) Review with the Board of Directors any issues that arise with respect to the quality or integrity of the Company's financial statements and financial reporting system, the Company's compliance with legal or regulatory requirements, the performance and independence of the Company's independent auditors or the performance of the internal audit function.
- Review guidelines and policies on risk assessment and risk management related to the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures.
- (8) Annually prepare a report to stockholders included in the Company's proxy statement (a) stating that the Committee has (i) reviewed and discussed the audited financial statements with management; (ii) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61; (iii) received a formal written report from the independent auditors concerning the auditors' independence; and (iv) based upon the review and discussion of the audited financial statements with both management and the independent auditors, the Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the last fiscal year for filing with the SEC and (b) cause the Charter to be included periodically in the proxy statement as required by applicable rules.

- (9) Review actions taken by management on the independent auditors and internal auditors' recommendations relating to organization, internal controls and operations.
- Meet separately and periodically with management, the internal auditors and the independent auditors to review the responsibilities, budget and staffing of the Company's internal audit function, the effectiveness of the Company's internal controls, including computerized information systems controls, and security. Review the Company's annual internal audit plan, staffing and budget, and receive regular reports on their activities, including significant findings and management's actions. Review annually the audit of the travel and entertainment expenses of the Company's senior management. Review periodically the audit of the travel expenses members of the Company's Board of Directors.
  - Review membership of Company's "Disclosure Control and Internal Control Committee" ("DCIC"), the DCIC's scheduled activities and the DCIC's quarterly report. Review on an annual basis the DCIC Charter.
  - Receive reports from the CEO and CFO on all significant deficiencies in the design or operation of certain internal controls over financial reporting and any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls.
  - Review reports, media coverage and similar public information provided to analysts and rating agencies, as the Committee deems appropriate.
  - Establish formal procedures for (i) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, (ii) the confidential, anonymous submissions by Company employees of concerns regarding questionable accounting or auditing matters, and (iii) the protection of reporting employees from retaliation.
  - The Committee shall annually review with the independent auditors any audit problems or difficulties and management's response. The Committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditors' activities or on access to requested information, and any significant disagreements with management. Among the items the Committee may want to review with the auditors are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the Company.

With regard to its compliance responsibilities, the Committee shall:

- (10) Review the management's monitoring of compliance with the Company's Business Code of Conduct and Foreign Corrupt Practices Act policy.
- Review in conjunction with counsel (i) any legal matters that could have significant impact on the organization's financial statements; (ii) correspondence and material inquiries received from regulators or governmental agencies; and (iii) all matters relating to the ethics of this Company and its subsidiaries.
- (11) Coordinate the Company's compliance with inquiries from any government officials concerning legal compliance in the areas covered by the Business Code of Conduct and the Foreign Corrupt Practices Act policy.
- (12) Review the Company's compliance with its environmental policy on an annual basis.
- (13) Respond to such other duties as may be assigned to the Committee, from time to time, by the Board of Directors.

While the Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles; these are the responsibilities of management and the independent auditor. Nor is it the duty of the Committee to conduct investigations, to resolve disagreements, if any, between management and the independent auditor or to assure compliance with laws and regulations or with Company policies.

### **Meetings**

The Committee will meet at least five times per year as determined by the Board of Directors. Special meetings may be called, as needed, by the Chairman of the Board of Directors or the Chairman of the Committee. The Committee may create subcommittees who shall report to the Committee. In addition, the Committee will make itself available to the independent auditors and the internal auditors of the Company as requested. All meetings of the Committee will be held pursuant to the Bylaws of the Company with regard to notice and waiver thereof, and written minutes of each meeting will be duly filed in the Company records. Reports of meetings of the Committee shall be made to the Board of Directors at its next regularly scheduled meeting following the Committee meeting accompanied by any recommendations to the Board of Directors approved by the Committee.

## ANNEX C

### BAKER HUGHES INCORPORATED GUIDELINES FOR MEMBERSHIP ON THE BOARD OF DIRECTORS

These Guidelines set forth the policies of the Board of Directors (“Board”) of Baker Hughes Incorporated (“Company”) regarding Board membership. These Guidelines shall be implemented by the Governance Committee of the Board with such modifications as it deems appropriate. The Governance Committee will consider candidates based upon:

- The size and existing composition of the Board
- The number and qualifications of candidates
- The benefit of continuity on the Board
- The relevance of the candidate’s background and experience to issues facing the Company.

#### 1. Criteria for Selection

In filling director vacancies on the Board, the Governance Committee will strive to:

- (A) Recommend candidates for director positions who will help create a collective membership on the Board with varied experience and perspective and who:
- i) Have demonstrated leadership, and significant experience in an area of endeavor such as business, finance, law, public service, banking or academia;
  - ii) Comprehend the role of a public company director, particularly the fiduciary obligations owed to the Company and its stockholders;
  - iii) Have relevant expertise and experience, and be able to offer advice and guidance based upon that expertise;
  - iv) Have a substantive understanding of domestic considerations and geopolitics, especially those pertaining to the service sector of the oil and gas and energy related industries;
  - v) Will dedicate sufficient time to Company business;
  - vi) Exhibit integrity, sound business judgment and support for the Core Values of the Company;
  - vii) Understand basic financial statements;
  - viii) Are independent as defined by the Securities and Exchange Commission (“SEC”) and the New York Stock Exchange;
  - ix) Support the ideals of the Company’s Business Code of Conduct and are not engaged in any activity adverse to, or do not serve on the board of another company whose interests are adverse to, or in conflict with the Company’s interests;
  - x) Possess the ability to oversee, as a director, the affairs of the Company for the benefit of its stockholders while keeping in perspective the interests of the Company’s customers, employees and the public; and
  - xi) Are able to exercise sound business judgment.
- (B) Maintain a Board that reflects diversity, including but not limited to gender, ethnicity and experience.

#### 2. Age

The Board will not nominate any person to serve as a director who has attained the age of 72.

#### 3. Audit/Ethics Committee

The Governance Committee believes that it is desirable that one or more members of the Company’s Audit/Ethics Committee possess such qualities and skills such that they qualify as an Audit Committee Financial Expert, as defined by SEC rules and regulations.

#### 4. Significant Change in Occupation or Employment

Any non-employee director who has a significant change in occupation or retires from his or her principal employment or position will promptly notify the Governance Committee. The Governance Committee will determine if it is in the best interests of the Company to nominate such person to serve another term as a director following expiration of the director’s current term.

#### 5. Board Review and Assessments

Each year the members of the Board will participate in a review and assessment of the Board and of each committee. In connection with such reviews, or at any other time, a director with concerns regarding performance, attendance, potential conflicts of interest, or any other concern respecting any other director shall report such concerns to the Chairman of the Governance Committee. The Chairman of the Governance Committee, in consultation with such other directors as he or she deems appropriate will determine how such concerns should be investigated and reported to members of the Governance Committee who are not the director in question (“Disinterested Committee Members”). If the Disinterested Committee Members conclude that the director is not fulfilling his or her duties, they will determine what actions should be taken. Such actions may include, without limitation, the Chairman of the Board or another Board member discussing the situation with the director in question, identifying what steps are required to improve performance, or, if appropriate, requesting that the director resign from the Board.



## ANNEX D

### BAKER HUGHES INCORPORATED SELECTION PROCESS FOR NEW BOARD OF DIRECTORS CANDIDATES

Baker Hughes Incorporated (“Company”) has established the following process for the selection of new candidates for the Company’s Board of Directors (“Board”). The Board or the Company’s Governance Committee will evaluate candidates properly proposed by stockholders in the same manner as all other candidates.

1. Chairman/CEO, the Governance Committee, or other Board members identify a need to fill vacancies or add newly created directorships.
2. Chairman of the Governance Committee initiates search, working with staff support and seeking input from the Board members and senior management, and hiring a search firm or obtaining advice from legal or other advisors, if necessary.
3. Candidates, including any candidates properly proposed by stockholders in accordance with the Company’s Bylaws that satisfy criteria as described in the Company’s “Guidelines For Membership on the Board of Directors” or otherwise qualify for membership on the Board, are identified and presented to the Governance Committee.
4. Determine if the Governance Committee members, Board members or senior management have a basis to initiate contact with preferred candidates; or if appropriate, utilize a search firm.
5. Chairman/CEO and at least one member of the Governance Committee interviews prospective candidate(s).
6. Full Board to be kept informed of progress.
7. The Governance Committee meets to consider and approve final candidate(s) (conduct interviews as necessary).
8. The Governance Committee will propose to the full Board candidates for Board membership to fill vacancies, or to stand for election at the next Annual Meeting of Stockholders.

## ANNEX E

### BAKER HUGHES INCORPORATED STOCKHOLDER COMMUNICATIONS WITH THE BOARD OF DIRECTORS

In order to provide the stockholders and other interested parties of Baker Hughes Incorporated (“Company”) with a direct and open line of communication to the Company’s Board of Directors (“Board”), the following procedures have been established for communications to the Board.

Stockholders and other interested persons may communicate with any member of the Board, including the Company’s Lead Director, the Chairman of any of the Company’s Governance Committee, Audit/Ethics Committee, Compensation Committee, Finance Committee or with the non-management directors of the Company as a group, by sending such written communication to the following address:

Corporate Secretary  
c/o Baker Hughes Incorporated  
3900 Essex Lane, Suite 1200  
Houston, TX 77027-5177

Stockholders desiring to make candidate recommendations for the Board may do so by submitting nominations to the Company’s Governance Committee, in accordance with the Company’s Bylaws and “Policy and Submission Procedures For Stockholder Recommended Director Candidates” addressed, as above, to the Corporate Secretary, or to:

Chairman, Governance Committee of the Board of Directors  
P.O. Box 4740  
Houston, TX 77210-4740

Any written communications received by the Corporate Secretary will be forwarded to the appropriate directors.

## ANNEX F

### BAKER HUGHES INCORPORATED ANNUAL INCENTIVE COMPENSATION PLAN

(Amendment and Restatement Adopted by  
the Board of Directors on January 26, 2006)

#### WITNESSETH:

**WHEREAS**, effective October 1, 1994, Baker Hughes Incorporated ("Baker Hughes") previously adopted the Baker Hughes Incorporated 1995 Employee Annual Incentive Compensation Plan (the "Plan") for the benefit of certain employees of Baker Hughes and affiliates of Baker Hughes;

**WHEREAS**, the Plan is a bonus program exempt from coverage under the Employee Retirement Income Security Act of 1974, as amended pursuant to Department of Labor regulation section 2510.3-2(c);

**WHEREAS**, Baker Hughes desires to amend and restate the Plan on behalf of itself and on behalf of the other adopting entities; and

**WHEREAS**, Baker Hughes desires to change the name of the Plan;

**NOW THEREFORE**, the name of the Plan is changed to the "Baker Hughes Incorporated Annual Incentive Compensation Plan" and the Plan is hereby amended and restated in its entirety as follows, effective as of January 1, 2005 except insofar as a later effective date is expressly specified.

### BAKER HUGHES INCORPORATED ANNUAL INCENTIVE COMPENSATION PLAN

(As Amended and Restated Effective January 1, 2005)

#### ARTICLE I

##### DEFINITIONS AND CONSTRUCTION

1.01 **Definitions.** The words and phrases defined in this Article shall have the meaning set out in the definition unless the context in which the word or phrase appears reasonably requires a broader, narrower or different meaning.

"Account(s)" means all ledger accounts pertaining to a Participant or former Participant which are maintained by the Plan Administrator to reflect the Employer's obligation to the Participant or former Participant under the Plan. The Plan Administrator shall establish the following subaccounts and any additional subaccounts that the Plan Administrator considers necessary to reflect the entire interest of the Participant or former Participant under the Plan. Each of the subaccounts listed below and any additional subaccounts established by the Plan Administrator shall reflect credits and debits made to such subaccounts for earnings, distributions and forfeitures:

- (a) **Banked Account** – the Participant's or former Participant's banked Final Award for a given Performance Period.
- (b) **Unbanked Account** – the Participant's or former Participant's Final Award for a given Performance Period that is not banked pursuant to Article V.

"Affiliate" means any entity which is a member of the same controlled group of corporations within the meaning of

section 414(b) of the Code or which is a trade or business (whether or not incorporated) which is under common control (within the meaning of section 414(c) of the Code), which is a member of an affiliated service group (within the meaning of section 414(m) of the Code) with Baker Hughes.

"Applicable Interest Rate" means the 10-year U.S. Treasury rate plus 25 basis points (0.25%).

"Award Opportunity" has the meaning specified in Section 3.01 of the Plan.

"Baker Hughes" means Baker Hughes Incorporated, a Delaware corporation.

"Baker Value Added" and "BVA" mean, with respect to a Performance Period, the amount calculated under the following formula:

$$[[ (a) + (b) + (c) ] \times (1 - (d))] - (e)$$

where (a) is the Profit Before Tax of the Company for the Performance Period, (b) is the net interest expense of the Company for the Performance Period, (c) is the goodwill and non-compete amortization of the Company for the Performance Period, (d) is the Tax Rate for the Performance Period and (e) is the Capital Charge determined for the Company for the Performance Period. For this purpose, "Average Adjusted Net Capital Employed" means the sum of the Monthly Adjusted Net Capital Employed during the Performance Period divided by 12; "Capital Charge" means Average Adjusted Net Capital Employed multiplied by the Cost of Capital; "Company" means Baker Hughes and all of its Affiliates in which Baker Hughes directly or indirectly has a capital investment, or one or more business units of Baker Hughes and its Affiliates, as specified in the written Award Opportunities; "Cost of Capital" means the weighted average after-tax cost of debt and cost of equity for the Company for the Performance Period; "Cost of Sales" means the cost of products sold and the cost of providing services, including personnel costs, repair and maintenance costs, freight/custom, depreciation and other costs (e.g., commission and royalty) directly relating to the service provided; "Monthly Adjusted Net Capital Employed" means the capital employed by the Company during a month of the Performance Period plus accumulated goodwill amortization plus the value of significant operating leases; "Operating Expenses" means costs incurred in non-manufacturing areas to provide products and services to customers (e.g., finance and administrative support) during the Performance Period; "Profit Before Tax" means the revenue of the Company for the Performance Period minus the Cost of Sales of the Company for the Performance Period minus the Operating Expenses of the Company for the Performance Period minus net interest expense of the Company for the Performance Period; and "Tax Rate" means the effective tax rate for the Company determined in a manner consistent with Baker Hughes tax policies and practices in effect on the date hereof.

"Beneficial Owner" or "Beneficial Ownership" shall have the meaning ascribed to the term in Rule 13d-3 of the General Rules and Regulations under the Exchange Act.

"Beneficiary" means the person or persons, or the trust or trusts created for the benefit of a natural person or persons or

the Participant's estate, designated by the Participant to receive the benefits payable under the Plan upon his death in accordance with the beneficiary designation procedures specified in Section 9.03.

"Board" means the Board of Directors of Baker Hughes.

"Cause" means (i) the willful and continued failure by the Participant to substantially perform the Participant's duties with the Employer (other than any such failure resulting from the Participant's incapacity due to physical or mental illness) after a written demand for substantial performance is delivered to the Participant by the Committee, which demand specifically identifies the manner in which the Committee believes that the Participant has not substantially performed the Participant's duties, or (ii) the willful engaging by the Participant in conduct which is demonstrably and materially injurious to Baker Hughes or any of the Affiliates, monetarily or otherwise. For purposes of clauses (i) and (ii) of this definition, (A) no act, or failure to act, on the Participant's part shall be deemed "willful" if done, or omitted to be done, by the Participant in good faith and with reasonable belief that the act, or failure to act, was in the best interest of the Employer and (B) in the event of a dispute concerning the application of this provision, no claim by the Employer that Cause exists shall be given effect unless the Employer establishes to the Committee by clear and convincing evidence that Cause exists. The Committee's determination regarding the existence of Cause shall be conclusive and binding upon all parties.

"Change in Control" means the occurrence of any of the following events:

- (a) the individuals who are Incumbent Directors cease for any reason to constitute a majority of the members of the Board;
- (b) the consummation of a Merger of Baker Hughes or an Affiliate with another Entity, unless the individuals and Entities who were the Beneficial Owners of the Voting Securities of Baker Hughes outstanding immediately prior to such Merger own, directly or indirectly, at least 50 percent of the combined voting power of the Voting Securities of any of Baker Hughes, the surviving Entity or the parent of the surviving Entity outstanding immediately after such Merger;
- (c) any Person, other than a Specified Owner, becomes a Beneficial Owner, directly or indirectly, of securities of Baker Hughes representing 30 percent or more of the combined voting power of Baker Hughes' then outstanding Voting Securities;
- (d) a sale, transfer, lease or other disposition of all or substantially all of Baker Hughes' Assets is consummated (an "Asset Sale"), unless:
  - (1) the individuals and Entities who were the Beneficial Owners of the Voting Securities of Baker Hughes immediately prior to such Asset Sale own, directly or indirectly, 50 percent or more of the combined voting power of the Voting Securities of the Entity that acquires such Assets in such Asset Sale or its parent immediately after such Asset Sale in substantially the

same proportions as their ownership of Baker Hughes' Voting Securities immediately prior to such Asset Sale; or

- (2) the individuals who comprise the Board immediately prior to such Asset Sale constitute a majority of the board of directors or other governing body of either the Entity that acquired such Assets in such Asset Sale or its parent (or a majority plus one member where such board or other governing body is comprised of an odd number of directors); or
- (e) the stockholders of Baker Hughes approve a plan of complete liquidation or dissolution of Baker Hughes.

"CIC Committee" means (i) the individuals (not fewer than three in number) who, on the date six months before a Change in Control or a Potential Change in Control, constitute the Committee, plus (ii) in the event that fewer than three individuals are available from the group specified in clause (i) above for any reason, such individuals as may be appointed by the individual or individuals so available (including for this purpose any individual or individuals previously so appointed under this clause (ii)); provided, however, that the maximum number of individuals constituting the CIC Committee shall not exceed six (6).

"Code" means the Internal Revenue Code of 1986, as amended from time to time.

"Committee" means the Compensation Committee of the Board.

"Covered Employee" has the meaning ascribed to that term in Section 162(m).

"Disability" means the inability of a Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months. The Committee's determination regarding the existence of Disability shall be conclusive and binding upon all parties.

"Domestic Relations Order" has the meaning ascribed to that term in section 414(p) of the Code.

"Employer" means Baker Hughes and any Affiliate that adopts the Plan pursuant to the provisions of Article XII.

"Entity" means any corporation, partnership, association, joint-stock company, limited liability company, trust, unincorporated organization or other business entity.

"Exchange Act" means the Securities Exchange Act of 1934, as amended from time to time, or any successor act.

"Final Award" means the actual award earned for a Plan Year by a Participant as determined by the Committee.

"Good Reason" for termination by the Participant of his employment means the occurrence (without the Participant's express written consent) after any Change in Control, or prior to a Change in Control under the circumstances described in clauses (ii) and (iii) of Section 10.04 (treating all references to "Change in Control" in paragraphs (a) through (f) below as references to a "Potential Change in Control"), of any one of the following acts by the Employer, or failures by the Employer to act, unless, in the case of any act or failure to act described

in paragraph (a), (e), (f) or (g) below, such act or failure to act is corrected prior to the effective date of the Participant's termination for Good Reason:

- (a) the assignment to the Participant of any duties or responsibilities which are substantially diminished as compared to the Participant's duties and responsibilities immediately prior to the Change in Control;
- (b) a reduction by the Employer in the Participant's annual base salary as in effect on the date hereof or as the same may be increased from time to time, except for across-the-board salary reductions similarly affecting all individuals having a similar level of authority and responsibility with the Employer and all individuals having a similar level of authority and responsibility with any Person in control of the Employer;
- (c) the relocation of the Participant's principal place of employment to a location outside of a 50-mile radius from the Participant's principal place of employment immediately prior to the Change in Control or the Employer's requiring the Participant to be based anywhere other than such principal place of employment (or permitted relocation thereof) except for required travel on the Employer's business to an extent substantially consistent with the Participant's business travel obligations immediately prior to the Change in Control;
- (d) the failure by the Employer to pay to the Participant any portion of the Participant's current compensation except pursuant to an across-the-board compensation deferral similarly affecting all individuals having a similar level of authority and responsibility with the Employer and all individuals having a similar level of authority and responsibility with any Person in control of the Employer, or to pay to the Participant any portion of an installment of deferred compensation under any deferred compensation program of the Employer, within seven (7) days of the date such compensation is due;
- (e) the failure by the Employer to continue in effect any compensation plan in which the Participant participates immediately prior to the Change in Control which is material to the Participant's total compensation, unless an equitable arrangement (embodied in an ongoing substitute or alternative plan) has been made with respect to such plan, or the failure by the Employer to continue the Participant's participation therein (or in such substitute or alternative plan) on a basis not materially less favorable, both in terms of the amount or timing of payment of benefits provided and the level of the Participant's participation relative to other Baker Hughes Participants, as existed immediately prior to the Change in Control;
- (f) the failure by the Employer to continue to provide the Participant with benefits substantially similar to those enjoyed by the Participant under any of the Employer's pension, savings, life insurance, medical, health and accident, or disability plans in which the Participant was participating immediately prior to the Change in Control (except for across the board changes similarly affecting all individuals

having a similar level of authority and responsibility with the Employer and all individuals having a similar level of authority and responsibility with any Person in control of the Employer), the taking of any other action by the Employer which would directly or indirectly materially reduce any of such benefits or deprive the Participant of any material fringe benefit or perquisite enjoyed by the Participant at the time of the Change in Control, or the failure by the Employer to provide the Participant with the number of paid vacation days to which the Participant is entitled on the basis of years of service with the Employer in accordance with the Employer's normal vacation policy in effect immediately prior to the time of the Change in Control; or

- (g) if the Participant is party to an individual employment, severance or other similar agreement with the Employer, any purported termination of the Participant's employment which is not effected pursuant to the notice of termination or other procedures specified therein.

The Participant shall have the right to terminate his employment for Good Reason even if he becomes incapacitated due to physical or mental illness. The Participant's continued employment shall not constitute consent to, or a waiver of any rights with respect to, any act or failure to act constituting Good Reason hereunder.

For purposes of any determination regarding the existence of Good Reason, any claim by the Participant that Good Reason exists shall be presumed to be correct unless the Employer establishes to the Committee by clear and convincing evidence that Good Reason does not exist. The Committee's determination regarding the existence of Good Reason shall be conclusive and binding upon all parties.

*"Incumbent Director"* means –

- (a) a member of the Board on January 25, 2006 or
- (b) an individual –
  - (1) who becomes a member of the Board after January 25, 2006;
  - (2) whose appointment or election by the Board or nomination for election by Baker Hughes' stockholders is approved or recommended by a vote of at least two-thirds of the then serving *Incumbent Directors* (as defined herein); and
  - (3) whose initial assumption of service on the Board is not in connection with an actual or threatened election contest.

*"Initial Payment Date"* has the meaning ascribed to that term in Section 7.01.

*"Involuntary Separation From Service"* means a Participant's Separation From Service as a result of the elimination of his job or a reduction in force.

*"Key Employee"* means a key employee of Baker Hughes or an Affiliate who, in the opinion of the Chief Executive Officer of Baker Hughes, is in a position to significantly contribute to the growth and profitability of Baker Hughes and the Affiliates.

*"Merger"* means a merger, consolidation or similar transaction.

"OA Level" means the over achievement level of performance applicable to the Award.

"Participant" means an individual who is or was a Key Employee who has been granted an Award Opportunity or who has unpaid Accounts.

"Performance Goals" means one or more of the criteria described in Section 3.02 on which the performance goals applicable to an Award Opportunity are based.

"Performance Period" means the 12-month period to which the Performance Goals apply. A Performance Period shall coincide with a Plan Year.

"Person" shall have the meaning ascribed to the term in section 3(a)(9) of the Exchange Act and used in sections 13(d) and 14(d) thereof, including a "group" as defined in section 13(d) thereof, except that the term shall not include (a) Baker Hughes or any of the Affiliates, (b) a trustee or other fiduciary holding Baker Hughes securities under an employee benefit plan of Baker Hughes or any of the Affiliates, (c) an underwriter temporarily holding securities pursuant to an offering of those securities or (d) a corporation owned, directly or indirectly, by the stockholders of Baker Hughes in substantially the same proportions as their ownership of stock of Baker Hughes.

"Plan" means the Baker Hughes Incorporated Annual Incentive Compensation Plan, as amended from time to time.

"Plan Administrator" means Baker Hughes, acting through its delegates. Such delegates shall include the Administrative Committee, the Investment Committee and any individual Plan Administrator appointed by the Board with respect to the employee benefit plans of Baker Hughes and its Affiliates, each of which shall have the duties and responsibilities assigned to it from time to time by the Board. As used in the Plan, the term "Plan Administrator" shall refer to the applicable delegate of Baker Hughes as determined pursuant to the actions of the Board.

"Plan Year" means the twelve-consecutive month period commencing January 1 of each year.

"Potential Change in Control" means the occurrence of any of the following events:

- (a) the Employer enters into an agreement, the consummation of which would result in the occurrence of a Change in Control;
- (b) the Employer or any Person publicly announces an intention to take or to consider taking actions which, if consummated, would constitute a Change in Control;
- (c) any Person becomes the Beneficial Owner, directly or indirectly, of securities of Baker Hughes representing 15 percent or more of either the then outstanding shares of common stock of Baker Hughes' or the combined voting power of Baker Hughes' then outstanding securities (not including in the securities beneficially owned by such Person any securities acquired directly from Baker Hughes or the Affiliates); or
- (d) the Board adopts a resolution to the effect that, for purposes of this Agreement, a Potential Change in Control has occurred.

"Profit After Tax" means revenues minus cost of sales (the cost of products sold and the cost of providing services, including personnel costs, repair and maintenance costs, freight/custom, depreciation, and other costs (e.g., commission and royalty) directly relating to the service provided) minus operating expenses (costs incurred in non-manufacturing areas to provide products and services to customers (e.g., finance and administrative support)) minus income taxes.

"Retirement" means a Participant's voluntary Separation From Service when he has attained at least 55 years of age and has at least ten (10) years of service with Baker Hughes and the Affiliates. For this purpose, "year of service" means a year of service for vesting purposes under the Baker Hughes Incorporated Thrift Plan, whether or not the Participant is a participant in such plan.

"Section 162(m)" means section 162(m) of the Code and the Department of Treasury rules and regulations issued thereunder.

"Section 409A" means section 409A of the Code and the Department of Treasury rules and regulations issued thereunder.

"Separation From Service" has the meaning ascribed to that term in Section 409A.

"Specified Employee" means as of any date, a person who is a "specified employee" within the meaning of Section 409A.

"Specified Owner" means any of the following:

- (a) Baker Hughes;
- (b) an Affiliate of Baker Hughes;
- (c) an employee benefit plan (or related trust) sponsored or maintained by Baker Hughes or any Affiliate of Baker Hughes;
- (d) a Person that becomes a Beneficial Owner of Baker Hughes' outstanding Voting Securities representing 30 percent or more of the combined voting power of Baker Hughes' then outstanding Voting Securities as a result of the acquisition of securities directly from Baker Hughes and/or its Affiliates; or
- (e) a Person that becomes a Beneficial Owner of Baker Hughes' outstanding Voting Securities representing 30 percent or more of the combined voting power of Baker Hughes' then outstanding Voting Securities as a result of a Merger if the individuals and Entities who were the Beneficial Owners of the Voting Securities of Baker Hughes outstanding immediately prior to such Merger own, directly or indirectly, at least 50 percent of the combined voting power of the Voting Securities of any of Baker Hughes, the surviving Entity or the parent of the surviving Entity outstanding immediately after such Merger in substantially the same proportions as their ownership of the Voting Securities of Baker Hughes outstanding immediately prior to such Merger.

"Voting Securities" means the outstanding securities entitled to vote generally in the election of directors or other governing body.

1.02 **Number and Gender.** Wherever appropriate herein, words used in the singular shall be considered to include the plural and words used in the plural shall be considered to include the singular. The masculine gender, where appearing in the Plan, shall be deemed to include the feminine gender.

1.03 **Headings.** The headings of Articles and Sections herein are included solely for convenience, and if there is any conflict between such headings and the text of the Plan, the text shall control.

## **ARTICLE II** **PARTICIPATION**

2.01 **Eligibility.** Eligibility for participation in the Plan shall be limited to those Key Employees who, by the nature and scope of their position, contribute to the overall results or success of the Employers.

2.02 **Participation.** Participation in the Plan shall be determined annually based upon the recommendation of the Chief Executive Officer of Baker Hughes and the approval of the Committee. Employees approved for participation shall be notified in writing of their selection, and of their Performance Goals and related Award Opportunities, as soon after approval as is practicable.

2.03 **Partial Plan Year Participation.** The Committee may, upon recommendation of the Chief Executive Officer of Baker Hughes, allow an individual who becomes eligible after the beginning of a Plan Year to participate in the Plan for that year. In such case, the Participant's Final Award normally shall be prorated based on the number of full months of participation. However, the Committee may, based upon the recommendation of the Chief Executive Officer of Baker Hughes, authorize an unreduced Final Award.

2.04 **Termination of Approval.** The Committee may withdraw its approval for participation in the Plan for a Participant at any time. In the event of such withdrawal, the individual concerned shall cease to be a Participant as of the date designated by the Committee and he shall be notified of such withdrawal as soon as practicable following such action. Further, such individual shall cease to have any right to a Final Award for the Plan Year in which such withdrawal is effective; provided, however, that the Committee may, in its sole discretion, authorize a prorated award based on the number of full months of participation prior to the effective date of such withdrawal. Notwithstanding the foregoing, the Committee may not withdraw its approval for participation in the Plan during the pendency of a Potential Change in Control and for a period of six (6) months after the cessation thereof.

## **ARTICLE III**

### **AWARD OPPORTUNITIES AND PERFORMANCE GOALS**

3.01 **Award Opportunities.** The Committee shall establish, in writing, over achievement, expected value, and entry value incentive award levels (the "*Award Opportunities*") for each Participant who is eligible to participate in the Plan for the Performance Period. The established Award Opportunities may vary in relation to the responsibility level of the Participant. Except in the case of a Covered Employee, if a Participant changes job levels or salary grades during the Plan Year, the Award Opportunities may be adjusted by the Committee, in its sole discretion, to reflect the amount of time at each job level and/or in each salary grade.

3.02 **Performance Goals.** The Committee shall establish, in writing, Performance Goals for each Participant for a Plan Year. A Performance Goal may be based on one or more business criteria that apply to the Participant, one or more business units of Baker Hughes and the Affiliates, or Baker Hughes and the Affiliates as a whole, with reference to one or more of the following: earnings per share, total shareholder return, cash return on capitalization, increased revenue, revenue ratios, net income, stock price, market share, return on equity, return on assets, return on capital, return on capital compared to cost of capital, return on capital employed, return on invested capital, shareholder value, net cash flow, operating income, earnings before interest and taxes, cash flow, cash flow from operations, cost reductions, cost ratios, Profit After Tax and Baker Value Added. Performance Goals may also be based on performance relative to a peer group of companies. Unless otherwise stated, a Performance Goal need not be based upon an increase or positive result under a particular business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to specific business criteria). All items of gain, loss, or expense for the Performance Period, and such other items utilized in measuring the achievement of Performance Goals for the Performance Period, determined to be extraordinary, unusual in nature, infrequent in occurrence, related to the acquisition or disposal of a business, or related to a change in accounting principle, all as determined in accordance with standards established by Opinion No. 30 of the Accounting Principles Board (APB Opinion No. 30), other applicable accounting rules, or consistent with Baker Hughes policies and practices for measuring the achievement of Performance Goals on the date the Committee establishes the Performance Goals may be included or excluded in calculating whether a Performance Goal has been achieved. In the case of a Participant other than a Participant who is or during the Performance Period may become a Covered Employee, non-financial objectives may also be included in a Participant's Performance Goals but may not represent more than 25 percent of the Participant's expected value Award Opportunity. No Participant who is a Covered Employee, or who the Committee expects may become a Covered Employee during the next three Plan Years, may have any portion of his Final Award based on nonfinancial, subjective Performance Goals.

**3.03 Time of Establishment of Award Opportunities and Performance Goals.** Performance Goals and Award Opportunities for a Participant for a Plan Year must be established by the Committee prior to the earlier to occur of (a) 90 days after the commencement of the period of service to which the Performance Goal relates or (b) the lapse of 25 percent of the period of service, and in any event while the outcome is substantially uncertain.

**3.04 Adjustment of Performance Goals.** The Committee shall have the right to adjust the Performance Goals (either up or down) during the Plan Year if it determines that external changes or other unanticipated business conditions have materially affected the fairness of the goals and unduly influenced the ability to meet them. Notwithstanding the foregoing, no such adjustment shall be made with respect to an individual who is a Covered Employee to the extent the same is considered an upward discretionary increase in the amount of the Final Award for such individual (within the meaning of Section 162(m)).

**3.05 Individual Award Cap.** Effective for Final Awards earned for Performance Periods commencing on and after January 1, 2006, the maximum annual Final Award any individual may receive under the Plan is \$4,000,000.

#### **ARTICLE IV**

#### **FINAL AWARD DETERMINATIONS**

**4.01 Final Award Determinations.** As soon as practicable after the end of each Plan Year, Final Awards shall be computed for each Participant as determined by the Committee. The Committee shall certify in writing the extent to which the Performance Goals established pursuant to Section 3.02 and any other material terms of an award were in fact satisfied.

In determining the Final Award, the Committee, in its sole discretion, may increase or decrease calculated amounts to reflect factors regarding performance during the Plan Year which were not, in the sole opinion of the Committee, appropriately reflected in the Final Award calculation. Notwithstanding the foregoing, the Final Award to an individual who is a Covered Employee will not be subject to upward discretionary adjustment by the Committee. Downward discretionary adjustment for Covered Employees will be permitted.

**4.02 Separation From Service Due to Death, Disability, or Retirement.** If a Participant incurs a Separation From Service by reason of death, Disability, or Retirement, the Final Award, determined in accordance with Section 4.01, shall be reduced so that it reflects only participation prior to the Separation From Service. This reduction shall be determined by multiplying the Final Award by a fraction, the numerator of which is the months of participation through the date of the Separation From Service rounded up to whole months, and the denominator of which is twelve (12).

**4.03 Employment Transfers.** If a Participant transfers from one division to another division within Baker Hughes and the Affiliates, the Final Award for the Participant's time at the Participant's former division will be prorated for the number of whole months rounded to the nearest whole month of the Plan Year the Participant was at that division. The Final Award will be determined as soon as practicable after the end of the Plan Year and will be based on the financial results at the close of the Plan Year. The Final Award will be paid at the same time the other Final Awards for that division are paid. If a Participant is eligible for a Final Award in his new position, the Final Award will be based on the months left in the Plan Year, on his new base salary level and Award Opportunities, as determined by the Committee based upon the recommendation of the Chief Executive Officer of Baker Hughes.

**4.04 Disposition of Business.** If the Participant's Employer or division is disposed of during the Plan Year and such disposition does not qualify as a Change in Control, payment of the Participant's Final Award shall be determined in accordance with the following alternatives:

- (a) If the acquirer offers employment to the Participant and assumes the obligations under the Plan, either directly or indirectly, and the Participant accepts such offer of employment, the Participant's Final Award will not be forfeited but the Employer shall not be obligated to pay the Final Award and such obligation shall be that of the acquiring party in accordance with the Final Award parameters.
- (b) If the acquirer does not assume the obligations under the Plan, whether or not the Participant is offered and accepts employment, then the Participant's Final Award will not be forfeited and the Participant will receive a prorated Final Award for the portion of the Plan Year that the Participant was employed by the Employer prior to the date of the consummation of the sale of the Employer or division, to be paid at the same time other Final Awards are paid under the Plan. The computation shall be made on the basis of the number of whole months rounded to the nearest whole month of the Plan Year that the Participant was in active service with the Employer.
- (c) If the acquirer offers employment to the Participant and assumes the obligations under the Plan, either directly or indirectly, and the Participant rejects such employment, the Participant shall forfeit his Final Award for the Performance Period then in progress pursuant to Section 4.05.

**4.05 Separation From Service for Other Reasons.** Except as specified in Article X or Section 4.04, if a Participant incurs a Separation From Service for any reason other than Retirement, Disability or death, all of the Participant's rights to any unpaid Final Award shall be forfeited.

## **ARTICLE V**

### **BANKING OF AWARDS**

5.01 **General Banking Procedures.** Except as specified in Section 5.02, if Performance Goals applicable to a Final Award that are designated by the Committee as company Performance Goals are achieved at a level in excess of the OA Level, the amount of the Final Award that is attributable to exceeding the OA Level will be banked and paid at the times specified in Section 7.02. To the extent that a Final Award for a Performance Period is banked, it shall be credited to the Participant's Banked Account for the Performance Period effective as of the Initial Payment Date.

5.02 **Exceptions.** No portion of a Final Award will be banked pursuant to Section 5.01 if (a) the amount that would be banked is \$2,000 or less, (b) the Participant incurs a Separation From Service and the Participant is described in clause (b) of Section 4.04, (c) a Change in Control occurs during the Performance Period, (c) applicable local laws prohibit banking of the Final Award or (d) written procedures adopted by the Committee prior to the Performance Period specify that the Final Award will not be banked.

## **ARTICLE VI**

### **DEEMED INVESTMENT OF FUNDS**

Amounts deemed credited to a Participant's Banked Account for a Performance Period shall be deemed to be credited with interest at the annual rate equal to the Applicable Interest Rate commencing as of the Initial Payment Date. For the period commencing on the Initial Payment Date and ending on the day before the first anniversary of the Initial Payment Date the Applicable Interest Rate will be based on the rate in effect as of the Initial Payment Date. For the period commencing on the first anniversary of the Initial Payment Date and ending on the second anniversary of the Initial Payment Date the Applicable Interest rate will be based on the rate in effect as of the first anniversary of the Initial Payment Date.

## **ARTICLE VII**

### **PAYMENT OF BENEFITS**

7.01 **Time of Payment of Unbanked Final Award.** Except to the extent that a Final Award is banked pursuant to Article V, or except as specified in Article X, a Participant's Final Award, to the extent not forfeited pursuant to Article VIII, shall be paid to him on March 15 following the Performance Period (the "Initial Payment Date").

7.02 **Time of Payment of Banked Final Award.** To the extent that a Participant's Final Award is banked pursuant to this Article V, fifty percent (50%) of the amount then credited to the Participant's Banked Account for the Performance Period, to the extent not forfeited pursuant to Article VIII, shall be distributed to the Participant on the first anniversary of the Initial Payment Date of the Final Award. The remaining portion of the amount credited to the Participant's Banked Account for the Performance Period, to the extent not forfeited pursuant to Article VIII, shall be distributed to the Participant on the second anniversary of the Initial Payment Date. Notwithstanding

the foregoing, (a) if a Participant incurs an Involuntary Separation From Service or if he incurs a Separation From Service due to Retirement, any amounts credited to his Banked Account(s) shall be paid to him on the earlier of (1) the date of the Participant's Separation From Service if the Participant is not a Specified Employee or the date that is six months following his Separation From Service if the Participant is a Specified Employee, or (2) the date the amount would otherwise be paid under this Section 7.02; (b) if the Participant incurs a Disability, any amounts credited to his Banked Accounts will be paid to him on the date the date of the Participant's Disability; or (c) if the Participant dies, any amounts credited to his Banked Accounts will be paid as specified in Section 9.02. Further, notwithstanding the foregoing, (a) upon the occurrence of a Change in Control all amounts that are credited to the Participant's Banked Accounts that are not deferred compensation within the meaning of Section 409A shall be paid to the Participant; (b) upon the occurrence of a Change in control that constitutes a "Change in Control" within the meaning of Section 409A all amounts that are credited to the Participant' Banked Accounts shall be paid to the Participant.

7.03 **Form of Payment of Benefits.** All benefit payments shall be made in cash.

7.04 **Account Debits.** Any benefit payments made to a Participant, or former Participant, or for his benefit pursuant to any provision of the Plan shall be debited to such Participant's or former Participant's Accounts.

7.05 **Unclaimed Benefits.** In the case of a benefit payable on behalf of a Participant or former Participant, if the Plan Administrator is unable, after reasonable efforts, to locate the Participant, the former Participant or the beneficiary to whom such benefit is payable, upon the Plan Administrator's determination thereof, such benefit shall be forfeited to the Employer. Notwithstanding the foregoing, if subsequent to any such forfeiture the Participant, the former Participant or beneficiary to whom such benefit is payable makes a valid claim for such benefit, such forfeited benefit (without any adjustment for earnings or loss) shall be restored to the Plan by the Employer and paid in accordance with the Plan.

7.05 **Statutory Benefits.** If any benefit obligations are required to be paid under the Plan to a Participant or former Participant in conjunction with severance of employment under the laws of the country where the Participant or former Participant is employed or under federal, state or local law, the benefits paid to a Participant or former Participant pursuant to the provisions of the Plan will be deemed to be in satisfaction of any statutorily required benefit obligations.



**7.06 Payment to Alternate Payee Under Domestic Relations Order.** Plan benefits that are awarded to an Alternate Payee in a Domestic Relations Order shall be paid to the Alternate Payee at the time and in the form directed in the Domestic Relations Order. The Domestic Relations Order may provide for an immediate lump sum payment to an Alternate Payee. A Domestic Relations Order may not otherwise provide for a time or form of payment that is not permitted under the Plan. A Domestic Relations Order will be disregarded to the extent it awards an Alternate Payee benefits in excess of the applicable Participant's or former Participant's Account balance under the Plan.

## **ARTICLE VIII** **FORFEITURE OF BENEFITS**

Except as specified in Section 4.04 or Article X, if a Participant incurs a Separation From Service for any reason other than Retirement, death, Disability or Involuntary Separation from Service before the time a payment to him is to be made under Article VII, he shall forfeit the payment and all amounts then deemed credited to his Accounts.

## **ARTICLE IX** **DEATH**

**9.01 Payment of Unbanked Amounts.** In the event of a death of a Participant prior to the Initial Payment Date of a Final Award, the Participant's Final Award will be paid to the Participant's Beneficiary on the Initial Payment Date.

**9.02 Payment of Banked Amounts.** Upon the death of a Participant any amounts deemed credited to the Participant's Banked Accounts will be paid to his Beneficiary as soon as administratively practicable.

### **9.03 Designation of Beneficiaries.**

- (a) Each Participant or former Participant shall have the right to designate the beneficiary or beneficiaries to receive payment of his benefit in the event of his death. Each such designation shall be made by executing the beneficiary designation form prescribed by the Plan Administrator and filing same with the Plan Administrator. Any such designation may be changed at any time by execution of a new designation in accordance with this Section 9.03.
- (b) If no such designation is on file with the Plan Administrator at the time of the death of the Participant or former Participant or such designation is not effective for any reason as determined by the Plan Administrator, then the designated beneficiary or beneficiaries to receive such benefit shall be as follows:
  - (i) If a Participant or former Participant leaves a surviving spouse, his benefit shall be paid to such surviving spouse;
  - (ii) If a Participant or former Participant leaves no surviving spouse, his benefit shall be paid to such Participant's or former Participant's executor or administrator, or to his heirs at law if there is no administration of such Participant's or former Participant's estate.

## **ARTICLE X** **CHANGE IN CONTROL**

**10.01 General.** The provisions of this Article X shall apply and supersede any contrary provisions of the Plan in the event of a Change in Control.

**10.02 CIC Committee.** If a Change in Control or Potential Change in Control occurs, all references in the Plan to "Committee" shall at that point be deemed to be references to the CIC Committee.

