MCDERMOTT INTERNATIONAL INC
Form 10-K
March 01, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from __________ to __________

Commission File Number 001-08430

McDERMOTT INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

REPUBLIC OF PANAMA	72-0593134
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
777 N. ELDRIDGE PKWY. HOUSTON, TEXAS	77079
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number, Including Area Code (281) 870-5901

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class	Name of each Exchange on which registered
Common Stock, $1.00 par value	New York Stock Exchange
Rights to Purchase Preferred Stock (Currently Traded with Common Stock)	New York Stock Exchange

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

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

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

The aggregate market value of the registrant s common stock held by nonaffiliates of the registrant on the last business day of the registrant s most recently completed second fiscal quarter (based on the closing sales price on the New York Stock Exchange on June 30, 2006) was approximately $4,995,795,675.

The number of shares of the registrant s common stock outstanding at January 31, 2007 was 110,831,565.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A under the Securities Exchange Act of 1934 in connection with the registrant s 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this report.

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Ratio of Earnings to Fixed Charges
Significant Subsidiaries
Consent of PricewaterhouseCoopers LLP
Consent of Deloitte & Touche LLP
Rule 13a-14(a)/15d-14(a) Certification of CEO
Rule 13a-14(a)/15d-14(a) Certification of CFO
Section 1350 Certification of CEO
Section 1350 Certification of CFO

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Statements we make in this Annual Report on Form 10-K which express a belief, expectation or intention, as well as those that are not historical fact, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to various risks, uncertainties and assumptions, including those to which we refer under the headings Cautionary Statement Concerning Forward-Looking Statements and Risk Factors in Items 1 and 1A of Part I of this report.

PART I

Item 1. BUSINESS

A. GENERAL

McDermott International, Inc. (MII), incorporated under the laws of the Republic of Panama in 1959, is an engineering and construction company with specialty manufacturing and service capabilities and is the parent company of the McDermott group of companies, which includes:

J. Ray McDermott, S.A., a Panamanian subsidiary of MII (JRMSA), and its consolidated subsidiaries;

McDermott Holdings, Inc., a Delaware subsidiary of MII (MHI), and its consolidated subsidiaries;

McDermott Incorporated, a Delaware subsidiary of MHI (MI), and its consolidated subsidiaries;

The Babcock & Wilcox Companies, a Delaware subsidiary of MI (B&WC);

BWX Technologies, Inc., a Delaware subsidiary of B&WC (BWXT), and its consolidated subsidiaries; and

The Babcock & Wilcox Company, a Delaware subsidiary of B&WC (B&W), and its consolidated subsidiaries.

In this Annual Report on Form 10-K, unless the context otherwise indicates, we, us and our mean MII and its consolidated subsidiaries.

We are a worldwide energy services company operating in three business segments:

Offshore Oil and Gas Construction, previously referred to as Marine Construction Services, includes the results of operations of JRMSA and its subsidiaries and JRMH and its subsidiaries, hereafter collectively referred to as JRM, which supply services primarily to offshore oil and gas field developments worldwide. This segment s principal activities include the front-end design and detailed engineering, fabrication and installation of offshore drilling and production facilities and installation of marine pipelines and subsea production systems. This segment operates in most major offshore oil and gas producing regions throughout the world, including the United States, Mexico, the Middle East, India, the Caspian Sea and Asia Pacific.

Government Operations includes the results of operations of BWXT and its subsidiaries. This segment supplies nuclear components and provides various services to the U.S. Government, including uranium processing, environmental site restoration services and management and operating services for various U.S. Government-owned facilities, primarily within the nuclear weapons complex of the U.S. Department of Energy (DOE).

Power Generation Systems includes the results of operations of B&W and its subsidiaries. This segment provides a variety of services, equipment and systems to generate steam and electric power at energy facilities worldwide. On February 22, 2006, B&W and three of its subsidiaries exited from Chapter 11 Bankruptcy proceedings. As a result of B&W s Chapter 11 proceedings, we did not consolidate the results of operations of B&W and its subsidiaries in our consolidated financial statements from February 22, 2000 through February 22, 2006. Amounts reported for this segment during that period reflect only the results of operations of several foreign subsidiaries not owned by B&W. See Note 20 to our consolidated financial statements included in this report for information on B&W and its subsidiaries.