**10.03 Change in Control During a Performance Period.** Notwithstanding any provision of the Plan to the contrary, upon the occurrence of a Change in Control during a Performance Period, (i) Final Awards for the Performance Period shall be computed for each Participant pursuant to Section 4.01 (assuming for this purpose that the Performance Goals established pursuant to Section 3.02 herein have been achieved to the extent required to earn the expected value Award Opportunity), and (ii) the Employer shall pay to each Participant an amount equal to the Final Award so determined multiplied by a fraction, the numerator of which is the number of the Participant's months of participation during the Performance Period through the date of Change of Control (rounded up to the nearest whole month), and the denominator of which is twelve (12).

**10.04 Termination of Employment Prior to Change in Control or Following Certain Changes in Control.** Notwithstanding any provision of the Plan to the contrary, a Participant shall be entitled to receive the payment described in Section 10.03 for a Performance Period if (i) such Participant's employment is terminated by Baker Hughes or an Affiliate during the Performance Period without Cause prior to a Change in Control (whether or not a Change in Control ever occurs) and such termination was at the request or direction of a Person who has entered into an agreement with Baker Hughes or an Affiliate the consummation of which would constitute a Change in Control, (ii) such Participant resigns during the Performance Period for Good Reason prior to a Change in Control (whether or not a Change in Control ever occurs) and the circumstance or event which constitutes Good Reason occurs at the request or direction of the Person described in clause (i), or (iii) such Participant's employment is terminated by Baker Hughes or an Affiliate during the Performance Period without Cause or by the Participant for Good Reason and such termination or the circumstance or event which constitutes Good Reason is otherwise in connection with or in anticipation of a Change in Control (whether or not a Change in Control ever occurs).

**10.05 Payment of Expected Value Awards and Tax-Gross Up for Delayed Payment.** If a Participant is entitled to a Final Award payment pursuant to Section 10.03, the Employer shall pay the Participant such Final Award within five days following the date of the Change in Control. If a Participant is entitled to a Final Award payment pursuant to Section 10.04, the Employer shall pay the Participant such Final Award within five days following the date of the Participant's termination of employment. If for any reason the Employer fails to timely pay a Participant the amounts due him pursuant to this

Article X, the Employer shall pay the Participant additional compensation in such amount as is necessary to put the Participant in the same federal income tax position he would have been in had the payment not been subject to Section 409A. Such additional compensation shall be paid to the Participant at the same time as the delinquent Final Award payment is paid to the Participant.

10.06 **Forfeiture Restrictions.** Notwithstanding any other provision of the Plan, upon the occurrence of a Change in Control during a Performance Period or upon a Participant's termination of employment during a Performance Period in a circumstance described in Section 10.04, the amount of the Participant's Final Award for the Performance Period, calculated in accordance with Section 10.03, shall not be forfeited, and any amounts then credited to the Participant's Accounts shall not be forfeited.

## **ARTICLE XI** **ADMINISTRATION OF THE PLAN**

11.01 **Resignation and Removal.** The members of a Committee serving as Plan Administrator shall serve at the pleasure of the Board; they may be officers, directors, or employees or any other individuals. At any time during his term of office, any member of a Committee or any individual serving as Plan Administrator may resign by giving written notice to the Board, such resignation to become effective upon the appointment of a substitute or, if earlier, the lapse of thirty days after such notice is given as herein provided. At any time during its term of office, and for any reason, any member of a Committee or any individual serving as Plan Administrator may be removed by the Board.

11.02 **Records and Procedures.** The Plan Administrator shall keep appropriate records of its proceedings and the administration of the Plan and shall make available for examination during business hours to any Participant, former Participant or the beneficiary of any Participant or former Participant such records as pertain to that individual's interest in the Plan. If a Committee is performing duties as the Plan Administrator, the Committee shall designate the individual or individuals who shall be authorized to sign for the Plan Administrator and, upon such designation, the signature of such individual or individuals shall bind the Plan Administrator.

11.03 **Self-Interest of Plan Administrator.** Neither the members of a Committee nor any individual Plan Administrator shall have any right to vote or decide upon any matter relating solely to himself under the Plan or to vote in any case in which his individual right to claim any benefit under the Plan is particularly involved. In any case in which any Committee member or individual Plan Administrator is so disqualified to act, the other members of the Committee shall decide the matter in which the Committee member or individual Plan Administrator is disqualified.

11.04 **Compensation and Bonding.** Neither the members of a Committee nor any individual Plan Administrator shall receive compensation with respect to their services on the Committee or as Plan Administrator. To the extent permitted by applicable law, neither the members of a Committee nor any individual Plan Administrator shall furnish bond or security for the performance of their duties hereunder.

11.05 **Plan Administrator Powers and Duties.** The Plan Administrator shall supervise the administration and enforcement of the Plan according to the terms and provisions hereof and shall have all powers necessary to accomplish these purposes, including, but not by way of limitation, the right, power and authority:

- (a) to make rules, regulations and bylaws for the administration of the Plan that are not inconsistent with the terms and provisions hereof, and to enforce the terms of the Plan and the rules and regulations promulgated thereunder by the Plan Administrator;
- (b) to construe in its discretion all terms, provisions, conditions and limitations of the Plan;
- (c) to correct any defect or to supply any omission or to reconcile any inconsistency that may appear in the Plan in such manner and to such extent as it shall deem in its discretion expedient to effectuate the purposes of the Plan;
- (d) to employ and compensate such accountants, attorneys, investment advisors and other agents, employees, and independent contractors as the Plan Administrator may deem necessary or advisable for the proper and efficient administration of the Plan;
- (e) to determine in its discretion all questions relating to eligibility;
- (f) to determine whether and when a Participant has incurred a Separation From Service, and the reason for such termination; and
- (g) to make a determination in its discretion as to the right of any individual to a benefit under the Plan and to prescribe procedures to be followed by distributees in obtaining benefits hereunder.

11.06 **Reliance on Documents, Instruments, etc.** The Plan Administrator may rely on any certificate statement or other representation made on behalf of the Employer or any Participant, which the Plan Administrator in good faith believes to be genuine, and on any certificate, statement, report or other representation made to it by any agent or any attorney, accountant or other expert retained by it or Baker Hughes in connection with the operation and administration of the Plan.

### **11.07 Claims Review Procedures; Claims Appeals Procedures.**

- (a) *Claims Review Procedures.* When a benefit is due, the Participant, or the person entitled to benefits under the Plan, should submit a claim to the office designated by the Plan Administrator to receive claims. Under normal circumstances, the Plan Administrator will make a final decision as to a claim within 90 days after receipt of the claim. If the Plan Administrator notifies the claimant in writing during the initial 90-day period, it may extend the period up

to 180 days after the initial receipt of the claim. The written notice must contain the circumstances necessitating the extension and the anticipated date for the final decision. If a claim is denied during the claims period, the Plan Administrator must notify the claimant in writing, and the written notice must set forth in a manner calculated to be understood by the claimant:

- (1) the specific reason or reasons for the denial;
- (2) specific reference to the Plan provisions on which the denial is based; and
- (3) a description of any additional material or information necessary for the claimant to perfect the claim and an explanation of why such material or information is necessary.

If a decision is not given to the Participant within the claims review period, the claim is treated as if it were denied on the last day of the claims review period.

(b) ***Claims Appeals Procedures.*** For purposes of this Section 11.07 the Participant or the person entitled to benefits under the Plan is referred to as the "claimant." If a claimant's claim made pursuant to Section 11.07(a) is denied and he wants a review, he must apply to the Plan Administrator in writing. That application can include any arguments, written comments, documents, records and other information relating to the claim for benefits. In addition, the claimant is entitled to receive on request and free of charge reasonable access to and copies of all information relevant to the claim. For this purpose, "relevant" means information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan's administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. The Plan Administrator must take into account all comments, documents, records and other information submitted by the claimant relating to the claim, without regard to whether the information was submitted or considered in the initial benefit determination. The claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The Plan Administrator can schedule any meeting with the claimant or his representative that it finds necessary or appropriate to complete its review.

The request for review must be filed within 90 days after the denial. If it is not, the denial becomes final. If a timely request is made, the Plan Administrator must make its decision, under normal circumstances, within 60 days of the receipt of the request for review. However, if the Plan Administrator notifies the claimant prior to the expiration of the initial review period, it may extend the period of review up to 120 days following the initial receipt of the request for a review. All decisions of the Plan Administrator

must be in writing and must include the specific reasons for its action, the Plan provisions on which its decision is based, and a statement that the claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records and other information relevant to the claimant's claim for benefits. If a decision is not given to the claimant within the review period, the claim is treated as if it were denied on the last day of the review period.

Within 60 days of receipt by a claimant of a notice denying a claim under the preceding paragraph, the claimant or his or her duly authorized representative may request in writing a full and fair review of the claim by the Plan Administrator. The Plan Administrator may extend the 60-day period where the nature of the benefit involved or other attendant circumstances make such extension appropriate. In connection with such review, the claimant or his or her duly authorized representative may review pertinent documents and may submit issues and comments in writing. The Plan Administrator shall make a decision promptly, and not later than 60 days after the Plan's receipt of a request for review, unless special circumstances (such as the need to hold a hearing) require an extension of time for processing, in which case a decision shall be rendered as soon as possible, but not later than 120 days after receipt of a request for review. The decision on review shall be in writing and shall include specific reasons for the decision, written in a manner calculated to be understood by the claimant, and specific references to the pertinent Plan provisions on which the decision is based.

**11.08 Employer to Supply Information.** The Employer shall supply full and timely information to the Plan Administrator, including, but not limited to, information relating to each Participant's base salary, age, Retirement, death, or other cause of Separation From Service and such other pertinent facts as the Plan Administrator may require. When making a determination in connection with the Plan, the Plan Administrator shall be entitled to rely upon the aforesaid information furnished by the Employer.

**11.09 Indemnity.** To the extent permitted by applicable law, Baker Hughes shall indemnify and save harmless the Board, each member of the Committee, each delegate of the Committee or the Board and the Plan Administrator against any and all expenses, liabilities and claims (including legal fees incurred to investigate or defend against such liabilities and claims) arising out of their discharge in good faith of responsibilities under or incident to the Plan. Expenses and liabilities arising out of willful misconduct shall not be covered under this indemnity. This indemnity shall not preclude such further indemnities as may be available under insurance purchased by Baker Hughes or provided by Baker Hughes under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, as such indemnities are permitted under applicable law.

## **ARTICLE XII**

### **ADOPTION OF PLAN BY AFFILIATES**

#### **12.01 Adoption Procedure.**

- (a) With the written approval of the Plan Administrator, any entity that is an Affiliate may adopt the Plan by appropriate action of its board of directors or noncorporate counterpart, as evidenced by a written instrument executed by an authorized officer of such entity or an executed adoption agreement (approved by the board of directors or noncorporate counterpart of the Affiliate), agreeing to be bound by all the terms, conditions and limitations of the Plan except those, if any, specifically described in the adoption instrument, and providing all information required by the Plan Administrator. The Plan Administrator and the adopting Affiliate may agree to incorporate specific provisions relating to the operation of the Plan that apply to the adopting Affiliate only and shall become, as to such adopting Affiliate and its employees, a part of the Plan.
- (b) The provisions of the Plan may be modified so as to increase the obligations of an adopting Affiliate *only* with the consent of such Affiliate, which consent shall be conclusively presumed to have been given by such Affiliate unless the Affiliate gives Baker Hughes written notice of its rejection of the amendment within 30 days after the adoption of the amendment.
- (c) The provisions of the Plan shall apply separately and equally to each adopting Affiliate and its employees in the same manner as is expressly provided for Baker Hughes and its employees, except that the power to appoint or otherwise affect the Plan Administrator and the power to amend or terminate the Plan shall be exercised by Baker Hughes. The Plan Administrator shall act as the agent for each Affiliate that adopts the Plan for all purposes of administration thereof.
- (d) Any adopting Affiliate may, by appropriate action of its board of directors or noncorporate counterpart, terminate its participation in the Plan. Moreover, the Plan Administrator may, in its discretion, terminate an Affiliate's participation in the Plan at any time.
- (e) The Plan will terminate with respect to any Affiliate that has adopted the Plan pursuant to this Section 12.01 if the Affiliate ceases to be an Affiliate or revokes its adoption of the Plan by resolution of its board of directors or noncorporate counterpart evidenced by a written instrument executed by an authorized officer of the Affiliate. If the Plan terminates with respect to any Affiliate, the employees of that Affiliate will no longer be eligible to be Participants in the Plan.
- (f) The Plan as adopted by the Affiliates shall constitute a single plan rather than a separate plan of each Affiliate.

**12.02 No Joint Venture Implied.** The document which evidences the adoption of the Plan by an Affiliate shall become a part of the Plan. However, neither the adoption of the Plan by an Affiliate nor any act performed by it in relation to the Plan shall ever create a joint venture or partnership relation between it and any other Affiliate.

## **ARTICLE XIII**

### **MISCELLANEOUS**

**13.01 Plan Not Contract of Employment.** The adoption and maintenance of the Plan shall not be deemed to be a contract between the Employer and any individual or to be consideration for the employment of any individual. Nothing herein contained shall be deemed to (a) give any individual the right to be retained in the employ of the Employer, (b) restrict the right of the Employer to discharge any individual at any time, (c) give the Employer the right to require any individual to remain in the employ of the Employer, or (d) restrict any individual's right to terminate his employment at any time.

**13.02 Funding.** Plan benefits are a contractual obligation of the Employers which shall be paid out of the Employers' general assets. The Plan is unfunded and Participants are merely unsecured creditors of the Employers with respect to their benefits under the Plan.

**13.03 Alienation of Interest Forbidden.** The interest of a Participant, former Participant or his beneficiary or beneficiaries hereunder may not be sold, transferred, assigned, or encumbered in any manner, either voluntarily or involuntarily, and any attempt so to anticipate, alienate, sell, transfer, assign, pledge, encumber or charge the same shall be null and void; neither shall the benefits hereunder be liable for or subject to the debts, contracts, liabilities, engagements or torts of any individual to whom such benefits or funds are payable, nor shall they be an asset in bankruptcy or subject to garnishment, attachment or other legal or equitable proceedings. The provisions of this Section 13.03 shall not apply to a Domestic Relations Order.

**13.04 Withholding.** All credits to a Participant's or former Participant's Accounts and payments provided for hereunder shall be subject to applicable withholding and other deductions as shall be required of the Employer under any applicable local, state or federal law.

**13.05 Amendment and Termination.** The Board, may from time to time, in its discretion, amend, in whole or in part, any or all of the provisions of the Plan on behalf of any Employer; provided, however, that no amendment may be made that would impair the rights of a Participant or former Participant with respect to amounts already credited to his Accounts. The Board may terminate the Plan at any time. If the Plan is terminated, the amounts credited to a Participant's or former Participant's Account shall be paid to such Participant, or former Participant, or his designated beneficiary at the time(s) specified in Articles VII, IX and X, as applicable.

**13.06 Severability.** If any provision of the Plan shall be held illegal or invalid for any reason, said illegality or invalidity shall not affect the remaining provisions hereof; instead, each provision shall be fully severable and the Plan shall be construed and enforced as if said illegal or invalid provision had never been included herein.

**13.07 Arbitration.** Any controversy arising out of or relating to the Plan, including without limitation, any and all disputes, claims (whether in tort, contract, statutory or otherwise) or disagreements concerning the interpretation or application of the provisions of the Plan, the Employer's employment of the Participant, or former Participant, and the termination of that employment, shall be resolved by arbitration in accordance with the Employee Benefit Plan Claims Arbitration Rules of the American Arbitration Association (the "AAA") then in effect. No arbitration proceeding relating to the Plan may be initiated by either the Employer or the Participant, or former Participant, unless the claims review and appeals procedures specified in Section 11.07 have been exhausted. Within ten (10) business days of the initiation of an arbitration hereunder, the Employer and the Participant, or former Participant, will each separately designate an arbitrator, and within twenty (20) business days of selection, the appointed arbitrators will appoint a neutral arbitrator from the panel of AAA National Panel of Employee Benefit Plan Claims Arbitrators. The arbitrators shall issue their written decision (including a statement of finding of facts) within thirty (30) days from the date of the close of the arbitration hearing. The decision of the arbitrators selected hereunder will be final and binding on both parties. This arbitration provision is expressly made pursuant to and shall be governed by the Federal Arbitration Act, 9 U.S.C. Sections 1-16 (or replacement or successor statute). Pursuant to Section 9 of the Federal Arbitration Act, the Employer and any Participant agrees that any judgment of the United States District Court for the District in which the headquarters of Baker Hughes is located at the time of initiation of an arbitration hereunder shall be entered upon the award made pursuant to the arbitration. Nothing in this Section 13.07 shall be construed to, in any way, limit the scope and effect of Article XI. In any arbitration proceeding full effect shall be given to the rights, powers, and authorities of the Plan Administrator under Article XI.

**13.08 Stockholder Approval.** Notwithstanding any other provision of the Plan, no payments shall be made under the Plan with respect to Performance Periods commencing on or after January 1, 2006 unless, prior to the payments, the stockholders of Baker Hughes approve the material terms of the performance goals under which the compensation is to be paid (within the meaning of Section 162(m)).

**13.09 Compliance With Section 409A.** To the extent applicable, the Plan shall be operated in compliance with Section 409A and the provisions of Section 409A shall override any provisions of the Plan to the extent that they are inconsistent with Section 409A.

**13.10 Governing Law.** All provisions of the Plan shall be construed in accordance with the laws of Texas, except to the extent preempted by federal law and except to the extent that the conflicts of laws provisions of the State of Texas would require the application of the relevant law of another jurisdiction, in which event the relevant law of the State of Texas will nonetheless apply, with venue for litigation being in Houston, Texas.

## ANNEX G

### AUDIT/ETHICS COMMITTEE BAKER HUGHES INCORPORATED GUIDELINES FOR PRE-APPROVAL OF AUDIT AND NON-AUDIT FEES OF INDEPENDENT AUDITOR

#### Audit Fees

The independent auditor will submit to the Audit/Ethics Committee of the Board of Directors ("Committee") for pre-approval a worldwide engagement letter outlining the scope of the audit services proposed to be performed for the fiscal year together with an audit services fee proposal annually.

#### Non-Audit Fees

Management will submit to the Committee for pre-approval proposed projects annually for the upcoming year requesting specific pre-approval for all projects over \$15,000 and general approval for all projects under \$15,000 with the Committee informed of the particular services. The Company's independent auditor may be awarded any type of non-audit services not prohibited by law or regulations, including the Sarbanes-Oxley Act, which services may include but not be limited to: tax compliance, planning and tax audit assistance; limited situation projects related to the Company or employee statutory filings, requirements or applications; assignments related to financial statement and internal control risk assessments. The annual request must include a representation from management and the independent auditor as to whether, in their view, the request is consistent with the Securities and Exchange Commission's rules on auditor independence.

The Committee has delegated to the Chairman of the Committee the pre-approval requirement of non-audit fees for new projects that are identified after the annual pre-approval by the Committee. Projects with estimated fees of \$15,000 and above arising subsequent to the annual Committee pre-approval will be presented to the Chairman of the Committee for approval prior to starting the project. New projects with estimated fees less than \$15,000 not included in the annual pre-approval will also be presented to the Chairman of the Committee "in total," with a comparison to original approvals. The Chairman (and subsequently the Committee) will be informed of the particular services. All such decisions by the Chairman will be reported to the Committee at a scheduled meeting. The Committee does not delegate its responsibilities to pre-approve services performed by the independent auditor to management.

The Committee will be provided an interim update during the year. However, if there are deviations of ten percent or greater from the aggregate pre-approved amount, the Committee will receive an update at a scheduled meeting. Any proposed services exceeding pre-approved cost levels will require specific approval by the Committee.

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

**Form 10-K**

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

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

Commission file number 1-9397

# Baker Hughes Incorporated

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction  
of incorporation or organization)

**76-0207995**

(I.R.S. Employer Identification No.)

**3900 Essex Lane, Suite 1200, Houston, Texas**

(Address of principal executive offices)

**77027-5177**

(Zip Code)

Registrant's telephone number, including area code: **(713) 439-8600**

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

Title of each class  
**Common Stock, \$1 Par Value Per Share**

Name of each exchange on which registered  
**New York Stock Exchange  
SWX Swiss Exchange**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.  
YES  NO

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  NO

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the voting and non-voting common stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter (based on the closing price on July 1, 2005 reported by the New York Stock Exchange) was approximately \$17,495,000,000.

As of February 24, 2006, the registrant has outstanding 342,267,902 shares of common stock, \$1 par value per share.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant's 2005 Proxy Statement for the Annual Meeting of Stockholders to be held April 27, 2006 are incorporated by reference into Part III of this Form 10-K.

# BAKER HUGHES INCORPORATED

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## PART I

### ITEM 1. BUSINESS

Baker Hughes Incorporated (“Baker Hughes,” “Company,” “we,” “our” or “us”) is a Delaware corporation engaged in the oilfield services industry. Baker Hughes is a major supplier of wellbore-related products and technology services and systems to the worldwide oil and natural gas industry, including products and services for drilling, formation evaluation, completion and production of oil and natural gas wells. We conduct our operations through subsidiaries, affiliates, ventures and alliances.

Baker Hughes was formed in April 1987 in connection with the combination of Baker International Corporation and Hughes Tool Company. We acquired Western Atlas Inc. in a merger completed on August 10, 1998.

As used herein, “Baker Hughes,” “Company,” “we,” “our” and “us” may refer to Baker Hughes Incorporated or its subsidiaries. The use of these terms is not intended to connote any particular corporate status or relationships.

Our 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, as amended (the “Exchange Act”), are made available free of charge on our Internet website at [www.bakerhughes.com](http://www.bakerhughes.com) as soon as reasonably practicable after these reports have been electronically filed with, or furnished to, the Securities and Exchange Commission (the “SEC”).

We have adopted a Business Code of Conduct to provide guidance to our directors, officers and employees on matters of business conduct and ethics, including compliance standards and procedures. We have also required our principal executive officer, principal financial officer and principal accounting officer to sign a Code of Ethical Conduct Certification. Our Business Code of Conduct and Code of Ethical Conduct Certifications are available on the Investor Relations section of our website at [www.bakerhughes.com](http://www.bakerhughes.com). We intend to promptly disclose on our website information about any waiver of these codes for our executive officers and directors. Our Corporate Governance Guidelines and the charters of our Audit/Ethics Committee, Compensation Committee, Executive Committee, Finance Committee and Governance Committee are also available on the Investor Relations section of our website at [www.bakerhughes.com](http://www.bakerhughes.com). In addition, a copy of our Business Code of Conduct, Code of Ethical Conduct Certification, Corporate Governance Guidelines and the charters of the Committees referenced above are available in print at no cost to any stockholder who requests them by writing or telephoning us at the following address or telephone number:

Baker Hughes Incorporated  
3900 Essex Lane, Suite 1200  
Houston, TX 77027  
Attention: Investor Relations  
Telephone: (713) 439-8039

Information contained on or connected to our website is not incorporated by reference into this annual report on Form 10-K and should not be considered part of this report or any other filing we make with the SEC.

We have organized our seven product-line focused divisions into two separate segments: Drilling and Evaluation and Completion and Production. The segments align product lines based on the types of products and services provided to our customers. We also own a 30% equity interest in WesternGeco, a seismic venture with Schlumberger Limited (“Schlumberger”). Accordingly, we report our results under three segments – Drilling and Evaluation, Completion and Production and WesternGeco:

- The Drilling and Evaluation segment consists of Baker Hughes Drilling Fluids (drilling fluids), Hughes Christensen (oilfield drill bits), INTEQ (conventional and rotary directional drilling, measurement-while-drilling and logging-while-drilling) and Baker Atlas (wireline formation evaluation and wireline completion services). The Drilling and Evaluation segment provides products and services used to drill oil and natural gas wells.
- The Completion and Production segment consists of Baker Oil Tools (completion, workover and fishing equipment), Baker Petrolite (oilfield specialty chemicals) and Centrilift (electric submersible pumps and progressing cavity pumps). The Completion and Production segment also includes our Production Optimization business unit (permanent down-hole monitoring). The Completion and Production segment provides equipment and services used from the completion phase through the productive life of oil and natural gas wells.
- The WesternGeco segment consists of our equity interest in WesternGeco that provides reservoir imaging, monitoring and development services.

We have aggregated our divisions into these segments because they have similar economic characteristics and because their long-term financial performance is affected by similar economic conditions. They also operate in the same markets, which include all of the major oil and natural gas producing regions of the world. The results of each segment are evaluated regularly by our chief operating decision maker in deciding how to allocate resources and in assessing performance.

For additional industry segment information for the three years ended December 31, 2005, see Note 13 of the Notes to Consolidated Financial Statements in Item 8 herein.

### DRILLING AND EVALUATION SEGMENT

#### Baker Hughes Drilling Fluids

Baker Hughes Drilling Fluids is a major provider of drilling fluids (also called “mud”), completion fluids (also called “brines”) and fluids environmental services. Drilling fluids are an important component of the drilling process and are pumped from the surface through the drill string, exiting nozzles in the drill bit and traveling back up the wellbore where the fluids are recycled. This process cleans the bottom of the well by transporting the cuttings to the surface while also cooling and lubricating the bit and drill string. Drilling fluids

typically contain barite or bentonite to give them weight, which enables the fluids to hold the wellbore open and stabilize it. Additionally, the fluids control downhole pressures and seal porous sections of the wellbore. To ensure maximum efficiency and wellbore stability, drilling fluids are often customized by the wellsite engineer. For drilling through the reservoir itself, Baker Hughes Drilling Fluids' drill-in or completion fluids possess properties that minimize formation damage. The fluids environmental services of Baker Hughes Drilling Fluids also provide equipment and services to separate the drill cuttings from the drilling fluids and re-inject the processed cuttings into a specially prepared well, or to transport and dispose of the cuttings by other means.

Although technology is very important in the selection of drilling fluids for many drilling programs, cost efficiency tends to drive customer purchasing decisions. Specific opportunities for competitive differentiation include:

- improving drilling efficiency,
- minimizing formation damage, and
- handling and disposing of drilling fluids and cuttings in an environmentally safe manner.

Baker Hughes Drilling Fluids' primary competitors include M-I SWACO, Halliburton Company ("Halliburton"), Newpark Resources, Inc. and various other competitors.

Key business drivers for Baker Hughes Drilling Fluids include the number of drilling rigs operating (especially the number of drilling programs targeting deep formations), total footage drilled, environmental regulations, as well as the current and expected future price of both oil and natural gas.

## Hughes Christensen

Hughes Christensen is a leading manufacturer and supplier of drill bits, primarily Tricone® roller cone bits and fixed-cutter polycrystalline diamond compact ("PDC") bits, to the worldwide oil and natural gas industry. The primary objective of a drill bit is to drill a high quality wellbore as efficiently as possible.

**Tricone® Bits.** Tricone® drill bits employ either hardened steel teeth or tungsten carbide insert cutting structures mounted on three rotating cones. These bits work by crushing and shearing the formation rock as they are turned. Tricone® drill bits have a wide application range.

**PDC Bits.** PDC (also known as "Diamond") bits use fixed position cutters that shear the formation rock with a milling action as they are turned. In many softer and less variable applications, PDC bits offer higher penetration rates and a longer life than Tricone® bits. Advances in PDC technology have expanded the application of PDC bits into harder, more abrasive formations. A rental market has developed for PDC bits in the Western Hemisphere as improvements in bit life and bit repairs allow a bit to be used to drill multiple wells.

The main driver of customer purchasing decisions in drill bits is the value added, usually measured in terms of savings in total operating costs per distance drilled. Specific opportunities for competitive differentiation include:

- improving the rate of penetration,
- extending bit life, and
- selecting the optimal bit for each section to be drilled.

Hughes Christensen's primary competitors in the oil and natural gas drill bit market are Smith International, Inc. ("Smith"), Grant Prideco, Inc., Halliburton and various other competitors.

Key business drivers for Hughes Christensen include the number of drilling rigs operating, total footage drilled, drilling rig rental costs, as well as the current and expected future price of both oil and natural gas.

## INTEQ

INTEQ is a leading supplier of drilling and evaluation services, which include directional drilling, measurement-while-drilling ("MWD") and logging-while-drilling ("LWD") services.

**Directional Drilling.** Directional drilling services are used to guide a drill string along a predetermined path to drill a wellbore to optimally recover hydrocarbons from the reservoir. These services are used to accurately drill vertical wells, deviated or directional wells (which deviate from vertical by a planned angle and direction), horizontal wells (which are sections of wells drilled perpendicular or nearly perpendicular to vertical) and extended reach wells.

INTEQ is a leading supplier of both conventional and rotary based directional drilling systems. Conventional directional drilling systems employ a downhole motor that turns the drill bit independently of drill string rotation from the surface. Placed just above the bit, a steerable motor assembly has a bend in its housing that is oriented to steer the well's course. During the "rotary" mode, the entire drill string is rotated from the surface, negating the effect of this bend and causing the bit to drill on a straight course. During the "sliding" mode, drill string rotation is stopped and a "mud" motor (which converts hydraulic energy from the drilling fluids being pumped through the drill string into rotational energy at the bit) allows the bit to drill in the planned direction by orienting its angled housing, gradually guiding the wellbore through an arc.

INTEQ was a pioneer and is a leader in the development and use of automated rotary steerable technology. In rotary steerable environments, the entire drill string is turned from the surface to supply energy to the bit. Unlike conventional systems, INTEQ's AutoTrak® rotary steerable system changes the trajectory of the well using three pads that push against the wellbore from a non-rotating sleeve and is controlled by a downhole guidance system.

INTEQ's AutoTrak® Xtreme® system combines conventional mud motor technology with rotary steerable technology to provide directional control and improved rate of penetration.

**Measurement-While-Drilling.** Directional drilling systems need real-time measurements of the location and orientation of the bottom hole assembly to operate effectively. INTEQ's MWD systems are downhole tools that provide this directional information, which is necessary to adjust the drilling process and guide the wellbore to a specific target. The AutoTrak® rotary steerable system has these MWD systems built in, allowing the tool to automatically alter its course based on a planned trajectory.

**Logging-While-Drilling.** LWD is a variation of MWD in which the LWD tool gathers information on the petrophysical properties of the formation through which the wellbore is

being drilled. Many LWD measurements are the same as those taken via wireline; however, taking them in real-time often allows for greater accuracy, as measurements occur before any damage has been sustained by the reservoir as a result of the drilling process. Real-time measurements also enable “geo-steering” where geological markers identified by LWD tools are used to guide the bit and assure placement of the wellbore in the optimal location.

In both MWD and LWD systems, surface communication with the tool is achieved through mud-pulse telemetry, which uses pulse signals (pressure changes in the drilling fluid traveling through the drill string) to communicate the operating conditions and location of the bottom hole assembly to the surface. The information transmitted is used to maximize the efficiency of the drilling process, update and refine the reservoir model and steer the well into the optimal location in the reservoir.

As part of INTEQ’s mud logging services, engineers monitor the interaction between the drilling fluid and the formation and perform laboratory analysis of drilling fluids and examinations of the drill cuttings to detect the presence of hydrocarbons and identify the different geological layers penetrated by the drill bit.

The main drivers of customer purchasing decisions in these areas are the value added by technology and the reliability and durability of the tools used in these operations. Specific opportunities for competitive differentiation include:

- the sophistication and accuracy of measurements,
- the efficiency of the drilling process (measured in cost per foot drilled),
- the reliability of equipment,
- the optimal placement of the wellbore in the reservoir, and
- the quality of the wellbore.

INTEQ’s primary competitors in drilling and evaluation services are Halliburton, Schlumberger, Weatherford International Ltd. (“Weatherford”) and various other competitors.

Key business drivers for INTEQ include the number of drilling rigs operating, the total footage drilled, the mix of conventional and rotary steerable systems used, as well as the current and expected future price of both oil and natural gas.

### **Baker Atlas**

Baker Atlas is a leading provider of formation evaluation and wireline completion and production services for oil and natural gas wells.

**Formation Evaluation.** Formation evaluation involves measuring and analyzing specific physical properties of the rock (petrophysical properties) in the immediate vicinity of a wellbore to determine an oil or natural gas reservoir’s boundaries, volume of hydrocarbons and ability to produce fluids to the surface. Electronic sensor instrumentation is run through the wellbore to measure porosity and density (how much open space there is in the rock), permeability (how well connected the spaces in the rock are) and resistivity (whether there is oil, natural gas or water in the spaces). Imaging tools are run through the wellbore to record a picture of the formation along the well’s length similar to a core sample. Acoustic logs measure rock properties and help correlate wireline data with

previous seismic surveys. Magnetic resonance measurements characterize the volume and type of fluids in the formation as well as providing a direct measure of permeability. At the surface, measurements are recorded digitally and can be displayed on a continuous graph, or “well log,” which shows how each parameter varies along the length of the wellbore. Formation evaluation tools can also be used to record formation pressures and take samples of formation fluids to be further evaluated on the surface.

Formation evaluation instrumentation can be run in the well in several ways and at different times over the life of the well. The two most common methods of data collection are wireline logging (performed by Baker Atlas) and LWD (performed by INTEQ). Wireline logging is conducted by pulling or pushing instruments through the wellbore after it is drilled, while LWD instruments are attached to the drill string and take measurements while the well is being drilled. Wireline logging measurements can be made before the well’s protective steel casing is set (open hole logging) or after casing has been set (cased hole logging). Baker Atlas also offers geophysical data interpretation services which help the operator interpret the petrophysical properties measured by the logging instruments and make inferences about the formation, presence and quantity of hydrocarbons present. This information is used to determine the next steps in drilling and completing the well.

**Wireline Completion and Production Services.** Wireline completion and production services include using wireline instruments to evaluate well integrity, perform mechanical intervention and perform cement evaluations. Wireline instruments can also be run in producing wells to perform production logging. Baker Atlas (and Baker Oil Tools) also provide perforating services, which involve puncturing a well’s steel casing and cement sheath with explosive charges. This creates a fracture in the formation and provides a path for hydrocarbons in the formation to enter the wellbore and be produced.

Baker Atlas’ services allow oil and natural gas companies to define, manage and reduce their exploration and production risk. As such, the main driver of customer purchasing decisions is the value added by formation evaluation and wireline completion and production services. Specific opportunities for competitive differentiation include:

- the efficiency of data acquisition,
- the sophistication and accuracy of measurements,
- the ability to interpret the information gathered to quantify the hydrocarbons producible from the formation, and
- the ability to differentiate services that can run exclusively or more efficiently on wireline from services that can run on either wireline or drill pipe.

Baker Atlas’ primary formation evaluation and wireline completion and perforating competitors are Schlumberger, Weatherford, Halliburton and various other competitors.

Key business drivers for Baker Atlas include the number of drilling and workover rigs operating, as well as the current and expected future price of both oil and natural gas.

## COMPLETION AND PRODUCTION SEGMENT

### Baker Oil Tools

Baker Oil Tools is a world leader in well completion and wellbore intervention solutions.

**Well Completion.** The economic success of a well largely depends on how the well is completed. A successful completion ensures and optimizes the efficient and safe production of oil and natural gas to the surface. Baker Oil Tools' completion systems are matched to the formation and reservoir for optimum production and can employ a variety of products and services including liner hangers, packers, flow control equipment, subsurface safety valves, sand control equipment and other advanced completion technologies.

Liner hangers suspend a section of steel casing (also called a liner) inside the bottom of the previous section of casing. The liner hanger's expandable slips grip the inside of the casing and support the weight of the liner below.

Packers seal the annular space between the steel production tubing and the casing. These tools control the flow of fluids in the well and protect the casing above and below from reservoir pressures and corrosive formation fluids.

Flow control equipment controls and adjusts the flow of downhole fluids. A common flow control device is a sliding sleeve, which can be opened or closed to allow or limit production from a particular portion of a reservoir. Flow control can be accomplished from the surface via wireline or downhole via hydraulic or electric motor-based automated systems.

Subsurface safety valves shut off all flow of fluids to the surface in the event of an emergency, thus saving the well and preventing pollution of the environment. These valves are required in substantially all offshore wells.

Sand control equipment includes gravel pack tools, sand screens and fracturing fluids. Sand control systems and pumping services are used in loosely consolidated formations to prevent the production of formation sand with the hydrocarbons.

Advanced completion technologies include multilateral systems, intelligent well systems and expandable metal technologies. Multilateral completion systems enable two or more zones to be produced from a single well, using multiple horizontal branches. Intelligent Completions® use real-time, remotely operated downhole systems to control the flow of hydrocarbons from one or more zones. Expandable metal technology involves the permanent downhole expansion of a variety of tubular products used in drilling, completion and well remediation applications.

**Wellbore Intervention.** Wellbore intervention products and services are designed to protect producing assets. Intervention operations troubleshoot drilling problems and improve, maintain or restore economical production from already-producing wells. In this area, Baker Oil Tools offerings range from service tools and inflatable products to conventional and through-tubing fishing systems, casing exits, wellbore cleaning and temporary abandonment.

Service tools function as surface-activated, downhole sealing and anchoring devices to isolate a portion of the wellbore during repair or stimulation operations. Service tool applications range from treating and cleaning to testing components from

the wellhead to the perforations. Service tools also refer to tools and systems that are used for temporary or permanent well abandonment.

Inflatable packers expand to set in pipe that is much larger than the outside diameter of the packer itself, so it can run through a restriction in the well and then set in the larger diameter below. Inflatable packers also can be set in "open hole" whereas conventional tools only can be set inside casing. Through-tubing inflatables enable remedial operations in producing wells. Significant cost savings result from lower rig requirements and the ability to intervene in the well without having to remove the completion.

Fishing tools and services are used to locate, dislodge and retrieve damaged or stuck pipe, tools or other objects from inside the wellbore, often thousands of feet below the surface.

Wellbore cleaning systems remove post-drilling debris to help ensure trouble-free well testing and completion and optimum production for the life of the well.

Casing exit systems are used to "sidetrack" new wells from existing ones, to provide a cost-effective method of tapping previously unreachable reserves.

The main drivers of customer purchasing decisions in well completion and wellbore intervention are superior wellsite service execution and value-adding technologies that improve production rates, protect the reservoir from damage and reduce cost. Specific opportunities for competitive differentiation include:

- engineering and manufacturing superior-quality products and providing solutions with a proven ability to reduce well construction costs,
- enhancing production and ultimate recovery,
- minimizing risks, and
- providing reliable performance over the life of the well, particularly in harsh environments and for critical wells.

Baker Oil Tools' primary competitors in well completion are Halliburton, Schlumberger, Weatherford and various other competitors. Its primary competitors in wellbore intervention are Halliburton, Schlumberger, Weatherford, Smith and various other competitors.

Key business drivers for Baker Oil Tools include the number of drilling and workover rigs operating, the relative complexity of the wells drilled and completed, as well as the current and expected future price of both oil and natural gas.

### Baker Petrolite

Baker Petrolite is a leading provider of specialty chemicals to the oil and gas industry. The division also supplies specialty chemicals to a number of industries including refining, pipeline transportation, petrochemical, agricultural and iron and steel manufacturing and provides polymer-based products to a broad range of industrial and consumer markets. Through its Pipeline Management Group ("PMG"), Baker Petrolite also offers a variety of products and services for the pipeline transportation industry.

**Oilfield Chemicals.** Baker Petrolite provides oilfield chemical programs for drilling, well stimulation, production, pipeline transportation and maintenance programs. Its products provide measurable increases in productivity, decreases in operating and

maintenance cost and solutions to environmental problems. Examples of specialty oilfield chemical programs include chemicals which inhibit hydrate-, paraffin-, scale- and corrosion-formation and emulsion breakers.

**Hydrate inhibitors** – Natural gas hydrates are solid ice-like crystals that form in production flowlines and tubing and cause shutdowns and the need for system maintenance. Sub-sea wells and flowlines, particularly in deepwater environments, are especially susceptible to hydrates.

**Paraffin inhibitors** – The liquid hydrocarbons produced from many oil and natural gas reservoirs become unstable soon after leaving the formation. Changing conditions, including decreases in temperature and pressure, can cause certain hydrocarbons in the produced fluids to crystallize and deposit on the walls of the well's tubing, flow lines and surface equipment. These deposits are commonly referred to as paraffin. Baker Petrolite offers solvents that remove the deposits, as well as inhibitors that prevent new deposits from forming.

**Scale inhibitors** – Unlike paraffin deposits that originate from organic material in the produced hydrocarbons, scale deposits come from mineral-based contaminants in water that are produced from the formation as the water undergoes changes in temperature or pressure. Similar to paraffin, scale deposits can clog the production system. Treatments prevent and remove deposits in production systems.

**Corrosion inhibitors** – Another problem caused by water mixed with downhole hydrocarbons is corrosion of the well's tubulars and other production equipment. Corrosion can also be caused by dissolved hydrogen sulfide ("H<sub>2</sub>S") gas, which reacts with the iron in tubulars, valves and other equipment, potentially causing failures and leaks. Additionally, the reaction creates iron sulfide, which can impair treating systems and cause blockages. Baker Petrolite offers a variety of corrosion inhibitors and H<sub>2</sub>S scavengers.

**Emulsion breakers** – Water and oil typically do not mix, but water present in the reservoir and co-produced with oil can often become emulsified, or mixed, causing problems for oil and natural gas producers. Baker Petrolite offers emulsion breakers that allow the water component of the emulsion to be separated from the oil.

#### **Refining, Industrial and Other Specialty Chemicals.**

For the refining industry, Baker Petrolite offers various process and water treatment programs, as well as finished fuel additives. Examples include programs to remove salt from crude oil and to control corrosion in processing equipment and environmentally friendly cleaners that decontaminate refinery equipment and petrochemical vessels at a lower cost than other methods. Baker Petrolite also provides chemical technology solutions to other industrial markets throughout the world, including petrochemicals, fuel additives, plastics, imaging, adhesives, steel and crop protection.

**Pipeline Management.** Baker Petrolite's Pipeline Management Group ("PMG") offers a variety of products and services for the pipeline transportation industry. To improve efficiency, Baker Petrolite offers custom turnkey cleaning programs that combine chemical treatments with brush and scraper tools that are pumped through the pipeline. Efficiency can also be improved by adding polymer-based drag reduction agents to

reduce the slowing effects of friction between the pipeline walls and the fluids within, thus increasing throughput and pipeline capacity. Additional services allow pipelines to operate more safely. These include inspection and internal corrosion assessment technologies, which physically confirm the structural integrity of the pipeline. In addition, PMG's flow-modeling capabilities can identify high-risk segments of a pipeline to ensure proper mitigation programs are in place.

The main driver of customer purchasing decisions in specialty chemicals is superior application of technology and service delivery. Specific opportunities for competitive differentiation include:

- higher levels of production or throughput,
- lower maintenance costs and frequency,
- lower treatment costs and treatment intervals, and
- successful resolution of environmental issues.

Baker Petrolite's primary competitors are GE Water Technologies, Nalco Company, Champion Technologies, Smith and various other competitors.

Key business drivers for Baker Petrolite include oil and natural gas production levels, the number of producing wells, total liquids production, and the current and expected future price of both oil and natural gas.

#### **Centrilift**

Centrilift is a leading manufacturer and supplier of electrical submersible pump systems ("ESPs") and progressing cavity pump systems ("PCPs").

**Electrical Submersible Pump Systems.** ESPs lift high quantities of oil or oil and water from wells that do not flow under their own pressure. These "artificial lift" systems consist of a centrifugal pump and electric motor installed in the wellbore, armored electric cabling to provide power to the downhole motor and a variable speed controller at the surface. Centrilift designs, manufactures, markets and installs all the components of ESP systems and also offers modeling software to size ESPs and simulate operating performance. ESPs may be used in both onshore or offshore wells. The range of appropriate application of ESP systems is expanding as technology and reliability enhancements have improved ESP system performance in harsher environments and marginal reservoirs.