The following tables summarize our revenues and operating income by business segment for the years ended December 31, 2006, 2005 and 2004. See Note 17 to our consolidated financial statements included in this report for

additional information about our business segments and operations in different geographic areas.

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	Year Ended December 31,		
	2006	*2005*	*2004*
		(In Millions)	
REVENUES			
Offshore Oil and Gas Construction	$1,610.3	$1,238.9	$1,357.8
Government Operations	630.1	601.0	555.1
Power Generation Systems	1,888.6		
Adjustments and Eliminations	(8.9)	(0.2)	
	$4,120.1	$1,839.7	$1,912.9
OPERATING INCOME:			
Segment Operating Income (Loss):			
Offshore Oil and Gas Construction	$ 209.9	$ 149.8	$ 53.8
Government Operations	82.8	68.0	76.7
Power Generation Systems	101.9	(0.9)	(0.9)
	$ 394.6	$ 216.9	$ 129.6
Gain (Loss) on Asset Disposals and Impairments Net:			
Offshore Oil and Gas Construction	$ (16.2)	$ 6.4	$ 30.3
Government Operations	1.1	0.1	0.6
Power Generation Systems	0.1		1.6
	$ (15.0)	$ 6.5	$ 32.5
Equity in Income (Loss) from Investees:			
Offshore Oil and Gas Construction	$ (2.9)	$ 2.8	$ 1.9
Government Operations	27.8	31.3	32.5
Power Generation Systems	12.5	6.4	1.2
	$ 37.4	$ 40.5	$ 35.6
Unallocated corporate[1]	(29.9)	(39.9)	(49.6)
	$ 387.1	$ 224.0	$ 148.1

(1) See Note 17 to our consolidated

financial statements included in this report for further information on unallocated corporate expenses.

B. OFFSHORE OIL AND GAS CONSTRUCTION

General

The Offshore Oil and Gas Construction segment s business involves the front-end design and detailed engineering, fabrication and installation of offshore drilling and production facilities and installation of marine pipelines and subsea production systems. This segment also provides comprehensive project management and procurement services. This segment operates in most major offshore oil and gas producing regions throughout the world, including the United States, Mexico, the Middle East, India, the Caspian Sea and Asia Pacific.

Offshore Oil and Gas Construction Vessels and Properties

We operate a fleet of marine vessels used in major offshore construction. We currently own or, through our ownership interest in a joint venture, operate one derrick vessel and six combination derrick-pipelaying vessels. We also operate a pipelay vessel and a dive support vessel for a subdivision of the state-owned oil company of Azerbaijan. The lifting capacities of our derrick and combination derrick-pipelaying vessels range from 660 to 4,400 tons. These vessels range in length from 350 to 497 feet and are fully equipped with revolving cranes, auxiliary cranes, welding equipment, pile-driving hammers, anchor winches and a variety of additional equipment. Four of our owned and operated vessels are self-propelled, with three also having dynamic positioning systems. We also have a substantial inventory of specialized support equipment for intermediate water and deepwater construction and

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pipelay. In addition, we own or lease a substantial number of other vessels, such as tugboats, utility boats, launch barges and cargo barges, to support the operations of our major marine construction vessels.

The following table sets forth certain information with respect to the major construction vessels utilized to conduct our Offshore Oil and Gas Construction business, including their location at December 31, 2006 (except where otherwise noted, each of the vessels is owned and operated by us):

Location and Vessel Name	Flag	Vessel Type	Year Entered Service/ Upgraded	Maximum Derrick Lift (tons)	Maximum Pipe Diameter (inches)
UNITED STATES					
DB 50 (a)	Panama	Pipelay/Derrick	1988	4,400	20
DB 16 (a)	U.S.A.	Pipelay/Derrick	1967/2000	860	30
Intermac 600 (b)	U.S.A.	Launch/Cargo Barge	1973		
MIDDLE EAST					
DB 27	Panama	Pipelay/Derrick	1974	2,400	60
DLB KP1	Panama	Pipelay/Derrick	1974	660	60
CASPIAN SEA					
Israfil Husseinov (c)	Azerbaijan	Pipelay	1997/2003		60
Akademik Tofiq Ismayilov (a)(c)	Azerbaijan	Dive Support Vessel	1987/2005		
ASIA PACIFIC					
DB 101	Panama	Semi-Submersible Derrick	1978/1984	3,500	
DB 30	Panama	Pipelay/Derrick	1975/1999	3,080	60
DB 26	Panama	Pipelay/Derrick	1975	900	60
Intermac 650 (d)	Panama	Launch/Cargo Barge	1980/2006		
Franklin III	Panama	Shallow Water Barge	1997		

(a) Vessel with dynamic positioning capability.