**Progressing Cavity Pump Systems.** PCPs are a form of artificial lift comprised of a downhole progressing cavity pump powered by either a downhole electric motor or a rod turned by a motor on the surface. PCP systems are preferred when the fluid to be lifted is viscous or when the volume is significantly less than could be economically lifted with an ESP system.

The main drivers of a customer purchasing decision in artificial lift include the depth of the well, the volume of the fluid, the physical and chemical properties of the fluid as well as the capital and operating cost of the system. Specific opportunities for competitive differentiation include:

- the ability to lift fluids of differing physical properties and chemical compositions,
- system reliability and run life,
- the ability of the system to optimize production,
- operating efficiency, and
- service delivery.

Centrilift's primary competitors in the ESP market are Schlumberger, John Wood Group PLC ("ESP Inc.") and various other competitors. In the PCP market the primary competitors are Weatherford, Robbins & Myers, Inc., Kudu Industries, Inc. and various other competitors.

Key business drivers for Centrilift include oil production levels, as well as the current and expected future price of oil, the volume of water produced in mature basins and gas dewatering in coal bed methane and other gas wells.

### Production Optimization

The Production Optimization business unit is a leading provider of permanent monitoring systems and chemical automation systems.

**Permanent Monitoring Systems.** Permanent downhole gauges are used in oil and gas wells to measure temperature, pressure, flow and other parameters in order to monitor well production as well as to confirm the integrity of the completion and production equipment in the well. Production Optimization is a leading provider of electronic gauges including the engineering, application and field services necessary to complete an installation of a permanent monitoring system. In addition, they provide chemical injection line installation and services for treating wells for corrosion, paraffin, scale and other well performance problems. They also provide fiber optic based permanent downhole gauge technology for measuring pressure, temperature and distributed temperature. The benefits of fiber optic sensing include reliability, high temperature properties and the ability for distributed readings.

**Chemical Automation Systems.** Chemical automation systems remotely monitor chemical tank levels that are resident in producing field locations for well treatment or production stimulation as well as continuously monitor and control chemicals being injected in individual wells. By using these systems, a producer can insure proper chemical injection through real time monitoring and can also remotely modify the injection parameters to insure optimized production.

The main drivers of customer purchasing decisions for both permanent monitoring and chemical automation include application engineering expertise, ability to integrate a complete system, product reliability, functionality and local field support. Specific opportunities for competitive differentiation include:

- the ability to provide application engineering and economic return analysis,
- innovative products,
- gauge measurement accuracy,
- product life and performance, and
- installation and service capabilities.

Production Optimization's primary competitors are Schlumberger, Halliburton and Weatherford.

Key business drivers for Production Optimization include the level of oil and gas prices, total daily oil and gas production and capital spending for critical wells (offshore, sub-sea, high production on-shore and remotely located on-shore).

### WesternGeco

WesternGeco is a seismic venture in which we own 30% and Schlumberger owns 70%. WesternGeco provides comprehensive worldwide reservoir imaging, monitoring and development services. The venture provides these services through its extensive number of seismic crews and data processing centers, as well as through its ownership of one of the world's largest multiclient seismic libraries. Services range from 3D and time-lapse (4D) seismic surveys to multicomponent surveys for delineating prospects and reservoir management. WesternGeco is positioned to meet the full range of customer needs in land, marine and shallow-water transition-zone areas.

Seismic solutions include proprietary Q-Technology\* for enhanced reservoir description, characterization and monitoring throughout the life of the field – from exploration through enhanced recovery.

WesternGeco's Omega\* Seismic Processing System encompasses one of the industry's most advanced and comprehensive suites of algorithms and runs on multiplatform technology, ensuring timely turnaround for even the most complex processing projects.

WesternGeco's major competitors are Compagnie Generale de Geophysique, Veritas DGC, Inc. and Petroleum Geo-Services ASA.

For additional information related to WesternGeco, see the "Related Party Transactions" section in Item 7 and Note 8 of the Notes to Consolidated Financial Statements in Item 8, both contained herein.

\* Mark of WesternGeco

### Marketing, Competition and Economic Conditions

We market our products and services on a product line basis primarily through our own sales organizations, although certain of our products and services are marketed through supply stores, independent distributors, agents, licensees or sales representatives. We ordinarily provide technical and advisory services to assist in our customers' use of our products and services. Stock points and service centers for our products and services are located in areas of drilling and production activity throughout the world.

Our products and services are sold in highly competitive markets, and revenues and earnings can be affected by changes in competitive prices, fluctuations in the level of drilling, workover and completion activity in major markets, general economic conditions, foreign currency exchange fluctuations and governmental regulations. We compete with the oil and natural gas industry's largest diversified oilfield services providers, as well as many small companies. We believe that the principal competitive factors in our industries are product and service quality, availability and reliability, health, safety and environmental standards, technical proficiency and price.

Further information is contained in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

## International Operations

We operate in over 90 countries worldwide, and our operations are subject to the risks inherent in doing business in multiple countries with various laws and differing political environments. These risks include the risks identified in "Item 1A. Risk Factors." Although it is impossible to predict the likelihood of such occurrences or their effect on us, division and corporate management routinely evaluate these risks and take appropriate actions to mitigate the risks where possible. However, there can be no assurance that an occurrence of any one or more of these events would not have a material adverse effect on our operations.

Further information is contained in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

## Research and Development; Patents

We are engaged in research and development activities directed primarily toward the improvement of existing products and services, the design of specialized products to meet specific customer needs and the development of new products, processes and services. For information regarding the amounts of research and development expense in each of the three years in the period ended December 31, 2005, see Note 17 of the Notes to Consolidated Financial Statements in Item 8 herein.

We have followed a policy of seeking patent and trademark protection both inside and outside the United States for products and methods that appear to have commercial significance. We believe our patents and trademarks to be adequate for the conduct of our business, and aggressively pursue protection of our patents against patent infringement worldwide. Although, patent and trademark protection is important to our business and future prospects, we consider the reliability and quality of our products and the technical skills of our personnel to be more important. No single patent or trademark is considered to be critical to our business.

## Raw Materials

We purchase various raw materials and component parts for use in manufacturing our products. The principal materials we purchase are steel alloys (including chromium and nickel), titanium, beryllium, copper, tungsten carbide, synthetic and natural diamonds, printed circuit boards and other electronic components and hydrocarbon-based chemical feed stocks. These materials are generally available from multiple sources and could be subject to rising costs. We have not experienced significant shortages of these materials and normally do not carry inventories of such materials in excess of those reasonably required to meet our production schedules. We do not expect significant interruptions in supply, but there can be no assurance that there will be no price or supply issues over the long term.

## Other Developments

In the fourth quarter of 2005, our management initiated and our Board of Directors approved a plan to sell the Baker Supply Products Division ("SPD"), a product line group within the Baker Oil Tools division of the Completion and Production segment. SPD distributes basic supplies, products and small

tools to the drilling industry. In January 2006, we signed a non-binding letter of intent for the sale of SPD. The sale is expected to close in the first quarter of 2006. We have reflected SPD as a discontinued operation in the consolidated financial statements. SPD had revenues of \$32.5 million for the year ended December 31, 2005. This transaction is subject to the negotiation and execution of a definitive sale agreement, as well as, various conditions, including satisfactory due diligence review of SPD's business. There can be no assurance that the transaction will be consummated.

In December 2005, we purchased Zerotech Technology Limited ("Zerotech"), a developer of an expandable metal sealing element, for \$20.3 million in cash, which is included in the Baker Oil Tools division of the Completion and Production segment. As a result of the acquisition and based on preliminary estimates of fair values, we recorded approximately \$19.5 million of goodwill and intangible assets, which may be revised based on the final purchase price allocations. The purchase price was preliminarily allocated based on the fair values of the assets acquired and liabilities assumed in the acquisition. Under the terms of the Purchase Agreement, the former owners of Zerotech are entitled to additional purchase price consideration of up to approximately \$14.0 million based on the performance of the business during 2006, 2007 and 2008.

In October 2005, we finalized the purchase of the remaining 50% interest in QuantX Wellbore Instrumentation venture ("QuantX"), a venture engaged in permanent in-well monitoring, for \$27.2 million, subject to final purchase price adjustments. QuantX is included in the Production Optimization business unit of the Completion and Production segment. Based on our carrying value of our existing investment in QuantX of \$35.5 million and the additional consideration of \$27.2 million, we recorded approximately \$28.4 million of goodwill and \$19.6 million of intangibles. We also assigned \$5.1 million to in-process research and development that was written off at the date of acquisition. The purchase price was allocated based on the fair value of the assets acquired and liabilities assumed of QuantX. The fair values were determined using a discounted cash flow approach.

In January 2006, we acquired Nova Technology Corporation ("Nova") for approximately \$67.0 million in cash and assumed debt. Nova is a leading supplier of permanent monitoring, chemical injection systems, and multi-line services for deepwater and subsea oil and gas well applications and will be included in the Production Optimization business unit of the Completion and Production segment.

## Employees

On December 31, 2005, we had approximately 29,100 employees, as compared with approximately 26,900 employees on December 31, 2004. Approximately 2,590 of these employees are represented under collective bargaining agreements or similar-type labor arrangements, of which the majority are outside the U.S. Based upon the geographic diversification of these employees, we believe any risk of loss from employee strikes or other collective actions would not be material to the conduct of our operations taken as a whole. We believe that our relations with our employees are good.

## Executive Officers

The following table shows, as of February 28, 2006, the name of each of our executive officers, together with his age and all offices presently held.

Name	Age
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*Chad C. Deaton* 53

Chairman of the Board and Chief Executive Officer of the Company since 2004. President and Chief Executive Officer of Hanover Compressor Company from 2002 to 2004. Senior Advisor to Schlumberger Oilfield Services from 1999 to 2001. Executive Vice President of Schlumberger from 1998 to 1999. Employed by the Company in 2004.

*James R. Clark* 55

President and Chief Operating Officer of the Company since February 2004. Vice President, Marketing and Technology of the Company from 2003 to 2004. Vice President of the Company and President of Baker Petrolite Corporation from 2001 to 2003. President and Chief Executive Officer of Consolidated Equipment Companies, Inc. from 2000 to 2001 and President of Sperry-Sun from 1996 to 1999. Employed by the Company in 2001.

*G. Stephen Finley* 55

Senior Vice President – Finance and Administration and Chief Financial Officer of the Company since 1999. Senior Vice President and Chief Administrative Officer of the Company from 1995 to 1999, Controller from 1987 to 1993 and Vice President from 1990 to 1995. Chief Financial Officer of Baker Hughes Oilfield Operations from 1993 to 1995. Employed by the Company in 1982. Mr. Finley has announced he will retire on March 31, 2006.

*Alan R. Crain, Jr.* 54

Vice President and General Counsel of the Company since October 2000. Executive Vice President, General Counsel and Secretary of Crown, Cork & Seal Company, Inc. from 1999 to 2000. Vice President and General Counsel from 1996 to 1999, and Assistant General Counsel from 1988 to 1996, of Union Texas Petroleum Holdings, Inc. Employed by the Company in 2000.

*Greg Nakanishi* 54

Vice President, Human Resources of the Company since November 2000. President of GN Resources from 1989 to 2000. Employed by the Company in 2000.

*David H. Barr* 56

Group President of Drilling and Evaluation since February 2005 and Vice President of the Company since 2000. President of Baker Atlas from 2000 to 2005. Vice President, Supply Chain Management, of Cooper Cameron from 1999 to 2000. Mr. Barr also held the following positions with the Company: Vice President, Business Process Development, from 1997 to 1998 and the following positions with Hughes Tool Company/Hughes Christensen: Vice President, Production and Technology, from 1994 to 1997; Vice President, Diamond Products, from 1993 to 1994; Vice President, Eastern Hemisphere Operations, from 1990 to 1993 and Vice President, North American Operations, from 1988 to 1990. Employed by the Company in 1972.

*Douglas J. Wall* 53

Group President of Completion and Production since February 2005 and Vice President of the Company since 1997. President of Baker Oil Tools from 2003 to 2005 and President of Hughes Christensen from 1997 to 2003. President and Chief Executive Officer of Western Rock Bit Company Limited, Hughes Christensen's former distributor in Canada, from 1991 to 1997. General Manager of Century Valve Company from 1989 to 1991 and Vice President, Contracts and Marketing, of Adeco Drilling & Engineering from 1980 to 1989. Employed by the Company in 1997.

*Christopher P. Beaver* 48

Vice President of the Company and President of Baker Oil Tools since February 2005. Vice President of Finance for Baker Petrolite from 2002 to 2005; Director of Finance and Controller at INTEQ from 1999 to 2002; Controller at Hughes Christensen from 1994 to 1999. Various accounting and finance positions at Hughes Christensen in the Eastern Hemisphere from 1985 to 1994. Employed by the Company in 1985.

*Paul S. Butero* 49

Vice President of the Company and President of Hughes Christensen since 2005. Vice President, Marketing, of Hughes Christensen from 2001 to 2005 and as Region Manager for various Hughes Christensen areas (both in the United States and the Eastern Hemisphere) from 1989 to 2001. Employed by the Company in 1981.



*Martin S. Craighead* 46

Vice President of the Company since 2005 and President of INTEQ since August 2005. Served as President of Baker Atlas from February 2005 to August 2005. Vice President of Worldwide Operations for Baker Atlas from 2003 to 2005 and Vice President, Marketing and Business Development for Baker Atlas from 2001 to 2003; Region Manager for Baker Atlas in Latin America and Asia and Region Manager for E&P Solutions from 1995 to 2001. Research Engineer for BJ Services Company from 1982 to 1986. Employed by the Company in 1986.

*William P. Faubel* 50

Vice President of the Company since 2001 and President of Baker Atlas since 2006. Served as President of Centri-lift from 2001 to 2006. Vice President, Marketing, of Hughes Christensen from 1994 to 2001 and as Region Manager for various Hughes Christensen areas (both domestic and international) from 1986 to 1994. Employed by the Company in 1977.

*Alan J. Keifer* 51

Vice President and Controller of the Company since July 1999. Western Hemisphere Controller of Baker Oil Tools from 1997 to 1999 and Director of Corporate Audit for the Company from 1990 to 1996. Employed by the Company in 1990.

*Jay G. Martin* 54

Vice President, Chief Compliance Officer and Senior Deputy General Counsel since July 2004. Shareholder at Winstead Sechrest & Minick P.C. from 2001 to July 2004. Partner, Phelps Dunbar from 2000 to 2001 and Partner, Andrews & Kurth from 1996 to 2000. Employed by the Company in 2004.

*John A. O'Donnell* 58

Vice President of the Company since 1998 and President of Baker Petrolite Corporation since May 2005. President of Baker Hughes Drilling Fluids from 2004 to 2005. Vice President, Business Process Development of the Company from 1998 to 2002; Vice President, Manufacturing, of Baker Oil Tools from 1990 to 1998 and Plant Manager of Hughes Tool Company from 1988 to 1990. Employed by the Company in 1975.

*Richard L. Williams* 50

Vice President of the Company and President of Baker Hughes Drilling Fluids since May 2005. Vice President, Eastern Hemisphere Operations, Baker Oil Tools from March 2005 to May 2005. Worldwide Operations Vice President, INTEQ from 2004 to 2005. Vice President Eastern Hemisphere, INTEQ from 2003 to 2004. Vice President Western Hemisphere, INTEQ from 2001 to 2003. Employed by the Company since 1975.

*Charles S. Wolley* 51

Vice President of the Company and President of Centri-lift since January 2006. Vice President of Manufacturing and Technology, Hughes Christensen from 2004 to 2006. Senior Vice President of Supply Chain Operations, Dresser Flow Solutions 2003. President, Dresser Measurement and Control from 2002 to 2003 and Senior Vice President from 2001 to 2002. Chief Executive Officer Van Leeuwen Pipe and Tube Corp. from 1999 to 2001. Employed by the Company since 2004.

There are no family relationships among our executive officers.

### **Environmental Matters**

We are committed to the health and safety of people, protection of the environment and compliance with laws, regulations and our policies. Our past and present operations include activities that are subject to domestic (including U.S. federal, state and local) and international regulations with regard to air and water quality and other environmental matters. We believe we are in substantial compliance with these regulations. Regulation in this area continues to evolve, and changes in standards of enforcement of existing regulations, as well as the enactment and enforcement of new legislation, may require us and our customers to modify, supplement or replace equipment or facilities or to change or discontinue present methods of operation.

We are involved in voluntary remediation projects at some of our present and former manufacturing facilities, the majority of which relate to properties obtained in acquisitions or to sites no longer actively used in operations. On rare occasions, remediation activities are conducted as specified by a government agency-issued consent decree or agreed order. Remediation costs are accrued based on estimates of probable exposure using currently available facts, existing environmental permits, technology and presently enacted laws and regulations. For sites where we are primarily responsible for the remediation, our cost estimates are developed based on internal evaluations and are not discounted. Such accruals are recorded when it is probable that we will be obligated to pay amounts for environmental site evaluation, remediation or related activities, and such amounts can be reasonably estimated. If the obligation can only be estimated within a range, we accrue the minimum amount in the range. Such accruals are recorded even if significant uncertainties exist over the ultimate cost of the remediation. Ongoing environmental compliance costs, such as obtaining environmental permits, installation of pollution control equipment and waste disposal, are expensed as incurred.

During the year ended December 31, 2005, we spent approximately \$32.1 million to comply with domestic and international standards regulating the discharge of materials into the environment or otherwise relating to the protection of the environment (collectively, "Environmental Regulations"). This cost includes the total spent on remediation projects at current or former sites, Superfund projects and environmental compliance activities, exclusive of capital. In 2006, we expect

to spend approximately \$34.2 million to comply with Environmental Regulations. Based upon current information, we believe that our compliance with Environmental Regulations will not have a material adverse effect upon our capital expenditures, earnings or competitive position because we have either established adequate reserves or our cost for that compliance is not expected to be material to our consolidated financial statements.

During the year ended December 31, 2005, we incurred approximately \$3.8 million in capital expenditures for environmental control equipment, and we estimate we will incur approximately \$6.3 million during 2006. We believe these capital expenditures for environmental control equipment will not have a material adverse effect upon our consolidated financial statements.

The Comprehensive Environmental Response, Compensation and Liability Act (known as "Superfund" or "CERCLA") imposes liability for the release of a "hazardous substance" into the environment. Superfund liability is imposed without regard to fault and even if the waste disposal was in compliance with laws and regulations. We have been identified as a potentially responsible party ("PRP") in remedial activities related to various Superfund sites, and we accrue our share of the estimated remediation costs of the site based on the ratio of the estimated volume of waste we contributed to the site to the total volume of waste disposed at the site. With the joint and several liability imposed under Superfund, a PRP may be required to pay more than its proportional share of such costs.

We have been identified as a PRP at various Superfund sites discussed below. The United States Environmental Protection Agency (the "EPA") and appropriate state agencies supervise investigative and cleanup activities at these sites. For the year ended December 31, 2005, we paid \$0.5 million in superfund costs and have accrued an additional \$4.9 million related to these sites. Payments made in 2005 are in addition to amounts previously paid in settlements, cash calls or other superfund costs, and these ongoing contributions reduce our financial liability for the total site cleanup costs shown below. When used in the descriptions of the sites that follow, the word *de minimis* refers to the smallest PRPs, whose contribution rate is usually less than 1%.

(a) Baker Petrolite, Hughes Christensen, an INTEQ predecessor entity, Baker Oil Tools and a former subsidiary were named in April 1984 as PRPs at the Sheridan Superfund Site located in Hempstead, Texas. The Texas Commission on Environmental Quality ("TCEQ") is overseeing the remedial work at this site. The Sheridan Site Trust was formed to manage the site remediation and we participate as a member. Based on the use of new remedial technologies, the cost projections remain at \$6.0 million for full remediation, of which \$5.5 million has been collected. Our additional contribution is approximately 1.8% of the remaining costs.

- (b) In 1997, we entered into a settlement agreement with Prudential Insurance Company ("Prudential") regarding cost recovery for the San Fernando Valley – Glendale Superfund. One of our predecessors operated on the Prudential property in Glendale. After Prudential was identified as a PRP for the Glendale Superfund, they instituted legal proceedings against us for cost recovery under CERCLA. Without any admission of liability, we agreed to pay 40% of Prudential's costs attributed to cleanup at the site, limited to a cap of \$0.3 million. A pump and treat system was selected as the cleanup remedy at Glendale, and it is expected to operate until 2012. We continue to contribute our portion of ongoing assessments to fund this remediation strategy.
- (c) In 1999, the EPA named a Hughes Christensen predecessor as a PRP at the Li Tungsten Site in Glen Cove, New York. We contributed a *de minimis* amount of hazardous substances to the site. In December 2004, the EPA issued us a special *de minimis* settlement offer based on the fact that our contribution was limited to metals contamination, not radiological contamination, at the site. We expect to settle this matter with the EPA for less than \$0.1 million.
- (d) In 1999, Baker Oil Tools, Baker Petrolite and predecessor entities of Baker Petrolite were named as PRPs by the State of California's Department of Toxic Substances Control for the Gibson site in Bakersfield, California. The most recent cost estimate for remediation of the site is \$17.9 million. The combined volume that we contributed to the site is estimated to be less than 0.5% for liquids and 0.25% for solids.
- (e) In 2001, a Hughes Christensen predecessor, Baker Oil Tools, INTEQ and one of our former subsidiaries were named as PRPs in the Force Road State Superfund Site located in Brazoria County, Texas. The TCEQ is overseeing the investigation and remediation at the Force Road State Site. We participate as a member of the steering and technical committees to effectively manage the project because our volumetric contribution is currently estimated at approximately 76%. The onsite investigation was completed in late 2005, while the offsite investigation is pending access to the adjacent property. The estimate of site remediation costs used for initial settlement purposes was \$17.7 million; however, we anticipate that a more accurate calculation of site remediation costs will be possible once the offsite investigation is complete. We believe that after further investigation at the site, negotiation of additional early settlements with other PRPs, future cost recovery actions against recalcitrant parties and other factors, our ultimate share of responsibility for cleanup costs at the site will be less than initial estimates.
- (f) In 2002, Baker Petrolite predecessors, Hughes Christensen predecessors and two of our former subsidiaries were identified as PRPs for the Malone site located on Campbell Bayou Road in Texas City, Texas. The EPA oversees the investigation and remediation of the Malone site and

has engaged in emergency removal actions. The investigation is nearly complete and in 2006, remedial options are expected to be developed and submitted to the EPA for evaluation. The estimate for cleanup at the Malone site is \$82 million with our contribution estimated at approximately 1.7%. The current owners of the site have filed a lawsuit against the PRPs seeking recovery of certain alleged damages, which may affect the ultimate resolution of this superfund.

- (g) In 2003, Western Atlas International, Inc., its predecessor companies and Baker Hughes Oilfield Operations, Inc. were identified as *de minimis* PRPs in the Gulf Nuclear Superfund site in Odessa, Texas. The EPA conducted an emergency removal at the site in 2000. Total investigation and cleanup costs were estimated by the EPA to be approximately \$24 million. The *de minimis* settlement proposal has been negotiated and should be finalized in 2006. Our settlement cost is expected to be less than \$0.1 million.
- (h) In 2003, we were identified as a *de minimis* PRP by the EPA for the Operating Industries, Inc. Superfund site in Monterrey Park, California. A settlement offer to all remaining *de minimis* parties has been repeatedly delayed, but is expected in mid 2006. The EPA and Steering Committee estimate cleanup costs in excess of \$650 million. As of January 2006, there was insufficient information to estimate our allocation or potential contribution to these cleanup costs.
- (i) In 2003, Baker Petrolite was notified by the EPA of their potential involvement at the Cooper Drum Superfund site located in South Gate, California. The company responded to an additional inquiry from the EPA in 2005. At this time there is no estimate available for comprehensive cleanup costs or our allocation and, accordingly, the extent of our financial liability at the site is unknown.
- (j) In 2004, we were notified that Baker Petrolite was included in the Container Recycling Superfund site in Kansas City, Kansas. We are a PRP at the site, which was a former drum recycler used by a predecessor company to Baker Petrolite. Site remediation has been completed and the EPA has extended a settlement offer of \$1.3 million to the PRP group with our allocation calculated at 4% of these costs. Baker Petrolite has signed the settlement offer.
- (k) In 2005, Centrilift was notified by the TCEQ of their potential involvement in the San Angelo Superfund site in Tom Green County, Texas. Polychlorinated biphenyls (PCBs) are present at the site as a result of the operations of the former San Angelo Electric Services Company (SESCO), which manufactured, repaired and serviced transformers. SESCO declared bankruptcy in mid 2003, after which the TCEQ conducted emergency removal actions in response to reports of contamination onsite and in the adjacent residential area. A *de minimis* settlement offer has been received, and our cost contribution for the remediation of soil and groundwater is less than \$0.1 million.

In addition to the sites mentioned above, there are four Superfund sites where we have ongoing obligations. The remedial work at most of these sites has been completed and remaining operations are limited to groundwater recovery and/or monitoring. The monitoring phase can continue for up to 30 years. Our aggregate cost for these sites is estimated to be approximately \$0.1 million over this period of time.

While PRPs in Superfund actions have joint and several liability for all costs of remediation, it is not possible at this time to quantify our ultimate exposure because some of the projects are either in the investigative or early remediation stage. Based upon current information, we do not believe that probable or reasonably possible expenditures in connection with the sites described above are likely to have a material adverse effect on our consolidated financial statements because we have established adequate reserves to cover the estimate we presently believe will be our ultimate liability in the matter. Further, other PRPs involved in the sites have substantial assets and may reasonably be expected to pay their share of the cost of remediation, and, in some circumstances, we have insurance coverage or contractual indemnities from third parties to cover a portion of or the ultimate liability.

We are subject to various other governmental proceedings and regulations, including foreign regulations, relating to environmental matters, but we do not believe that any of these matters is likely to have a material adverse effect on our consolidated financial statements. We continue to focus on reducing future environmental liabilities by maintaining appropriate company standards and improving our assurance programs. See Note 16 of the Notes to Consolidated Financial Statements in Item 8 herein for further discussion of environmental matters.

"Environmental Matters" contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act (each a "Forward-Looking Statement"). The words "will," "believe," "to be," "expect," "estimate" and similar expressions are intended to identify forward-looking statements. Our expectations regarding our compliance with Environmental Regulations and our expenditures to comply with Environmental Regulations, including (without limitation) our capital expenditures for environmental control equipment, are only our forecasts regarding these matters. These forecasts may be substantially different from actual results, which may be affected by the following factors: changes in Environmental Regulations; a material change in our allocation or other unexpected, adverse outcomes with respect to sites where we have been named as a PRP, including (without limitation) the Superfund sites described above; the discovery of new sites of which we are not aware and where additional expenditures may be required to comply with Environmental Regulations; an unexpected discharge of hazardous materials in the course of our business or operations; a catastrophic event causing discharges into the environment; or an acquisition of one or more new businesses.

## ITEM 1A. RISK FACTORS

An investment in our common stock involves various risks. When considering an investment in our company, you should consider carefully all of the risk factors described below, as well as other information included and incorporated by reference in this report. These risks and uncertainties are not the only ones facing us and there may be additional matters that we are unaware of or that we currently consider immaterial. All of these could adversely affect our business, financial condition, results of operations and cash flows and, thus, the value of an investment in our company.

### Risk Factors Related to the Worldwide Oil and Natural Gas Industry

Our business is focused on providing products and services to the worldwide oil and natural gas industry; therefore, our risk factors include those factors that impact, either positively or negatively, the markets for oil and natural gas. Expenditures by our customers for exploration, development and production of oil and natural gas are based on their expectations of future hydrocarbon demand, the risks associated with developing the reserves and the future value of the hydrocarbon reserves. Their evaluation of the future value is based, in part, on their expectations for global demand, global supply and other factors that influence oil and natural gas prices. The key risk factors currently influencing the worldwide oil and natural gas markets are discussed below.

#### **Demand for oil and natural gas is subject to factors beyond our control, which may adversely affect our operating results.**

Growth in worldwide demand for oil and natural gas, as well as the demand for our services, is highly correlated with global economic growth – and in particular by the economic growth of countries such as the U.S. and China, who are significant users of oil and natural gas. Increases in global economic activity, particularly in China and developing Asia, create more demand for oil and natural gas and higher oil and natural gas prices. A slowing of global economic growth, and in particular in the U.S. or China, will likely reduce demand for oil and natural gas, increase excess productive capacity and result in lower prices and adversely impact the demand for our services.

#### **Volatility of oil and natural gas prices can adversely affect demand for our products and services.**

Volatility in oil and natural gas prices can also impact our customers' activity levels and spending for our products and services. While current energy prices are important contributors to positive cash flow for our customers, expectations about future prices and price volatility are generally more important for determining future spending levels. While higher oil and natural gas prices generally lead to increased spending by our customers, sustained high energy prices can be an impediment to economic growth, and can therefore negatively impact spending by our customers. Our customers also take into account the volatility of energy prices and other risk

factors by requiring higher returns for individual projects if there is higher perceived risk. Any of these factors could affect the demand for oil and natural gas and could have a material adverse effect on our results of operations.

#### **Supply of oil and natural gas is subject to factors beyond our control, which may adversely affect our operating results.**

Productive capacity for oil and natural gas is dependent on our customers' decisions to develop and produce oil and natural gas reserves. The ability to produce oil and natural gas can be affected by the number and productivity of new wells drilled and completed, as well as the rate of production and resulting depletion of existing wells. Advanced technologies, such as horizontal drilling, improve total recovery but also result in a more rapid production decline.

Access to prospects and capital are also important to our customers. Access to prospects may be limited because host governments do not allow access to the reserves or because another oil and natural gas exploration company owns the rights to develop the prospect. Access to capital is dependent on our customers' ability to access the funds necessary to develop economically attractive projects based on their expectations of future energy prices, required investments and resulting returns. Government regulations and the costs incurred by oil and natural gas exploration companies to conform to and comply with government regulations, may also limit the quantity of oil and natural gas that may be economically produced.

Supply can be interrupted by a number of factors including political instability, civil unrest, labor issues, terrorist attacks, war or military activity. Key oil producing countries which could be subject to supply interruptions include, but are not limited to, Saudi Arabia, Iran, Iraq and other Middle Eastern countries, Nigeria, Norway, Russia and Venezuela. The impact of supply and demand disruptions on oil and natural gas prices and oil and natural gas price volatility is tempered by the size and expected duration of the disruption relative to the excess productive capacity at the time of the disruption.

Supply can also be impacted by the degree to which individual Organization of Petroleum Exporting Countries ("OPEC") nations and other large oil and natural gas producing countries, including, but not limited to, Mexico, Norway and Russia, are willing and able to control production and exports of oil, to decrease or increase supply and to support their targeted oil price while meeting their market share objectives. Any of these factors could affect the supply of oil and natural gas and could have a material adverse effect on our results of operations.

#### **Excess productive capacity and future demand impact our operations.**

Oil and natural gas storage inventory levels are an indicator of the relative balance between supply and demand. High or increasing storage or inventories generally indicate that supply is exceeding demand and that energy prices are likely to soften. Low or decreasing storage or inventories are an indicator

that demand is growing faster than supply and that energy prices are likely to rise. Measures of maximum productive capacity compared to demand (“excess productive capacity”) are also an important factor influencing energy prices and spending by oil and natural gas exploration companies. When excess productive capacity is low compared to demand, energy prices tend to be higher and more volatile reflecting the increased vulnerability of the entire system to disruption.

**Seasonal and adverse weather conditions adversely affect demand for our services and operations.**

Weather can also have a significant impact on demand as consumption of energy is seasonal and any variation from normal weather patterns, cooler or warmer summers and winters, can have a significant impact on demand. Adverse weather conditions, such as hurricanes in the Gulf of Mexico, may interrupt or curtail our operations, or our customers’ operations, cause supply disruptions and result in a loss of revenue and damage to our equipment and facilities, which may or may not be insured.

**Risk Factors Related to Our Business**

Our expectations regarding our business are affected by the following risk factors and the timing of any of these risk factors:

**We operate in a highly competitive environment, which may adversely affect our ability to succeed.**

We operate in a highly competitive environment for marketing oil and natural gas and securing equipment and trained personnel. Our ability to continually provide competitive products and services can impact our ability to maintain or increase prices for our products and services, maintain market share and negotiate acceptable contract terms with our customers. In order to be competitive, we must provide new technologies, and reliable products and services that perform as expected and that create value for our customers. Our ability to maintain or increase prices for our products and services is in part dependent on the industry’s capacity relative to customer demand, and on our ability to differentiate the value delivered by our products and services from our competitor’s products and services. In addition, our ability to negotiate acceptable contract terms and conditions with our customers, especially state-owned national oil companies, our ability to manage warranty claims and our ability to effectively manage our commercial agents can also impact our results of operations.

Managing development of competitive technology and new product introductions on a forecasted schedule and at forecasted costs can impact our financial results. Development of competing technology that accelerates the obsolescence of any of our products or services can have a detrimental impact on our financial results and can result in the potential impairment of long-lived assets.

We may be disadvantaged competitively and financially by a significant movement of exploration and production operations to areas of the world in which we are not currently active.

**The high cost or unavailability of materials, equipment, supplies and personnel could adversely affect our ability to execute our operations on a timely basis.**

Our manufacturing operations are dependent on having sufficient raw materials, component parts and manufacturing capacity available to meet our manufacturing plans at a reasonable cost while minimizing inventories. Our ability to effectively manage our manufacturing operations and meet these goals can have an impact on our business, including our ability to meet our manufacturing plans and revenue goals, control costs and avoid shortages of raw materials and component parts. Raw materials and components of particular concern include steel alloys, copper, carbide, chemicals and electronic components. Our ability to repair or replace equipment damaged or lost in the well can also impact our ability to service our customers.

People are a key resource to developing, manufacturing and delivering our products and services to our customers around the world. Our ability to recruit, train and retain the highly skilled workforce required by our plans will impact our business. A well-trained, motivated work force has a positive impact on our ability to attract and retain business. Rapid growth presents a challenge to us and our industry to recruit, train and retain our employees while managing the impact of wage inflation and potential lack of available qualified labor in the markets where we operate. Labor-related actions, including strikes, slowdowns and facility occupations can also have a negative impact on our business.

**Compliance with and changes in laws and regulations and risks from investigations and legal proceedings could be costly and could adversely affect operating results.**

Our operations in the U.S. and over 90 countries can be impacted by expected and unexpected changes in the legal and business environments in which we operate, as well as the outcome of ongoing government and internal investigations and legal proceedings.

Changes that could impact the legal environment include new legislation, new regulation, new policies, investigations and legal proceedings and new interpretations of the existing legal rules and regulations. In particular, changes in export control laws or exchange control laws, additional restrictions on doing business in countries subject to sanctions, and changes in laws in Russia or other countries identified by management for immediate focus. Changes that impact the business environment include changes in accounting standards, changes in environmental laws, changes in tax laws or tax rates, the resolution of audits by various tax authorities, and the ability to fully utilize our tax loss carryforwards and tax credits. Compliance related issues could limit our ability to do business in certain countries.

These changes could have a significant financial impact on our future operations and the way we conduct, or if we conduct, business in the affected countries.

**Uninsured claims and litigation could adversely impact our operating results.**

We have insurance coverage against operating hazards, including product liability claims and personal injury claims related to our products, to the extent deemed prudent by our management and to the extent insurance is available, but no assurance can be given that the nature and amount of that insurance will be sufficient to fully indemnify us against liabilities arising out of pending and future claims and litigation. This insurance has deductibles or self-insured retentions and contains certain coverage exclusions. The insurance does not cover damages from breach of contract by us or based on alleged fraud or deceptive trade practices. Whenever possible, we obtain agreements from customers that limit our liability. Insurance and customer agreements do not provide complete protection against losses and risks, and our results of operations could be adversely affected by unexpected claims not covered by insurance.

**Compliance with and rulings and litigation in connection with environmental regulations may adversely affect our business and operating results.**

Our business is impacted by unexpected outcomes or material changes in environmental liability. Changes in our environmental liability could originate with the discovery of new environmental remediation sites, changes in environmental regulations, or the discharge of hazardous materials or oil and natural gas into the environment.

**Changes in economic conditions and currency fluctuations may adversely affect our operating results.**

Fluctuation in foreign currencies relative to the U.S. Dollar can impact our costs of doing business. Most of our products and services are sold through contracts denominated in U.S. Dollars or local currency indexed to U.S. Dollars. Local expenses and some of our manufacturing costs are incurred in local currencies and therefore changes in the exchange rates between the U.S. Dollar and foreign currencies, particularly the British Pound Sterling, Euro, Canadian Dollar, Norwegian Krone, Venezuelan Bolivar, Australian Dollar and Brazilian Real, can increase or decrease our U.S. Dollar expenses and impact our operating margins. The majority of our significant foreign subsidiaries have designated the local currency as their functional currency and, as such, gains and losses resulting from balance sheet translation of foreign operations are included as a separate component of accumulated other comprehensive loss within stockholders' equity. Gains and losses from foreign currency transactions, such as those resulting from the settlement of receivables or payables in the non-functional currency, are included in the consolidated statements of operations as incurred. For those foreign subsidiaries that have designated the U.S. Dollar as the functional currency, gains and losses resulting from balance sheet translation of foreign operations are also included in the consolidated statements of operations as incurred. Such transaction and translation losses may adversely impact our results of operations.

The condition of the capital markets and equity markets in general can affect the price of our common stock and our ability to obtain financing, if necessary. If the Company's credit rating is downgraded, this would increase our costs under our credit agreement, as well as the cost of obtaining, or make it more difficult to obtain or issue, new debt financing.

Our ability to forecast the size of and changes in the worldwide oil and natural gas industry and our ability to forecast our customers' activity levels and demand for our products and services impacts our management of our manufacturing and distribution activities, our staffing levels and our cash and financing requirements. Unanticipated changes in our customers' requirements can impact our costs, creating temporary shortages or surpluses of equipment and people and demands for cash or financing.

**The market price of our common stock may fluctuate.**

Historically, the market price of common stock of companies engaged in the oil and natural gas industry has been highly volatile. Likewise, the market price of our common stock has varied significantly in the past. News announcements and changes in oil and natural gas prices, changes in the demand for oil and natural gas exploration and changes in the supply and demand for oil and natural gas have all been factors that have affected the price of our common stock.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

We are headquartered in Houston, Texas and operate 42 principal manufacturing plants, ranging in size from approximately 5,000 to 333,000 square feet of manufacturing space. The total area of the plants is approximately 3.2 million square feet, of which approximately 2.1 million square feet (65%) are located in the United States, 0.3 million square feet (11%) are located in Canada and South America, 0.7 million square feet (22%) are located in Europe, and a minimal amount of space is located in the Far East. Our principal manufacturing plants are located as follows: United States – Houston, Texas; Broken Arrow and Claremore, Oklahoma; Lafayette, Louisiana; South America – various cities in Venezuela; and Europe – Aberdeen and East Kilbride, Scotland; Liverpool, England; Celle, Germany; Belfast, Northern Ireland.

We own or lease numerous service centers, shops and sales and administrative offices throughout the geographic areas in which we operate. We also have a significant investment in service vehicles, rental tools and manufacturing and other equipment. We believe that our manufacturing facilities are well maintained and suitable for their intended purposes.

The table below shows our principal manufacturing plants by segment and geographic area:

Segment	United States	Canada and South America	Europe	Far East	Total
Completion and Production	16	4	5	1	26
Drilling and Evaluation	12	1	3	–	16

## ITEM 3. LEGAL PROCEEDINGS

We are involved in litigation or proceedings that have arisen in our ordinary business activities. We insure against these risks to the extent deemed prudent by our management and to the extent insurance is available, but no assurance can be given that the nature and amount of that insurance will be sufficient to fully indemnify us against liabilities arising out of pending and future legal proceedings. Many of these insurance policies contain deductibles or self-insured retentions in amounts we deem prudent and for which we are responsible for payment. In determining the amount of self-insurance, it is our policy to self-insure those losses that are predictable, measurable and recurring in nature, such as claims for automobile liability, general liability and workers compensation. We record accruals for the uninsured portion of losses related to these types of claims. The accruals for losses are calculated by estimating losses for claims using historical claim data, specific loss development factors and other information as necessary.

On September 12, 2001, we, without admitting or denying the factual allegations contained in the Order, consented with the Securities and Exchange Commission (“SEC”) to the entry of an Order making Findings and Imposing a Cease-and-Desist Order (the “Order”) for violations of Section 13(b)(2)(A) and Section 13(b)(2)(B) of the Exchange Act. Among the findings included in the Order were the following: In 1999, we discovered that certain of our officers had authorized an improper \$75,000 payment to an Indonesian tax official, after which we embarked on a corrective course of conduct, including voluntarily and promptly disclosing the misconduct to the SEC and the Department of Justice (the “DOJ”). In the course of our investigation of the Indonesia matter, we learned that we had made payments in the amount of \$15,000 and \$10,000 in India and Brazil, respectively, to our agents, without taking adequate steps to ensure that none of the payments would be passed on to foreign government officials. The Order found that the foregoing payments violated Section 13(b)(2)(A). The Order also found us in violation of Section 13(b)(2)(B) because we did not have a system of internal controls to determine if payments violated the Foreign Corrupt Practices Act (“FCPA”). The FCPA makes it unlawful for U.S. issuers, including us, or anyone acting on their behalf, to make improper payments to any foreign official in order to obtain or retain business. In addition, as discussed below, the FCPA establishes accounting and internal control requirements for U.S. issuers. We cooperated with the SEC’s investigation.

By the Order, dated September 12, 2001 (previously disclosed by us and incorporated by reference in this annual report as Exhibit 99.1), we agreed to cease and desist from committing or causing any violation and any future violation of Section 13(b)(2)(A) and Section 13(b)(2)(B) of the Exchange Act. Such Sections of the Exchange Act require issuers to: (x) make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer and (y) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management’s general or specific authorization; and (ii) transactions are recorded as necessary: (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets.

On March 29, 2002, we announced that we had been advised that the SEC and the DOJ are conducting investigations into allegations of violations of law relating to Nigeria and other related matters. The SEC has issued a formal order of investigation into possible violations of provisions under the Foreign Corrupt Practices Act (“FCPA”) regarding anti-bribery, books and records and internal controls. The SEC has issued subpoenas seeking information about our operations in Angola (subpoena dated August 6, 2003) and Kazakhstan (subpoenas dated August 6, 2003 and April 22, 2005) as part of its ongoing investigation. We are providing documents to

and cooperating fully with the SEC and DOJ. The DOJ and the SEC have issued subpoenas to, or otherwise asked for interviews with, current and former employees in connection with the investigations regarding Nigeria, Angola and Kazakhstan. In addition, we have conducted internal investigations into these matters.

Our internal investigations have identified issues regarding the propriety of certain payments and apparent deficiencies in our books and records and internal controls with respect to certain operations in Nigeria, Angola and Kazakhstan, as well as potential liabilities to governmental authorities in Nigeria. The internal investigation in Nigeria was substantially completed during the first quarter of 2003, and, based upon current information, we do not expect that any such potential liabilities will have a material adverse effect on our consolidated financial statements. The internal investigations in Angola and Kazakhstan were substantially completed in the third quarter of 2004. Evidence obtained during the course of the internal investigations has been provided to the SEC and DOJ.

The Department of Commerce, Department of the Navy and DOJ (the "U.S. agencies") have investigated compliance with certain export licenses issued to Western Geophysical from 1994 through 2000 for export of seismic equipment leased by the People's Republic of China. We acquired Western Geophysical in August 1998 and subsequently transferred related assets to WesternGeco in December 2000. WesternGeco continued to use the licenses until 2001. Under the WesternGeco Formation Agreement, we owe indemnity to WesternGeco for certain matters and, accordingly, we have agreed to indemnify WesternGeco with certain limitations in connection with this matter. We are cooperating fully with the U.S. agencies.

We have received a subpoena from a grand jury in the Southern District of New York regarding goods and services we delivered to Iraq from 1995 through 2003 during the United Nations Oil-for-Food Program. We have also received a request from the SEC to provide a written statement and certain information regarding our participation in that program. We have responded to both the subpoena and the request and may provide additional information and documents in the future. Other companies in the energy industry are believed to have received similar subpoenas and requests.

The U.S. agencies, the SEC and other authorities have a broad range of civil and criminal sanctions they may seek to impose against corporations and individuals in appropriate circumstances including, but not limited to, injunctive relief, disgorgement, fines, penalties and modifications to business practices and compliance programs. Such agencies and authorities have entered into agreements with, and obtained a range of sanctions against, several public corporations and individuals arising from allegations of improper payments and deficiencies in books and records and internal controls, whereby civil and criminal penalties were imposed, including in some cases multi-million dollar fines and other sanctions. We are in discussions with the U.S. agencies and the SEC regarding the resolution, including sanctions, associated with certain of the matters described above. It is not possible to accurately predict at this time when any of these matters will be resolved. Based on current information, we cannot predict the outcome of such investigations, whether we will reach resolution through such discussions or what, if any, actions may be taken by the U.S. agencies, the SEC or other authorities or the effect the actions may have on our consolidated financial statements.

On May 10, 2004, the District Court of Andrews County, Texas entered a judgment in favor of LOTUS, LLC and against INTEQ in the amount of \$14.8 million for lost profits resulting from a breach of contract in drilling a well to create a salt cavern for disposing of naturally occurring radioactive waste. We have filed an appeal and taken other actions. We believe that any liability that we may incur as a result of this litigation would not have a material adverse financial effect on our consolidated financial statements.

Further information is contained in the "Environmental Matters" section of Item 1 herein.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.



## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock, \$1.00 par value per share, is principally traded on the New York Stock Exchange. Our common stock is also traded on the SWX Swiss Exchange. As of February 24, 2006, there were approximately 88,700 stockholders and approximately 16,200 stockholders of record.

For information regarding quarterly high and low sales prices on the New York Stock Exchange for our common stock during the two years ended December 31, 2005, and information regarding dividends declared on our common stock during the two years ended December 31, 2005, see Note 18 of the Notes to Consolidated Financial Statements in Item 8 herein.

The following table contains information about our purchases of equity securities during the fourth quarter of 2005.

#### Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Total Number of Shares Purchased as Part of a Publicly Announced Program <sup>(1)</sup>	Average Price Paid per Share <sup>(2)</sup>	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Program <sup>(1)</sup>
October 1–31, 2005	–	–	\$ –	–
November 1–30, 2005	–	888,200	55.66	–
December 1–31, 2005	–	805,900	60.93	–
Total	–	1,694,100	\$ 58.17	–

<sup>(1)</sup> On September 10, 2002, we announced a program to repurchase from time to time up to \$275.0 million of our outstanding common stock. On October 27, 2005, we had authorization remaining to repurchase up to \$44.5 million in common stock and we announced that the Board of Directors authorized us to repurchase up to an additional \$455.5 million of our common stock from time to time. As of December 31, 2005, we now have authorization remaining to repurchase up to a total of \$401.5 million of our common stock. The program has no expiration date, but may be terminated by the Board of Directors at any time.

On November 3, 2005, we entered into a Stock Purchase Plan with an agent for the purchase of shares of our common stock that complies with the requirements of Rule 10b5-1 promulgated by the Securities Exchange Act of 1934. The term of the November Plan will run from November 7, 2005 until April 30, 2006, unless earlier terminated. On February 22, 2006, we entered into another Plan for a term that will run from February 23, 2006 until April 30, 2006, unless earlier terminated. During that term, the agent will use its best efforts to repurchase a fixed dollar value of our common stock each trading day, subject to applicable trading rules, until the cumulative amount purchased under the November Plan equals \$250.0 million and under the February Plan equals \$150.0 million, inclusive of all commissions and fees paid by us to the agent related to such repurchases. Shares will be repurchased by the agent at the prevailing market prices, subject to limitations provided by us, in open market transactions intended to comply with Rule 10b-18 of the Exchange Act. We or the agent may terminate the Plans. However, no shares will be repurchased at any time that the cost of the shares exceeds an amount that has been specified by us to the agent.

<sup>(2)</sup> Average price paid includes commissions.

## ITEM 6. SELECTED FINANCIAL DATA

The Selected Financial Data should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data," both contained herein.

<i>(In millions, except per share amounts)</i>	Year Ended December 31,				
	2005	2004	2003	2002	2001
Revenues	\$ 7,185.5	\$ 6,079.6	\$ 5,233.3	\$ 4,843.5	\$ 4,980.5
Costs and expenses:					
Cost of revenues	4,942.5	4,351.0	3,807.5	3,478.5	3,519.1
Selling, general and administrative	1,009.6	912.2	824.6	805.5	748.3
Impairment of investment in affiliate	–	–	45.3	–	–
Restructuring charge reversals	–	–	(1.1)	–	(4.2)
Gain on disposal of assets	–	–	–	–	(2.4)
Total costs and expenses	5,952.1	5,263.2	4,676.3	4,284.0	4,260.8
Operating income	1,233.4	816.4	557.0	559.5	719.7
Equity in income (loss) of affiliates	100.1	36.3	(137.8)	(69.7)	45.8
Interest expense	(72.3)	(83.6)	(103.1)	(111.1)	(126.3)
Interest income	18.0	6.8	5.3	5.2	11.7
Income from continuing operations before income taxes	1,279.2	775.9	321.4	383.9	650.9
Income taxes	(404.8)	(250.6)	(145.6)	(157.9)	(221.7)
Income from continuing operations	874.4	525.3	175.8	226.0	429.2
Income (loss) from discontinued operations, net of tax	4.9	3.3	(41.3)	(14.6)	9.5
Income before extraordinary loss and cumulative effect of accounting change	879.3	528.6	134.5	211.4	438.7
Extraordinary loss, net of tax	–	–	–	–	(1.5)
Cumulative effect of accounting change, net of tax	(0.9)	–	(5.6)	(42.5)	0.8
Net income	\$ 878.4	\$ 528.6	\$ 128.9	\$ 168.9	\$ 438.0
Per share of common stock:					
Income from continuing operations:					
Basic	\$ 2.58	\$ 1.57	\$ 0.52	\$ 0.67	\$ 1.28
Diluted	2.56	1.57	0.52	0.67	1.27
Dividends	0.475	0.46	0.46	0.46	0.46
Financial Position:					
Working capital	\$ 2,479.4	\$ 1,738.3	\$ 1,210.5	\$ 1,498.6	\$ 1,661.6
Total assets	7,807.4	6,821.3	6,416.5	6,499.7	6,676.2
Long-term debt	1,078.0	1,086.3	1,133.0	1,424.3	1,682.4
Stockholders' equity	4,697.8	3,895.4	3,350.4	3,397.2	3,327.8

## Notes to Selected Financial Data

- (1) *Discontinued operations.* The selected financial data includes reclassifications to reflect Baker Supply Products Division, Baker Hughes Mining Tools, BIRD Machine, EIMCO Process Equipment and our oil producing operations in West Africa as discontinued operations. See Note 2 of the Notes to Consolidated Financial Statements in Item 8 herein for additional information regarding discontinued operations.
- (2) *Impairment of investment in affiliate.* See Note 8 of the Notes to Consolidated Financial Statements in Item 8 herein for a description of the \$45.3 million impairment of our investment in WesternGeco in 2003 and for a description of the impairment and restructuring charges of \$135.7 million recorded in equity in income (loss) of affiliates in 2003, also related to WesternGeco. Included in equity in income (loss) of affiliates for 2002 is \$90.2 million for our share of a \$300.7 million restructuring charge related to WesternGeco's impairment of assets, reductions in workforce, closing certain operations and reducing its marine seismic fleet.
- (3) *Restructuring charge reversals.* See Note 4 of the Notes to Consolidated Financial Statements in Item 8 herein for a description of the restructuring charge reversal in 2003. During 2000, we recorded a restructuring charge of \$29.5 million related to our plan to substantially exit the oil and natural gas exploration business. Included in the restructuring charge were costs to settle contractual obligations of \$4.5 million for the minimum amount of our share of project costs relating to our interest in an oil and natural gas property in Colombia. After unsuccessful attempts to negotiate a settlement with our joint venture partner, we decided to abandon further involvement in the project. Subsequently, in 2001, a third party agreed to assume the remaining obligation in exchange for our interest in the project. Accordingly, we reversed \$4.2 million related to this obligation.
- (4) *Cumulative effect of accounting change.* In 2005, we adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47 ("FIN 47"), *Accounting for Conditional Asset Retirement Obligations*. In 2003, we adopted Statement of Financial Accounting Standards ("SFAS") No. 143, *Accounting for Asset Retirement Obligations*. In 2002, we adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. In 2001, we adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 137 and 138.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the consolidated financial statements of "Item 8. Financial Statements and Supplementary Data" contained herein.

### Executive Summary

We are a leading provider of drilling, formation evaluation, completion and production products and services to the worldwide oil and natural gas industry. We compete as one of the three largest diversified oilfield services companies. In early 2005, we organized our product-line focused divisions into two separate segments: the Drilling and Evaluation segment and the Completion and Production segment. The segments are aligned by product line based on the types of products and services provided to our customers and on the business characteristics of the divisions during business cycles. Activity of the businesses under the Drilling and Evaluation segment is closely correlated to rig counts and, therefore, is prone to cyclicality as drilling activity increases or decreases. Activity of businesses in the Completion and Production segment is more dependent on production volumes and, therefore, is less cyclical than the Drilling and Evaluation segment. We also own a 30% equity interest in WesternGeco, a seismic venture with Schlumberger Limited ("Schlumberger"). Accordingly, we report our results under three segments – Drilling and Evaluation, Completion and Production and WesternGeco:

- The Drilling and Evaluation segment consists of Baker Hughes Drilling Fluids (drilling fluids), Hughes Christensen (oilfield drill bits), INTEQ (conventional and rotary directional drilling, measurement-while-drilling and logging-while-drilling) and Baker Atlas (wireline formation evaluation and wireline completion services). The Drilling and Evaluation segment provides products and services used to drill oil and natural gas wells.
- The Completion and Production segment consists of Baker Oil Tools (workover, fishing and completion equipment), Baker Petrolite (oilfield specialty chemicals) and Centrilift (electric submersible pumps and progressing cavity pumps). The Completion and Production segment also includes our Production Optimization business unit (permanent downhole monitoring). The Completion and Production segment provides equipment and services used from the completion phase through the productive life of oil and natural gas wells.
- The WesternGeco segment consists of our equity interest in WesternGeco.

Also in 2005, we organized the business operations of our divisions around four primary geographic regions: North America, Latin America, Middle East/Asia Pacific, and Europe, Africa, Russia and the Caspian. Each region has a council comprised of regional vice presidents from each division as well as representatives from various functions such as human resources, legal, marketing and health, safety and environmental. The regional vice presidents report directly to each division president. Through this structure, we have placed our management

closer to the customer, improving our customer relationships and allowing us to react more quickly to local market conditions and needs.

Our headquarters are in Houston, Texas, and we have significant manufacturing operations in various countries, including, but not limited to, the United States (Texas, Oklahoma and Louisiana), Scotland (Aberdeen and East Kilbride), Germany (Celle), Northern Ireland (Belfast) and Venezuela (Maracaibo). We operate in over 90 countries around the world and employ approximately 29,100 employees – about one-half of which work outside the U.S. Our revenue in 2005 was \$7.2 billion – approximately 36% of which came from providing products and services to oil and natural gas companies operating in the U.S.

During 2005, the Baker Hughes worldwide rig count continued to increase, as oil and natural gas companies around the world recognized the need to build productive capacity to meet the growing demand for hydrocarbons and to offset depletion of existing developed reserves. Oil and natural gas prices were at historic highs in 2005, reflecting continued strong demand, relatively low excess productive capacity, and disruptions in supply due to hurricanes in the Gulf of Mexico. We reported revenues of \$7,185.5 million for 2005, an 18.2% increase compared with 2004, approximating the 14.8% increase in the worldwide average rig count for 2005 compared with 2004. In addition to the growth in our revenues from increased activity, our revenues were impacted by pricing improvements and changes in market share in certain product lines. Net income for 2005 was \$878.4 million, a 66.2% increase compared with \$528.6 million in 2004.

- North American revenues increased 20.9% in 2005 compared with 2004, while the rig count increased 18.0% for 2005 compared with 2004, driven primarily by land-based drilling for natural gas. In 2005, hurricane-related disruptions negatively impacted our revenues from the U.S. offshore market by approximately \$68.0 million.
- Latin American revenues increased 15.3% and the Latin American rig count increased 9.0% in 2005 compared with 2004.
- Europe, Africa, Russia and the Caspian revenues increased 14.0% in 2005 compared with 2004. Growth in revenues from Europe and Africa exceeded the increase in the rig counts for both regions for the comparable periods.
- Middle East and Asia Pacific revenues were up 20.2% in 2005 compared with 2004. Revenue from the Middle East was up 20.5% compared to a rig count which increased 7.4% and Asia Pacific revenue was up 20.0% compared to a rig count which increased 14.2%.

The customers for our products and services include the super-major and major integrated oil and natural gas companies, independent oil and natural gas companies and state-owned national oil companies (“NOCs”). Our ability to compete in the oilfield services market is dependent on our ability to differentiate our product and service offerings by technology, service and the price paid for the value we deliver.

The primary driver of our business is our customers’ capital and operating expenditures dedicated to exploring and drilling for and developing and producing oil and natural gas. Our business is cyclical and is dependent upon our customers’

forecasts of future oil and natural gas prices, future economic growth and hydrocarbon demand and estimates of future oil and natural gas production. During 2005, our customers’ spending directed to both worldwide oil and North American oil and natural gas projects increased compared with 2004. The increase in spending was driven by the multi-year requirement to find, develop and produce more hydrocarbons to meet the growth in demand, offset production declines, increase inventory levels and rebuild productive capacity. Additionally, the increase was supported by historically high oil and natural gas prices. Our customers’ spending on oil and gas projects is expected to continue to grow through 2006.

The critical success factors for our business are embodied in our long-term strategy, which we call our Strategic Framework. This strategy includes the development and maintenance of a high performance culture founded on our Core Values; our product line focused organization and our focus on Best-in-Class opportunities; maintaining our financial flexibility and financial discipline; and execution of our strategies for product development and commercialization, manufacturing quality and service quality.

Our ongoing effort to develop and maintain a high performance culture starts with our Core Values of integrity, teamwork, performance and learning. We employ succession planning efforts to develop leaders across all our businesses that embody these Core Values and represent the diversity of our customer base. We hire and train employees from around the world to ensure that we have a well-trained workforce in place to support our business plans.

Our focus on Best-in-Class opportunities starts with our product line focused organization structure. We believe that through our product line focused divisions, we develop the technologies that deliver Best-in-Class value to our customers. As an enterprise, we are also focused on those markets that we believe provide Best-in-Class opportunities for growth. Our management team has identified markets for immediate focus including the Middle East, Russia and the Caspian region and NOCs.

Our focus on financial flexibility and financial discipline is the backbone of our effort to deliver differential growth at superior margins while earning an acceptable return on our investments throughout the business cycle. Investments are given priority and funded depending on their ability to provide risk-adjusted returns in excess of our cost of capital. Our effort to obtain the best price for our products and services begins with our approach to capital discipline. Over the past few years, we have invested for growth in our business, repaid debt, paid dividends and repurchased stock, and we expect to maintain the flexibility to undertake such activities in the future.

The last element of our Strategic Framework focuses on our ability to identify, develop and commercialize new products and services that will lead to differential growth at superior margins in our business. The effort extends to every phase of our operations, including continuous improvement programs in our manufacturing facilities and field operations that support our goal of flawless execution at the well site.

The execution of our 2006 business plan and the ability to meet our 2006 financial objectives are dependent on a num-

ber of factors. These factors include, but are not limited to, our ability to: recruit, train and retain the skilled and diverse workforce necessary to meet our business needs; realize price increases commensurate with the value we provide to our customers and in excess of the increase in raw material and labor costs; expand our business in areas that are growing rapidly with customers whose spending is expected to increase substantially (such as NOCs), and in areas where we have market share opportunities (such as the Middle East, Russia and the Caspian region); manage increasing raw material and component costs (especially steel alloys, copper, carbide, chemicals and electronic components); continue to make ongoing improvements in the productivity of our manufacturing organization.

For a full discussion of risk factors and forward-looking statements, please see the "Risk Factors Related to the Worldwide Oil and Natural Gas Industry" and the "Risk Factors Related to Our Business" in Item 1A. Risk Factors and in the "Forward-Looking Statements" section in Item 6, both contained herein.

### Business Environment

Our business environment and its corresponding operating results are significantly affected by the level of energy industry spending for the exploration and production ("E&P") of oil and natural gas reserves. An indicator for this spending is the rig count, because when drilling and workover rigs are active, many of the products and services provided by the oilfield services industry are required. Our products and services are used during the drilling and workover phases, during the completion of oil and natural gas wells and during actual production of the hydrocarbons. This E&P spending by oil and natural gas companies is, in turn, influenced strongly by expectations about the supply and demand for oil and natural gas products and by current and expected prices for both oil and natural gas. Rig counts, therefore, generally reflect the relative strength and stability of energy prices.

### Rig Counts

We have been providing rig counts to the public since 1944. We gather all relevant data through our field service personnel, who obtain the necessary data from routine visits to the various rigs, customers, contractors or other outside sources. This data is then compiled and distributed to various wire services and trade associations and is published on our website. Rig counts are compiled weekly for the U.S. and Canada and monthly for all international and U.S. workover rigs. Published international rig counts do not include rigs drilling in certain locations, such as Russia, onshore China and other countries, because this information is extremely difficult to obtain or we do not have local resources to make an accurate count.

Rigs in the U.S. are counted as active if, on the day the count is taken, the well being drilled has been started, drilling has not been completed and the well is anticipated to be of sufficient depth, which may change from time to time and may vary from region to region, and is expected to be a potential consumer of our drill bits. In general, rigs are counted as active if the well has been started but has not

reached its target depth, even if there are extensive delays due to weather or other reasons. If the well has been started but not completed and the rig is expected to resume work in two weeks or less, the rig is counted as active during a weather delay. Rigs are not typically counted as active if the rig is lost or damaged or if drilling operations are expected to be suspended for more than two weeks.

Rigs in Canada are counted as active if data obtained by the Canadian Association of Oilwell Drillers and Contractors indicates that drilling operations have occurred during the week and we are able to verify this information. In most other international areas, rigs are counted as active if drilling operations have taken place for at least 15 days during the month. In some active international areas where better data is available, a weekly or daily average of active rigs is taken. In those international areas where there is poor availability of data, the rig counts are estimated or quoted from third party data.

The rig count does not include rigs that are in transit from one location to another, are rigging up, are being used in non-drilling activities, including production testing, completion and workover, or are not, in our opinion, deemed to be a potential user of our drill bits.

Our rig counts are summarized in the table below as averages for each of the periods indicated.

	2005	2004	2003
U.S. – land and inland waters	1,290	1,095	924
U.S. – offshore	93	97	108
Canada	455	365	372
North America	1,838	1,557	1,404
Latin America	316	290	244
North Sea	43	39	46
Other Europe	27	31	38
Africa	50	49	54
Middle East	247	230	211
Asia Pacific	225	197	177
Outside North America	908	836	770
Worldwide	2,746	2,393	2,174
U.S. Workover Rigs	1,356	1,235	1,129

The U.S. land and inland waters rig count increased 17.8% in 2005 compared with 2004, due to the increase in drilling for natural gas. The U.S. offshore rig count decreased 4.1% in 2005 compared with 2004, reflecting the activity disruptions caused by hurricanes in the Gulf of Mexico in the third quarter of 2005. The Canadian rig count increased 24.7% due to the increase in drilling for natural gas.

Outside North America, the rig count increased 8.6% in 2005 compared with 2004. The rig count in Latin America increased 9.0% in 2005 compared with 2004, driven primarily by activity increases in Venezuela, Colombia and Argentina. The North Sea rig count increased 10.3% in 2005 compared with 2004. The rig count in Africa increased by 2.0% in 2005 compared with 2004. Activity in the Middle East continued to rise steadily, with a 7.4% increase in the rig count in 2005

compared with 2004, driven primarily by activity increases in Saudi Arabia, Qatar, Sudan and Yemen. The rig count in the Asia Pacific region was up 14.2% in 2005 compared with 2004, primarily due to activity increases in India, Indonesia, offshore China and Thailand.

### Oil and Natural Gas Prices

Generally, changes in the current price and expected future prices of oil or natural gas drive both customers' expectations about their prospects from oil and natural gas sales and their expenditures to explore for or produce oil and natural gas. Accordingly, changes in these expenditures will normally result in increased or decreased demand for our products and services. Oil (Bloomberg West Texas Intermediate (WTI) Cushing Crude Oil Spot Price) and natural gas (Bloomberg Henry Hub Natural Gas Spot Price) prices are summarized in the table below as averages of the daily closing prices during each of the periods indicated.

	2005	2004	2003
Oil prices (\$/Bbl)	\$ 56.59	\$ 41.51	\$ 31.06
Natural gas prices (\$/mmBtu)*	8.66	5.90	5.49

\* In late September 2005, Hurricane Rita damaged natural gas processing facilities in Henry, Louisiana ("Henry Hub") and the New York Mercantile Exchange declared *force majeure* on its Henry Hub natural gas contracts. As a result, the average natural gas prices for 2005 exclude price data for September 22, 2005 through October 6, 2005 when there was insufficient activity to determine a spot price.

Oil prices averaged a historic high of \$56.59/Bbl in 2005. Prices increased from the low \$40s/Bbl in January 2005 to a high of almost \$70/Bbl in late September 2005, before moderating and ending the year in the low \$60s/Bbl. Between mid-August and the end of September oil prices traded between \$60/Bbl and \$70/Bbl primarily due to the disruptive impact of hurricanes in the Gulf of Mexico. Worldwide demand for hydrocarbons was driven by strong worldwide economic growth, which was particularly strong in China and developing Asia. Worldwide excess productive capacity was at the lowest level in 30 years, and disruptions, or the potential for disruptions, in oil supply resulted in volatile oil prices throughout the year.

During 2005, natural gas prices averaged a historic high of \$8.66/mmBtu. Throughout the first seven months of 2005, a tight balance between supply and demand supported prices between \$5.50/mmBtu and \$8/mmBtu. In the last five months of 2005, natural gas was extremely volatile trading between \$9/mmBtu and \$15/mmBtu due to supply disruptions caused by Gulf of Mexico hurricanes and supported by high oil prices.

### Worldwide Oil and Natural Gas Industry Outlook

This section should be read in conjunction with the factors described in the "Risk Factors Related to the Worldwide Oil and Natural Gas Industry" and the "Risk Factors Related to Our Business" in Item 1A. Risk Factors and in the "Forward-Looking Statements" section in Item 6, both contained herein. These factors could impact, either positively or negatively, our

expectation for oil and natural gas demand, oil and natural gas prices and drilling activity.

**Oil** – Average oil prices in 2006 are expected to be between \$55/Bbl and \$75/Bbl. Strong worldwide economic growth and the lack of excess productive capacity are expected to support prices within this range. Growth in oil demand is expected to increase in 2006 compared with 2005, as worldwide economic growth and, in particular, economic growth in China is expected to continue to grow in 2006. At the beginning of December 2005, the International Energy Agency estimated that excess productive capacity was less than 3% of demand and that more than three-quarters of the excess capacity was in Saudi Arabia and Iraq. The ongoing lack of excess productive capacity will leave the energy markets susceptible to price volatility and the Organization of Petroleum Exporting Countries ("OPEC") is unlikely to be able to rapidly increase production should there be any significant disruptions or threat of disruptions in oil supplies.

Factors that could lead to prices at the lower end of this range include, but are not limited to: (1) a significant slowing of worldwide economic growth, particularly economic growth in China; (2) increases in Russian oil exports; (3) any significant disruption to demand; or (4) other factors that result in excess productive capacity and higher oil inventory levels or decreased demand. Factors that could lead to prices at the higher end of this range include, but are not limited to: (1) more rapid than planned expansion of the worldwide economy, particularly the economy in China; (2) a significant slowing of exports from Russia and the inability of key exporting countries to produce additional crude; or (3) other factors that result in excess productive capacity remaining at low levels.

Factors that could lead to disruptions or the threat of disruptions in oil supply and volatility in oil prices include, but are not limited to: (1) terrorist attacks targeting oil production from Saudi Arabia or other key producers; (2) labor strikes in key oil producing areas such as Nigeria; (3) the potential for other military actions in the Middle East; or (4) adverse weather conditions, especially in the Gulf of Mexico. The potential for these and other events to cause volatility will be mitigated by the degree to which OPEC and, in particular, Saudi Arabia are able to increase excess productive capacity as well as the capability of the markets to refine and market products refined from crude oil.

**Natural Gas** – Natural gas prices in 2006 are expected to remain volatile, averaging between \$6/mmBtu and \$15/mmBtu. A significant factor for the markets will be the pace of recovery of production of natural gas in the Gulf of Mexico following the disruptions from hurricanes in the Gulf of Mexico in 2005.

Natural gas prices could trade at the top, or beyond the top, of this range if: (1) storage levels are relatively low at the beginning of the withdrawal season; (2) winter weather is colder than normal or summer weather is warmer than normal; (3) we experience slower than expected restoration of hurricane damaged production facilities; or (4) the U.S. economy, particularly the industrial sector, exhibits greater than expected growth and continued levels of oilfield customer spending are not sufficient to support the production growth

required to meet the growth of natural gas demand. Natural gas prices could move to the bottom, or below the bottom, of this range if: (1) storage levels are relatively high at the beginning of the injection season; (2) U.S. economic growth is weaker than expected; or (3) weather is milder than expected.

**Customer Spending** – Based upon our discussions with major customers, review of published industry reports and our outlook for oil and natural gas prices described above, anticipated customer spending trends are as follows:

- North America – Customer spending in North America, primarily towards developing natural gas supplies, is expected to increase approximately 18% to 22% in 2006 compared with 2005.
- Outside North America – Customer spending, primarily directed at developing oil supplies, is expected to increase approximately 16% to 20% in 2006 compared with 2005.
- Total spending is expected to increase approximately 17% to 21% in 2006 compared with 2005.

**Drilling Activity** – Based upon our outlook for oil and natural gas prices and customer spending described above, our outlook for drilling activity, as measured by the Baker Hughes rig count, is as follows:

- Drilling activity in North America is expected to increase approximately 12% to 14% in 2006 compared with 2005.
- Drilling activity outside of North America is expected to increase approximately 8% to 10% in 2006 compared with 2005, excluding Iran and Sudan.

### **Risk Factors Related to the Worldwide Oil and Natural Gas Industry**

For discussion of our risk factors and cautions regarding forward-looking statements, see the “Risk Factors Related to the Worldwide Oil and Natural Gas Industry” in Item 1A. Risk Factors and in the “Forward-Looking Statements” section in Item 6, both contained herein. The risk factors discussed there are not intended to be all inclusive.

### **Business Outlook**

This section should be read in conjunction with the factors described in the “Risk Factors Related to Our Business,” “Risk Factors Related to the Worldwide Oil and Natural Gas Industry” and “Forward-Looking Statements” sections contained herein. These factors could impact, either positively or negatively, our expectation for oil and natural gas demand, oil and natural gas prices and drilling activity.

In our outlook for 2006, we took into account the factors described herein. Revenues in 2006 are expected to increase by approximately 19% to 21%, in line with the expected increase in customer spending. We expect the growth in our revenues will primarily be due to increased activity and pricing improvement. Our assumptions regarding overall growth in customer spending assume strong economic growth in the U.S. and China, resulting in an average oil price exceeding \$50/Bbl. Our assumptions regarding customer spending in North America assume strong economic growth in the U.S. and natural gas prices exceeding an average of \$8/mmBtu.

In North America, we expect revenues to increase approximately 21% to 23% in 2006 compared with 2005. We expect

spending on land-based projects to continue to increase in 2006 driven by demand for natural gas, following the trend evident in 2005. We also expect offshore spending in the Gulf of Mexico to increase modestly in 2006 compared with 2005. The normal weather-driven seasonal decline in U.S. and Canadian spending in the first half of the year should result in sequentially softer revenues in the first and second quarters of 2006.

In 2005, 2004 and 2003, revenues outside North America were 57.6%, 58.5% and 57.9% of total revenues, respectively. In 2006, we expect revenues outside North America to continue to be between 55% and 60% of total revenues, and we expect these revenues to increase approximately 18% to 21% in 2006 compared with 2005, continuing the multi-year trend of growth in customer spending. Spending on large projects by NOCs is expected to reflect established seasonality trends, resulting in softer revenues in the first half of the year and stronger revenues in the second half. In addition, customer spending should be affected by weather-related reductions in the North Sea in the first and second quarters of 2006. The Middle East, Africa and Latin America regions are expected to grow modestly in 2006 compared with 2005. Our expectations for spending and revenue growth could decrease if there are disruptions in key oil and natural gas production markets, such as Venezuela or Nigeria.

In 2005, WesternGeco contributed \$96.7 million of equity in income of affiliates compared with \$34.5 million of equity in income of affiliates in 2004. We expect the trend of improving operating results for WesternGeco to continue throughout 2006. Information regarding WesternGeco's profitability in 2006 is based on information that WesternGeco has provided to us. Should this information not be accurate, our forecasts for profitability could be impacted, either positively or negatively.

Based on the above forecasts, we believe net income per diluted share in 2006 will be in the range of \$3.40 to \$3.60, which includes the impact of expensing stock option awards and stock issued under the employee stock purchase plan of between \$18.0 million and \$20.0 million, net of tax. Significant price increases, lower than expected raw material and labor costs, higher than planned activity or significantly better than expected results from WesternGeco could cause earnings per share to reach the upper end of this range. Conversely, less than expected price increases, higher than expected raw material and labor costs, lower than expected productivity or significantly worse than expected results at WesternGeco could result in earnings per share being at or below the bottom of this range. Our ability to improve pricing is dependent on demand for our products and services and our competitors strategies of managing capacity. While the commercial introduction of new technology is an important factor in realizing pricing improvement, without pricing discipline throughout the industry as a whole, meaningful improvements in our prices are not likely to be realized. Additionally, significant changes in drilling activity outside our expectations could impact operating results positively or negatively.

We do business in approximately 90 countries including over one-half of the 35 countries having the lowest scores, which indicates high levels of corruption, in Transparency International's Corruption Perception Index (“CPI”) survey for

2005. We devote significant resources to the development, maintenance and enforcement of our Business Code of Conduct policy, our Foreign Corrupt Practices Act (the "FCPA") policy, our internal control processes and procedures and other compliance related policies. Notwithstanding the devotion of such resources, and in part as a consequence thereof, from time to time we discover or receive information alleging potential violations of laws and regulations, including the FCPA and our policies, processes and procedures. We conduct internal investigations of these potential violations and take appropriate action depending upon the outcome of the investigation. In addition, U.S. government agencies and authorities are conducting investigations into allegations of potential violations of laws.

We anticipate that the devotion of significant resources to compliance related issues, including the necessity for investigations, will continue to be an aspect of doing business in a number of the countries in which oil and natural gas exploration, development and production take place and in which we are requested to conduct operations. Compliance related issues could limit our ability to do business in these countries. In order to provide products and services in some of these countries, we may in the future utilize ventures with third parties, sell products to distributors or otherwise modify our business approach in order to improve our ability to conduct our business in accordance with laws and regulations and our Business Code of Conduct. In the third quarter of 2005, our independent foreign subsidiaries initiated a process to prohibit any business activity that directly or indirectly involves or facilitates transactions in Iran, Sudan or with their governments, including government-controlled companies operating outside of these countries. Implementation of this process should be substantially complete by the end of 2006 and is not expected to have a material impact on our consolidated financial statements.

### **Risk Factors Related to Our Business**

For discussion of our risk factors and cautions regarding forward-looking statements, see the "Risk Factors Related to Our Business" in Item 1A. Risk Factors and in the "Forward-Looking Statements" section, both contained herein. This list of risk factors is not intended to be all inclusive.

### **Critical Accounting Estimates**

The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures and about contingent assets and liabilities. We base these estimates and judgments on historical experience and other assumptions and information that are believed to be reasonable under the circumstances. Estimates and assumptions about future events and their effects cannot be perceived with certainty, and accordingly, these estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as the business environment in which we operate changes.

We have defined a critical accounting estimate as one that is both important to the portrayal of either our financial condition or results of operations and requires us to make difficult, subjective or complex judgments or estimates about matters

that are uncertain. We have discussed the development and selection of our critical accounting estimates with the Audit/Ethics Committee of our Board of Directors and the Audit/Ethics Committee has reviewed the disclosure presented below. During the past three fiscal years, we have not made any material changes in the methodology used to establish the critical accounting estimates discussed below. We believe that the following are the critical accounting estimates used in the preparation of our consolidated financial statements. In addition, there are other items within our consolidated financial statements that require estimation but are not deemed critical as defined above.

### **Allowance for Doubtful Accounts**

The determination of the collectibility of amounts due from our customers requires us to use estimates and make judgments regarding future events and trends, including monitoring our customers' payment history and current credit worthiness to determine that collectibility is reasonably assured, as well as consideration of the overall business climate in which our customers operate. Inherently, these uncertainties require us to make frequent judgments and estimates regarding our customers' ability to pay amounts due us in order to determine the appropriate amount of valuation allowances required for doubtful accounts. Provisions for doubtful accounts are recorded when it becomes evident that the customer will not make the required payments at either contractual due dates or in the future. At December 31, 2005 and 2004, allowance for doubtful accounts totaled \$51.4 million, or 3.0%, and \$50.2 million, or 3.6%, of total gross accounts receivable, respectively. We believe that our allowance for doubtful accounts is adequate to cover potential bad debt losses under current conditions; however, uncertainties regarding changes in the financial condition of our customers, either adverse or positive, could impact the amount and timing of any additional provisions for doubtful accounts that may be required. A five percent change in the allowance for doubtful accounts would have had a pre-tax impact of approximately \$2.6 million in 2005.

### **Inventory Reserves**

Inventory is a significant component of current assets and is stated at the lower of cost or market. This requires us to record provisions and maintain reserves for excess, slow moving and obsolete inventory. To determine these reserve amounts, we regularly review inventory quantities on hand and compare them to estimates of future product demand, market conditions, production requirements and technological developments. These estimates and forecasts inherently include uncertainties and require us to make judgments regarding potential outcomes. At December 31, 2005 and 2004, inventory reserves totaled \$201.3 million, or 15.2%, and \$220.0 million, or 17.7%, of gross inventory, respectively. We believe that our reserves are adequate to properly value potential excess, slow moving and obsolete inventory under current conditions. Significant or unanticipated changes to our estimates and forecasts, either adverse or positive, could impact the amount and timing of any additional provisions



for excess or obsolete inventory that may be required. A five percent change in this inventory reserve balance would have had a pre-tax impact of approximately \$10.1 million in 2005.

### **Impairment of Long-Lived Assets**

Long-lived assets, which include property, goodwill, intangible assets, investments in affiliates and certain other assets, comprise a significant amount of our total assets. We review the carrying values of these assets for impairment periodically, and at least annually for goodwill, 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 us to make judgments regarding long-term forecasts of future revenues and costs related to the assets subject to review. In turn, these forecasts are uncertain in that they require assumptions about demand for our products and services, future market conditions and technological developments. Significant and unanticipated changes to these assumptions could require a provision for impairment in a future period. Given the nature of these evaluations and their application to specific assets and specific times, it is not possible to reasonably quantify the impact of changes in these assumptions; however, based upon our evaluation of the current business climate in which we operate, we do not currently anticipate that any significant asset impairment losses will be necessary in the foreseeable future.

### **Income Taxes**

The liability method is used for determining our income taxes, under which current and deferred tax liabilities and assets are recorded in accordance with enacted tax laws and rates. Under this method, the amounts of deferred tax liabilities and assets at the end of each period are determined using the tax rate expected to be in effect when taxes are actually paid or recovered. Valuation allowances are established to reduce deferred tax assets when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In determining the need for valuation allowances, we have considered and made judgments and estimates regarding estimated future taxable income and ongoing prudent and feasible tax planning strategies. These estimates and judgments include some degree of uncertainty and changes in these estimates and assumptions could require us to adjust the valuation allowances for our deferred tax assets. Historically, changes to valuation allowances have been caused by major changes in the business cycle in certain countries and changes in local country law. The ultimate realization of the deferred tax assets depends on the generation of sufficient taxable income in the applicable taxing jurisdictions.

We operate in more than 90 countries under many legal forms. As a result, we are subject to the jurisdiction of numerous domestic and foreign tax authorities, as well as to tax agreements and treaties among these governments. Our operations in these different jurisdictions are taxed on various bases: actual income before taxes, deemed profits (which are generally determined using a percentage of revenues rather than profits) and withholding taxes based on revenue. Determination of taxable

income in any jurisdiction requires the interpretation of the related tax laws and regulations and the use of estimates and assumptions regarding significant future events such as the amount, timing and character of deductions, permissible revenue recognition methods under the tax law and the sources and character of income and tax credits. Changes in tax laws, regulations, agreements and treaties, foreign currency exchange restrictions or our level of operations or profitability in each taxing jurisdiction could have an impact on the amount of income taxes that we provide during any given year.

Our tax filings for various periods are subjected to audit by the tax authorities in most jurisdictions where we conduct business. These audits may result in assessments of additional taxes that are resolved with the authorities or potentially through the courts. We believe these assessments may occasionally be based on erroneous and even arbitrary interpretations of local tax law. Resolution of these situations inevitably includes some degree of uncertainty; accordingly, we provide taxes only for the amounts we believe will ultimately result from these proceedings. The resulting change to our tax liability, if any, is dependent on numerous factors that are difficult to estimate. These include, among others, the amount and nature of additional taxes potentially asserted by local tax authorities; the willingness of local tax authorities to negotiate a fair settlement through an administrative process; the impartiality of the local courts; the sheer number of countries in which we do business; and the potential for changes in the tax paid to one country to either produce, or fail to produce, an offsetting tax change in other countries. Our experience has been that the estimates and assumptions we have used to provide for future tax assessments have proven to be appropriate. However, past experience is only a guide, and the potential exists, however limited, that the tax resulting from the resolution of current and potential future tax controversies may differ materially from the amount accrued. Although we have provided for the taxes that we believe will ultimately be payable as a result of these assessments, the aggregate assessments are approximately \$34.1 million in excess of the taxes provided for in our consolidated financial statements.

In addition to the aforementioned assessments that have been received from various taxing authorities, we provide for taxes in certain situations where assessments have not been received. In those situations, we consider it probable that the taxes ultimately payable will exceed those amounts reflected in filed tax returns; accordingly, taxes are provided in those situations under the guidance in Statement of Financial Accounting Standards ("SFAS") No. 5, *Accounting for Contingencies*. Future events such as changes in the facts or tax law, judicial decisions regarding existing law or a favorable audit outcome may later indicate the assertion of additional taxes is no longer probable. In that circumstance, it is possible that taxes previously provided would be released.

### **Pensions and Postretirement Benefit Obligations**

Pensions and postretirement benefit obligations and the related plan expenses are calculated using actuarial models and methods. This involves the use of two critical assumptions, the discount rate and the expected rate of return on assets, both of

which are important elements in determining plan expenses and in measuring plan assets and liabilities. We evaluate these critical assumptions at least annually. Although considered less critical, other assumptions used in determining benefit obligations and plan expenses, such as demographic factors like retirement age, mortality and turnover, are also evaluated periodically and are updated to reflect our actual and expected experience.

The discount rate enables us to state expected future cash flows at a present value on the measurement date. A lower discount rate increases the present value of benefit obligations and increases plan expenses. We used a discount rate of 6.00% in 2005, 6.25% in 2004 and 6.75% in 2003 to determine plan expenses. A 50 basis point reduction in the discount rate would have increased plan expenses in 2005 by \$3.4 million.

To determine the expected rate of return on plan assets, we consider the current and expected asset allocations, as well as historical and expected returns on various categories of plan assets. A lower rate of return increases plan expenses. We assumed rates of return on our plan investments were 8.50% in 2005, 2004 and 2003. A 50 basis point reduction in the expected rate of return on assets of our principal plans would have increased plan expenses in 2005 by \$2.9 million.

### Discontinued Operations

In the fourth quarter of 2005, our management initiated and our Board of Directors approved a plan to sell the Baker Supply Products Division ("SPD"), a product line group within the Completion and Production segment. SPD distributes basic supplies, products and small tools to the drilling industry. In January 2006, we signed a non-binding letter of intent for the sale of SPD. SPD had revenues of \$32.5 million for the year ended December 31, 2005. The sale is expected to close in the first quarter of 2006. This transaction is subject to the negotiation and execution of a definitive sale agreement, as well as, various conditions, including satisfactory due diligence review of SPD's business. There can be no assurance that the transaction will be consummated.

In September 2004, we completed the sale of Baker Hughes Mining Tools ("BHMT"), a product line group within the Drilling and Evaluation segment that manufactured rotary drill bits used in the mining industry, for \$31.5 million. We recorded a gain on the sale of \$0.2 million, net of tax of \$3.6 million, which consisted of a gain on the disposal of \$6.8 million offset by a loss of \$6.6 million related to the recognition of the cumulative foreign currency translation adjustments into earnings.

In October 2003, we signed a definitive agreement for the sale of BIRD Machine ("BIRD"), the remaining division of the former Process segment, and recorded charges totaling

\$37.4 million, net of tax of \$10.9 million, which consisted of a loss of \$13.5 million on the write-down of BIRD to fair value, \$6.2 million of severance and warranty accruals and a loss of \$17.7 million related to the recognition of cumulative foreign currency translation adjustments into earnings. In January 2004, we completed the sale of BIRD and recorded an additional loss on the sale of \$0.5 million with no tax benefit. We received \$5.6 million in proceeds, which were subject to post-closing adjustments to the purchase price, and retained certain accounts receivable, inventories and other assets. During the second quarter of 2004, we made a net payment of \$6.8 million to the buyer in settlement of the final purchase price adjustments. The adjustments were the result of changes in the value of assets sold to and liabilities assumed by the buyer between the date the initial sales price was negotiated and the closing of the sale.

In December 2002, we entered into exclusive negotiations for the sale of our interest in our oil producing operations in West Africa and received \$10.0 million as a deposit. The transaction was effective as of January 1, 2003, and resulted in a gain on the sale of \$4.1 million, net of a tax benefit of \$0.2 million. We received the remaining \$22.0 million in proceeds in April 2003.

In 2003, all purchase price adjustments related to the sale of EIMCO Process Equipment ("EIMCO") were completed, resulting in the release of the escrow balance, of which we received \$2.0 million and \$2.9 million was returned to the buyer. We recorded an additional loss on the sale of EIMCO of \$2.5 million, net of tax of \$1.3 million.

We have reclassified the consolidated financial statements for all prior periods presented to reflect these operations as discontinued. See Note 2 of the Notes to Consolidated Financial Statements in Item 8 herein for additional information regarding discontinued operations.

### Results of Operations

The discussions below relating to significant line items from our consolidated statements of operations are based on available information and represent our analysis of significant changes or events that impact the comparability of reported amounts. Where appropriate, we have identified specific events and changes that affect comparability or trends and, where possible and practical, have quantified the impact of such items. The discussions are based on our consolidated financial results, as individual segments do not contribute disproportionately to our revenues, profitability or cash requirements.