(b) The dimensions of this vessel are 500 x 120 x 33 .

(c) Operated by us for a subdivision of the State Oil Company of the Azerbaijan Republic.

(d) The overall dimensions of this vessel are 650 x 170 x 40 .

Governmental regulations, our insurance policies and some of our financing arrangements require us to maintain our vessels in accordance with standards of seaworthiness and safety set by governmental authorities or classification societies. We maintain our fleet to the standards for seaworthiness, safety and health set by the American Bureau of Shipping, Den Norske Veritas and other world-recognized classification societies.

Our principal fabrication facilities are located near Morgan City, Louisiana, in Indonesia on Batam Island and in Dubai, U.A.E., and we are currently developing a new fabrication facility on the east coast of Mexico in the Port of Altamira, for which we are targeting to begin operations in the third quarter of 2007. We also operate a portion of the Baku Deepwater Jacket Factory fabrication facility in Baku, Azerbaijan, which is owned by a subsidiary of the State Oil Company of the Azerbaijan Republic. Our fabrication facilities are equipped with a wide variety of heavy-duty construction and fabrication equipment, including cranes, welding equipment, machine tools and robotic and other automated equipment. We fabricate a full range of offshore structures, from conventional jacket-type fixed platforms to intermediate water and deepwater platform configurations employing Spar, compliant-tower and tension leg technologies, as well as floating, production, storage and offtake (FPSO) technology.

Expiration dates, including renewal options, of leases covering land for JRM s fabrication facilities at December 31, 2006 were as follows:

Morgan City, Louisiana	Years 2008-2048
Dubai (Jebel Ali), U.A.E.	Year 2015
Batam Island, Indonesia	Years 2029-2038
Altamira, Mexico	Year 2036

As a result of renewal options on the various tracts comprising the Morgan City fabrication facility, we have the ability, within our sole discretion, to continue leasing almost all the land we are currently using for that facility until 2048.

Foreign Operations

JRM s revenues, net of intersegment revenues, and its segment income derived from operations located outside of the United States, as well as the approximate percentages to our total consolidated revenues and total consolidated segment income, respectively, for each of the last three years were as follows (dollars in thousands):

	Revenues		*Segment Income*	
	Amount	*Percent*	*Amount*	*Percent*
Year ended December 31, 2006	$1,378,339	33%	$214,822	52%
Year ended December 31, 2005	$1,051,547	57%	$204,474	77%
Year ended December 31, 2004	$ 832,722	44%	$ 84,914	43%

We participate in joint ventures involving operations in foreign countries that sometimes require majority ownership by local interests. See Note 17 to our consolidated financial statements included in this report for further information on the geographic distribution of our revenues.

Customers

JRM s customers are primarily oil and gas companies, including several foreign government-owned companies. JRM s five largest customers during 2006 were Azerbaijan International Operating Company, Aramco Overseas Company BV, Dolphin Energy Limited, Ras Laffan Liquified Natural Gas Company Limited and Conoco Indonesia, Inc., which accounted for 8.5%, 6.6%, 3.1%, 1.9% and 1.3% of our total consolidated revenues, respectively. JRM s five largest customers during 2005 were Azerbaijan International Operating Company, Ras Laffan Liquified Natural Gas Company Limited, BP Plc and its subsidiaries, Exxon Neftegas Limited and Apache Energy Limited, which accounted for 20.0%, 5.8%, 5.3%, 4.9% and 4.5% of our total consolidated revenues, respectively.

The level of engineering and construction services required by any one customer depends upon the amount of that customer s capital expenditure budget for offshore construction services in any single year. Consequently, customers that account for a significant portion of revenues in one year may represent an immaterial portion of revenues in subsequent years.

Contracts

We have historically performed work on a fixed-price, cost-plus or day-rate basis or a combination of these methods. Most of our long-term contracts have provisions for progress payments. We attempt to cover anticipated increases in costs of labor, material and service costs of our long-term contracts, either through an estimate of such charges, which is reflected in the original price, or through price escalation clauses.