The table below details certain consolidated statement of operations data and their percentage of revenues for 2005, 2004 and 2003, respectively.

	2005		2004		2003	
	\$	%	\$	%	\$	%
Revenues	\$ 7,185.5	100.0%	\$ 6,079.6	100.0%	\$ 5,233.3	100.0%
Cost of revenues	4,942.5	68.8%	4,351.0	71.6%	3,807.5	72.8%
Selling, general and administrative	1,009.6	14.1%	912.2	15.0%	824.6	15.8%

## Revenues

Revenues for 2005 increased 18.2% compared with 2004, primarily due to increases in activity, as evidenced by a 14.8% increase in the worldwide rig count, pricing improvements of between four and six percent and increases in market share in selected product lines and geographic areas. These increases were partially offset by the impact of hurricanes in the Gulf of Mexico. Revenues in North America, which accounted for 42.4% of total revenues, increased 20.9% for 2005 compared with 2004, despite the unfavorable impact on our U.S. off-shore revenues of approximately \$68.0 million from hurricane-related disruptions. This increase reflects increased activity in the U.S., as evidenced by the 18.0% increase in the North American rig count, with activity dominated by land-based gas-directed drilling. Revenues outside North America, which accounted for 57.6% of total revenues, increased 16.3% for 2005 compared with 2004. This increase reflects the improvement in international drilling activity, as evidenced by the 8.6% increase in the rig count outside North America, particularly in Latin America, the Middle East and Asia Pacific, coupled with price increases in certain markets and product lines.

Revenues for 2004 increased 16.2% compared with 2003, reflecting a 10.1% increase in the worldwide rig count. Revenues in North America, which accounted for 41.5% of total revenues, increased 14.4% compared with 2003. This increase reflects increased drilling activity in the U.S. and Canada, as evidenced by a 10.9% increase in the North American rig count, and \$24.8 million related to intellectual property license fees, which is not expected to recur in the same magnitude in the future. Revenues outside North America, which accounted for 58.5% of total revenues, increased 17.5% compared with 2003. This increase reflects the improvement in international drilling activity, as evidenced by an 8.6% increase in the rig count outside North America, primarily in Latin America and Asia Pacific, partially offset by decreased drilling activity in the North Sea and Africa. During 2004, our revenue growth was primarily due to increases in activity and, to a lesser extent, pricing improvements.

## Cost of Revenues

Cost of revenues for 2005 increased 13.6% compared with 2004. Cost of revenues as a percentage of revenues was 68.8% and 71.6% for 2005 and 2004, respectively. The decrease in cost of revenues as a percentage of revenue is primarily the result of overall price increases of between four and six percent and very high utilization of our rental tool fleet and personnel. These increases were partially offset by higher raw material costs and employee compensation expenses.

Cost of revenues for 2004 increased 14.3% compared with 2003. Cost of revenues as a percentage of revenues was 71.6% and 72.8% for 2004 and 2003, respectively. The decrease in cost of revenues as a percentage of revenues is primarily related to limited pricing improvement in certain markets and product lines and improved cost control measures, including lower repair and maintenance costs at our INTEQ division, partially offset by increased material costs and higher employee compensation expense. A change in the geographic and product

mix from the sale of our products and services also contributed to the decrease in the cost of revenues as a percentage of revenues. During 2004, our revenue increases came predominantly from outside North America and our margins on revenues generated outside North America are typically higher than margins generated in North America.

## Selling, General and Administrative

Selling, general and administrative ("SG&A") expenses increased 10.7% in 2005 compared with 2004. The increase corresponds with increased activity and resulted primarily from higher marketing and employee compensation expenses.

SG&A expenses for 2004 increased 10.6% compared with 2003. This increase was primarily due to higher marketing and administrative expenses as a result of increased activity, including higher employee compensation expense, and increased costs related to our continued focus on compliance, including legal investigations and increased staffing in our legal, compliance and audit groups. The increase was also due to the implementation of programs and procedures as a result of the requirements of the Sarbanes-Oxley Act of 2002.

## Reversal of Restructuring Charge

In 2000, our Board of Directors approved a plan to substantially exit the oil and natural gas exploration business and we recorded a restructuring charge of \$29.5 million. Included in the restructuring charge was \$1.1 million for a contractual obligation related to an oil and natural gas property in Angola. The property was subsequently sold in 2003, and we reversed the liability related to this contractual obligation, accordingly.

## Impairment of Investment in Affiliate

In 2003, as a result of the continued weakness in the seismic industry, we evaluated the carrying value of our investment in WesternGeco and recorded an impairment loss of \$45.3 million to write-down the investment to its fair value. The fair value was determined using a combination of a market capitalization and discounted cash flow approach. We were assisted in the determination of the fair value by a third party. Although not anticipated, further declines in the fair value of the investment in WesternGeco would result in additional impairments.

## Equity in Income (Loss) of Affiliates

Equity in income of affiliates increased \$63.8 million in 2005 compared with 2004. The increase is almost entirely due to the increase in equity in income of WesternGeco, our most significant equity method investment. WesternGeco's revenue and profitability has continued to improve as a result of ongoing favorable market conditions in the seismic industry.

Equity in income of affiliates was \$36.3 million in 2004 compared with equity in loss of affiliates of \$2.1 million in 2003, which excludes the \$135.7 million related to our portion of the restructuring and impairment charge taken by WesternGeco in the third quarter of 2003. During 2003, the operating results of WesternGeco continued to be adversely affected by the weakness in the seismic industry and, as a result of this

weakness, WesternGeco recorded certain impairment and restructuring charges of \$452.0 million for impairment of its multiclient seismic library and rationalization of its marine seismic fleet.

### Interest Expense and Interest Income

Interest expense decreased \$11.3 million in 2005 compared with 2004. The decrease was primarily due to lower total debt levels partially offset by the impact of the interest rate swap agreement that was in place from April 2004 through June 2005. The lower total debt levels were a result of the repayment of \$350.0 million of long-term debt in the second quarter of 2004. Interest income in 2005 increased \$11.2 million over 2004, due to significantly higher cash balances and short-term investments during the year resulting primarily from higher cash flows from operations.

Interest expense for 2004 decreased \$19.5 million compared with 2003, primarily due to lower total debt levels and the effect of the interest rate swap agreement entered into in April 2004. The lower total debt levels are the result of the repayment of \$350.0 million of long-term debt in the second quarter of 2004, which decreased interest expense by \$16.0 million in 2004 compared with 2003. Additionally, the favorable impact of the interest rate swap agreement decreased interest expense by \$4.1 million in 2004 compared with 2003.

### Income Taxes

Our effective tax rates differ from the U.S. statutory income tax rate of 35% due to state income taxes, differing rates of tax on international operations and higher taxes within the WesternGeco venture. Additionally, in 2005 we have reflected a \$10.6 million reduction to tax expense attributable to the recognition of a deferred tax asset associated with our supplemental retirement plan ("SRP").

During 2003, we recognized an incremental effect of \$36.3 million of additional taxes attributable to our portion of the operations of WesternGeco. Of this amount, \$15.9 million related to the reduction in the carrying value of our equity investment in WesternGeco for which there was no tax benefit. The remaining \$20.4 million arose from operations of the venture due to: (i) the venture being taxed in certain foreign jurisdictions based on a deemed profit basis, which is a percentage of revenues rather than profits and (ii) unbenefitted foreign losses of the venture, which are operating losses and impairment and restructuring charges in certain foreign jurisdictions where there was no current tax benefit and where a deferred tax asset was not recorded due to the uncertainty of realization.

During 2005 and 2003, benefits of \$4.3 million and \$3.3 million, respectively, were recognized as the result of various refund claims filed in the U.S.

Our tax filings for various periods are subjected to audit by tax authorities in most jurisdictions where we conduct business. These audits may result in assessments of additional taxes that are resolved with the authorities or potentially through the courts. We believe that these assessments

may occasionally be based on erroneous and even arbitrary interpretations of local tax law. We have received tax assessments from various taxing authorities and are currently at varying stages of appeals and/or litigation regarding these matters. We have provided for the amounts we believe will ultimately result from these proceedings. We believe we have substantial defenses to the questions being raised and will pursue all legal remedies should an unfavorable outcome result. However, resolution of these matters involves uncertainties and there are no assurances that the outcomes will be favorable.

### Cumulative Effect of Accounting Change

On December 31, 2005, we adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47 ("FIN 47"), *Conditional Asset Retirement Obligations*. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The adoption of FIN 47 resulted in a charge of \$0.9 million, net of tax of \$0.5 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded conditional asset retirement obligations of \$1.6 million as the fair value of the costs associated with the special handling of asbestos related materials in certain facilities. We also have certain facilities that contain asbestos related materials for which a liability has not been recognized because the fair value cannot be reasonably estimated. We believe that there are indeterminate settlement dates for these obligations because the range of time over which we would settle these obligations is unknown or cannot be estimated; therefore, sufficient information does not exist to apply an expected present value technique.

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 requires that the fair value of a liability associated with an asset retirement obligation ("ARO") be recognized in the period in which it is incurred if a reasonable estimate can be made. The liability for the ARO is revised each subsequent period due to the passage of time and changes in estimates. The associated retirement costs are capitalized as part of the carrying amount of the long-lived asset and subsequently depreciated over the estimated useful life of the asset. The adoption of SFAS No. 143 in 2003 resulted in a charge of \$5.6 million, net of tax of \$2.8 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded ARO liabilities of \$11.4 million primarily for anticipated costs of obligations associated with the future disposal of power source units at certain of our divisions and refurbishment costs associated with certain leased facilities in Europe and with a fleet of leased railcars and tanks.

## Liquidity and Capital Resources

Our objective in financing our business is to maintain adequate financial resources and access to additional liquidity. During 2005, cash flows from operations and proceeds from the issuance of common stock resulting from the exercise of stock options were the principal sources of funding. We anticipate that cash flows from operations will be sufficient to fund our liquidity needs in 2006. We also have a \$500.0 million committed revolving credit facility that provides back-up liquidity in the event an unanticipated and significant demand on cash flows could not be funded by operations.

Our capital planning process is focused on utilizing cash flows generated from operations in ways that enhance the value of our company. In 2005, we used cash for a variety of activities including working capital needs, payment of dividends, repurchase of common stock, repayments of borrowings and capital expenditures.

## Cash Flows

Cash flows provided (used) by continuing operations by type of activity were as follows for the years ended December 31:

<i>(In millions)</i>	2005	2004	2003
Operating activities	\$ 949.6	\$ 781.8	\$ 649.0
Investing activities	(465.3)	(196.3)	(360.7)
Financing activities	(108.1)	(352.2)	(335.8)

Statements of cash flows for entities with international operations that are local currency functional exclude the effects of the changes in foreign currency exchange rates that occur during any given year, as these are noncash changes. As a result, changes reflected in certain accounts on the consolidated statements of cash flows may not reflect the changes in corresponding accounts on the consolidated balance sheets.

### Operating Activities

Cash flows from operating activities have been steadily increasing over the last three years and we expect this trend to continue in 2006. We attribute the increases in our cash flow to the increasing levels of income from continuing operations adjusted for noncash items.

Cash flows from operating activities of continuing operations increased \$167.8 million in 2005 compared with 2004. This increase was primarily due to an increase in income from continuing operations of \$349.1 million partially offset by a change in net operating assets and liabilities that used \$180.6 million more in cash flows during 2005 compared with 2004.

The underlying drivers of the changes in net operating assets and liabilities are as follows:

- An increase in accounts receivable used \$329.4 million in cash in 2005 compared with using \$173.7 million in cash in 2004. This was due to the increase in revenues and an increase in days sales outstanding (defined as the average number of days our accounts receivable are outstanding) of approximately three days.

- A build up in inventory in anticipation of and related to increased activity used \$108.7 million in cash in 2005 compared with using \$3.2 million in cash in 2004.
- An increase in accounts payable, accrued employee compensation and other accrued liabilities provided \$269.6 million in cash in 2005 compared with providing \$189.0 million in cash in 2004. This was due primarily to increased activity and increased employee compensation accruals.

Our contributions to our defined benefit pension plans in 2005 were approximately \$48.0 million, a decrease of approximately \$62.0 million compared to 2004, due to higher funding in excess of the minimum requirements in 2004.

Cash flows from operating activities of continuing operations increased \$132.8 million in 2004 compared with 2003. The increase was primarily due to increased operating performance attributable to our increased revenues. In addition, changes in net operating assets and liabilities provided \$11.1 million less in cash flows during 2004 compared with 2003.

The underlying drivers of the changes in working capital are as follows:

- An increase in accounts receivable used \$173.7 million in cash in 2004 compared with using \$13.8 million in cash in 2003. This was due to the increase in revenues and an increase in days sales outstanding of approximately two days.
- A build up in inventory in anticipation of increased activity used \$3.2 million in cash in 2004 compared with providing \$20.7 million in cash in 2003. The build up in inventory was partially offset by our continued focus on improving the utilization of inventory on hand.
- An increase in accounts payable, accrued employee compensation and other accrued liabilities provided \$189.0 million in cash in 2004 compared with providing \$16.3 million in cash in 2003. This was due primarily to increased activity and increased employee compensation accruals.

Our contributions to our defined benefit pension plans in 2004 were approximately \$110.0 million, an increase of approximately \$82.0 million compared with 2003, due to our decision to improve the funded status of certain pension plans and to provide us with increased flexibility on the future funding of these pension plans.

### Investing Activities

Our principal recurring investing activity is the funding of capital expenditures to ensure that we have the appropriate levels and types of rental tools in place to generate revenues from operations. Expenditures for capital assets totaled \$478.3 million, \$348.2 million and \$403.9 million for 2005, 2004 and 2003, respectively. The majority of these expenditures were for rental tools and machinery and equipment, including wireline tools and equipment.

During 2005, we paid \$46.8 million for acquisitions of businesses, net of cash acquired. In December, we purchased Zeroth Technology Limited ("Zertech"), a developer of an expandable metal sealing element, for \$20.3 million. In

November, we paid \$25.5 million, net of cash acquired of \$1.7 million, for the remaining 50% interest in QuantX Wellbore Instrumentation ("QuantX"), a venture we entered into in 2003 which is engaged in the permanent in-well monitoring market. During 2005, we also made smaller acquisitions having an aggregate purchase price of \$1.0 million.

During 2005, we purchased \$77.0 million of auction rate securities, which are highly liquid, variable-rate debt securities. While the underlying security has a long-term maturity, the interest rate is reset through Dutch auctions that are typically held every 7, 28 or 35 days, creating short-term liquidity. These short-term investments are classified as available-for-sale and are recorded at cost, which approximates market value.

Proceeds from disposal of assets were \$90.1 million, \$106.9 million and \$66.8 million for 2005, 2004 and 2003, respectively. These disposals relate to rental tools that were lost-in-hole, as well as machinery, rental tools and equipment no longer used in operations that were sold throughout the year. Included in the proceeds for 2004 was \$12.2 million related to the sale of certain real estate properties held for sale.

In 2005, we received distributions of \$30.0 million from WesternGeco, which were recorded as a reduction in the carrying value of our investment. We also received \$13.3 million from Schlumberger related to the WesternGeco true-up payment, of which \$13.0 million was recorded as a reduction in the carrying value of our investment and \$0.3 million as interest income.

In May 2005, we received \$3.7 million from the release of a portion of the amount held in escrow related to our sale of Petreco International. The remainder is expected to be released to us in the first quarter of 2006, subject to the indemnity obligations under the sales agreement.

In 2004, we paid \$6.6 million for acquisition of businesses, net of cash acquired. We purchased the remaining 60% interest in Luna Energy L.L.C. ("Luna"), a venture we entered into in 2002, for \$1.0 million. We also paid \$5.6 million in settlement of the final purchase price related to an acquisition completed in a prior year and invested an additional \$7.1 million in certain of our investments in affiliates.

In 2003, we made two acquisitions having an aggregate purchase price of \$16.9 million, of which \$9.5 million was paid in cash. In addition, during 2003, we invested \$38.1 million in affiliates, of which \$30.1 million related to our 50% interest in QuantX.

In 2004, we received \$58.7 million in net proceeds from the sale of businesses and our interest in an affiliate. In January, we completed the sale of BIRD and received \$5.6 million in proceeds, which were subject to post-closing adjustments to the purchase price. In June 2004, we made a net payment of \$6.8 million to the buyer of BIRD in settlement of the final purchase price adjustments. In February 2004, we completed the sale of our minority interest in Petreco International, a venture we entered into in 2001, and received proceeds of \$35.8 million, of which \$7.4 million was placed in escrow pending the outcome of potential indemnification obligations pursuant to the sales agreement. In September, we also completed the sale of BHMT and received proceeds of \$31.5 million.

In 2003, we received \$24.0 million in net proceeds from the sale of businesses. In April, we completed the sale of our interest in an oil producing property in West Africa and received the remaining \$22.0 million in proceeds. We also completed all purchase price adjustments related to the sale of our EIMCO division and received \$2.0 million from the release of the escrow balance.

We routinely evaluate potential acquisitions of businesses of third parties that may enhance our current operations or expand our operations into new markets or product lines. We may also from time to time sell business operations that are not considered part of our core business.

#### *Financing Activities*

We had net (repayments) borrowings of commercial paper and other short-term debt of \$(71.1) million, \$35.5 million and \$11.2 million in 2005, 2004 and 2003, respectively. In 2004, we repaid the \$100.0 million 8.0% Notes due May 2004 and the \$250.0 million 7.875% Notes due June 2004. In 2003, we repaid the \$100.0 million 5.8% Notes due February 2003. These repayments were funded with cash on hand, cash flows from operations and the issuance of commercial paper.

Total debt outstanding at December 31, 2005 was \$1,087.9 million, a decrease of \$74.4 million compared with December 31, 2004. The total debt to total capitalization (defined as total debt plus stockholders' equity) ratio was 0.19 at December 31, 2005 and 0.23 at December 31, 2004.

In April 2004, we entered into an interest rate swap agreement for a notional amount of \$325.0 million associated with our 6.25% Notes due January 2009. The interest rate swap agreement was designated and qualified as a fair value hedging instrument. Due to our outlook for interest rates, we terminated the interest rate swap agreement in June 2005, which required us to make a payment of \$5.5 million. This amount was deferred and is being amortized as an increase to interest expense over the remaining life of the underlying debt security.

At different times during 2003, we entered into three separate interest rate swap agreements, each for a notional amount of \$325.0 million, associated with our 6.25% Notes due January 2009. These agreements had been designated and had qualified as fair value hedging instruments. Due to our outlook for interest rates, we terminated the three agreements and received payments totaling \$26.9 million. Each of the three agreements was terminated prior to entering into a new agreement. The deferred gains are being amortized as a reduction of interest expense over the remaining life of the underlying debt security.

We received proceeds of \$228.1 million, \$115.9 million and \$61.8 million in 2005, 2004 and 2003, respectively, from the issuance of common stock through the exercise of stock options and the employee stock purchase plan.

On October 27, 2005, the Board of Directors authorized us to repurchase up to \$455.5 million of common stock, which was in addition to the balance of \$44.5 million remaining from the Board of Directors' September 2002 authorization, resulting in the authorization to repurchase up to a total of \$500.0 million of common stock. On November 3, 2005, we entered into a Stock Purchase Plan with an agent for the

purchase of shares of our common stock that complies with the requirements of Rule 10b5-1 promulgated by the Securities Exchange Act of 1934. The term of the November Plan will run from November 7, 2005 until April 30, 2006, unless earlier terminated. On February 22, 2006, we entered into another Plan for a term that will run from February 23, 2006 until April 30, 2006, unless earlier terminated. During that term, the agent will use its best efforts to repurchase a fixed dollar value of our common stock each trading day, subject to applicable trading rules, until the cumulative amount purchased under the November Plan equals \$250.0 million and under the February Plan equals \$150.0 million, inclusive of all commissions and fees paid by us to the agent related to such repurchases. Shares will be repurchased by the agent at the prevailing market prices, subject to limitations provided by us, in open market transactions intended to comply with Rule 10b-18 of the Exchange Act. We or the agent may terminate the Plans. However, no shares will be repurchased at any time that the cost of the shares exceeds an amount that has been specified by us to the agent. During the fourth quarter of 2005, we repurchased 1.7 million shares of our common stock at an average price of \$58.17 per share, for a total of \$98.5 million. During 2003, we repurchased 6.3 million shares at an average price of \$28.78 per share, for a total of \$181.4 million. Upon repurchase, the shares were retired.

We paid dividends of \$161.1 million, \$153.6 million and \$154.3 million in 2005, 2004 and 2003, respectively. Beginning in the fourth quarter of 2005 as authorized by our Board of Directors, we increased our quarterly dividend to \$0.13 per share, compared to \$0.115 per share that was paid in prior quarters.

### Available Credit Facilities

At December 31, 2005, we had \$955.6 million of credit facilities with commercial banks, of which \$500.0 million is a committed revolving credit facility (the "facility") that expires in July 2010. The facility provides for up to three one-year extensions, subject to the approval and acceptance by the lenders, among other conditions. In addition, the facility contains a provision to allow for an increase in the facility amount of an additional \$500.0 million, subject to the approval and acceptance by the lenders, among other conditions. The facility contains certain covenants which, among other things, require the maintenance of a funded indebtedness to total capitalization ratio (a defined formula per the facility) of less than or equal to 0.60, restrict certain merger transactions or the sale of all or substantially all of the assets of the company or a significant subsidiary and limit the amount of subsidiary indebtedness. Upon the occurrence of certain events of default, our obligations under the facility may be accelerated. Such events of default include payment defaults to lenders under the facility, covenant defaults and other customary defaults. At December 31, 2005, we were in compliance with all of the facility covenants. There were no direct borrowings under the facility during the year ended December 31, 2005; however, to the extent we have outstanding commercial paper, our ability to borrow under the facility is reduced. At December 31, 2005, we had no outstanding commercial paper.

If market conditions were to change and revenues were to be significantly reduced or operating costs were to increase, our cash flows and liquidity could be reduced. Additionally, it could cause the rating agencies to lower our credit rating. We do not have any ratings triggers in the facility that would accelerate the maturity of any borrowings under the facility. However, a downgrade in our credit ratings could increase the cost of borrowings under the facility and could also limit or preclude our ability to issue commercial paper. Should this occur, we would seek alternative sources of funding, including borrowing under the facility.

We believe our credit ratings and relationships with major commercial and investment banks would allow us to obtain interim financing over and above our existing credit facilities for any currently unforeseen significant needs or growth opportunities. We also believe that such interim financings could be funded with subsequent issuances of long-term debt or equity, if necessary.

### Cash Requirements

In 2006, we believe operating cash flows will provide us with sufficient capital resources and liquidity to manage our working capital needs, meet contractual obligations, fund capital expenditures, pay dividends, repurchase common stock and support the development of our short-term and long-term operating strategies.

We currently expect 2006 capital expenditures will be between \$750.0 million and \$780.0 million, excluding acquisitions. The expenditures are expected to be used primarily for normal, recurring items necessary to support the growth of our business and operations.

In 2006, we expect to make interest payments of between \$72.0 million and \$77.0 million. This is based on our current expectations of debt levels during 2006. We also expect to make income tax payments of between \$490.0 million and \$530.0 million in 2006.

As of December 31, 2005, we have authorization remaining to repurchase up to \$401.5 million in common stock. We may repurchase our common stock depending on market conditions, applicable legal requirements, our liquidity and other considerations. We anticipate paying dividends of between \$170.0 million and \$180.0 million in 2006; however, the Board of Directors can change the dividend policy at anytime.

During 2006, we estimate we will contribute between \$18.0 million and \$23.0 million to our defined benefit pension plans and make benefit payments related to postretirement welfare plans of between \$15.0 million and \$17.0 million. We also estimate we will contribute between \$85.0 million and \$95.0 million to our defined contribution plans.

We do not believe there are any other material trends, demands, commitments, events or uncertainties that would have, or are reasonably likely to have, a material impact on our financial condition and liquidity. Other than previously discussed, we currently have no information that would create a reasonable likelihood that the reported levels of revenues and cash flows from operations in 2005 are not indicative of what we can expect in the future.

## Contractual Obligations

In the table below, we set forth our contractual cash obligations as of December 31, 2005. Some of the figures we include in this table are based on our estimates and assumptions about these obligations, including their duration, anticipated actions by third parties and other factors. The contractual cash obligations we will actually pay in future periods may vary from those reflected in the table because the estimates and assumptions are subjective.

(In millions)	Payments Due by Period				
	Total	Less Than 1 year	1 – 3 Years	4 – 5 Years	More than 5 Years
Total debt <sup>(1)</sup>	\$ 1,084.9	\$ 9.9	\$ –	\$ 525.0	\$ 550.0
Estimated interest payments <sup>(2)</sup>	996.5	72.6	145.2	96.8	681.9
Operating leases <sup>(3)</sup>	314.0	74.7	93.8	41.8	103.7
Purchase obligations <sup>(4)</sup>	173.0	163.2	9.8	–	–
Other long-term liabilities <sup>(5)</sup>	52.4	12.8	20.7	6.0	12.9
<b>Total</b>	<b>\$ 2,620.8</b>	<b>\$ 333.2</b>	<b>\$ 269.5</b>	<b>\$ 669.6</b>	<b>\$ 1,348.5</b>

<sup>(1)</sup> Amounts represent the expected cash payments for our total debt and do not include any unamortized discounts, deferred issuance costs or net deferred gains on terminated interest rate swap agreements.

<sup>(2)</sup> Amounts represent the expected cash payments for interest on our fixed rate long-term debt.

<sup>(3)</sup> We enter into operating leases in the normal course of business. Some lease agreements provide us with the option to renew the lease. Our future operating lease payments would change if we exercised these renewal options and if we entered into additional operating lease agreements.

<sup>(4)</sup> Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase obligations exclude agreements that are cancelable at anytime without penalty.

<sup>(5)</sup> Amounts represent other long-term liabilities, including the current portion, reflected in the consolidated balance sheet where both the timing and amount of payment streams are known. Amounts include: payments for certain environmental remediation liabilities, payments for deferred compensation, payouts under acquisition agreements and payments for certain asset retirement obligations. Amounts do not include: payments for pension contributions, payments for various postretirement welfare benefit plans and postemployment benefit plans and payments for deferred taxes and other tax liabilities.

## Off-Balance Sheet Arrangements

In the normal course of business with customers, vendors and others, we have entered into off-balance sheet arrangements, such as letters of credit and other bank issued guarantees, which totaled approximately \$319.8 million at December 31, 2005. In addition, at December 31, 2005, we have guaranteed debt and other obligations of third parties with a maximum potential exposure of \$1.4 million. None of these off-balance sheet arrangements either has, or is likely to have, a material effect on our current or future financial condition, results of operations, liquidity or capital resources.

Other than normal operating leases, we do not have any off-balance sheet financing arrangements such as securitization agreements, liquidity trust vehicles, synthetic leases or special purpose entities. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such financing arrangements.

## New Accounting Standards

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*, which amends the guidance in ARB No. 43 to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 requires that these items be recognized as current period charges. In addition, SFAS No. 151 requires the allocation of fixed production

overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We adopted SFAS No. 151 on January 1, 2006, with no material effect on our consolidated financial statements.

In December 2004, the FASB issued the revised SFAS No. 123, *Share-Based Payment* (“SFAS No. 123(R)”). SFAS No. 123(R) is a revision of SFAS No. 123 and supersedes APB No. 25. SFAS No. 123(R) requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period in which an employee is required to provide service in exchange for the award. SFAS No. 123(R) also requires an entity to initially measure the cost of employee services rendered in exchange for an award of liability instruments at its current fair value. The fair value of that award is to be remeasured subsequently at each reporting date through the settlement date. Changes in the fair value during the required service period are to be recognized as compensation cost over that period. In accordance with guidance issued by the SEC that delayed the effective date of SFAS No. 123(R), we adopted SFAS No. 123(R) on January 1, 2006 using the modified prospective method, whereby we will recognize expense on any previously granted unvested awards over the remaining service period of the award. New awards granted after the adoption date will be expensed over the estimated



service period. Based on our current estimates, we expect the impact in 2006 of the adoption of SFAS No. 123(R) to be additional expense of between \$18.0 million and \$20.0 million, net of tax. We are continuing to evaluate the various option pricing models and the required assumptions and estimates that will be used in determining the fair value of awards made in 2006. In addition, we have estimated the number of awards to be granted in 2006 because the final amount has not been determined. As a result, the actual amount recorded as expense in 2006 may be different from this estimated amount and this estimated amount may not be indicative of the expense we may incur in future years.

In December 2004, the FASB issued FASB Staff Position No. 109-1 ("FSP 109-1"), *Application of FASB Statement No. 109, "Accounting for Income Taxes" ("SFAS No. 109") to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*, which provides guidance on the American Jobs Creation Act of 2004 (the "Act"). The Act provides a tax deduction for income from qualified domestic production activities. FSP 109-1 provides for the treatment of the deduction as a special deduction as described in SFAS No. 109. As such, the deduction will have no effect on existing deferred tax assets and liabilities. The impact of the deduction is to be reported in the period in which the deduction is claimed on our U.S. tax return. We adopted FSP 109-1 on January 1, 2005, with no material impact on our 2005 effective tax rate, and we do not expect that this deduction will have a material impact on our effective tax rate in future years.

In December 2004, the FASB issued FASB Staff Position No. 109-2 ("FSP 109-2"), *Accounting and Disclosure Guidance for the Foreign Repatriation Provision within the American Jobs Creation Act of 2004*, which provides guidance under SFAS No. 109 with respect to recording the potential impact of the repatriation provisions of the Act on a company's income tax expense and deferred tax liability. FSP 109-2 states that a company is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. We have decided not to elect to repatriate foreign earnings under the provisions in the Act. Accordingly, our consolidated financial statements do not reflect a provision for taxes related to this election.

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47"), *Accounting for Conditional Asset Retirement Obligations*. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. We adopted FIN 47 on December 31, 2005, which resulted in a charge of \$0.9 million, net of tax of \$0.5 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded conditional asset retirement obligations of \$1.6 million as the fair value of the costs associated with certain conditional asset retirement obligations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 replaces Accounting Principles Board Opinion No. 20 ("APB No. 20"), *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application of changes in accounting principle to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We adopted SFAS No. 154 on January 1, 2006.

### Related Party Transactions

In conjunction with the formation of WesternGeco in November 2000, we entered into an agreement with Schlumberger whereby a cash true-up payment was to be made by either of the parties based on a formula comparing the ratio of the net present value of sales revenue from each party's contributed multient seismic data libraries during the four-year period ending November 30, 2004 and the ratio of the net book value of those libraries as of November 30, 2000. The maximum payment that either party would be required to make as a result of this adjustment was \$100.0 million. In August 2005, we received \$13.3 million from Schlumberger related to the true-up payment. We recorded \$13.0 million as a reduction in the carrying value of our investment in WesternGeco and \$0.3 million as interest income. The income tax effect of \$3.3 million related to this payment is included in our provision for income taxes for the year ended December 31, 2005.

In November 2000, we also entered into an agreement with WesternGeco whereby WesternGeco subleased a facility from us for a period of ten years at then current market rates. During 2005, 2004 and 2003, we received payments of \$6.5 million, \$5.5 million and \$5.0 million, respectively, from WesternGeco related to this lease.

During 2005, we received distributions of \$30.0 million from WesternGeco, which were recorded as reductions in the carrying value of our investment.

Effective December 1, 2005, either party to the WesternGeco Master Formation Agreement may offer to sell its entire interest in the venture to the other party at a cash purchase price per percentage interest specified in an offer notice. If the offer to sell is not accepted, the offering party will be obligated to purchase and the other party will be obligated to sell its entire interest at the same price per percentage interest as the price specified in the offer notice.

At December 31, 2005 and 2004, net accounts receivable (payable) from unconsolidated affiliates totaled \$0.4 million and \$(1.1) million, respectively. There were no other significant related party transactions.

## Forward-Looking Statements

MD&A and certain statements in the Notes to Consolidated Financial Statements include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, (each a “forward-looking statement”). The words “anticipate,” “believe,” “ensure,” “expect,” “if,” “intend,” “estimate,” “project,” “forecasts,” “predict,” “outlook,” “aim,” “will,” “could,” “should,” “would,” “may,” “likely” and similar expressions, and the negative thereof, are intended to identify forward-looking statements. Our forward-looking statements are based on assumptions that we believe to be reasonable but that may not prove to be accurate. The statements do not include the potential impact of future transactions, such as an acquisition, disposition, merger, joint venture or other transaction that could occur. We undertake no obligation to publicly update or revise any forward-looking statement. Our expectations regarding our business outlook, including changes in revenue, pricing, capital spending, profitability, strategies for our operations, impact of our common stock repurchases, oil and natural gas market conditions, market share and contract terms, costs and availability of resources, economic and regulatory conditions, and environmental matters are only our forecasts regarding these matters.

All of our forward-looking information is subject to risks and uncertainties that could cause actual results to differ materially from the results expected. Although it is not possible to identify all factors, these risks and uncertainties include the risk factors and the timing of any of those risk factors identified in the “Risk Factors Related to the Worldwide Oil and Natural Gas Industry” and “Risk Factors Related to Our Business” sections contained in Item 1A. Risk Factors and those set forth from time to time in our filings with the Securities and Exchange Commission (“SEC”). These documents are available through our web site or through the SEC’s Electronic Data Gathering and Analysis Retrieval System (“EDGAR”) at <http://www.sec.gov>.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to certain market risks that are inherent in our financial instruments and arise in the normal course of business. We may enter into derivative financial instrument transactions to manage or reduce market risk but do not enter into derivative financial instrument transactions for speculative purposes. A discussion of our primary market risk exposure in financial instruments is presented below.

### Indebtedness

We are subject to interest rate risk on our long-term fixed interest rate debt. Commercial paper borrowings, other short-term borrowings and variable rate long-term debt do not give rise to significant interest rate risk because these borrowings either have maturities of less than three months or have variable interest rates. All other things being equal, the fair market value of debt with a fixed interest rate will increase as interest rates fall and will decrease as interest rates rise. This exposure to interest rate risk is managed by borrowing money that has a variable interest rate or using interest rate swaps to change fixed interest rate borrowings to variable interest rate borrowings.

At December 31, 2005 and 2004, we had fixed rate debt aggregating \$1,075.0 million and \$1,075.2 million, respectively. The following table sets forth the required cash payments for our indebtedness, which bear a fixed rate of interest and are denominated in U.S. Dollars, and the related weighted average effective interest rates by expected maturity dates as of December 31, 2005 and 2004 (dollar amounts in millions).

	2005	2006	2007	2008	2009	2010	Thereafter	Total
As of December 31, 2005:								
Long-term debt <sup>(1) (2)</sup>	\$ –	\$ –	\$ –	\$ –	\$ 525.0	\$ –	\$ 550.0	\$ 1,075.0
Weighted average effective interest rates					5.19% <sup>(3)</sup>		7.55%	6.37% <sup>(3)</sup>
As of December 31, 2004:								
Long-term debt <sup>(1) (2)</sup>	\$ 0.1	\$ 0.1	\$ –	\$ –	\$ 525.0	\$ –	\$ 550.0	\$ 1,075.2
Weighted average effective interest rates	12.30%	6.50%			4.96% <sup>(3)(4)</sup>		7.55%	6.24% <sup>(3)(4)</sup>
Fixed to variable swaps <sup>(4)</sup>								
Notional amount					\$ 325.0			\$ 325.0
Pay rate					4.60% <sup>(5)</sup>			4.60% <sup>(5)</sup>
Receive rate					6.25%			6.25%

<sup>(1)</sup> Amounts do not include any unamortized discounts, deferred issuance costs or net deferred gains on terminated interest rate swap agreements.

<sup>(2)</sup> Fair market value of fixed rate long-term debt was \$1,223.7 million at December 31, 2005 and \$1,239.0 million at December 31, 2004.

<sup>(3)</sup> Includes the effect of the amortization of net deferred gains on terminated interest rate swap agreements.

<sup>(4)</sup> Includes the fair market value of the interest rate swap agreement entered into in April 2004. The fair market value of the interest rate swap agreement was a \$2.3 million liability at December 31, 2004.

<sup>(5)</sup> Six-month LIBOR for the U.S. Dollar, reset semi-annually in January and July, plus 2.741%.

### Interest Rate Swap Agreements

At December 31, 2005, there were no interest rate swap agreements in effect. Due to our outlook for interest rates, on June 2, 2005, we terminated the interest rate swap agreement we had entered into in April 2004. This agreement had been designated and had qualified as a fair value hedging instrument. Upon termination we were required to pay \$5.5 million. This amount is being amortized as an increase to interest expense over the remaining life of the underlying debt security, which matures in January 2009.

In April 2004, we entered into an interest rate swap agreement for a notional amount of \$325.0 million associated with our 6.25% Notes due January 2009. Under the agreement we received interest at a fixed rate of 6.25% and paid interest at a floating rate of six-month LIBOR plus a spread of 2.741%. The interest rate swap agreement was designated and qualified as a fair value hedging instrument. The interest rate swap agreement was fully effective, resulting in no gain or loss recorded in the consolidated statement of operations. We recorded the fair value of the interest rate swap agreement, which was a \$2.3 million liability at December 31, 2004, based on quoted market prices for contracts with similar terms and maturity dates.

### Foreign Currency and Foreign Currency Forward Contracts

We conduct operations around the world in a number of different currencies. Many of our significant foreign subsidiaries have designated the local currency as their functional currency. As such, future earnings are subject to change due to fluctuations in foreign currency exchange rates when transactions are denominated in currencies other than our functional currencies. To minimize the need for foreign currency forward contracts to hedge this exposure, our objective is to manage foreign currency exposure by maintaining a minimal consolidated net asset or net liability position in a currency other than the functional currency.

At December 31, 2005, we had entered into several foreign currency forward contracts with notional amounts aggregating \$65.0 million to hedge exposure to currency fluctuations in various foreign currency payables and receivables, including the British Pound Sterling, the Norwegian Krone, the Euro and the Brazilian Real. These contracts are designated and qualify as fair value hedging instruments. Based on quoted market prices as of December 31, 2005 for contracts with similar terms and maturity dates, we recorded a gain of \$0.1 million to adjust these foreign currency forward contracts to their fair market value. This gain offsets designated foreign exchange losses resulting from the underlying exposures and is included in selling, general and administrative expense in the consolidated statement of operations.

At December 31, 2004, we had entered into several foreign currency forward contracts with notional amounts aggregating \$78.0 million to hedge exposure to currency fluctuations in various foreign currency payables and receivables, including the British Pound Sterling, the Norwegian Krone, the Euro and the Brazilian Real. These contracts were designated and qualified as fair value hedging instruments. Based on quoted market prices as of December 31, 2004 for contracts with similar terms and maturity dates, we recorded a loss of \$0.4 million to adjust these foreign currency forward contracts to their fair market value. This loss offsets designated foreign exchange gains resulting from the underlying exposures and is included in selling, general and administrative expense in the consolidated statement of operations.

At December 31, 2004, we had also entered into several foreign currency forward contracts with notional amounts aggregating \$122.4 million to hedge exposure to currency fluctuations in various foreign currencies, including the British Pound Sterling and the Canadian Dollar. These exposures arise when local currency operating expenses are not in balance with local currency revenue collections. The funding of such imbalances was supported by short-term intercompany borrowing commitments that had definitive amounts and funding dates. All funding took place before December 31, 2005.

These foreign currency forward contracts were designated as cash flow hedging instruments and were fully effective. Based on quoted market prices as of December 31, 2004 for contracts with similar terms and maturity dates, we recorded a loss of \$0.1 million to adjust these foreign currency forward contracts to their fair market value. The loss was recorded in other comprehensive income in the consolidated balance sheet.

The counterparties to the forward contracts are major financial institutions. The credit ratings and concentration of risk of these financial institutions are monitored on a continuing basis. In the unlikely event that the counterparties fail to meet the terms of a foreign currency contract, our exposure is limited to the foreign currency rate differential.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

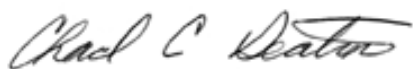
### Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our control environment is the foundation for our system of internal control and is embodied in our Business Code of Conduct, which sets the tone of our company and includes our Core Values of Integrity, Teamwork, Performance and Learning. Included in our system of internal control are written policies, an organizational structure providing division of responsibilities, the selection and training of qualified personnel and a program of financial and operations reviews by a professional staff of internal auditors. Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of our financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

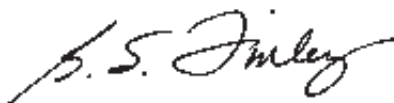
Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting. Our evaluation was based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on our evaluation under the framework in *Internal Control – Integrated Framework*, our principal executive officer and principal financial officer concluded that our internal control over financial reporting was effective as of December 31, 2005. The conclusion of our principal executive officer and principal financial officer is based on the recognition that there are inherent limitations in all systems of internal control. Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Chad C. Deaton  
Chairman and  
Chief Executive Officer



G. Stephen Finley  
Senior Vice President –  
Finance and Administration  
and Chief Financial Officer



Alan J. Keifer  
Vice President and  
Controller

Houston, Texas  
February 23, 2006

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Baker Hughes Incorporated  
Houston, Texas

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Baker Hughes Incorporated and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

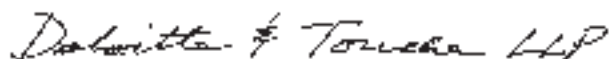
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule II as of and for the year ended December 31, 2005 of the Company; and our report dated February 23, 2006, expressed an unqualified opinion on those consolidated financial statements and financial statement schedule.



Houston, Texas  
February 23, 2006

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

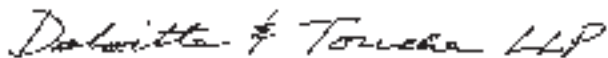
To the Board of Directors and Stockholders of Baker Hughes Incorporated  
Houston, Texas

We have audited the accompanying consolidated balance sheets of Baker Hughes Incorporated and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule II, valuation and qualifying accounts listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Baker Hughes Incorporated and subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 23, 2006, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.