We recognize our contract revenues and related costs on a percentage-of-completion basis. Accordingly, we review contract price and cost estimates periodically as the work progresses and reflect adjustments in income proportionate to the percentage of completion in the period when we revise those estimates. To the extent that these adjustments result in a reduction or an elimination of previously reported profits with respect to a project, we would recognize a charge against current earnings, which could be material.

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Our arrangements with customers frequently require us to provide letters of credit or bid and performance bonds to secure bids or performance under contracts for offshore construction services. While these letters of credit and bonds may involve significant dollar amounts, historically, there have been no material payments to our customers under these arrangements. These arrangements are typical in the industry for projects outside the U.S. Gulf of Mexico.

In the event of a contract deferral or cancellation, we are generally entitled to recover costs incurred, settlement expenses and profit on work completed prior to deferral or termination. While we have not generally experienced significant project cancellations, significant or numerous cancellations could adversely affect our business, financial condition and results of operations.

Backlog

As of December 31, 2006 and 2005, our Offshore Oil and Gas Construction segment s backlog amounted to approximately $4.1 billion and $1.8 billion, respectively. This represents approximately 54% and 50% of our total consolidated backlog at December 31, 2006 and 2005, respectively. Of our December 31, 2006 backlog in this segment, we expect to recognize revenues as follows (in approximate millions):

	Amount
Quarter Ended:	
March 31, 2007	$ 500
June 30, 2007	$ 490
September 30, 2007	$ 530
December 31, 2007	$ 600
Year Ended December 31, 2008	$1,550
Thereafter	$ 460

While fabrication projects are typically awarded substantially in advance of performance as a result of the required lead time for procurement, the offshore construction industry is highly seasonal in some geographic regions. Because of the more conducive weather conditions, most installation operations are conducted in the warmer months of the year in those areas, and many of these contracts are awarded with only a short period of time before the desired time of project performance. Projects in our backlog may be cancelled by customers.

Raw Materials

Our Offshore Oil and Gas Construction segment uses raw materials, such as carbon and alloy steels in various forms, welding gases, paint, fuels and lubricants, which are available from many sources. We generally purchase these raw materials and components as needed for individual contracts. Although shortages of some raw materials and fuels have existed from time to time, no serious shortage exists at the present time. Our Offshore Oil and Gas Construction segment does not depend on a single source of supply for any significant raw materials.

Competition

We believe we are among the few offshore construction contractors capable of providing a full range of services in major offshore oil and gas producing regions of the world. We believe that the substantial capital costs involved in becoming a full-service offshore construction contractor create a significant barrier to entry into the market as a global, fully integrated competitor. We do, however, face substantial competition from regional competitors and less integrated providers of offshore construction services, such as engineering firms, fabrication facilities, pipelaying companies and shipbuilders.

A number of companies compete with us in each of the separate marine pipelay and construction and fabrication phases in various parts of the world. These competitors include Allseas Marine Contractors S.A.; Daewoo Engineering & Construction Co., Ltd.; Global Industries, Ltd.; NPCC (Abu Dhabi); Heerema Group;

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Hyundai Heavy Industrial Co., Ltd.; Kiewit Offshore Services, Ltd.; Nippon Steel Corporation; Saipem S.p.A.; Acergy S.A.; and Technip S.A. Contracts are usually awarded on a competitive bid basis. Although we believe customers consider, among other things, the availability and technical capabilities of equipment and personnel, efficiency, condition of equipment, safety record and reputation, price competition is normally the primary factor in determining which qualified contractor with available equipment is awarded a contract. Major construction vessels have few alternative uses and, because of their nature and the environment in which they work, have relatively high maintenance costs whether or not they are operating. See the discussion in Item 1A, Risk Factors, for additional information on the competitive nature of our Offshore Oil and Gas Construction segment.

Factors Affecting Demand

Our Offshore Oil and Gas Construction segment s activity depends mainly on the capital expenditures for offshore construction services of oil and gas companies and foreign governments for construction of development projects. Numerous factors influence these expenditures, including:

- oil and gas prices, along with expectations about future prices;
- the cost of exploring for, producing and delivering oil and gas;
- the terms and conditions of offshore leases;
- the discovery rates of new oil and gas reserves in offshore areas;
- the ability of businesses in the oil and gas industry to raise capital; and
- local and international political and economic conditions.