Houston, Texas  
February 23, 2006

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except per share amounts)	Year Ended December 31,		
	2005	2004	2003
Revenues	\$ 7,185.5	\$ 6,079.6	\$ 5,233.3
Costs and expenses:			
Cost of revenues	4,942.5	4,351.0	3,807.5
Selling, general and administrative	1,009.6	912.2	824.6
Impairment of investment in affiliate	–	–	45.3
Reversal of restructuring charge	–	–	(1.1)
Total costs and expenses	5,952.1	5,263.2	4,676.3
Operating income	1,233.4	816.4	557.0
Equity in income (loss) of affiliates	100.1	36.3	(137.8)
Interest expense	(72.3)	(83.6)	(103.1)
Interest income	18.0	6.8	5.3
Income from continuing operations before income taxes	1,279.2	775.9	321.4
Income taxes	(404.8)	(250.6)	(145.6)
Income from continuing operations	874.4	525.3	175.8
Income (loss) from discontinued operations, net of tax	4.9	3.3	(41.3)
Income before cumulative effect of accounting change	879.3	528.6	134.5
Cumulative effect of accounting change, net of tax	(0.9)	–	(5.6)
Net income	\$ 878.4	\$ 528.6	\$ 128.9
Basic earnings per share:			
Income from continuing operations	\$ 2.58	\$ 1.57	\$ 0.52
Income (loss) from discontinued operations	0.01	0.01	(0.12)
Cumulative effect of accounting change	–	–	(0.02)
Net income	\$ 2.59	\$ 1.58	\$ 0.38
Diluted earnings per share:			
Income from continuing operations	\$ 2.56	\$ 1.57	\$ 0.52
Income (loss) from discontinued operations	0.01	0.01	(0.12)
Cumulative effect of accounting change	–	–	(0.02)
Net income	\$ 2.57	\$ 1.58	\$ 0.38

See Notes to Consolidated Financial Statements



## CONSOLIDATED BALANCE SHEETS

December 31,

(In millions, except par value)

2005 2004

### Assets

#### Current Assets:

Cash and cash equivalents	\$ 697.0	\$ 319.0
Short-term investments	77.0	–
Accounts receivable – less allowance for doubtful accounts: December 31, 2005, \$51.4; December 31, 2004, \$50.2	1,673.4	1,351.2
Inventories	1,126.3	1,025.3
Deferred income taxes	181.2	199.7
Other current assets	68.6	56.6
Assets of discontinued operations	16.6	16.7
<b>Total current assets</b>	<b>3,840.1</b>	<b>2,968.5</b>
Investments in affiliates	678.9	678.1
Property – less accumulated depreciation: December 31, 2005, \$2,475.7; December 31, 2004, \$2,380.5	1,355.5	1,332.2
Goodwill	1,315.8	1,267.0
Intangible assets – less accumulated amortization: December 31, 2005, \$84.5; December 31, 2004, \$70.2	163.4	155.1
Other assets	453.7	420.4
<b>Total assets</b>	<b>\$ 7,807.4</b>	<b>\$ 6,821.3</b>

### Liabilities and Stockholders' Equity

#### Current Liabilities:

Accounts payable	\$ 558.1	\$ 452.1
Short-term borrowings and current portion of long-term debt	9.9	76.0
Accrued employee compensation	424.5	368.4
Income taxes	141.5	104.8
Other accrued liabilities	222.9	226.0
Liabilities of discontinued operations	3.8	2.9
<b>Total current liabilities</b>	<b>1,360.7</b>	<b>1,230.2</b>
Long-term debt	1,078.0	1,086.3
Deferred income taxes and other tax liabilities	228.1	231.9
Pensions and postretirement benefit obligations	336.1	308.3
Other liabilities	106.7	69.2
Commitments and contingencies		

#### Stockholders' Equity:

Common stock, one dollar par value (shares authorized – 750.0; outstanding – 341.5 at December 31, 2005 and 336.6 at December 31, 2004)	341.5	336.6
Capital in excess of par value	3,293.5	3,127.8
Retained earnings	1,263.2	545.9
Accumulated other comprehensive loss	(188.0)	(109.8)
Unearned compensation	(12.4)	(5.1)
<b>Total stockholders' equity</b>	<b>4,697.8</b>	<b>3,895.4</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 7,807.4</b>	<b>\$ 6,821.3</b>

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<i>(In millions, except per share amounts)</i>	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Loss	Unearned Compensation	Total
Balance, December 31, 2002	\$ 335.8	\$ 3,111.6	\$ 196.3	\$ (246.5)	\$ –	\$ 3,397.2
Comprehensive income:						
Net income			128.9			
Foreign currency translation adjustments:						
Reclassifications included in net income due to sale of business				17.7		
Translation adjustments, net of tax of \$0.3				95.6		
Change in minimum pension liability, net of tax of \$5.3				(17.9)		
Total comprehensive income						224.3
Cash dividends (\$0.46 per share)			(154.3)			(154.3)
Stock issued pursuant to employee stock plans, net of tax of \$1.5	2.5	62.1				64.6
Repurchase and retirement of common stock	(6.3)	(175.1)				(181.4)
Balance, December 31, 2003	332.0	2,998.6	170.9	(151.1)	–	3,350.4
Comprehensive income:						
Net income			528.6			
Foreign currency translation adjustments:						
Reclassifications included in net income due to sale of business				6.6		
Translation adjustments, net of tax of \$2.3				30.8		
Change in minimum pension liability, net of tax of \$(1.8)				4.0		
Loss on derivative instruments, net of tax of \$0.01				(0.1)		
Total comprehensive income						569.9
Cash dividends (\$0.46 per share)			(153.6)			(153.6)
Issuance of restricted stock, net of tax of \$1.1	0.2	6.7			(5.6)	1.3
Amortization of unearned compensation, net of tax of \$(0.2)					0.5	0.5
Stock issued pursuant to employee stock plans, net of tax of \$12.5	4.4	122.5				126.9
Balance, December 31, 2004	336.6	3,127.8	545.9	(109.8)	(5.1)	3,895.4
Comprehensive income:						
Net income			878.4			
Foreign currency translation adjustments, net of tax of \$0.1				(65.0)		
Change in minimum pension liability, net of tax of \$5.5				(12.2)		
Other				(1.0)		
Total comprehensive income						800.2
Cash dividends (\$0.475 per share)			(161.1)			(161.1)
Issuance of restricted stock net of cancellations, net of tax of \$6.6	0.4	19.2			(12.3)	7.3
Amortization of unearned compensation, net of tax of \$(2.1)					5.0	5.0
Stock issued pursuant to employee stock plans, net of tax of \$19.8	6.2	243.3				249.5
Repurchase and retirement of common stock	(1.7)	(96.8)				(98.5)
Balance, December 31, 2005	\$ 341.5	\$ 3,293.5	\$ 1,263.2	\$ (188.0)	\$ (12.4)	\$ 4,697.8

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)	Year Ended December 31,		
	2005	2004	2003
Cash flows from operating activities:			
Income from continuing operations	\$ 874.4	\$ 525.3	\$ 175.8
Adjustments to reconcile income from continuing operations to net cash flows from operating activities:			
Depreciation and amortization	382.4	371.6	347.3
Amortization of net deferred gains on derivatives	(5.7)	(7.9)	(6.7)
Amortization of unearned compensation	7.1	0.7	–
Acquired in-process research and development	5.1	1.8	–
Provision (benefit) for deferred income taxes	7.4	48.4	(20.1)
Gain on disposal of assets	(34.8)	(37.8)	(30.2)
Impairment of investment in affiliate	–	–	45.3
Equity in (income) loss of affiliates	(100.1)	(36.3)	137.8
Changes in operating assets and liabilities:			
Accounts receivable	(329.4)	(173.7)	(13.8)
Inventories	(108.7)	(3.2)	20.7
Accounts payable	122.3	48.3	15.6
Accrued employee compensation and other accrued liabilities	147.3	140.7	0.7
Pensions and postretirement benefit obligations and other liabilities	41.7	(30.4)	(23.0)
Other	(59.4)	(65.7)	(0.4)
Net cash flows from continuing operations	949.6	781.8	649.0
Net cash flows from discontinued operations	5.8	1.9	7.1
Net cash flows from operating activities	955.4	783.7	656.1
Cash flows from investing activities:			
Expenditures for capital assets	(478.3)	(348.2)	(403.9)
Acquisition of businesses, net of cash acquired	(46.8)	(6.6)	(9.5)
Purchase of short-term investments	(77.0)	–	–
Proceeds from disposal of assets	90.1	106.9	66.8
Distributions from WesternGeco	30.0	–	–
Receipt of true-up payment related to WesternGeco	13.0	–	–
Net proceeds from sale of business and interest in affiliate	3.7	58.7	24.0
Investments in affiliates	–	(7.1)	(38.1)
Net cash flows from continuing operations	(465.3)	(196.3)	(360.7)
Net cash flows from discontinued operations	(0.1)	(0.5)	(1.5)
Net cash flows from investing activities	(465.4)	(196.8)	(362.2)
Cash flows from financing activities:			
Net (repayments) borrowings of commercial paper and other short-term debt	(71.1)	35.5	11.2
Repayment of indebtedness	–	(350.0)	(100.0)
Payment to terminate interest rate swap agreement	(5.5)	–	–
Proceeds from termination of interest rate swap agreements	–	–	26.9
Proceeds from issuance of common stock	228.1	115.9	61.8
Repurchase of common stock	(98.5)	–	(181.4)
Dividends	(161.1)	(153.6)	(154.3)
Net cash flows from financing activities	(108.1)	(352.2)	(335.8)
Effect of foreign exchange rate changes on cash	(3.9)	(14.1)	(3.6)
Increase (decrease) in cash and cash equivalents	378.0	220.6	(45.5)
Cash and cash equivalents, beginning of year	319.0	98.4	143.9
Cash and cash equivalents, end of year	\$ 697.0	\$ 319.0	\$ 98.4
Income taxes paid	\$ 299.7	\$ 143.2	\$ 188.5
Interest paid	\$ 80.8	\$ 97.5	\$ 116.2

See Notes to Consolidated Financial Statements

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 1. Summary of Significant Accounting Policies

#### Nature of Operations

Baker Hughes Incorporated (“Baker Hughes”) is engaged in the oilfield services industry. Baker Hughes is a major supplier of wellbore-related products and technology services and systems to the worldwide oil and natural gas industry and provides products and services for drilling, formation evaluation, completion and production of oil and natural gas wells.

#### Basis of Presentation

The consolidated financial statements include the accounts of Baker Hughes and all majority owned subsidiaries (“we,” “our” or “us”). Investments over which we have the ability to exercise significant influence over operating and financial policies, but do not hold a controlling interest, are accounted for using the equity method of accounting. All significant inter-company accounts and transactions have been eliminated in consolidation. In the Notes to Consolidated Financial Statements, all dollar and share amounts in tabulations are in millions of dollars and shares, respectively, unless otherwise indicated.

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates and judgments on historical experience and on various other assumptions and information that are believed to be reasonable under the circumstances. Estimates and assumptions about future events and their effects cannot be perceived with certainty and, accordingly, these estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. While we believe that the estimates and assumptions used in the preparation of the consolidated financial statements are appropriate, actual results could differ from those estimates. Estimates are used for, but are not limited to, determining the following: allowance for doubtful accounts and inventory valuation reserves, recoverability of long-lived assets, useful lives used in depreciation and amortization, income taxes and related valuation allowances and insurance, environmental, legal and pensions and postretirement benefit obligations.

#### Revenue Recognition

Our products and services are generally 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. Our products are produced in a standard

manufacturing operation, even if produced to our customer’s specifications, and are sold in the ordinary course of business through our regular marketing channels. We recognize revenue for these products upon delivery, when title passes and when collectibility is reasonably assured. Provisions for estimated warranty returns or similar types of items are made at the time the related revenue is recognized. Revenue for services is recognized as the services are rendered and when collectibility is reasonably assured. Rates for services are typically priced on a per day, per meter, per man hour or similar basis.

#### Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents.

#### Short-term Investments

During 2005, we began investing in auction rate securities, which are highly liquid, variable-rate debt securities. While the underlying security has a long-term maturity, the interest rate is reset through Dutch auctions that are typically held every 7, 28 or 35 days, creating short-term liquidity. The securities trade at par and are callable at par on any interest payment date at the option of the issuer. Interest is paid at the end of each auction period. We limit our investments in auction rate securities to securities that carry a AAA (or equivalent) rating from a recognized rating agency. The investments are classified as available-for-sale and are recorded at cost, which approximates market value.

#### Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out (“FIFO”) method or the average cost method, which approximates FIFO, and includes the cost of materials, labor and manufacturing overhead.

#### Property and Depreciation

Property is stated at cost less accumulated depreciation, which is generally provided by using the straight-line method over the estimated useful lives of the individual assets. We manufacture a substantial portion of our rental tools and equipment and the cost of these items, which includes direct and indirect manufacturing costs, are capitalized and carried in inventory until the tool is completed. Once the tool has been completed, the cost of the tool is reflected in capital expenditures and the tool is classified as rental tools and equipment in property. Significant improvements and betterments are capitalized if they extend the useful life of the asset.

#### Goodwill, Intangible Assets and Amortization

Goodwill, including goodwill associated with equity method investments, and intangible assets with indefinite lives are not amortized. Intangible assets with finite useful lives are amortized either on a straight-line basis over the

asset's estimated useful life or on a basis that reflects the pattern in which the economic benefits of the intangible assets are realized.

### **Impairment of Long-Lived Assets**

We review property, intangible assets and certain other assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The determination of recoverability is made based upon the estimated undiscounted future net cash flows, excluding interest expense. The amount of impairment loss, if any, is determined by comparing the fair value, as determined by a discounted cash flow analysis, with the carrying value of the related assets.

We perform an annual impairment test of goodwill for each of our reporting units as of October 1, or more frequently if circumstances indicate an impairment may exist. Our reporting units are based on our organizational and reporting structure. Corporate and other assets and liabilities are allocated to the reporting units to the extent that they relate to the operations of those reporting units in determining their carrying amount. Investments in affiliates are also reviewed for impairment whenever events or changes in circumstances indicate that impairment may exist. The determination of impairment is made by comparing the carrying amount with its fair value, which is calculated using a combination of a market capitalization and discounted cash flow approach.

### **Income Taxes**

We use the liability method for determining our income taxes, under which current and deferred tax liabilities and assets are recorded in accordance with enacted tax laws and rates. Under this method, the amounts of deferred tax liabilities and assets at the end of each period are determined using the tax rate expected to be in effect when taxes are actually paid or recovered. Future tax benefits are recognized to the extent that realization of such benefits is more likely than not.

Deferred income taxes are provided for the estimated income tax effect of temporary differences between financial and tax bases in assets and liabilities. Deferred tax assets are also provided for certain tax credit carryforwards. A valuation allowance to reduce deferred tax assets is established when it is more likely than not that some portion or all of the deferred tax assets will not be realized.

We intend to indefinitely reinvest certain earnings of our foreign subsidiaries in operations outside the U.S., and accordingly, we have not provided for U.S. income taxes on such earnings. We do provide for the U.S. and additional non-U.S. taxes on earnings anticipated to be repatriated from our non-U.S. subsidiaries.

We operate in more than 90 countries under many legal forms. As a result, we are subject to the jurisdiction of numerous domestic and foreign tax authorities, as well as to tax agreements and treaties among these governments. Our operations in these different jurisdictions are taxed on various bases: actual income before taxes, deemed profits (which are generally determined using a percentage of revenues rather

than profits) and withholding taxes based on revenue. Determination of taxable income in any jurisdiction requires the interpretation of the related tax laws and regulations and the use of estimates and assumptions regarding significant future events, such as the amount, timing and character of deductions, permissible revenue recognition methods under the tax law and the sources and character of income and tax credits. Changes in tax laws, regulations, agreements and treaties, foreign currency exchange restrictions or our level of operations or profitability in each taxing jurisdiction could have an impact upon the amount of income taxes that we provide during any given year.

Our tax filings for various periods are subjected to audit by tax authorities in most jurisdictions where we conduct business. These audits may result in assessments of additional taxes that are resolved with the authorities or potentially through the courts. We believe that these assessments may occasionally be based on erroneous and even arbitrary interpretations of local tax law. We have received tax assessments from various taxing authorities and are currently at varying stages of appeals and/or litigation regarding these matters. We have provided for the amounts we believe will ultimately result from these proceedings. We believe we have substantial defenses to the questions being raised and will pursue all legal remedies should an unfavorable outcome result. However, resolution of these matters involves uncertainties and there are no assurances that the outcomes will be favorable.

### **Product Warranties**

We sell certain products with a product warranty that provides that customers can return a defective product during a specified warranty period following the purchase in exchange for a replacement product, repair at no cost to the customer or the issuance of a credit to the customer. We accrue amounts for estimated warranty claims based upon current and historical product sales data, warranty costs incurred and any other related information known to us.

### **Environmental Matters**

Remediation costs are accrued based on estimates of known environmental remediation exposure using currently available facts, existing environmental permits, technology and presently enacted laws and regulations. For sites where we are primarily responsible for the remediation, our cost estimates are developed based on internal evaluations and are not discounted. Such accruals are recorded when it is probable that we will be obligated to pay for environmental site evaluation, remediation or related activities, and such costs can be reasonably estimated. If the obligation can only be estimated within a range, we accrue the minimum amount in the range. Such accruals are recorded even if significant uncertainties exist over the ultimate cost of the remediation. As additional or more accurate information becomes available, accruals are adjusted to reflect current cost estimates. Ongoing environmental compliance costs, such as obtaining environmental permits, installation of pollution control equipment and waste disposal, are

expensed as incurred. Where we have been identified as a potentially responsible party in a United States federal or state "Superfund" site, we accrue our share of the estimated remediation costs of the site. This share is based on the ratio of the estimated volume of waste we contributed to the site to the total volume of waste disposed at the site.

### Foreign Currency

The majority of our significant foreign subsidiaries have designated the local currency as their functional currency and, as such, gains and losses resulting from balance sheet translation of foreign operations are included as a separate component of accumulated other comprehensive loss within stockholders' equity. Gains and losses from foreign currency transactions, such as those resulting from the settlement of receivables or payables in the non-functional currency, are included in selling, general and administrative ("SG&A") expense in the consolidated statements of operations as incurred. For those foreign subsidiaries that have designated the U.S. Dollar as the functional currency, gains and losses resulting from balance sheet translation of foreign operations are also included in SG&A expense in the consolidated statements of operations as incurred. We recorded net foreign currency transaction and translation gains in SG&A in the consolidated statement of operations of \$6.8 million, \$4.0 million and \$1.5 million in 2005, 2004 and 2003, respectively.

### Derivative Financial Instruments

We monitor our exposure to various business risks including commodity price, foreign currency exchange rate and interest rate risks and occasionally use derivative financial instruments to manage the impact of certain of these risks. Our policies do not permit the use of derivative financial instruments for speculative purposes. We use foreign currency forward contracts to hedge certain firm commitments and transactions denominated in foreign currencies. We use interest rate swaps to manage interest rate risk.

At the inception of any new derivative, we designate the derivative as a cash flow or fair value hedge or we determine the derivative to be undesignated as a hedging instrument as the facts dictate. We document all relationships between the hedging instruments and the hedged items, as well as our risk management objectives and strategy for undertaking various hedge transactions. We assess whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged item at both the inception of the hedge and on an ongoing basis.

### Stock-Based Compensation

As allowed under Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*, we account for compensation related to stock options and our employee stock purchase plan using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), *Accounting for Stock Issued to Employees*. Under this method, compensation expense is recognized only for the difference between the quoted market price of the stock at the measurement date less the amount, if any, the employee is required to pay for the stock. Our reported net income does not include any compensation expense associated with our employee stock purchase plan or with stock option awards because the exercise prices of our stock option awards equal the market prices of the underlying stock when granted and because our employee stock purchase plan is non compensatory. Our reported net income does include compensation expense associated with restricted stock awards.

In December 2004, the Financial Accounting Standards Board ("FASB") issued the revised SFAS No. 123, *Share-Based Payment* ("SFAS No. 123(R)"). SFAS No. 123(R) is a revision of SFAS No. 123 and supersedes APB No. 25. SFAS No. 123(R) requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period in which an employee is required to provide service in exchange for the award. SFAS No. 123(R) also requires an entity to initially measure the cost of employee services rendered in exchange for an award of liability instruments at its current fair value with the fair value remeasured at each subsequent reporting date through the settlement date. Changes in the fair value during the required service period are to be recognized as compensation cost over that period.

SFAS No. 123(R) clarified the accounting in SFAS No. 123 related to estimating the service period for employees that are or become retirement eligible during the vesting period, requiring that the recognition of compensation expense for these employees be accelerated. This impacts the timing of expense recognition, but not the total expense to be recognized over the vesting period. In the first quarter of 2005, we adopted this new methodology on a prospective basis. The cumulative effect of this clarification is \$11.8 million, net of tax, which, for purposes of calculating the pro forma disclosure, is included in our pro forma disclosure for stock-based compensation below for the year ended December 31, 2005.

If we had recognized compensation expense by applying the fair value based method to all awards as provided for under SFAS No. 123, our pro forma net income, earnings per share ("EPS") and stock-based compensation cost would have been as follows for the years ended December 31:

	2005	2004	2003
Net income, as reported	\$ 878.4	\$ 528.6	\$ 128.9
Add: Stock-based compensation for restricted stock awards included in reported net income, net of tax	6.1	1.6	1.9
Deduct: Stock-based compensation determined under the fair value method, net of tax	(35.0)	(23.1)	(23.1)
Pro forma net income	\$ 849.5	\$ 507.1	\$ 107.7
Basic EPS			
As reported	\$ 2.59	\$ 1.58	\$ 0.38
Pro forma	2.50	1.52	0.32
Diluted EPS			
As reported	\$ 2.57	\$ 1.58	\$ 0.38
Pro forma	2.49	1.51	0.32

Under SFAS No. 123, the fair value of stock-based awards is calculated through the use of option pricing models. These models require a number of subjective assumptions and estimates which can significantly affect the calculated values. These include future stock price volatility, expected time to exercise, discount rates, forfeiture rates and employee turnover rates. In addition, the number of awards granted impacts the amount of expense. As a result, the above pro forma amounts may not be indicative of future amounts. The above proforma calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions for the years ended December 31:

	Assumptions			
	Dividend Yield	Expected Volatility	Risk-Free Interest Rate	Expected Life (In years)
2005	1.0%	35.0%	3.7%	3.7
2004	1.3%	39.9%	2.8%	3.5
2003	1.6%	45.0%	2.5%	3.8

The weighted average fair values of options granted in 2005, 2004 and 2003 were \$14.62, \$11.16 and \$10.25 per share, respectively.

In accordance with guidance issued by the SEC that delayed the effective date, we adopted SFAS No. 123(R) on January 1, 2006 using the modified prospective method whereby we will recognize expense on any previously granted unvested awards over the remaining service period of the award. New awards granted after the adoption date will be expensed over the estimated service period. Based on our current estimates, we expect the impact in 2006 of the adoption of SFAS No. 123(R) to be additional expense of between \$18.0 million and \$20.0 million, net of tax. We are continuing to evaluate the various option pricing models and the required assumptions and estimates that will be used in determining the fair value of awards made in 2006. In addition, we have estimated the number of awards to be granted in 2006 because the final amount has not been determined. As a result, the actual amount recorded as expense in 2006 may be different from this estimated amount and this estimated amount may not be indicative of the expense we may incur in future years.

### New Accounting Standards

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*, which amends the guidance in ARB No. 43 to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 requires that these items be recognized as current period charges. In addition, SFAS No. 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 was effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We adopted SFAS No. 151 on January 1, 2006 with no material impact on our consolidated financial statements.

In December 2004, the FASB issued FASB Staff Position No. 109-1 ("FSP 109-1"), *Application of FASB Statement No. 109, "Accounting for Income Taxes" ("SFAS No. 109") to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*, which provides guidance on the American Jobs Creation Act of 2004 (the "Act"). The Act provides a tax deduction for income from qualified domestic production activities. FSP 109-1 provides for the treatment of the deduction as a special deduction as described in SFAS No. 109. As such, the deduction will have no effect on existing deferred tax assets and liabilities. The impact of the deduction is to be reported in the period in which the deduction is claimed on our U.S. tax return. We adopted FSP 109-1 on January 1, 2005, with no material impact on our 2005 effective tax rate, and we do not expect that this deduction will have a material impact on our effective tax rate in future years.

In December 2004, the FASB issued FASB Staff Position No. 109-2 ("FSP 109-2"), *Accounting and Disclosure Guidance for the Foreign Repatriation Provision within the American Jobs Creation Act of 2004*, which provides guidance under SFAS No. 109 with respect to recording the potential impact of the repatriation provisions of the Act on a company's income tax expense and deferred tax liability. FSP 109-2 states that a company is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. We have decided not to elect to repatriate foreign earnings under the provisions in the Act. Accordingly, our consolidated financial statements do not reflect a provision for taxes related to this election.

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47"), *Accounting for Conditional Asset Retirement Obligations*. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. We adopted FIN 47 on December 31, 2005, which resulted in a charge of \$0.9 million, net of tax of \$0.5 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded conditional asset retirement obligations of \$1.6 million as the fair value of the costs associated with certain conditional asset retirement obligations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 replaces Accounting Principles Board Opinion No. 20 ("APB No. 20"), *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application of changes in accounting principle to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We adopted SFAS No. 154 on January 1, 2006.

## Note 2. Discontinued Operations

In the fourth quarter of 2005, our management initiated and our Board of Directors approved a plan to sell the Baker Supply Products Division ("SPD"), a product line group within the Completion and Production segment. SPD distributes basic supplies, products and small tools to the drilling industry. In January 2006, we signed a non-binding letter of intent for the sale of SPD. The sale is expected to close in the first quarter of 2006. This transaction is subject to the negotiation and execution of a definitive sale agreement, as well as, various conditions, including satisfactory due diligence review of SPD's business. There can be no assurance that the transaction will be consummated.

In September 2004, we completed the sale of Baker Hughes Mining Tools ("BHMT"), a product line group within the Drilling and Evaluation segment that manufactured rotary drill bits used in the mining industry, for \$31.5 million. We recorded a gain on the sale of \$0.2 million, net of tax of \$3.6 million, which consisted of a gain on the disposal of \$6.8 million offset by a loss of \$6.6 million related to the recognition of the cumulative foreign currency translation adjustments into earnings.

In October 2003, we signed a definitive agreement for the sale of BIRD Machine ("BIRD"), the remaining division of the former Process segment, and recorded charges totaling \$37.4 million, net of tax of \$10.9 million, which consisted of a loss of \$13.5 million on the write-down of BIRD to fair value, \$6.2 million of severance and warranty accruals and a loss of \$17.7 million related to the recognition of cumulative foreign currency translation adjustments into earnings. In January 2004, we completed the sale of BIRD and recorded an additional loss on the sale of \$0.5 million with no tax benefit. We received \$5.6 million in proceeds, which were subject to post-closing adjustments to the purchase price, and retained certain accounts receivable, inventories and other assets. During the second quarter of 2004, we made a net payment of \$6.8 million to the buyer in settlement of the final purchase price adjustments. The adjustments were the result of changes in the value of assets sold to and liabilities assumed by the buyer between the date the initial sales price was negotiated and the closing of the sale.

In December 2002, we entered into exclusive negotiations for the sale of our interest in our oil producing operations in West Africa and received \$10.0 million as a deposit. The transaction was effective as of January 1, 2003, and resulted in a gain on the sale of \$4.1 million, net of a tax benefit of \$0.2 million. We received the remaining \$22.0 million in proceeds in April 2003.

In 2003, all purchase price adjustments related to the sale of EIMCO Process Equipment ("EIMCO") were completed, resulting in the release of the escrow balance, of which we received \$2.0 million and \$2.9 million was returned to the buyer. We recorded an additional loss on the sale of EIMCO of \$2.5 million, net of tax of \$1.3 million.



We have reclassified the consolidated financial statements for all prior periods presented to reflect these operations as discontinued. Summarized financial information from discontinued operations is as follows for the years ended December 31:

	2005	2004	2003
<b>Revenues:</b>			
SPD	\$ 32.5	\$ 24.2	\$ 19.1
BHMT	–	29.4	40.4
BIRD	–	1.6	94.2
Oil producing operations	–	–	4.2
<b>Total</b>	<b>\$ 32.5</b>	<b>\$ 55.2</b>	<b>\$ 157.9</b>
<b>Income (loss) before income taxes:</b>			
SPD	\$ 7.7	\$ 4.7	\$ 3.3
BHMT	–	1.1	3.5
BIRD	–	(0.2)	(16.9)
Oil producing operations	–	–	1.8
<b>Total</b>	<b>7.7</b>	<b>5.6</b>	<b>(8.3)</b>
<b>Income taxes:</b>			
SPD	(2.8)	(1.8)	(1.2)
BHMT	–	(0.3)	(1.3)
BIRD	–	0.1	6.0
Oil producing operations	–	–	(0.7)
<b>Total</b>	<b>(2.8)</b>	<b>(2.0)</b>	<b>2.8</b>
<b>Income (loss) before gain (loss) on disposal:</b>			
SPD	4.9	2.9	2.1
BHMT	–	0.8	2.2
BIRD	–	(0.1)	(10.9)
Oil producing operations	–	–	1.1
<b>Total</b>	<b>4.9</b>	<b>3.6</b>	<b>(5.5)</b>
<b>Gain (loss) on disposal, net of tax:</b>			
BHMT	–	0.2	–
BIRD	–	(0.5)	(37.4)
Oil producing operations	–	–	4.1
EIMCO	–	–	(2.5)
<b>Total</b>	<b>–</b>	<b>(0.3)</b>	<b>(35.8)</b>
<b>Income (loss) from discontinued operations</b>	<b>\$ 4.9</b>	<b>\$ 3.3</b>	<b>\$ (41.3)</b>

Assets and liabilities of discontinued operations are as follows for the years ended December 31:

	2005	2004
Accounts receivable, net	\$ 6.0	\$ 4.9
Inventories	8.8	9.9
Property, net	1.8	1.9
<b>Assets of discontinued operations</b>	<b>\$ 16.6</b>	<b>\$ 16.7</b>
Accounts payable	\$ 2.7	\$ 2.2
Accrued employee compensation	0.7	0.4
Other accrued liabilities	0.4	0.3
<b>Liabilities of discontinued operations</b>	<b>\$ 3.8</b>	<b>\$ 2.9</b>

### Note 3. Acquisitions

In December 2005, we purchased Zeroth Technology Limited (“Zertech”), a developer of an expandable metal sealing element, for \$20.3 million in cash, which is included in the Completion and Production segment. As a result of the acquisition and based on preliminary estimates of fair values, we recorded approximately \$19.5 million of goodwill and intangible assets, which may be revised based on the final purchase price allocations. The purchase price was preliminarily allocated based on the fair values of the assets acquired and liabilities assumed in the acquisition. Pro forma results of the operations have not been presented because the effects of the acquisition were not material to our consolidated financial statements. Under the terms of the Purchase Agreement, the former owners of Zertech are entitled to additional purchase price consideration of up to approximately \$14.0 million based on the performance of the business during 2006, 2007 and 2008.

In 2003, we obtained a 50% interest in the QuantX Wellbore Instrumentation venture (“QuantX”), which is engaged in permanent in-well monitoring. Through August 2005, we accounted for our ownership in QuantX using the equity method of accounting. In August 2005, we exercised our right to acquire the remaining 50% interest in QuantX and began to consolidate QuantX’s accounts and discontinued using the equity method of accounting. In October 2005, we finalized the purchase of the remaining 50% interest in QuantX for \$27.2 million, subject to final purchase price adjustments. Based on our carrying value of our existing investment in QuantX of \$35.5 million and the additional consideration of \$27.2 million, we recorded approximately \$28.4 million of goodwill and \$19.6 million of intangibles. We also assigned \$5.1 million to in-process research and development that was written off in October 2005 at the date of acquisition. This write-off is included in research and development expenses, which are included in cost of revenues in the consolidated statement of operations. The purchase price was allocated based on the fair value of the assets acquired and liabilities assumed of QuantX. The fair values were determined using a discounted cash flow approach. Pro forma results of operations have not been presented because the effect of this acquisition was not material to our consolidated financial statements. QuantX is included in the Completion and Production segment.

In 2002, we entered into a venture, Luna Energy, L.L.C. ("Luna"), in which we had a 40% interest and that we accounted for using the equity method of accounting. In December 2004, we acquired the remaining 60% interest in Luna for \$1.0 million in cash. As a result of the acquisition, we have recorded approximately \$19.0 million of goodwill and \$5.5 million of intangible assets. We also assigned \$1.8 million to in-process research and development that was written off at the date of acquisition. This write-off is included in research and development expenses, which are included in cost of revenues in the consolidated statement of operations. The purchase price was allocated based on the fair value of the assets acquired and liabilities assumed of Luna. The fair values were determined using a discounted cash flow approach. Pro forma results of operations have not been presented because the effect of this acquisition was not material to our consolidated financial statements. Luna is included in the Completion and Production segment.

In 2003, we made two acquisitions having an aggregate purchase price of \$16.9 million, of which \$9.5 million was paid in cash. As a result of these acquisitions, we recorded approximately \$3.9 million of goodwill and \$9.6 million of intangible assets. The purchase price was allocated based on the fair value of the assets acquired and liabilities assumed in each of these acquisitions. Pro forma results of operations have not been presented because the effects of these acquisitions were not material to our consolidated financial statements on either an individual or aggregate basis.

#### Note 4. Reversal of Restructuring Charge

In 2000, our Board of Directors approved a plan to substantially exit the oil and natural gas exploration business and recorded a restructuring charge of \$29.5 million. Included in the restructuring charge was \$1.1 million for a contractual obligation related to an oil and natural gas property in Angola. The property was sold in 2003, and we reversed the liability related to this contractual obligation.

#### Note 5. Income Taxes

The provision for income taxes on income from continuing operations is comprised of the following for the years ended December 31:

	2005	2004	2003
Current:			
United States	\$ 146.3	\$ 51.7	\$ 1.6
Foreign	251.1	150.5	164.1
Total current	397.4	202.2	165.7
Deferred:			
United States	7.0	45.4	(38.1)
Foreign	0.4	3.0	18.0
Total deferred	7.4	48.4	(20.1)
Provision for income taxes	\$ 404.8	\$ 250.6	\$ 145.6

The geographic sources of income from continuing operations before income taxes are as follows for the years ended December 31:

	2005	2004	2003
United States	\$ 409.6	\$ 213.9	\$ (137.4)
Foreign	869.6	562.0	458.8
Income from continuing operations before income taxes	\$ 1,279.2	\$ 775.9	\$ 321.4

Tax benefits of \$19.8 million, \$12.5 million and \$1.5 million associated with the exercise of employee stock options were allocated to equity and recorded in capital in excess of par value in the years ended December 31, 2005, 2004 and 2003, respectively.

The provision for income taxes differs from the amount computed by applying the U.S. statutory income tax rate to income from continuing operations before income taxes for the reasons set forth below for the years ended December 31:

	2005	2004	2003
Statutory income tax at 35%	\$ 447.7	\$ 271.6	\$ 112.5
Effect of WesternGeco operations	4.1	1.8	36.3
Effect of foreign operations	(46.0)	(28.3)	(5.8)
Net tax charge related to foreign losses	5.5	4.0	4.9
State income taxes – net of U.S. tax benefit	8.8	3.4	4.0
IRS audit agreement and refund claims	(4.3)	–	(3.3)
Cumulative tax effect of SRP	(10.6)	–	–
Other – net	(0.4)	(1.9)	(3.0)
Provision for income taxes	\$ 404.8	\$ 250.6	\$ 145.6

During 2005 and 2004, we recognized an incremental effect of \$4.1 million and \$1.8 million, respectively, of additional taxes attributable to our portion of the operations of WesternGeco. This consists of \$3.3 million of tax expense associated with the \$13.3 million WesternGeco true-up payment received from Schlumberger in 2005 and the state tax effect related to increased income in the U.S. in 2005 and 2004.

During 2003, we recognized an incremental effect of \$36.3 million of additional taxes related to our investment in WesternGeco. Of this amount, \$15.9 million related to the reduction in the carrying value of our equity investment in WesternGeco, for which there was no tax benefit. The remaining \$20.4 million arose from operations of the venture due to: (i) the venture being taxed in certain foreign jurisdictions based on a deemed profit basis, which is a percentage of revenues rather than profits, and (ii) unbenefitted foreign losses of the venture, which are operating losses and impairment and restructuring charges in certain foreign jurisdictions where there was no current tax benefit and where a deferred tax asset was not recorded due to the uncertainty of realization.

In 2005 and 2003, we recognized a benefit of \$4.3 million and \$3.3 million, respectively, as the result of refund claims filed in the U.S.

In 2005, we recognized a \$10.6 million deferred tax asset attributable to the cumulative temporary difference between the carrying values of our Supplemental Retirement Plan ("SRP") for financial reporting and income tax purposes, which had the effect of reducing current year tax expense.

We have received tax assessments from various taxing authorities and are currently at varying stages of appeals and/or litigation regarding these matters. We have provided for the amounts we believe will ultimately result from these proceedings. We believe we have substantial defenses to the questions being raised and will pursue all legal remedies should an unfavorable outcome result. While we have provided for the taxes that we believe will ultimately be payable as a result of these assessments, the aggregate assessments are approximately \$34.1 million in excess of the taxes provided for in our consolidated financial statements.

In addition to the aforementioned assessments that have been received from various taxing authorities, we provide for taxes in certain situations where assessments have not been received. In those situations, we consider it probable that the taxes ultimately payable will exceed the amounts reflected in filed tax returns; accordingly, taxes are provided in those situations under the guidance in SFAS No. 5, *Accounting for Contingencies*, and are included in both income taxes in current liabilities and in deferred income taxes and other tax liabilities in the consolidated balance sheets.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, as well as operating loss and tax credit carryforwards. The tax effects of our temporary differences and carryforwards are as follows at December 31:

	2005	2004
Deferred tax assets:		
Receivables	\$ 9.9	\$ 9.7
Inventory	125.9	110.6
Property	40.8	5.8
Employee benefits	28.7	25.0
Other accrued expenses	31.5	26.5
Operating loss carryforwards	44.1	49.1
Tax credit carryforwards	46.7	76.9
Capitalized research and development costs	63.5	74.1
Other	46.0	41.3
Subtotal	437.1	419.0
Valuation allowances	(42.4)	(36.7)
Total	394.7	382.3
Deferred tax liabilities:		
Goodwill	113.4	105.4
Undistributed earnings of foreign subsidiaries	61.7	34.7
Other	20.7	9.1
Total	195.8	149.2
Net deferred tax asset	\$ 198.9	\$ 233.1

We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability to generate sufficient taxable income of the appropriate character in the future and in the appropriate taxing jurisdictions. We have provided a valuation allowance for operating loss carryforwards in certain non-U.S. jurisdictions where our operations have decreased, currently ceased or we have withdrawn entirely.

We have provided for U.S. and additional foreign taxes for the anticipated repatriation of certain earnings of our foreign subsidiaries. We consider the undistributed earnings of our foreign subsidiaries above the amount already provided to be indefinitely reinvested, as we have no intention to repatriate these earnings. These additional foreign earnings could become subject to additional tax if remitted, or deemed remitted, as a dividend; however, it is not practicable to estimate the additional amount of taxes payable.

At December 31, 2005, we had approximately \$41.0 million of foreign tax credits expiring in varying amounts between 2014 and 2016 and \$5.7 million of state tax credits which may be carried forward indefinitely under current state law. The operating loss carryforwards without a valuation allowance will expire in varying amounts over the next twenty years.

## Note 6. Earnings Per Share

A reconciliation of the number of shares used for the basic and diluted EPS computations is as follows for the years ended December 31:

	2005	2004	2003
Weighted average common shares outstanding for basic EPS	339.4	333.8	334.9
Effect of dilutive securities – stock plans	2.1	1.8	1.0
Adjusted weighted average common shares outstanding for diluted EPS	341.5	335.6	335.9
Future potentially dilutive shares excluded from diluted EPS:			
Options with an exercise price greater than average market price for the period	0.7	4.6	6.8

## Note 7. Inventories

Inventories are comprised of the following at December 31:

	2005	2004
Finished goods	\$ 914.5	\$ 860.3
Work in process	134.2	107.3
Raw materials	77.6	57.7
Total	\$ 1,126.3	\$ 1,025.3

## Note 8. Investments in Affiliates

We have investments in affiliates that are accounted for using the equity method of accounting. The most significant of these affiliates is WesternGeco, a seismic venture in which we own 30% and Schlumberger Limited (“Schlumberger”) owns 70%.

In conjunction with the formation of WesternGeco in November 2000, we entered into an agreement with Schlumberger whereby a cash true-up payment was to be made by either of the parties based on a formula comparing the ratio of the net present value of sales revenue from each party's contributed multiclient seismic data libraries during the four-year period ending November 30, 2004 and the ratio of the net book value of those libraries as of November 30, 2000. In August 2005, we received \$13.3 million from Schlumberger related to the true-up payment. We recorded \$13.0 million as a reduction in the carrying value of our investment in WesternGeco and \$0.3 million as interest income. The income tax effect of \$3.3 million related to this payment is included in our provision for income taxes for the year ended December 31, 2005.

In November 2000, we also entered into an agreement with WesternGeco whereby WesternGeco subleased a facility from us for a period of ten years at then current market rates. During 2005, 2004 and 2003, we received payments of \$6.5 million, \$5.5 million and \$5.0 million, respectively, from WesternGeco related to this lease.

During 2005, we received distributions of \$30.0 million from WesternGeco, which were recorded as reductions in the carrying value of our investment.

Effective December 1, 2005, either party to the WesternGeco Master Formation Agreement may offer to sell its entire interest in the venture to the other party at a cash purchase price per percentage interest specified in an offer notice. If the offer to sell is not accepted, the offering party will be obligated to purchase and the other party will be obligated to sell its entire interest at the same price per percentage interest as the price specified in the offer notice.

Included in the caption “Equity in income (loss) of affiliates” in our consolidated statement of operations for 2003 is \$135.7 million for our share of \$452.0 million of certain impairment and restructuring charges taken by WesternGeco in 2003. The charges related to the impairment of WesternGeco's multiclient seismic library and rationalization of WesternGeco's marine seismic fleet. In addition, as a result of the continued weakness in the seismic industry, we evaluated the value of our investment in WesternGeco and recorded an impairment loss of \$45.3 million in 2003 to write-down the investment to its fair value. The fair value was determined using a combination of a market capitalization and discounted cash flow approach.

In February 2004, we completed the sale of our minority interest in Petreco International, a venture we entered into in 2001, for \$35.8 million, of which \$7.4 million was placed in escrow pending the outcome of potential indemnification obligations pursuant to the sales agreement. In May 2005, we received \$3.7 million from the release of a portion of the amount held in escrow. The remainder is expected to be released in the first quarter of 2006, subject to the indemnity obligations under the sales agreement. In 2004, we recognized a gain on the sale of \$1.3 million, net of tax of \$1.5 million.

Summarized unaudited combined financial information for the affiliates, in which we account for our interests using the equity method of accounting, is as follows as of December 31:

	2005	2004
<b>Combined operating results:</b>		
Revenues	\$ 1,700.7	\$ 1,313.8
Operating income	327.3	131.9
Net income	279.7	124.9
<b>Combined financial position:</b>		
Current assets	\$ 1,110.8	\$ 755.2
Noncurrent assets	1,056.6	1,162.8
<b>Total assets</b>	<b>\$ 2,167.4</b>	<b>\$ 1,918.0</b>
Current liabilities	\$ 522.7	\$ 423.6
Noncurrent liabilities	85.2	101.2
Stockholders' equity	1,559.5	1,393.2
<b>Total liabilities and stockholders' equity</b>	<b>\$ 2,167.4</b>	<b>\$ 1,918.0</b>

At December 31, 2005 and 2004, net accounts receivable (payable) from unconsolidated affiliates totaled \$0.4 million and \$(1.1) million, respectively. As of December 31, 2005 and 2004, the excess of our investment over our equity in affiliates was \$239.4 million and \$268.9 million, respectively.

## Note 9. Property

Property is comprised of the following at December 31:

	Depreciation Period	2005	2004
Land		\$ 39.7	\$ 40.5
Buildings and improvements	5 – 40 years	611.7	616.3
Machinery and equipment	2 – 20 years	2,022.3	1,958.4
Rental tools and equipment	1 – 8 years	1,157.5	1,097.5
<b>Total property</b>		<b>3,831.2</b>	<b>3,712.7</b>
<b>Accumulated depreciation</b>		<b>(2,475.7)</b>	<b>(2,380.5)</b>
<b>Property – net</b>		<b>\$ 1,355.5</b>	<b>\$ 1,332.2</b>

## Note 10. Goodwill and Intangible Assets

The changes in the carrying amount of goodwill are detailed below by segment:

	Drilling and Evaluation	Completion and Production	Total
Balance as of December 31, 2003	\$ 895.0	\$ 344.4	\$ 1,239.4
Goodwill from acquisitions during the period	5.6	19.0	24.6
Translation adjustments and other	2.3	0.7	3.0
Balance as of December 31, 2004	902.9	364.1	1,267.0
Goodwill from acquisitions during the period	–	48.1	48.1
Translation adjustments and other	1.2	(0.5)	0.7
Balance as of December 31, 2005	\$ 904.1	\$ 411.7	\$ 1,315.8

We perform an annual impairment test of goodwill as of October 1 of every year. There were no impairments of goodwill in 2005, 2004 or 2003 related to the annual impairment test.

Intangible assets are comprised of the following at December 31:

	2005			2004		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Technology based	\$ 204.8	\$ (71.3)	\$ 133.5	\$ 190.2	\$ (58.8)	\$ 131.4
Contract based	11.1	(6.5)	4.6	11.0	(4.8)	6.2
Marketing related	6.1	(5.6)	0.5	6.1	(5.6)	0.5
Customer based	6.4	(0.4)	6.0	0.6	(0.2)	0.4
Other	1.2	(0.7)	0.5	1.2	(0.8)	0.4
Total amortizable intangible assets	229.6	(84.5)	145.1	209.1	(70.2)	138.9
Marketing related intangible asset with an indefinite useful life	18.3	—	18.3	16.2	—	16.2
Total	\$ 247.9	\$ (84.5)	\$ 163.4	\$ 225.3	\$ (70.2)	\$ 155.1

Intangible assets are amortized either on a straight-line basis with estimated useful lives ranging from 1 to 20 years, or on a basis that reflects the pattern in which the economic benefits of the intangible assets are consumed, which range from 15 to 30 years.

Amortization expense included in net income for the years ended December 31, 2005, 2004 and 2003 was \$15.2 million, \$14.9 million and \$13.5 million, respectively. Estimated amortization expense for each of the subsequent five fiscal years is expected to be within the range of \$11.6 million to \$18.2 million.

#### Note 11. Indebtedness

Total debt consisted of the following at December 31:

	2005	2004
6.25% Notes due January 2009 with an effective interest rate of 4.65%, net of unamortized discount of \$1.0 at December 31, 2005 (\$1.3 at December 31, 2004)	\$ 339.5	\$ 348.2
6.00% Notes due February 2009 with an effective interest rate of 6.11%, net of unamortized discount of \$0.5 at December 31, 2005 (\$0.7 at December 31, 2004)	199.5	199.3
8.55% Debentures due June 2024 with an effective interest rate of 8.80%, net of unamortized discount of \$2.5 at December 31, 2005 (\$2.6 at December 31, 2004)	147.5	147.4
6.875% Notes due January 2029 with an effective interest rate of 7.08%, net of unamortized discount of \$8.5 at December 31, 2005 (\$8.7 at December 31, 2004)	391.5	391.3
Other debt	9.9	76.1
Total debt	1,087.9	1,162.3
Less short-term debt and current maturities	9.9	76.0
Long-term debt	\$ 1,078.0	\$ 1,086.3

At December 31, 2005, we had \$955.6 million of credit facilities with commercial banks, of which \$500.0 million is a committed revolving credit facility (the "facility") that expires in July 2010. The facility provides for up to three one-year extensions, subject to the approval and acceptance by the lenders, among other conditions. In addition, the facility contains a provision to allow for an increase in the facility amount of an additional \$500.0 million, subject to the approval and acceptance by the lenders, among other conditions. The facility contains certain covenants which, among other things, require the maintenance of a funded indebtedness to total capitalization ratio (a defined formula per the facility) of less than or equal to 0.60, restrict certain merger transactions or the sale of all or substantially all of the assets of the company or a significant

subsidiary and limit the amount of subsidiary indebtedness. Upon the occurrence of certain events of default, our obligations under the facility may be accelerated. Such events of default include payment defaults to lenders under the facility, covenant defaults and other customary defaults. At December 31, 2005, we were in compliance with all of the facility covenants. There were no direct borrowings under the facility during the year ended December 31, 2005; however, to the extent we have outstanding commercial paper, our ability to borrow under the facility is reduced. At December 31, 2005, we had no outstanding commercial paper.

We realized net gains as a result of terminating various interest rate swap agreements prior to their scheduled maturities. The net gains were deferred and are being amortized as

a net reduction of interest expense over the remaining life of the underlying debt securities. The unamortized deferred gains of \$15.5 million and \$26.8 million are included in the 6.25% Notes due January 2009 and reported in long-term debt in the consolidated balance sheets at December 31, 2005 and 2004, respectively.

Maturities of debt at December 31, 2005 are as follows: 2006 – \$9.9 million; 2007 – \$0.0 million; 2008 – \$0.0 million; 2009 – \$539.0 million; 2010 – \$0.0 million and \$539.0 million thereafter.

## **Note 12. Financial Instruments**

### **Fair Value of Financial Instruments**

Our financial instruments include cash and short-term investments, receivables, payables, debt and foreign currency forward contracts. Except as described below, the estimated fair value of such financial instruments at December 31, 2005 and 2004 approximates their carrying value as reflected in our consolidated balance sheets. The fair value of our debt and foreign currency forward contracts has been estimated based on year-end quoted market prices.

The estimated fair value of total debt at December 31, 2005 and 2004 was \$1,233.6 million and \$1,315.0 million, respectively, which differs from the carrying amounts of \$1,087.9 million and \$1,162.3 million, respectively, included in our consolidated balance sheet.

### **Interest Rate Swap Agreements**

At December 31, 2005, there were no interest rate swap agreements in effect. Due to our outlook for interest rates, on June 2, 2005, we terminated the interest rate swap agreement we had entered into in April 2004. This agreement had been designated and had qualified as a fair value hedging instrument. Upon termination we were required to pay \$5.5 million. This amount is being amortized as an increase to interest expense over the remaining life of the underlying debt security, which matures in January 2009.

In April 2004, we entered into an interest rate swap agreement for a notional amount of \$325.0 million associated with our 6.25% Notes due January 2009. The interest rate swap agreement was designated and qualified as a fair value hedging instrument. The interest rate swap agreement was fully effective, resulting in no gain or loss recorded in the consolidated statement of operations. We recorded the fair value of the interest rate swap agreement, which was a \$2.3 million liability at December 31, 2004, based on quoted market prices for contracts with similar terms and maturity dates.

### **Foreign Currency Forward Contracts**

At December 31, 2005, we had entered into several foreign currency forward contracts with notional amounts aggregating \$65.0 million to hedge exposure to currency fluctuations in various foreign currency payables and receivables, including the British Pound Sterling, the Norwegian Krone, the Euro and the Brazilian Real. These contracts are designated and qualify as fair value hedging instruments.

Based on quoted market prices as of December 31, 2005 for contracts with similar terms and maturity dates, we recorded a gain of \$0.1 million to adjust these foreign currency forward contracts to their fair market value. This gain offsets designated foreign exchange losses resulting from the underlying exposures and is included in selling, general and administrative expense in the consolidated statement of operations.

At December 31, 2004, we had entered into several foreign currency forward contracts with notional amounts aggregating \$78.0 million to hedge exposure to currency fluctuations in various foreign currency payables and receivables, including the British Pound Sterling, the Norwegian Krone, the Euro and the Brazilian Real. These contracts were designated and qualified as fair value hedging instruments. Based on quoted market prices as of December 31, 2004, for contracts with similar terms and maturity dates, we recorded a loss of \$0.4 million to adjust these foreign currency forward contracts to their fair market value. This loss offsets designated foreign exchange gains resulting from the underlying exposures and is included in selling, general and administrative expense in the consolidated statement of operations.

At December 31, 2004, we had also entered into several foreign currency forward contracts with notional amounts aggregating \$122.4 million to hedge exposure to currency fluctuations in various foreign currencies, including the British Pound Sterling and the Canadian Dollar. These exposures arise when local currency operating expenses are not in balance with local currency revenue collections. The funding of such imbalances was supported by short-term intercompany borrowing commitments that had definitive amounts and funding dates. All funding took place before December 31, 2005. These foreign currency forward contracts were designated as cash flow hedging instruments and were fully effective. Based on quoted market prices as of December 31, 2004, for contracts with similar terms and maturity dates, we recorded a loss of \$0.1 million to adjust these foreign currency forward contracts to their fair market value. The loss was recorded in other comprehensive income in the consolidated balance sheet.

Additionally, during 2005 and 2004, we entered into and settled foreign currency forward contracts to hedge exposure to currency fluctuations for specific transactions or balances. The impact on our consolidated statements of operations was not significant for these contracts either individually or in the aggregate.

The counterparties to our foreign currency forward contracts are major financial institutions. The credit ratings and concentration of risk of these financial institutions are monitored on a continuing basis. In the unlikely event that the counterparties fail to meet the terms of a foreign currency contract, our exposure is limited to the foreign currency exchange rate differential.

### **Concentration of Credit Risk**

We sell our products and services to numerous companies in the oil and natural gas industry. Although this concentration could affect our overall exposure to credit risk, we believe that

we are exposed to minimal risk since the majority of our business is conducted with major companies within the industry. We perform periodic credit evaluations of our customers' financial condition and generally do not require collateral for our accounts receivable. In some cases, we will require payment in advance or security in the form of a letter of credit or bank guarantee.

We maintain cash deposits with major banks that may exceed federally insured limits. We periodically assess the financial condition of the institutions and believe that the risk of any loss is minimal.

### Note 13. Segment and Related Information

In 2005, we reorganized our operating divisions into two separate segments: the Drilling and Evaluation segment, which consists of the Baker Atlas, Baker Hughes Drilling Fluids, Hughes Christensen and INTEQ divisions, and the Completion and Production segment, which consists of the Baker Oil Tools, Baker Petrolite and Centrilift divisions. The Completion and Production segment also includes our Production Optimization business unit. The reorganization was done to align product lines based on the types of products and services provided to our customers, to provide additional focus on our product lines and technology and to be able to more effectively serve our customers.

Accordingly, we are reporting our results under three segments: Drilling and Evaluation, Completion and Production and WesternGeco. Divisions in the Drilling and Evaluation segment generally provide services and products used directly in the

drilling and formation evaluation of oil and natural gas wells. Divisions in the Completion and Production segment generally provide services and products used to complete wells, rework existing wells and enhance or initiate production from new wells.

We have aggregated the divisions within each segment because they have similar economic characteristics and because the long-term financial performance of these divisions is affected by similar economic conditions. They also operate in the same markets, which include all of the major oil and natural gas producing regions of the world. The results of each segment are evaluated regularly by our chief operating decision maker in deciding how to allocate resources and in assessing performance. All prior period segment information has been restated to reflect these changes.

The accounting policies of our segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements. We evaluate the performance of our segments based on segment profit (loss), which is defined as income from continuing operations before income taxes, accounting changes, restructuring charge reversals, impairment of assets and interest income and expense.

Summarized financial information is shown in the following table. The "Corporate and Other" column includes corporate-related items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to the segments, including restructuring charge reversals and impairment of assets. The "Corporate and Other" column, for all periods presented, also includes assets of discontinued operations.

	Drilling and Evaluation	Completion and Production	WesternGeco	Total Oilfield	Corporate and Other	Total
<b>2005</b>						
Revenues	\$ 3,694.2	\$ 3,490.0	\$ —	\$ 7,184.2	\$ 1.3	\$ 7,185.5
Equity in income of affiliates	1.1	2.2	96.7	100.0	0.1	100.1
Segment profit (loss)	766.3	682.4	96.7	1,545.4	(266.2)	1,279.2
Total assets	3,221.9	2,882.6	688.0	6,792.5	1,014.9	7,807.4
Investment in affiliates	6.1	12.2	660.6	678.9	—	678.9
Capital expenditures	347.8	129.6	—	477.4	0.9	478.3
Depreciation and amortization	232.7	121.1	—	353.8	28.6	382.4
<b>2004</b>						
Revenues	\$ 3,033.3	\$ 3,042.9	\$ —	\$ 6,076.2	\$ 3.4	\$ 6,079.6
Equity in income (loss) of affiliates	0.4	1.9	34.5	36.8	(0.5)	36.3
Segment profit (loss)	510.4	514.4	34.5	1,059.3	(283.4)	775.9
Total assets	2,893.1	2,625.4	643.9	6,162.4	658.9	6,821.3
Investment in affiliates	5.2	48.3	624.6	678.1	—	678.1
Capital expenditures	236.4	110.4	—	346.8	1.4	348.2
Depreciation and amortization	226.7	116.7	—	343.4	28.2	371.6
<b>2003</b>						
Revenues	\$ 2,653.8	\$ 2,579.5	\$ —	\$ 5,233.3	\$ —	\$ 5,233.3
Equity in income (loss) of affiliates	(0.6)	1.8	(9.8)	(8.6)	(129.2)	(137.8)
Segment profit (loss)	367.5	388.4	(10.1)	745.8	(424.4)	321.4
Total assets	2,820.2	2,451.6	606.0	5,877.8	538.7	6,416.5
Investment in affiliates	9.6	64.8	588.5	662.9	28.4	691.3
Capital expenditures	286.4	114.2	—	400.6	3.3	403.9
Depreciation and amortization	210.1	109.9	—	320.0	27.3	347.3



For the years ended December 31, 2005, 2004 and 2003, there were no revenues attributable to one customer that accounted for more than 10% of total revenues.

The following table presents the details of "Corporate and Other" segment loss for the years ended December 31:

	2005	2004	2003
Corporate and other expenses	\$ (211.9)	\$ (206.6)	\$ (146.7)
Interest – net	(54.3)	(76.8)	(97.8)
Impairment of investment in affiliate	–	–	(45.3)
Reversal of restructuring charge	–	–	1.1
Impairment and restructuring charges related to investment in affiliate	–	–	(135.7)
<b>Total</b>	<b>\$ (266.2)</b>	<b>\$ (283.4)</b>	<b>\$ (424.4)</b>

The following table presents the details of "Corporate and Other" total assets at December 31:

	2005	2004	2003
Current deferred tax asset	\$ 29.4	\$ 61.7	\$ 35.7
Property	78.5	107.6	134.7
Accounts receivable	9.3	26.5	50.0
Other tangible assets	109.3	115.6	107.5
Investment in affiliate	–	–	28.4
Assets of discontinued operations	16.6	16.7	62.4
Cash and other assets	771.8	330.8	120.0
<b>Total</b>	<b>\$ 1,014.9</b>	<b>\$ 658.9</b>	<b>\$ 538.7</b>

The following table presents consolidated revenues by country based on the location of the use of the products or services for the years ended December 31:

	2005	2004	2003
United States	\$ 2,576.1	\$ 2,132.9	\$ 1,873.0
Canada	472.8	389.1	332.3
United Kingdom	402.9	329.2	295.8
Norway	376.1	310.7	328.9
China	218.5	192.9	117.6
Venezuela	176.8	163.3	130.3
Saudi Arabia	170.6	89.3	74.4
Other countries	2,791.7	2,472.2	2,081.0
<b>Total</b>	<b>\$ 7,185.5</b>	<b>\$ 6,079.6</b>	<b>\$ 5,233.3</b>

The following table presents net property by country based on the location of the asset at December 31:

	2005	2004	2003
United States	\$ 734.4	\$ 724.6	\$ 789.2
United Kingdom	133.2	146.0	143.4
Canada	67.9	56.4	54.4
Germany	49.4	44.4	43.3
Norway	43.8	46.8	47.5
United Arab Emirates	29.0	15.4	19.0
Angola	26.0	16.5	27.6
Other countries	271.8	282.1	268.8
<b>Total</b>	<b>\$ 1,355.5</b>	<b>\$ 1,332.2</b>	<b>\$ 1,393.2</b>

#### Note 14. Employee Stock Plans

We have stock option plans that provide for the issuance of incentive and non-qualified stock options to directors, officers and other key employees at an exercise price equal to the fair market value of the stock at the date of grant. These stock options generally vest over three years. Vested options are exercisable in part or in full at any time prior to the expiration date of ten years from the date of grant. As of December 31, 2005, 11.3 million shares were available for future option grants. The following table summarizes the activity for our stock option plans:

	Number of Shares (In thousands)	Weighted Average Exercise Price Per Share
Outstanding at December 31, 2002	10,868	\$ 32.68
Granted	2,481	30.92
Exercised	(1,005)	21.44
Forfeited	(515)	38.97
Outstanding at December 31, 2003	11,829	32.99
Granted	2,495	37.68
Exercised	(3,764)	25.62
Forfeited	(255)	39.07
Outstanding at December 31, 2004	10,305	36.67
Granted	1,321	49.63
Exercised	(5,594)	36.96
Forfeited	(457)	44.01
Outstanding at December 31, 2005	5,575	\$ 38.84

Shares exercisable at December 31:

2005	2,420	\$ 35.38
2004	6,417	\$ 38.02
2003	7,611	\$ 33.80

The following table summarizes information for stock options outstanding at December 31, 2005:

Range of Exercise Prices	Outstanding			Exercisable	
	Shares (In thousands)	Weighted Average Remaining Contractual Life (In years)	Weighted Average Exercise Price	Shares (In thousands)	Weighted Average Exercise Price
\$ 8.80 – \$ 15.99	11	2.2	\$ 11.59	11	\$ 11.59
16.08 – 21.00	140	2.6	20.64	140	20.64
21.06 – 26.07	375	4.5	24.48	374	24.49
28.25 – 39.23	2,861	7.3	34.65	1,046	33.08
41.06 – 56.21	2,188	6.8	48.08	849	45.75
Total	5,575	6.8	\$ 38.84	2,420	\$ 35.38

We also have an employee stock purchase plan whereby eligible employees may purchase shares of our common stock at a price equal to 85% of the lower of the closing price of our common stock on the first or last trading day of the calendar year. A total of 3.4 million shares are remaining for issuance under the plan. Employees purchased 0.6 million, 0.8 million and 0.8 million shares in the three years ending December 31, 2005, 2004 and 2003, respectively.

We have a plan under which restricted stock is issued to directors and executive officers and beginning in 2005 to other key employees. The fair value of the restricted stock on the date of grant is amortized ratably over the vesting period. The following table summarizes the restricted stock awarded during the years ended December 31:

	2005	2004	2003
Number of shares of restricted stock awarded (in thousands)	460	163	10
Fair value of restricted stock at date of grant (in millions)	\$ 20.4	\$ 6.9	\$ 0.3

**Note 15. Employee Benefit Plans****Defined Benefit Pension Plans**

We have noncontributory defined benefit pension plans ("Pension Benefits") covering employees primarily in the U.S., the U.K. and Germany. We make annual contributions to the plans in amounts at least necessary to meet minimum governmental

funding requirements. The measurements of plan assets and obligations are as of October 1 of each year presented.

The reconciliation of the beginning and ending balances of the projected benefit obligations ("PBO") and fair value of plan assets and the funded status of the plans are as follows for the years ended December 31:

	U.S. Pension Benefits		Non-U.S. Pension Benefits	
	2005	2004	2005	2004
Change in projected benefit obligation:				
Projected benefit obligation at beginning of year	\$ 203.8	\$ 175.6	\$ 261.0	\$ 269.2
Service cost	22.8	20.6	2.2	2.1
Interest cost	11.9	10.6	13.8	12.7
Actuarial loss	10.9	6.7	47.8	7.9
Benefits paid from fund	(11.3)	(9.7)	(5.3)	(5.8)
Curtailments/settlements (gain) loss	–	–	(1.2)	(42.2)
Other	0.7	–	0.2	–
Exchange rate adjustments	–	–	(31.0)	17.1
Projected benefit obligation at end of year	238.8	203.8	287.5	261.0
Change in plan assets:				
Fair value of plan assets at beginning of year	284.9	237.9	158.3	135.2
Actual gain on plan assets	45.9	33.4	30.7	18.3
Employer contributions	34.6	23.3	45.6	18.4
Benefits paid from fund	(11.3)	(9.7)	(5.3)	(5.8)
Settlements (gain) loss	–	–	(1.3)	(17.6)
Exchange rate adjustments	–	–	(20.4)	9.8
Fair value of plan assets at end of year	354.1	284.9	207.6	158.3
Funded status – over (under)	115.3	81.1	(79.9)	(102.7)
Unrecognized actuarial loss	47.8	59.5	95.1	77.0
Unrecognized prior service cost	0.3	0.3	0.2	0.2
Net amount recognized	163.4	140.9	15.4	(25.5)
Employer contributions/benefits paid – October to December	28.8	32.5	8.3	36.1
Net amount recognized in the balance sheet	\$ 192.2	\$ 173.4	\$ 23.7	\$ 10.6

We report prepaid benefit cost in other assets and accrued benefit and minimum liabilities in pensions and postretirement benefit obligations in the consolidated balance sheet. The amounts recognized in the consolidated balance sheet are as follows at December 31:

	U.S. Pension Benefits		Non-U.S. Pension Benefits	
	2005	2004	2005	2004
Prepaid benefit cost	\$ 203.6	\$ 185.0	\$ 46.2	\$ 33.8
Accrued benefit liability	(11.4)	(11.6)	(22.5)	(23.2)
Minimum liability	(14.2)	(14.9)	(86.6)	(68.3)
Intangible asset	0.1	0.1	–	–
Accumulated other comprehensive loss	14.1	14.8	86.6	68.3
Net amount recognized in the balance sheet	\$ 192.2	\$ 173.4	\$ 23.7	\$ 10.6

Weighted average assumptions used to determine benefit obligations for these plans are as follows for the years ended December 31:

	U.S. Pension Benefits		Non-U.S. Pension Benefits	
	2005	2004	2005	2004
Discount rate	5.50%	6.00%	4.90%	5.67%
Rate of compensation increase	4.00%	3.50%	3.38%	3.53%

The accumulated benefit obligation ("ABO") is the actuarial present value of pension benefits attributed to employee service to date and present compensation levels. The ABO differs from the PBO in that the ABO does not include any assumptions about future compensation levels. The ABO for all U.S. plans was \$232.9 million and \$201.8 million at December 31, 2005 and 2004, respectively. The ABO for all non-U.S. plans was \$279.2 million and \$252.5 million at December 31, 2005 and 2004, respectively.

Information for the plans with ABOs in excess of plan assets is as follows at December 31:

	U.S. Pension Benefits		Non-U.S. Pension Benefits	
	2005	2004	2005	2004
Projected benefit obligation	\$ 108.0	\$ 78.6	\$ 281.7	\$ 256.3
Accumulated benefit obligation	102.2	76.6	274.6	248.2
Fair value of plan assets	77.9	40.3	203.0	153.3

The components of net periodic benefit cost are as follows for the years ended December 31:

	U.S. Pension Benefits			Non-U.S. Pension Benefits		
	2005	2004	2003	2005	2004	2003
Service cost	\$ 22.8	\$ 20.6	\$ 16.6	\$ 2.2	\$ 2.1	\$ 5.4
Interest cost	11.9	10.6	9.1	13.8	12.7	12.1
Expected return on plan assets	(25.9)	(20.7)	(15.0)	(13.2)	(9.2)	(8.1)
Amortization of prior service cost	–	0.1	–	–	–	(0.1)
Recognized actuarial loss	2.6	4.0	6.5	2.6	4.6	2.9
Special termination benefit cost	0.7	–	–	–	–	–
Recognized curtailment (gain) loss	–	–	–	–	(2.1)	–
Recognized settlement (gain) loss	–	–	–	0.2	(1.1)	–
Net periodic benefit cost	\$ 12.1	\$ 14.6	\$ 17.2	\$ 5.6	\$ 7.0	\$ 12.2

Weighted average assumptions used to determine net costs for these plans are as follows for the years ended December 31:

	U.S. Pension Benefits			Non-U.S. Pension Benefits		
	2005	2004	2003	2005	2004	2003
Discount rate	6.00%	6.25%	6.75%	5.67%	5.37%	5.82%
Expected rate of return on plan assets	8.50%	8.50%	8.50%	7.38%	7.28%	7.41%
Rate of compensation increase	3.50%	3.50%	4.00%	3.53%	2.50%	3.40%

In selecting the expected rate of return on plan assets, we consider the average rate of earnings expected on the funds invested or to be invested to provide for the benefits of these plans. This includes considering the trusts' asset allocation and the expected returns likely to be earned over the life of the plans.

The weighted-average asset allocations by asset category for the plans are as follows at December 31:

Asset Category	Percentage of Plan Assets					
	U.S. Pension Benefits			Non-U.S. Pension Benefits		
	Target	2005	2004	Target	2005	2004
Equity securities	68%	69%	68%	55%	58%	65%
Debt securities	25%	21%	23%	21%	20%	21%
Real estate	7%	9%	8%	21%	17%	9%
Other	–	1%	1%	3%	5%	5%
Total	100%	100%	100%	100%	100%	100%

We have an investment committee that meets quarterly to review the portfolio returns and to determine asset-mix targets based on asset/liability studies. A third-party investment consultant assisted us in developing an asset allocation strategy to determine our expected rate of return and expected risk for various investment portfolios. The investment committee considered these studies in the formal establishment of the current asset-mix targets based on the projected risk and return levels for each asset class.

In 2006, we expect to contribute between \$2.0 million and \$3.0 million to the U.S. pension plans and between \$16.0 million and \$20.0 million to the non-U.S. pension plans.

The expected benefit payments related to our U.S. pension plans for each of the five years in the period ending December 31, 2010 are \$12.7 million, \$13.4 million, \$14.6 million, \$16.8 million and \$18.9 million, respectively, and \$141.7 million in the aggregate for the five years thereafter. The expected benefit payments related to our non-U.S. pension plans for each of the five years in the period ending December 31, 2010 are \$7.1 million, \$9.6 million, \$4.4 million, \$3.6 million and \$4.4 million, respectively, and \$27.0 million in the aggregate for the five years thereafter. These payments reflect benefits attributable to estimated future employee service and are primarily funded from plan assets.

### Postretirement Welfare Benefits

We provide certain postretirement health care and life insurance benefits ("postretirement welfare benefits") to substantially all U.S. employees who retire and have met certain age and service requirements. The plan is unfunded. The measurement of plan obligations is as of October 1 of each year presented. The reconciliation of the beginning and ending balances of benefit obligations and the funded status of the plan is as follows for the years ended December 31:

	2005	2004
Change in benefit obligation:		
Accumulated benefit obligation		
at beginning of year	\$ 169.5	\$ 174.8
Service cost	6.1	5.5
Interest cost	9.7	9.6
Actuarial (gain) loss	12.5	(7.1)
Benefits paid	(13.3)	(13.3)
Accumulated benefit obligation		
at end of year	184.5	169.5
Funded status – over (under)	(184.5)	(169.5)
Unrecognized actuarial loss	45.4	34.9
Unrecognized prior service cost	7.2	7.8
Net amount recognized	(131.9)	(126.8)
Benefits paid – October to December	3.3	3.6
Net amount recognized	(128.6)	(123.2)
Less current portion reported in accrued employee compensation	(15.5)	(16.3)
Long-term portion reported in pensions and postretirement benefit obligations	\$ (113.1)	\$ (106.9)

Weighted average discount rates of 5.50% and 6.00% were used to determine postretirement welfare benefit obligations for the plan for the years ended December 31, 2005 and 2004, respectively.

The components of net periodic benefit cost are as follows for the years ended December 31:

	2005	2004	2003
Service cost	\$ 6.1	\$ 5.5	\$ 4.8
Interest cost	9.7	9.6	10.3
Amortization of prior service cost	0.6	0.6	0.6
Recognized actuarial loss	2.0	1.0	1.1
Net periodic benefit cost	\$ 18.4	\$ 16.7	\$ 16.8

Weighted average discount rates of 6.00%, 6.25% and 6.75% were used to determine net postretirement welfare benefit costs for the plan for the years ended December 31, 2005, 2004 and 2003, respectively.

Assumed health care cost trend rates have a significant effect on the amounts reported for the postretirement welfare benefits plan. The assumed health care cost trend rate used in measuring the accumulated benefit obligation for postretirement welfare benefits was increased in 2003. As of December 31, 2005, the health care cost trend rate was 10.0% for employees under age 65 and 7.0% for participants over age 65, with each declining gradually each successive year until it reaches 5.0% for both employees under age 65 and over age 65 in 2011. A one percentage point change in assumed health care cost trend rates would have had the following effects on 2005:

	One Percentage Point Increase	One Percentage Point Decrease
Effect on total of service and interest cost components	\$ 0.6	\$ (0.5)
Effect on postretirement welfare benefit obligation	9.4	(8.5)

The expected benefit payments related to postretirement welfare benefits are as follows for the years ending December 31:

	2006	2007	2008	2009	2010	2011 – 2015
Gross benefit payments	\$ 17.4	\$ 18.1	\$ 18.9	\$ 19.8	\$ 20.3	\$ 115.8
Expected Medicare subsidies	(1.9)	(2.1)	(2.2)	(2.4)	(2.5)	(13.9)
Net benefit payments	\$ 15.5	\$ 16.0	\$ 16.7	\$ 17.4	\$ 17.8	\$ 101.9

### Defined Contribution Plans

During the periods reported, generally all of our U.S. employees were eligible to participate in our sponsored Thrift Plan, which is a 401(k) plan under the Internal Revenue Code of 1986, as amended. The Thrift Plan allows eligible employees to elect to contribute from 1% to 50% of their salaries to an investment trust. Employee contributions are matched in cash by us at the rate of \$1.00 per \$1.00 employee contribution for the first 3% and \$0.50 per \$1.00 employee contribution for the next 2% of the employee's salary. Such contributions vest immediately. In addition, we make cash contributions for all eligible employees between 2% and 5% of their salary depending on the employee's age. Such contributions become fully vested to the employee after five years of employment. The Thrift Plan provides for ten different investment options, for which the employee has sole discretion in determining how both the employer and employee contributions are invested. Our contributions to the Thrift Plan and several other non-U.S. defined contribution plans amounted to \$86.5 million, \$75.5 million and \$67.7 million in 2005, 2004 and 2003, respectively.

For certain non-U.S. employees who are not eligible to participate in the Thrift Plan, we provide a non-qualified defined contribution plan that provides basically the same benefits as the Thrift Plan. In addition, we provide a non-qualified supplemental retirement plan ("SRP") for certain officers and employees whose benefits under the Thrift Plan and/or the U.S. defined benefit pension plan are limited by federal tax law. The SRP also allows the eligible employees to defer a portion of their eligible compensation and provides for employer matching and base contributions pursuant to limitations. Both non-qualified plans are fully funded and invested through trusts, and the assets and corresponding liabilities are included in our consolidated balance sheet. Our contributions to these non-qualified plans were \$7.2 million, \$6.1 million and \$5.5 million for 2005, 2004 and 2003, respectively.

### Postemployment Benefits

We provide certain postemployment disability income, medical and other benefits to substantially all qualifying former or inactive U.S. employees. Income benefits for long-term disability are provided through a fully-insured plan. The continuation of medical and other benefits while on disability ("Continuation Benefits") are provided through a qualified self-insured plan. The accrued postemployment liability for Continuation Benefits at December 31, 2005 and 2004 was \$17.5 million and \$20.2 million, respectively, and is included in other liabilities in our consolidated balance sheet.

### Note 16. Commitments and Contingencies

#### Leases

At December 31, 2005, we had long-term non-cancelable operating leases covering certain facilities and equipment. The minimum annual rental commitments, net of amounts due under subleases, for each of the five years in the period ending December 31, 2010 are \$74.7 million, \$54.6 million, \$39.2 million, \$25.0 million and \$16.8 million, respectively, and \$103.7 million in the aggregate thereafter. We have not entered into any significant capital leases.

#### Litigation

We are involved in litigation or proceedings that have arisen in our ordinary business activities. We insure against these risks to the extent deemed prudent by our management and to the extent insurance is available, but no assurance can be given that the nature and amount of such insurance will be sufficient to fully indemnify us against liabilities arising out of pending and future legal proceedings. Many of these insurance policies contain deductibles or self-insured retentions in amounts we deem prudent, and for which we are responsible for payment. In determining the amount of self-insurance, it is our policy to self-insure those losses that are predictable, measurable and recurring in nature, such as claims for automobile liability, general liability and workers compensation. We record accruals for the uninsured portion of losses related to these types of claims. The accruals for losses are calculated by estimating losses for claims using historical claim data, specific loss development factors and other information as necessary.

On March 29, 2002, we announced that we had been advised that the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ") are conducting investigations into allegations of violations of law relating to Nigeria and other related matters. The SEC has issued a formal order of investigation into possible violations of provisions under the Foreign Corrupt Practices Act ("FCPA") regarding anti-bribery, books and records and internal controls. The SEC has issued subpoenas seeking information about our operations in Angola (subpoena dated August 6, 2003) and Kazakhstan (subpoenas dated August 6, 2003 and April 22, 2005) as part of its ongoing investigation. We are providing documents to and cooperating fully with the SEC and DOJ. The DOJ and the SEC have issued subpoenas to, or otherwise asked for interviews with, current and former employees in connection with the investigations regarding Nigeria, Angola and Kazakhstan. In addition, we have conducted internal investigations into these matters.

Our internal investigations have identified issues regarding the propriety of certain payments and apparent deficiencies in our books and records and internal controls with respect to certain operations in Nigeria, Angola and Kazakhstan, as well as potential liabilities to governmental authorities in Nigeria. The internal investigation in Nigeria was substantially completed during the first quarter of 2003 and, based upon current information, we do not expect that any such potential liabilities will have a material adverse effect on our consolidated financial statements. The internal investigations in Angola and Kazakhstan were substantially completed in the third quarter of 2004. Evidence obtained during the course of the internal investigations has been provided to the SEC and DOJ.

The Department of Commerce, Department of the Navy and DOJ (the "U.S. agencies") have investigated compliance with certain export licenses issued to Western Geophysical from 1994 through 2000 for export of seismic equipment leased by the People's Republic of China. We acquired Western Geophysical in August 1998 and subsequently transferred related assets to WesternGeco in December 2000. WesternGeco continued to use the licenses until 2001. Under the WesternGeco Formation Agreement, we owe indemnity to WesternGeco for certain matters and, accordingly, we have agreed to indemnify WesternGeco with certain limitations in connection with this matter. We are cooperating fully with the U.S. agencies.

We have received a subpoena from a grand jury in the Southern District of New York regarding goods and services we delivered to Iraq from 1995 through 2003 during the United Nations Oil-for-Food Program. We have also received a request from the SEC to provide a written statement and certain information regarding our participation in that program. We have responded to both the subpoena and the request and may provide additional information and documents in the future. Other companies in the energy industry are believed to have received similar subpoenas and requests.

The U.S. agencies, the SEC and other authorities have a broad range of civil and criminal sanctions they may seek to impose against corporations and individuals in appropriate circumstances including, but not limited to, injunctive relief, disgorgement, fines, penalties and modifications to business practices and compliance programs. Such agencies and authorities have entered into agreements with, and obtained a range of sanctions against, several public corporations and individuals arising from allegations of improper payments and deficiencies in books and records and internal controls, whereby civil and criminal penalties were imposed, including in some cases multi-million dollar fines and other sanctions. We are in discussions with the U.S. agencies and the SEC regarding the resolution, including sanctions, associated with certain of the matters described above. It is not possible to accurately predict at this time when any of these matters will be resolved. Based on current information, we cannot predict the outcome of such investigations, whether we will reach resolution through such discussions or what, if any, actions may be taken by the U.S. agencies, the SEC or other authorities or the effect the actions may have on our consolidated financial statements.

On May 10, 2004, the District Court of Andrews County, Texas entered a judgment in favor of LOTUS, LLC and against INTEQ in the amount of \$14.8 million for lost profits resulting from a breach of contract in drilling a well to create a salt cavern for disposing of naturally occurring radioactive waste. We have filed an appeal and taken other actions. We believe that any liability that we may incur as a result of this litigation would not have a material adverse financial effect on our consolidated financial statements.

### **Environmental Matters**

Our past and present operations include activities which are subject to extensive domestic (including U.S. federal, state and local) and international environmental regulations with regard to air and water quality and other environmental matters. Our environmental procedures, policies and practices are designed to ensure compliance with existing laws and regulations and to minimize the possibility of significant environmental damage.

We are involved in voluntary remediation projects at some of our present and former manufacturing facilities, the majority of which relate to properties obtained in acquisitions or to sites no longer actively used in operations. On rare occasions, remediation activities are conducted as specified by a government agency-issued consent decree or agreed order. Remediation costs are accrued based on estimates of probable exposure using currently available facts, existing environmental permits, technology and presently enacted laws and regulations. Remediation cost estimates include direct costs related to the environmental investigation, external consulting activities, governmental oversight fees, treatment equipment and costs associated with long-term operation, maintenance and monitoring of a remediation project.

We have also been identified as a potentially responsible party ("PRP") in remedial activities related to various Superfund sites. We participate in the process set out in the Joint Participation and Defense Agreement to negotiate with government agencies, identify other PRPs and determine each PRP's allocation and estimate remediation costs. We have accrued what we believe to be our pro-rata share of the total estimated cost of remediation and associated management of these Superfund sites. This share is based upon the ratio that the estimated volume of waste we contributed to the site bears to the total estimated volume of waste disposed at the site. Applicable United States federal law imposes joint and several liability on each PRP for the cleanup of these sites leaving us with the uncertainty that we may be responsible for the remediation cost attributable to other PRPs who are unable to pay their share. No accrual has been made under the joint and several liability concept for those Superfund sites where our participation is *de minimis* since we believe that the probability that we will have to pay material costs above our volumetric share is remote. We believe there are other PRPs who have greater involvement on a volumetric calculation basis, who have substantial assets and who may be reasonably expected to pay their share of the cost of remediation. For those Superfund sites where we are a significant PRP, remediation costs

are estimated to include recalcitrant parties. In some cases, we have insurance coverage or contractual indemnities from third parties to cover a portion of or the ultimate liability.

Our total accrual for environmental remediation is \$17.4 million and \$13.6 million, which includes accruals of \$4.9 million and \$3.6 million for the various Superfund sites, at December 31, 2005 and 2004, respectively. The determination of the required accruals for remediation costs is subject to uncertainty, including the evolving nature of environmental regulations and the difficulty in estimating the extent and type of remediation activity that will be utilized. We believe that the likelihood of material losses in excess of the recorded accruals is remote.

#### Other

In the normal course of business with customers, vendors and others, we have entered into off-balance sheet arrangements, such as letters of credit and other bank issued guarantees, which totaled approximately \$319.8 million at December 31, 2005. We also had commitments outstanding for purchase obligations related to capital expenditures and inventory under purchase orders and contracts of approximately \$173.0 million at December 31, 2005. In addition, at December 31, 2005, we have guaranteed debt and other obligations of third parties with a maximum exposure of \$1.4 million. It is not practicable to estimate the fair value of these financial instruments. None of the off-balance sheet arrangements either has, or is likely to have, a material effect on our consolidated financial statements.

#### Note 17. Other Supplemental Information

Supplemental consolidated statement of operations information is as follows for the years ended December 31:

	2005	2004	2003
Rental expense (generally transportation equipment and warehouse facilities)	\$ 138.7	\$ 123.5	\$ 111.5
Research and development	188.2	176.7	173.3

The changes in the aggregate product warranty liability are as follows:

Balance as of December 31, 2003	\$ 14.1
Claims paid	(4.9)
Additional warranties	7.6
Other	(0.2)
Balance as of December 31, 2004	16.6
Claims paid	(2.6)
Additional warranties	2.1
Revisions in estimates for previously issued warranties	(2.5)
Other	(0.2)
Balance as of December 31, 2005	\$ 13.4

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 requires that the fair value of a liability associated with an asset retirement obligation ("ARO") be recognized in the period in which it is incurred if a reasonable estimate can be made. The liability for the ARO is revised each subsequent period due to the passage of time and changes in estimates. The associated retirement costs are capitalized as part of the carrying amount of the long-lived asset and subsequently depreciated over the estimated useful life of the asset. The adoption of SFAS No. 143 in 2003 resulted in a charge of \$5.6 million, net of tax of \$2.8 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded ARO liabilities of \$11.4 million primarily for anticipated costs of obligations associated with the future disposal of power source units at certain of our divisions and refurbishment costs associated with certain leased facilities in Europe and with a fleet of leased railcars and tanks.

On December 31, 2005, we adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47 ("FIN 47"), *Conditional Asset Retirement Obligations*. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The adoption of FIN 47 resulted in a charge of \$0.9 million, net of tax of \$0.5 million, recorded as the cumulative effect of accounting change in the consolidated statement of operations. In conjunction with the adoption, we recorded conditional asset retirement obligations of \$1.6 million as the fair value of the costs associated with the special handling of asbestos related materials in certain facilities. We also have certain facilities that contain asbestos related materials for which a liability has not been recognized because the fair value cannot be reasonably estimated. We believe that there are indeterminate settlement dates for these obligations because the range of time over which we would settle these obligations is unknown or cannot be estimated; therefore, sufficient information does not exist to apply an expected present value technique.



The changes in the asset retirement obligation liability are as follows:

Balance as of December 31, 2003	\$ 11.5
Liabilities incurred	1.5
Liabilities settled	(0.4)
Accretion expense	0.2
Revisions to existing liabilities	(0.1)
Translation adjustments	0.2
Balance as of December 31, 2004	12.9
Liabilities incurred	1.6
Liabilities settled	(0.2)
Accretion expense	0.5
Revisions to existing liabilities	1.2
Adoption of FIN 47	1.6
Translation adjustments	(0.2)
Balance as of December 31, 2005	\$ 17.4

Accumulated other comprehensive loss, net of tax, is comprised of the following at December 31:

	2005	2004
Foreign currency translation adjustments	\$ (117.4)	\$ (52.4)
Pension adjustment	(69.5)	(57.3)
Other	(1.1)	(0.1)
Total	\$ (188.0)	\$ (109.8)

## Note 18. Quarterly Data (Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
<b>2005</b>					
Revenues	\$ 1,642.9	\$ 1,768.4	\$ 1,784.8	\$ 1,989.4	\$ 7,185.5
Gross profit <sup>(1)</sup>	487.3	552.6	564.8	638.3	2,243.0
Income from continuing operations	178.4	218.0	220.6	257.4	874.4
Net income	179.8	218.8	221.9	257.9	878.4
Basic earnings per share:					
Income from continuing operations	0.53	0.65	0.64	0.76	2.58
Net income	0.53	0.65	0.65	0.76	2.59
Diluted earnings per share:					
Income from continuing operations	0.53	0.64	0.64	0.75	2.56
Net income	0.53	0.64	0.65	0.75	2.57
Dividends per share	0.115	0.115	0.115	0.130	0.475
Common stock market prices:					
High	47.70	51.95	60.79	62.76	
Low	41.20	42.51	51.54	51.20	
<b>2004</b>					
Revenues	\$ 1,381.5	\$ 1,493.7	\$ 1,532.0	\$ 1,672.4	\$ 6,079.6
Gross profit <sup>(1)</sup>	370.3	426.3	432.5	499.5	1,728.6
Income from continuing operations	93.6	116.2	136.7	178.8	525.3
Net income	94.6	116.9	137.5	179.6	528.6
Basic earnings per share					
Income from continuing operations	0.28	0.35	0.40	0.54	1.57
Net income	0.28	0.35	0.41	0.54	1.58
Diluted earnings per share					
Income from continuing operations	0.28	0.35	0.40	0.53	1.57
Net income	0.28	0.35	0.41	0.53	1.58
Dividends per share	0.11	0.12	0.11	0.12	0.46
Common stock market prices:					
High	38.42	38.27	44.57	44.89	
Low	32.00	33.71	37.80	40.28	

<sup>(1)</sup> Represents revenues less cost of revenues.