See Item 1A, Risk Factors, for further information on factors affecting demand.

C. GOVERNMENT OPERATIONS

General

Our Government Operations segment consists of the operations of BWXT and its subsidiaries. Through this segment, we manage complex, high-consequence nuclear and national security operations, and we are a principal supplier of nuclear components and advanced energy products to the U.S. Government. Through our operation of this segment, we have over 50 years of experience in the ownership and operation of large nuclear development, production and reactor facilities, including 48 years of providing precision-manufactured components for the U.S. Navy. Principal areas of operation include:

- providing precision manufactured components for the U.S. Navy s nuclear vessels;
- managing and operating nuclear production facilities;
- managing and operating environmental management sites;
- managing spent nuclear fuel and transuranic waste for the DOE;
- providing critical skills and resources for DOE sites; and
- developing and deploying next generation technology in support of U.S. Government programs.

BWXT conducts the operations of our Government Operations segment through two primary subsidiaries or divisions: BWXT Services, Inc. and its Nuclear Operations Division.

In 2006, BWXT formed its Nuclear Operations Division by consolidating its Nuclear Equipment Division and its Nuclear Products Division. We believe this consolidation will result in greater operating efficiencies, cost savings and synergies in BWXT s nuclear business.

Properties

BWXT s principal manufacturing facilities are located in:

- Lynchburg, Virginia;
- Barberton, Ohio; and
- Mount Vernon, Indiana.

Each of these facilities is located on property we own.

The Lynchburg, Virginia facility, which is BWXT s Nuclear Operations Division s primary manufacturing plant, is the nation s largest commercial high-enriched uranium processing facility. The facility resides on 437 acres with 870,000 square feet of manufacturing area and comprises approximately 60 buildings and trailers. The site is the recipient of the highest rating given by the Nuclear Regulatory Commission for license performance. The performance review determines the safe and secure conduct of operations of the facility. The site is also the largest commercial International Atomic Energy Agency-certified facility in the U.S.

Precision components and products ranging in size from a few grams to hundreds of tons can be accommodated in the Lynchburg facility. Modern multi-axis machining centers use computer controls with direct links to distributed computer-aided design and manufacturing networks. Computer-controlled electron beam, plasma and tungsten inert gas welding are used for joining a variety of special materials, including nuclear, refractory, superconducting alloys, stainless steel, inconel, titanium and aluminum. Other facility capabilities include:

- advanced heat treatment to optimize material properties of components;
- computerized real-time accept/reject dimensional inspection coordinate measuring systems for dimensional inspection, custom inspection gauging and calibration, destructive/nondestructive testing, dye check, Zyglo inspection, Cryogenic testing, ultrasonic inspection, magnetic particle inspection and computer or direct numerical control machining and inspection;
- the design and development of advanced nuclear fuels systems for space, defense, research and commercial applications; and
- the production of aluminum-clad uranium fuel elements of high and low enrichments for research and test reactors.

The other manufacturing facilities for BWXT s Nuclear Operations Division are the Barberton, Ohio and Mount Vernon, Indiana facilities. The Barberton facility includes 69 acres with 548,000 square feet of manufacturing area and 119,000 square feet of office area. The Mount Vernon facility, located on the Ohio River, includes 580,000 square feet of manufacturing space and 61,000 square feet of office space. The main manufacturing bay of the Mount Vernon facility is serviced by two 500-ton cranes, which extend over a barge dock on the Ohio River.

Both the Barberton and Mount Vernon facilities utilize multiple, full-contouring, computer numerical control horizontal and vertical machining centers; large gantry robotic welding centers; and state-of-the-art support equipment for machining and welding.

Operations

BWXT manages and operates complex, high-consequence nuclear and national security operations for the DOE and the National Nuclear Security Administration (NNSA), primarily through joint ventures, limited liability corporations and partnerships. In addition, BWXT provides a broad array of technical services in support of DOE and NNSA operations and facilities.

BWXT provides operations, management and technical services in support of the following U.S. Government facilities:

- **Idaho National Laboratory**. The Idaho National Laboratory is an 890-square-mile DOE site near Idaho Falls, Idaho that serves nuclear, national security and scientific research purposes. Operations at the facility include processing and managing radioactive and hazardous materials and nuclear reactor design, demonstration and safety. BWXT manages the nuclear and national security operations of this site as a team member of the Battelle Energy Alliance, the operator of the site.
- **Savannah River Site.** The Savannah River Site is a 310-square mile DOE industrial complex, located in Aiken, South Carolina, dedicated to the processing and storing of nuclear materials in support of the national defense and U.S. nuclear nonproliferation efforts. The site also develops and deploys technologies to improve the environment and treat nuclear and hazardous wastes. As an integrated contractor at this site, BWXT is responsible for nuclear materials management and the startup and operation of a facility to extract tritium, a

radioactive form of hydrogen necessary for the nation s nuclear weapons stockpile.

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Strategic Petroleum Reserve. The Strategic Petroleum Reserve provides emergency supply of crude oil stored at four sites in huge underground salt caverns along the Texas and Louisiana Gulf Coast. Since 1993, the facility has been managed and operated by DynMcDermott Petroleum Operations Company, a joint venture of DynCorp/CSC, McDermott International, Inc., International Matex Tank and Terminals and Jacobs Engineering. BWXT manages the contract for McDermott International, Inc.

Pantex Plant. The Pantex Plant is a 16,000-acre NNSA site located near Amarillo, Texas. Key operations at this facility include evaluating, retrofitting and repairing nuclear weapons; dismantling and sanitizing nuclear weapons components; developing, testing and fabricating high-explosive components; and handling and storing plutonium pits. BWXT, through a joint venture with Honeywell International Inc. and Bechtel National, Inc., manages and operates the facility.

Y-12 National Security Complex. The Y-12 facility is an 811-acre NNSA site located in Oak Ridge, Tennessee. Operations at the site focus on the production, refurbishment and dismantlement of nuclear weapons components, storage of nuclear material and the prevention of the proliferation of weapons of mass destruction. As the prime contractor, BWXT, through a joint venture with Bechtel National, Inc., manages the facility.

Los Alamos National Laboratory. The Los Alamos National Laboratory is located in New Mexico and is the DOE weapons laboratory with the largest number of defense facilities and weapons-related activities. It is the foremost site for the government s ongoing research and development on the measures necessary for certifying the safety and reliability of nuclear weapons without the use of nuclear testing. Since 2006, BWXT, as part of Los Alamos National Security, LLC, is the management and operations contractor for this facility. Previously, BWXT was a subcontractor to the University of California at this facility, providing Nuclear Facility Operations Assessment, Advisory and Technical Support Services.

Oak Ridge National Laboratory. The Oak Ridge National Laboratory is a multi-disciplined science and technology complex located on a 58-square mile site near Oak Ridge, Tennessee. This facility is managed and operated by UT-Battelle, LLC for the DOE. BWXT, as an integrated subcontractor to UT-Battelle, LLC, provides technical support in the areas of nuclear facility management and operation.

With manufacturing facilities located in Barberton, Ohio, Mount Vernon, Indiana, and Lynchburg, Virginia, BWXT s Nuclear Operations Division specializes in the design and manufacture of close-tolerance and high-quality equipment for nuclear applications. In addition, it is a leading manufacturer of critical nuclear components, fuels and assemblies for government and commercial uses. The division has supplied nuclear components for DOE programs since the 1950s. In addition, it is the largest domestic supplier of research reactor fuel elements for colleges, universities and national laboratories. BWXT s Nuclear Operations Division also provides uranium targets used for medical isotopes and converts or downblends high-enriched uranium into low-enriched fuel for use in commercial reactors to generate electricity. The division also has over 100 years of experience in supplying heavy fabrications for industrial use, including components for defense applications.

BWXT s Nuclear Operations Division works closely with the DOE supported non-proliferation program. Currently, it is assisting in the development of a high-density, low-enriched uranium fuel required for high-enriched uranium test reactor conversions. In addition, this division has been a leader in the receipt, storage, characterization, dissolution, recovery and purification of a variety of uranium-bearing materials. All phases of uranium downblending and uranium recovery are provided at the division s Lynchburg, Virginia site.

BWXT s Nuclear Operations Division has an experienced staff of design and manufacturing engineers capable of performing full scope, prototype design work coupled with manufacturing integration. Its engineering capabilities include:

steam separation equipment design and development;

thermal-hydraulic design of reactor plant components;

structural component design for precision manufacturing;

materials expertise in high-strength, low-alloy steels, nickel-based materials and others;

material procurement of tubing, forgings, weld wire; and

fully-equipped metallographic and chemical analysis laboratory facility.