## Note 19. Subsequent Events (Unaudited)

In January 2006, we acquired Nova Technology Corporation ("Nova") for approximately \$67.0 million in cash and assumed debt. Nova is a leading supplier of permanent monitoring, chemical injection systems, and multi-line services for deepwater and subsea oil and gas well applications and will be included in the Production Optimization business unit within the Completion and Production segment.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

### **ITEM 9A. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Our management has established and maintains a system of disclosure controls and procedures to provide reasonable assurances that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. As of December 31, 2005, our management, including our principal executive officer and principal financial officer, conducted an evaluation of our disclosure controls and procedures. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures as of December 31, 2005 are effective in ensuring that the information required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

#### **Design and Evaluation of Internal Control Over Financial Reporting**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, our management included a report of their assessment of the design and effectiveness of our internal controls as part of this Annual Report on Form 10-K for the fiscal year ended December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein. Management's report and the independent registered public accounting firm's attestation report are included in Item 8 under the captions entitled "Management's Report on Internal Control Over Financial Reporting" and "Report of Independent Registered Public Accounting Firm" and are incorporated herein by reference.

#### **Changes in Internal Control Over Financial Reporting**

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

### **ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

Information concerning our directors is set forth in the sections entitled "Proposal No. 1, Election of Directors," and "Corporate Governance – Committees of the Board – Audit/Ethics Committee" in our Proxy Statement for the Annual Meeting of Stockholders to be held April 27, 2006 ("Proxy Statement"), which sections are incorporated herein by reference. For information regarding our executive officers, see "Item 1. Business – Executive Officers" in this annual report on Form 10-K. Additional information regarding compliance by directors and executive officers with Section 16(a) of the Exchange Act is set forth under the section entitled "Compliance with Section 16(a) of the Securities Exchange Act of 1934" in our Proxy Statement, which section is incorporated herein by reference. For information concerning our code of ethics, see "Item 1. Business" in this annual report on Form 10-K.

### **ITEM 11. EXECUTIVE COMPENSATION**

Information for this item is set forth in the sections entitled "Executive Compensation – Summary Compensation Table," "Corporate Governance – Board of Directors," "Stock Options Granted During 2005," "Aggregated Option Exercises During 2005 and Option Values at December 31, 2005," "Long-Term Incentive Plan Awards During 2005," "Pension Plan Table," "Employment, Change in Control, and Indemnification Agreements," "Compensation Committee Report," "Compensation Committee Interlocks and Insider Participation," and "Corporate Performance Graph" in our Proxy Statement, which sections are incorporated herein by reference.

### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information concerning security ownership of certain beneficial owners and our management is set forth in the sections entitled "Voting Securities" and "Security Ownership of Management" in our Proxy Statement, which sections are incorporated herein by reference.

Our Board of Directors has approved procedures for use under our Securities Trading and Disclosure Policy to permit our employees, officers and directors to enter into written trading plans complying with Rule 10b5-1 under the Exchange Act. Rule 10b5-1 provides criteria under which such an individual may establish a prearranged plan to buy or sell a specified number of shares of a company's stock over a set period of time. Any such plan must be entered into in good faith at a time when the individual is not in possession of material, non-public information. If an individual establishes a plan satisfying the requirements of Rule 10b5-1, such individual's subsequent receipt of material, nonpublic information will not prevent transactions under the plan from being executed. Certain of our officers have advised us that they have and may enter into a stock sales plan for the sale of shares of our common stock which are intended to comply with the requirements of Rule 10b5-1 promulgated by the Securities Exchange Act of 1934.

## Equity Compensation Plan Information

The information in the following table is presented as of December 31, 2005 with respect to shares of our common stock that may be issued under our existing equity compensation plans, including the Baker Hughes Incorporated 1993 Stock Option Plan, the Baker Hughes Incorporated Long-Term Incentive Plan and the Baker Hughes Incorporated 2002 Directors & Officers Long-Term Incentive Plan, all of which have been approved by our stockholders.

Equity Compensation Plan Category	(In millions of shares)		
	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in the first column)
Stockholder-approved plans (excluding Employee Stock Purchase Plan)	1.7 <sup>(2)</sup>	\$ 39.23	4.1
Nonstockholder-approved plans <sup>(1)</sup>	3.8	38.79	7.2
Subtotal (except for weighted average exercise price)	5.5	38.92	11.3
Employee Stock Purchase Plan	—	<sup>(3)</sup>	3.4
<b>Total</b>	<b>5.5<sup>(4)</sup></b>		<b>14.7</b>

<sup>(1)</sup> The table includes the nonstockholder-approved plans: the 1998 Employee Stock Option Plan, the 1998 Special Employee Stock Option Plan, the 2002 Employee Long-Term Incentive Plan and the Director Compensation Deferral Plan. A description of each of these plans is set forth below.

<sup>(2)</sup> The table includes approximately 0.9 million shares of our common stock that would be issuable upon the exercise of the outstanding options under our 1993 Stock Option Plan, which expired in 2003. No additional options may be granted under the 1993 Stock Option Plan.

<sup>(3)</sup> In the Baker Hughes Incorporated Employee Stock Purchase Plan, the purchase price is determined in accordance with Section 423 of the Code, as amended, as 85% of the lower of the fair market value on the date of grant or the date of purchase.

<sup>(4)</sup> The table does not include shares subject to outstanding options we assumed in connection with certain mergers and acquisitions of entities which originally granted those options. When we acquired the stock of Western Atlas Inc. in a transaction completed in August 1998, we assumed the options granted under the Western Atlas Director Stock Option Plan and the Western Atlas 1993 Stock Incentive Plan. As of December 31, 2005, 36,159 shares and 3,836 shares of our common stock would be issuable upon the exercise of outstanding options previously granted under the Western Atlas Director Stock Option Plan and the Western Atlas 1993 Stock Incentive Plan, with a weighted average exercise price per share of \$25.56 and \$26.07, respectively.

Our nonstockholder-approved plans are described below:

### 1998 Employee Stock Option Plan

The Baker Hughes Incorporated 1998 Employee Stock Option Plan (the "1998 ESOP") was adopted effective as of October 1, 1998. The number of shares authorized for issuance under the 1998 ESOP is 3.5 million shares. Nonqualified stock options may be granted under the 1998 ESOP to our employees. The exercise price of the options will be equal to the fair market value per share of our common stock on the date of grant, and option terms may be up to ten years. Under the terms and conditions of the option award agreements for options issued under the 1998 ESOP, options generally vest and become exercisable in installments over the optionee's period of service, and the options vest on an accelerated basis in the event of a change in control. As of December 31, 2005, options covering approximately 0.5 million shares of our common stock were outstanding under the 1998 ESOP, options covering approximately 0.9 million shares were exercised during fiscal year 2005 and approximately 0.3 million shares remained available for future options.

### 1998 Special Employee Stock Option Plan

The Baker Hughes Incorporated 1998 Special Employee Stock Option Plan (the "1998 SESOP") was adopted effective as of October 22, 1997. The number of shares authorized for issuance upon the exercise of options granted under the 1998 SESOP is 2.5 million shares. Under the 1998 SESOP, the Compensation Committee of our Board of Directors has the authority to grant nonqualified stock options to purchase shares of our common stock to a broad-based group of employees. The exercise price of the options will be equal to the fair market value per share of our common stock at the time of the grant, and option terms may be up to ten years. Stock option grants of 100 shares, with an exercise price of \$47.813 per share, were issued to all of our U.S. employees in October 1997 and to our international employees in May 1998. As of December 31, 2005, options covering approximately 0.5 million shares of our common stock were outstanding under the 1998 SESOP, options covering approximately 0.4 million shares were exercised during fiscal year 2005 and approximately 1.7 million shares remained available for future options.

### *2002 Employee Long-Term Incentive Plan*

The Baker Hughes Incorporated 2002 Employee Long-Term Incentive Plan (the "2002 Employee LTIP") was adopted effective as of March 6, 2002. The 2002 Employee LTIP permits the grant of awards as nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units, stock awards and cash-based awards to our corporate officers and key employees. The number of shares authorized for issuance under the 2002 Employee LTIP is 9.5 million, with no more than 3.0 million available for grant as awards other than options (the number of shares is subject to adjustment for changes in our common stock).

The 2002 Employee LTIP is the companion plan to the Baker Hughes Incorporated 2002 Director & Officer Long-Term Incentive Plan, which was approved by our stockholders in 2002. The rationale for the two companion plans was to discontinue the use of the remaining older option plans and to have only two plans from which we would issue compensation awards.

*Options.* The exercise price of the options will not be less than the fair market value of the shares of our common stock on the date of grant, and options terms may be up to ten years. The maximum number of shares of our common stock that may be subject to options granted under the 2002 Employee LTIP to any one employee during any one fiscal year will not exceed 3.0 million, subject to adjustment under the antidilution provisions of the 2002 Employee LTIP. Under the terms and conditions of the stock option awards for options issued under the 2002 Employee LTIP, options generally vest and become exercisable in installments over the optionee's period of service, and the options vest on an accelerated basis in the event of a change in control or certain terminations of employment. As of December 31, 2005, options covering approximately 2.8 million shares of our common stock were outstanding under the 2002 Employee LTIP, options covering approximately 1.0 million shares were exercised during fiscal year 2005 and approximately 4.8 million shares remained available for future options.

*Performance Shares and Units; Cash-Based Awards.* Performance shares may be granted to employees in the amounts and upon the terms determined by the Compensation Committee of our Board of Directors, but must be limited to no more than 1.0 million shares to any one employee in any one fiscal year. Performance shares will have an initial value equal to the fair market value of our common stock at the date of the award. Performance units and cash-based awards may be granted to employees in amounts and upon the terms determined by the Compensation Committee, but must be limited to no more than \$10.0 million for any one employee in any one fiscal year. The performance measures that may be used to determine the extent of the actual performance payout or vesting include, but are not limited to, net earnings; earnings per share; return measures; cash flow return on investments (net cash flows divided by owner's equity); earnings before or after taxes, interest, depreciation and/or amortization; share price (including growth measures and total shareholder return) and Baker Value Added (our metric that measures operating profit after tax less the cost of capital employed).

*Restricted Stock and Restricted Stock Units.* With respect to awards of restricted stock and restricted stock units, the Compensation Committee will determine the conditions or restrictions on the awards, including whether the holders of the restricted stock or restricted stock units will exercise full voting rights or receive dividends and other distributions during the restriction period. At the time the award is made, the Compensation Committee will determine the right to receive unvested restricted stock or restricted units after termination of service. Awards of restricted stock are limited to 1.0 million shares in any one year to any one individual.

*Stock Appreciation Rights.* Stock appreciation rights may be granted under the 2002 Employee LTIP on the terms and conditions determined by the Compensation Committee. The grant price of a freestanding stock appreciation right will not be less than the fair market value of our common stock on the date of grant. The maximum number of shares of our common stock that may be utilized for purposes of determining an employee's compensation under stock appreciation rights granted under the 2002 Employee LTIP during any one fiscal year will not exceed 3.0 million shares, subject to adjustment under the antidilution provisions of the 2002 Employee LTIP.

*Administration; Amendment and Termination.* The Compensation Committee shall administer the 2002 Employee LTIP, and in the absence of the Compensation Committee, the Board will administer the Plan. The Compensation Committee will have full and exclusive power to interpret the provisions of the 2002 Employee LTIP as the Committee may deem necessary or proper, with the powers exercised in the best interests of the Company and in keeping with the objectives of the Plan. The Board may alter, amend, modify, suspend or terminate the 2002 Employee LTIP, except that no amendment, modification, suspension or termination that would adversely affect in any material way the rights of a participant under any award previously granted under the Plan may be made without the written consent of the participant or to the extent stockholder approval is otherwise required by applicable legal requirements.

#### *Director Compensation Deferral Plan*

The Baker Hughes Incorporated Director Compensation Deferral Plan, as amended and restated effective July 24, 2002 (the "Deferral Plan"), is intended to provide a means for members of our Board of Directors to defer compensation otherwise payable and provide flexibility with respect to our compensation policies. Under the provisions of the Deferral Plan, directors may elect to defer income with respect to each calendar year. The compensation deferrals may be stock option-related deferrals or cash-based deferrals. The stock option-related deferrals may be either market-priced stock options or discounted stock options. The number of shares to be issued for the market-priced stock option deferral is calculated on a quarterly basis by multiplying the deferred compensation by 4.4 and then dividing by the fair market value of our

common stock on the last day of the quarter. The number of shares to be issued for the discounted stock option deferral is calculated on a quarterly basis by dividing the deferred compensation by the discounted price of our common stock on the last day of the quarter. The discounted price is 50% of the fair market value of our common stock on the valuation date. Stock options granted under the Deferral Plan vest on the first anniversary of the date of grant and must be exercised within 10 years of the date of grant. If a director's directorship terminates for any reason, any options outstanding will expire 3 years after the termination of the directorship. The maximum aggregate number of shares of our common stock that may be issued under the Deferral Plan is 0.5 million. As of December 31, 2005, options covering 4,191 shares of our common stock were outstanding under the Deferral Plan, options covering 2,880 shares were exercised during fiscal 2005 and approximately 0.5 million shares remained available for future options.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information regarding related party transactions is set forth in the sections entitled "Executive Compensation – Employment, Change in Control and Indemnification Agreements" in our Proxy Statement, which sections are incorporated by reference herein.

### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

Information concerning principal accounting fees and services is set forth in the section entitled "Fees Paid to Deloitte & Touche LLP" in our Proxy Statement, which section is incorporated herein by reference.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) List of Documents filed as part of this Report

(1) Financial Statements

All financial statements of the Registrant as set forth under Item 8 of this Annual Report on Form 10-K.

(2) Financial Statement Schedules

Schedule II – Valuation and Qualifying Accounts

(3) Exhibits

Each exhibit identified below is filed as a part of this report. Exhibits designated with an “\*” are filed as an exhibit to this Annual Report on Form 10-K. Exhibits designated with a “+” are identified as management contracts or compensatory plans or arrangements. Exhibits previously filed as indicated below are incorporated by reference.

- 3.1 Restated Certificate of Incorporation (filed as Exhibit 3.1 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended June 30, 2002).
- 3.2 Certificate of Amendment to the Restated Certificate of Incorporation (filed as Exhibit 3.1 to Current Report of Baker Hughes Incorporated on Form 8-K filed May 4, 2005).
- 3.3 Bylaws of Baker Hughes Incorporated restated as of April 28, 2005 (filed as Exhibit 3.2 to Current Report of Baker Hughes Incorporated on Form 8-K filed May 4, 2005).
- 4.1 Rights of Holders of the Company’s Long-Term Debt. The Company has no long-term debt instrument with regard to which the securities authorized thereunder equal or exceed 10% of the total assets of the Company and its subsidiaries on a consolidated basis. The Company agrees to furnish a copy of its long-term debt instruments to the SEC upon request.
- 4.2 Restated Certificate of Incorporation (filed as Exhibit 3.1 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended June 30, 2002).
- 4.3 Certificate of Amendment to the Restated Certificate of Incorporation (filed as Exhibit 3.1 to Current Report of Baker Hughes Incorporated on Form 8-K filed May 4, 2005).
- 4.4 Bylaws of Baker Hughes Incorporated restated as of April 28, 2005 (filed as Exhibit 3.2 to Current Report of Baker Hughes Incorporated on Form 8-K filed May 4, 2005).
- 4.5 Indenture dated as of May 15, 1994 between Western Atlas Inc. and The Bank of New York, Trustee, providing for the issuance of securities in series (filed as Exhibit 4.4 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2004).
- 10.1+ Employment Agreement by and between Baker Hughes Incorporated and Chad C. Deaton dated as of October 25, 2004 (filed as Exhibit 10.3 to Current Report of Baker Hughes Incorporated on Form 8-K filed October 7, 2004).
- 10.2+ Change in Control Agreement between Baker Hughes Incorporated and Chad C. Deaton dated as of October 25, 2004 (filed as Exhibit 10.2 to Current Report of Baker Hughes Incorporated on Form 8-K filed October 7, 2004).
- 10.3+ Indemnification Agreement dated as of October 25, 2004 between Baker Hughes Incorporated and Chad C. Deaton (filed as Exhibit 10.1 to Current Report of Baker Hughes Incorporated on Form 8-K filed on October 7, 2004).
- 10.4+ Stock Option Agreement issued to Chad C. Deaton on October 25, 2004 in the amount of 75,000 shares of Company Common Stock (filed as Exhibit 10.4 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2004).
- 10.5+ Agreement regarding restricted stock award issued to Chad C. Deaton on October 25, 2004 in the amount of 80,000 shares of Company Common Stock (filed as Exhibit 10.5 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2004).
- 10.6+ Agreement regarding restricted stock award issued to James R. Clark on October 27, 2004 in the amount of 40,000 shares of Baker Hughes Incorporated Common Stock (filed as Exhibit 10.7 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2004).
- 10.7+ Second Amended and Restated Stock Matching Agreement by and between Baker Hughes Incorporated and James R. Clark dated as of October 25, 2004 (filed as Exhibit 10.6 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2004).
- 10.8+ Letter dated October 26, 2005 to James R. Clark clarifying Mr. Clark’s employment terms (filed as Exhibit 10.2 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2005).
- 10.9+\* Retirement and Consulting Agreement dated November 1, 2005 and clarification letter dated February 15, 2006 between Baker Hughes Incorporated and G. Stephen Finley effective as of April 1, 2006.
- 10.10+ Form of Change in Control Severance Plan (filed as Exhibit 10.8 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).

- 10.11+ Form of Change in Control Severance Agreement between Baker Hughes Incorporated and David H. Barr and John A. O'Donnell effective as of July 28, 2004, and with James R. Clark, Alan R. Crain, Jr., William P. Faubel, G. Stephen Finley, Greg Nakanishi and Douglas J. Wall to be effective as of January 1, 2006 and with Chris P. Beaver, Paul S. Butero and Martin S. Craighead effective as of February 28, 2005 and with Richard L. Williams effective as of May 2, 2005 and with Charles S. Wolley effective as of January 1, 2006 (filed as Exhibit 10.8 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2004).
- 10.12+ Form of Indemnification Agreement between Baker Hughes Incorporated and each of the directors and executive officers (filed as Exhibit 10.4 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).
- 10.13+ Baker Hughes Incorporated Director Retirement Policy for Certain Members of the Board of Directors (filed as Exhibit 10.10 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).
- 10.14+ Baker Hughes Incorporated Director Compensation Deferral Plan, as amended and restated effective as of July 24, 2002 (filed as Exhibit 10.16 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.15+ Baker Hughes Incorporated Executive Severance Plan (effective November 1, 2002) (filed as Exhibit 10.13 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.16 1995 Employee Annual Incentive Compensation Plan, as amended by Amendment No. 1997-1 to the 1995 Employee Annual Incentive Compensation Plan and as amended by Amendment No. 1999-1 to the 1995 Employee Annual Incentive Compensation Plan (filed as Exhibit 10.17 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.17+ Baker Hughes Incorporated Supplemental Retirement Plan, as amended and restated effective as of January 1, 2005 (filed as Exhibit 10.1 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2005).
- 10.18 Long-Term Incentive Plan, as amended by Amendment No. 1999-1 to Long-Term Incentive Plan (filed as Exhibit 10.18 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.19 Baker Hughes Incorporated 1998 Employee Stock Option Plan, as amended by Amendment No. 1999-1 to 1998 Employee Stock Option Plan (filed as Exhibit 10.3 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended June 30, 2003).
- 10.20 Baker Hughes Incorporated 2002 Employee Long-Term Incentive Plan (filed as Exhibit 4.4 to Registration Statement No. 333-87372 on Form S-8 filed May 1, 2002).
- 10.21+ Baker Hughes Incorporated 2002 Director & Officer Long-Term Incentive Plan (filed as Exhibit 10.2 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended September 30, 2003).
- 10.22+ Amendment to 2002 Director & Officer Long-Term Incentive Plan, effective as of October 27, 2005 (filed as Exhibit 10.3 to Quarterly Report on Form 10-Q for the quarter ended September 30, 2005).
- 10.23 Baker Hughes Incorporated Employee Stock Purchase Plan, as amended and restated, effective as of March 3, 2003 (filed as Exhibit 10.1 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended March 31, 2003).
- 10.24 Baker Hughes Incorporated Pension Plan effective as of January 1, 2002, as amended by First Amendment, effective January 1, 2002 (filed as Exhibit 10.51 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.25 Form of Nonqualified Stock Option Agreement for employees effective October 25, 1995 (filed as Exhibit 10.27 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).
- 10.26 Form of Incentive Stock Option Agreement for employees effective October 25, 1995 (filed as Exhibit 10.28 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).
- 10.27+ Form of Nonqualified Stock Option Agreement for directors effective October 25, 1995 (filed as Exhibit 10.26 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).
- 10.28+ Form of Stock Option Agreement for executive officers effective October 1, 1998 (filed as Exhibit 10.37 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2000).
- 10.29+ Form of Nonqualified Stock Option Agreement for directors effective October 25, 1998 (filed as Exhibit 10.39 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2000).
- 10.30+ Form of Baker Hughes Incorporated Nonqualified Stock Option Agreement for executive officers, dated January 24, 2001 (filed as Exhibit 10.41 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).
- 10.31 Form of Baker Hughes Incorporated Nonqualified Stock Option Agreement for employees, dated January 30, 2002 (filed as Exhibit 10.43 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).



- 10.32 Form of Baker Hughes Incorporated Incentive Stock Option Agreement for employees, dated January 30, 2002 (filed as Exhibit 10.44 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2001).
- 10.33+ Form of Baker Hughes Incorporated Stock Option Award Agreements, with Terms and Conditions (filed as Exhibit 10.46 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2002).
- 10.34+ Form of Baker Hughes Incorporated Performance Award Agreement, including Terms and Conditions for certain executive officers (filed as Exhibit 10.4 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended March 31, 2004).
- 10.35+ Form of Restricted Stock Award Resolution, including Terms and Conditions (filed as Exhibit 10.3 to Quarterly Report of Baker Hughes Incorporated on Form 10-Q for the quarter ended March 31, 2004).
- 10.36+ Form of Baker Hughes Incorporated Restricted Stock Award Agreement (filed as Exhibit 10.54 to Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.37+ Form of Baker Hughes Incorporated Restricted Stock Award Terms and Conditions (filed as Exhibit 10.54 to Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.38 Form of Baker Hughes Incorporated Restricted Stock Unit Agreement (filed as Exhibit 10.54 to Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.39 Form of Baker Hughes Incorporated Restricted Stock Unit Terms and Conditions (filed as Exhibit 10.54 to Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.40+\* Form of Baker Hughes Incorporated Restricted Stock Award, including Terms and Conditions for directors.
- 10.41+\* Form of Baker Hughes Incorporated Stock Option Award Agreement, including Terms and Conditions for directors.
- 10.42+\* Form of Baker Hughes Incorporated Performance Unit Award Agreement, including Terms and Conditions.
- 10.43+\* Performance Goals for the Performance Unit Award granted in 2006.
- 10.44+\* Compensation Table for Named Executive Officers and Directors.
- 10.45 Form of Credit Agreement, dated as of July 7, 2005, among Baker Hughes Incorporated, JP Morgan Chase Bank, N.A., as Administrative Agent and fourteen lenders for \$500 million, in the aggregate for all banks (filed as Exhibit 10.1 to Current Report of Baker Hughes Incorporated on Form 8-K filed July 11, 2005).
- 10.46 Agreement and Plan of Merger among Baker Hughes Incorporated, Baker Hughes Delaware I, Inc. and Western Atlas Inc. dated as of May 10, 1998 (filed as Exhibit 10.30 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).
- 10.47 Tax Sharing Agreement dated October 31, 1997, between Western Atlas Inc. and UNOVA Inc. (filed as Exhibit 10.31 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).
- 10.48 Employee Benefits Agreement dated October 31, 1997, between Western Atlas Inc. and UNOVA Inc. (filed as Exhibit 10.32 to Annual Report of Baker Hughes Incorporated on Form 10-K for the year ended December 31, 2003).
- 10.49 Master Formation Agreement by and among the Company, Schlumberger Limited and certain wholly owned subsidiaries of Schlumberger Limited dated as of September 6, 2000 (filed as Exhibit 2.1 to Current Report of Baker Hughes Incorporated on Form 8-K dated September 7, 2000).
- 10.50 Shareholders' Agreement by and among Schlumberger Limited, Baker Hughes Incorporated and other parties listed on the signature pages thereto dated November 30, 2000 (filed as Exhibit 10.1 to Current Report of Baker Hughes Incorporated on Form 8-K dated November 30, 2000).
- 21.1\* Subsidiaries of Registrant.
- 23.1\* Consent of Deloitte & Touche LLP.
- 31.1\* Certification of Chad C. Deaton, Chief Executive Officer, dated February 28, 2006, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
- 31.2\* Certification of G. Stephen Finley, Chief Financial Officer, dated February 28, 2006, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
- 32\* Statement of Chad C. Deaton, Chief Executive Officer, and G. Stephen Finley, Chief Financial Officer, dated February 28, 2006, furnished pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended.
- 99.1 Administrative Proceeding, File No. 3-10572, dated September 12, 2001, as issued by the Securities and Exchange Commission (filed as Exhibit 99.1 to Current Report on Form 8-K filed on September 19, 2001).

## SIGNATURES

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

### BAKER HUGHES INCORPORATED

Date: February 28, 2006

/s/CHAD C. DEATON

Chad C. Deaton

Chairman of the Board and Chief Executive Officer

KNOWN ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Chad C. Deaton and G. Stephen Finley, each of whom may act without joinder of the other, as their true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for such person and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or their substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
<u>/s/CHAD C. DEATON</u> (Chad C. Deaton)	Chairman of the Board and Chief Executive Officer (principal executive officer)	February 28, 2006
<u>/s/G. STEPHEN FINLEY</u> (G. Stephen Finley)	Senior Vice President – Finance and Administration and Chief Financial Officer (principal financial officer)	February 28, 2006
<u>/s/ALAN J. KEIFER</u> (Alan J. Keifer)	Vice President and Controller (principal accounting officer)	February 28, 2006
<u>/s/LARRY D. BRADY</u> (Larry D. Brady)	Director	February 28, 2006
<u>/s/CLARENCE P. CAZALOT, JR.</u> (Clarence P. Cazalot, Jr.)	Director	February 28, 2006
_____ (Edward P. Djerejian)	Director	
<u>/s/ANTHONY G. FERNANDES</u> (Anthony G. Fernandes)	Director	February 28, 2006
<u>/s/CLAIRE W. GARGALLI</u> (Claire W. Gargalli)	Director	February 28, 2006
<u>/s/JAMES A. LASH</u> (James A. Lash)	Director	February 28, 2006
<u>/s/JAMES F. MCCALL</u> (James F. McCall)	Director	February 28, 2006
<u>/s/J. LARRY NICHOLS</u> (J. Larry Nichols)	Director	February 28, 2006
<u>/s/H. JOHN RILEY, JR.</u> (H. John Riley, Jr.)	Director	February 28, 2006
<u>/s/CHARLES L. WATSON</u> (Charles L. Watson)	Director	February 28, 2006

## SCHEDULE II – VALUATION AND QUALIFYING ACCOUNTS

(In millions)	Balance at Beginning of Period	Additions Charged to Cost and Expenses	Deductions			Balance at End of Period
			Reversal of Prior Deductions <sup>(1)</sup>	Write-offs <sup>(2)</sup>	Charged to Other Accounts <sup>(3)</sup>	
Year ended December 31, 2005:						
Reserve for doubtful accounts receivable	\$ 50.2	\$ 28.3	\$ (14.8)	\$ (8.0)	\$ (4.3)	\$ 51.4
Reserve for inventories	220.0	31.4	–	(42.1)	(8.0)	201.3
Year ended December 31, 2004:						
Reserve for doubtful accounts receivable	61.6	21.1	(19.3)	(14.4)	1.2	50.2
Reserve for inventories	231.5	38.8	–	(59.3)	9.0	220.0
Year ended December 31, 2003:						
Reserve for doubtful accounts receivable	66.2	18.1	(9.7)	(13.5)	0.5	61.6
Reserve for inventories	233.6	23.0	–	(36.1)	11.0	231.5

<sup>(1)</sup> Represents the reversals of prior accruals as receivables are collected.

<sup>(2)</sup> Represents the elimination of accounts receivable and inventory deemed uncollectible or worthless.

<sup>(3)</sup> Represents reclasses, currency translation adjustments and divestitures.

## GOVERNANCE AT BAKER HUGHES

### **Baker Hughes Corporate Governance Guidelines –**

Our board's *Corporate Governance Guidelines* regulate its relationship with stockholders, the conduct of the company's affairs and its relationship with our senior executive management. The guidelines recognize that the board has a separate and unique role as the link in the chain of authority between the stockholders and senior executive management. The *Corporate Governance Guidelines* can be accessed electronically at [www.bakerhughes.com](http://www.bakerhughes.com) in the "About Baker Hughes" section.

The Baker Hughes board consists of 11 directors, including 10 independent non-employee directors. The company's bylaws allow the board to have between 9 and 12 members. Expansion above 12 members requires an affirmative vote of 75% of the members of the board. The sole inside director is Chad C. Deaton, Chairman and Chief Executive Officer of Baker Hughes. Director H. John Riley serves as the Lead Director.

Directors are elected annually. Non-employee directors cannot stand for re-election at the annual meeting of stockholders following their 72nd birthday, or must resign if attendance at board and committee meetings falls below 66%. The board may waive these requirements if it believes retention of the board member is in the best interest of our company. In addition, any nominee for director who receives a "withhold" vote representing a majority of the votes cast for his or her election is required to submit a letter of resignation to the Board's Governance Committee. The Governance Committee would recommend to the Board whether or not the resignation should be accepted.

### **Baker Hughes Directors At A Glance**

- All 10 independent non-employee directors serve on no more than three other public boards.
- The average age of the directors is 62. The average tenure on the board is approximately five and one-half years.
- The diversity of principal occupations represented on our board includes Diplomacy (Djerejian), Diversified Industrial and Manufacturing (Fernandes and Riley), Energy (Cazalat, Nichols and Watson), Executive Search (Gargalli), Finance (McCall), High Technology (Lash), Industrial Technologies (Brady) and Oilfield Services (Deaton).
- The board has five meetings scheduled in 2006.
- In 2005, the board held ten meetings and all directors attended at least 75% of all committee and board meetings.
- All five members of the Audit/Ethics Committee meet the SEC requirements of an "audit committee financial expert." The board has named Anthony G. Fernandes as its financial expert.
- The Audit/Ethics, Compensation, Finance and Governance Committees are all comprised solely of independent non-employee directors.
- The board conducts continuing director education and director orientation.

**Committees of the Board –** The board has five standing committees – Audit/Ethics, Compensation, Finance, Governance and Executive. The Audit/Ethics, Compensation and Governance Committees are comprised solely of independent directors in accordance with NYSE corporate governance listing standards. The Finance Committee is also comprised of independent directors. Additionally, the board has adopted charters for the Audit/Ethics, Compensation and Governance Committees that comply with the requirements of the NYSE standards, applicable provisions of the Sarbanes-Oxley Act of 2002 ("SOX") and SEC rules. Each of the charters has been posted and is available for public viewing in the "About Baker Hughes" section of our website at [www.bakerhughes.com](http://www.bakerhughes.com). The Audit/Ethics Committee met eight times in 2005. The Compensation Committee meets at least four times per year. The Finance and Governance Committees meet at least two times per year. The Executive Committee meets as required. Independent non-employee directors meet without the CEO on a regular basis.

**The Audit/Ethics Committee** is comprised of five independent non-employee directors and is responsible for assisting the board with the oversight of the integrity of our financial statements, our compliance with legal and regulatory requirements, the qualification and independence of our independent auditor and the performance of our internal audit function.

The Committee:

- selects the independent auditor used by the company and reviews their performance;
- reviews financial reporting and disclosure issues with management and the internal auditors;
- establishes guidelines with respect to earnings news releases and the financial information and earnings guidance provided to analysts;
- meets periodically with management, the internal auditors and the independent auditor to review the work of each. The independent auditor and internal auditors have full and free access to the Audit/Ethics Committee, without management present, to discuss auditing and financial reporting matters;
- reviews and pre-approves audit and non-audit fees;
- provides assistance to the board in overseeing matters related to risk analysis and risk management;
- annually reviews compliance with our Business Code of Conduct and Foreign Corrupt Practices Act policies. The Baker Hughes Business Code of Conduct and Code of Ethical Conduct Certification are available on our website;
- annually reviews compliance with our environmental policy. The Baker Hughes Environmental Policy is available on our website;
- prepares an annual report to stockholders which is published in our proxy statement (contained herein) and made available on our website.

**The Compensation Committee** is comprised of five independent non-employee directors and is responsible for seeing that the senior executives of our company are compensated effectively in a manner that is consistent with our compensation strategy, internal equity considerations and competitive practice.

The Committee:

- reviews our compensation strategy to ensure that management is rewarded appropriately for its contributions to growth and profitability, and that executive compensation supports both company and stockholder interests;
- reviews our long-term equity incentive plans (and makes grants thereunder), employee retirement income plans, the employee thrift plan and the employee stock purchase plan;
- annually approves revisions to our annual salary increase guidelines and sets bonus goals;
- approves salary and bonus awards to key executives;
- recommends incentive compensation and stock award plans for approval by stockholders;
- periodically reviews management succession plans;
- annually reviews levels of stock ownership by officers in accordance with our stock ownership guidelines;
- prepares an annual report to stockholders which is published in our proxy statement (contained herein) and is available on our website.

**The Finance Committee** is comprised of five independent non-employee directors and is responsible for reviewing and monitoring the financial planning and actions taken that are related to the financial structure of our company.

The Committee:

- reviews and approves for recommendation to the board any public equity offerings, public debt offerings or other

debt arrangements, issuances of warrants, options or convertible or exchangeable securities, loans to third parties and dividend policy changes;

- periodically reviews our activities with credit rating agencies and monitors key financial ratios;
- annually reviews our policies regarding approval levels for capital expenditures;
- periodically reviews our policy and controls with regard to derivatives and foreign exchange exposure;
- annually reviews our insurance programs.

**The Governance Committee** is comprised of five independent non-employee directors and is responsible for all governance related matters overseen by the board, including recruiting and recommending candidates for election to the board, reviewing the criteria for board membership against the current needs of the board, recommending directors' fees and monitoring compliance with the *Corporate Governance Guidelines*.

The Committee:

- annually reviews the structure of the board and the skills and experiences of its members, to assure that the proper skills and diversity of experience are represented on the board;
- assesses the board contributions of the directors and recommends to the board if the director should be re-nominated at the next annual meeting;
- annually reviews board compensation and compensation methods;
- reviews outside directorships in other companies by Baker Hughes' senior officers;
- reviews and recommends directors' fees.

Directors	Age	Committee*							Director Since
		Executive	Audit/Ethics	Governance	Finance	Compensation	Employee	Independent	
Chad C. Deaton	53	C					X		2004
Larry D. Brady	63				M	M		X	2004
Clarence P. Cazalot, Jr.	55	M	M	C				X	2002
Edward P. Djerejian	66			M		M		X	2001
Anthony G. Fernandes	60		M		C			X	2001
Claire W. Gargalli	63				M	M		X	1998
James A. Lash	61		M		M			X	2002
James F. McCall	71		C	M				X	1996
J. Larry Nichols	63		M		M			X	2001
H. John Riley, Jr.	65	M		M		C		X	1997
Charles L. Watson	56	M		M		M		X	1998

\* M=Member; C=Chairman

## Resources on [www.bakerhughes.com](http://www.bakerhughes.com)

Corporate Governance Guidelines . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/guidelines.htm">www.bakerhughes.com/investor/about/bod/guidelines.htm</a>
Governance Committee . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/charters/governance.htm">www.bakerhughes.com/investor/about/bod/charters/governance.htm</a>
Audit/Ethics Committee Charter . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/charters/audit.htm">www.bakerhughes.com/investor/about/bod/charters/audit.htm</a>
Audit/Ethics Committee Annual Report . . . . .	<a href="http://www.bakerhughes.com/investor/bod/auditethics/2005report.htm">www.bakerhughes.com/investor/bod/auditethics/2005report.htm</a>
Finance Committee Charter . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/charters/finance.htm">www.bakerhughes.com/investor/about/bod/charters/finance.htm</a>
Compensation Committee Charter . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/charters/compensation.htm">www.bakerhughes.com/investor/about/bod/charters/compensation.htm</a>
Compensation Committee Annual Report . . . . .	<a href="http://www.bakerhughes.com/investor/bod/compensation/2005report.htm">www.bakerhughes.com/investor/bod/compensation/2005report.htm</a>
Executive Committee Charter . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod/charters/executive.htm">www.bakerhughes.com/investor/about/bod/charters/executive.htm</a>
Business Code of Conduct . . . . .	<a href="http://www.bakerhughes.com/investor/about/code_of_conduct.htm">www.bakerhughes.com/investor/about/code_of_conduct.htm</a>
Code of Ethical Conduct Certification . . . . .	<a href="http://www.bakerhughes.com/investor/about/code_certification.htm">www.bakerhughes.com/investor/about/code_certification.htm</a>
Stockholder Rights Plan Policy Statement . . . . .	<a href="http://www.bakerhughes.com/investor/about/rights_statement.htm">www.bakerhughes.com/investor/about/rights_statement.htm</a>
Environmental Policy . . . . .	<a href="http://www.bakerhughes.com/HSE/plan_policy.htm">www.bakerhughes.com/HSE/plan_policy.htm</a>
Biographies of Board Members . . . . .	<a href="http://www.bakerhughes.com/investor/about/bod.htm">www.bakerhughes.com/investor/about/bod.htm</a>
Biographies of Executive Officers . . . . .	<a href="http://www.bakerhughes.com/investor/about/management.htm">www.bakerhughes.com/investor/about/management.htm</a>

## Ownership Structure

Investors	Source	Shares (millions)	% of Total
Capital Research	(12/05, 13F)	43.3	12.7%
Fidelity Management	(12/05, 13F)	26.4	7.7%
Dodge & Cox	(12/05, 13F)	19.2	5.6%
Barclays	(12/05, 13F)	17.9	5.2%
T. Rowe Price	(12/05, 13F)	12.0	3.5%
State Street	(12/05, 13F)	10.9	3.2%
Vanguard Group	(12/05, 13F)	8.2	2.4%
Lord Abbett	(12/05, 13F)	8.0	2.4%
Montag & Caldwell	(12/05, 13F)	7.9	2.4%
Goldman Sachs	(12/05, 13F)	7.3	2.1%
Top 10 investors		161.1	47.2%
Other institutional investors		162.0	47.4%
Other holders		18.4	5.4%

## New York Stock Exchange

Last year our Annual CEO Certification, without qualifications, was timely submitted to the NYSE. Also, we have filed our certifications required under SOX as exhibits to our Form 10-K.

## Important Stockholder Dates

Q106 Earnings News Release*	4/26/06
2006 Annual Meeting	4/27/06
Q206 Earnings News Release*	7/28/06
Q306 Earnings News Release*	10/27/06

\*Dates subject to change without notice

## Independent Auditor

In 2005, we paid our independent auditor, Deloitte & Touche LLP, the member firms of Deloitte Touche Tohmatsu, and their respective affiliates, audit fees of \$11.0 million; and tax fees of \$1.0 million primarily for the preparation of income, payroll, value added and other tax returns.

## Corporate Officers

**Chad C. Deaton**  
Chairman and Chief Executive Officer

**James R. Clark**  
President and Chief Operating Officer

**David H. Barr**  
Vice President and Group President,  
Baker Hughes Drilling and Evaluation

**Martin S. Craighead**  
Vice President and President, INTEQ

**Paul S. Butero**  
Vice President and President,  
Hughes Christensen

**William P. Faubel**  
Vice President and President, Baker Atlas

**Richard L. Williams**  
Vice President and President,  
Baker Hughes Drilling Fluids

**Douglas J. Wall**  
Vice President and Group President,  
Baker Hughes Completion and Production

**Christopher P. Beaver**  
Vice President and President,  
Baker Oil Tools

**Charles S. Wolley**  
Vice President and President, Centrillift

**John A. O'Donnell**  
Vice President and President,  
Baker Petrolite

**G. Stephen Finley\***  
Senior Vice President—Finance and  
Administration and Chief Financial Officer  
\*Retires March 31, 2006

**Douglas C. Doty**  
Vice President and Treasurer

**David E. Emerson**  
Vice President, Business Development

**John H. Lohman, Jr.**  
Vice President, Tax

**Alan J. Keifer**  
Vice President and Controller

**Alan R. Crain, Jr.**  
Vice President and General Counsel

**Sandra E. Alford**  
Corporate Secretary

**Jay G. Martin**  
Vice President, Chief Compliance Officer  
and Senior Deputy General Counsel

**Greg Nakanishi**  
Vice President, Human Resources

## Board of Directors

**Larry D. Brady**  
Chairman and Chief Executive Officer,  
Intermec, Inc.

**Clarence P. Cazalot, Jr.**  
President and Chief Executive Officer,  
Marathon Oil Corporation

**Chad C. Deaton**  
Chairman and Chief Executive Officer,  
Baker Hughes Incorporated

**Edward P. Djerejian**  
Director, James A. Baker III Institute for  
Public Policy, Rice University

**Anthony G. Fernandes**  
Former Chairman, President and  
Chief Executive Officer,  
Phillip Services Corporation

**Claire W. Gargalli**  
Former Vice Chairman, Diversified Search and  
Diversified Health Search Companies

**James A. Lash**  
First Selectman, Greenwich, Connecticut and  
Chairman, Manchester Principal LLC

**James F. McCall**  
Lt. General, U.S. Army (Retired) and Former  
Executive Director of the American Society of  
Military Comptrollers

**J. Larry Nichols**  
Chairman and Chief Executive Officer,  
Devon Energy Corporation

**H. John Riley, Jr.**  
Former Chairman, Cooper Industries, Ltd.

**Charles L. Watson**  
Chairman, Eagle Energy Partners  
and Wincrest Ventures L.P.

## Stockholder Information

Transfer Agent and Registrar  
Mellon Investor Services, LLC  
480 Washington Boulevard  
Jersey City, NJ 07310  
(888) 216-8057

## Stock Exchange Listings

Ticker Symbol "BHI"  
New York Stock Exchange, Inc.  
SWX Swiss Exchange

## Investor Relations Office

Gary R. Flaharty  
Director, Investor Relations  
Baker Hughes Incorporated  
P.O. Box 4740  
Houston, Texas 77210-4740  
ir@bakerhughes.com

## Form 10-K

Additional copies of the company's  
Annual Report to the Securities and Exchange  
Commission (Form 10-K) are available by  
writing to Baker Hughes Investor Relations.

## Annual Meeting

The company's Annual Meeting of  
Stockholders will be held at 9:00 a.m.  
Central Time on April 27, 2006 at the offices  
of the company:  
3900 Essex Lane, Suite 210  
Houston, Texas.

## Corporate Office Location and Mailing Address

3900 Essex Lane  
Houston, Texas 77027-5177  
Telephone: (713) 439-8600  
P.O. Box 4740  
Houston, Texas 77210-4740

## Website

[www.bakerhughes.com](http://www.bakerhughes.com)  
Baker Hughes  
Information Systems  
(888) 408-4244

As a Baker Hughes stockholder, you are invited to take advantage of our convenient stockholder services or request more information about Baker Hughes.

Mellon Investor Services, our transfer agent, maintains the records for our registered stockholders and can help you with a variety of stockholder related services at no charge including:

- Change of name or address
- Duplicate mailings
- Lost stock certificates
- Additional administrative services
- Consolidation of accounts
- Dividend reinvestment enrollment
- Transfer of stock to another person

Access your investor statements online 24 hours a day, 7 days a week with MLink<sup>SM</sup>.  
For more information, go to [www.melloninvestor.com/ISD](http://www.melloninvestor.com/ISD).

Baker Hughes Incorporated

3900 Essex Lane  
Houston, TX 77027

P.O. Box 4740  
Houston, TX 77210-4740

(713) 439-8600

[www.bakerhughes.com](http://www.bakerhughes.com)