The Nuclear Operations Division also implements strong quality assurance programs for its products.

Customers

The U.S. Government is the primary customer of our Government Operations segment, comprising 97% of segment revenues for the year ended December 31, 2006 and 94% of segment revenues for the year ended December 31, 2005.

The U.S. Government accounted for approximately 15%, 31%, and 27% of our total consolidated revenues for the years ended December 31, 2006, 2005, and 2004, respectively, including 14%, 28%, and 26%, respectively, related to nuclear components.

Contracts

Our contracts with the federal government are subject to annual funding determinations. In addition, contracts with the federal government and its prime contractors usually contain standard provisions for termination at the convenience of the government or the prime contractor. Upon termination of such a contract, we are generally entitled to recover costs incurred, settlement expenses and profit on work completed prior to termination. While we have not generally experienced significant project cancellations, significant or numerous cancellations could adversely affect our business, financial condition and results of operations.

The contracts for the management and operation of U.S. Government facilities are generally structured as five-year contracts with five-year renewal options, which are exercisable by the customer. These are cost-reimbursement contracts with a U.S. Government credit line with little corporate-funded working capital. As a U.S. Government contractor, we are subject to federal regulations under which our right to receive future awards of new federal contracts may be unilaterally suspended or barred if we are convicted of a crime or indicted based on allegations of a violation of specific federal statutes.

Backlog

As of December 31, 2006 and 2005, our Government Operations segment s backlog amounted to approximately $1.3 billion and $1.8 billion, or approximately 17% and 50%, respectively, of our total consolidated backlog. Of our December 31, 2006 backlog in this segment, we expect to recognize revenues as follows (in approximate millions):

	Amount
Quarter Ended:	
March 31, 2007	$150
June 30, 2007	$120
September 30, 2007	$120
December 31, 2007	$110
Year Ended December 31, 2008	$310
Thereafter	$460

As of December 31, 2006, this segment s backlog with the U.S. Government was $1.3 billion (of which $25.1 million had not yet been funded), or approximately 15% of our total consolidated backlog. During the year ended December 31, 2006, the U.S. Government awarded new orders of approximately $94.3 million to this segment. Historically, this segment received a substantial amount of its backlog from the U.S. Government in the fourth quarter of each year. We are currently negotiating terms and conditions on potential new bookings with the U.S. Government and expect to receive awards in the first quarter of 2007, in line with prior years fourth quarter amounts.

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Raw Materials

Our Government Operations segment relies on several single-source suppliers for materials used in its products. We believe these suppliers are viable, and we and the U.S. Government expend significant effort to maintain the supplier base.

Competition

Our Government Operations segment is engaged in a highly competitive business, through its management and operation of U.S. Government facilities, in which customer contracts are typically awarded through competitive bidding processes. We compete with other general and specialty contractors, primarily on price, reputation, value and quality of service. Our Government Operations segment s competitors in the delivery of goods and services to the U.S. Government and the operation of U.S. Government facilities include Bechtel National, Inc., Washington Group International, CH2M Hill, Inc., Fluor Corporation, Lockheed Martin Corporation and Nuclear Fuel Services, Inc.

Factors Affecting Demand

Our Government Operations segment s operations are generally capital-intensive on the manufacturing side. This segment may be impacted by U.S. Government budget restraints and delays.

The demand for nuclear components for the U.S. Government comprises a substantial portion of this segment s backlog. We expect that orders for nuclear components will continue to be a significant part of backlog for the foreseeable future; however, such orders are subject to defense department budget constraints.

See Section 1A, Risk Factors, for further information on factors affecting demand.

D. POWER GENERATION SYSTEMS

General

Our Power Generation Systems segment consists primarily of the operations of B&W, which were not consolidated in our financial results from February 22, 2000 through February 22, 2006. See Note 20 to our consolidated financial statements included in this report for information on the reconsolidation of B&W, effective February 22, 2006.

B&W is a leading supplier of fossil fuel-fired steam generating systems, large replacement commercial nuclear steam generators and components, environmental equipment and components and related services to customers around the world. It designs, engineers, manufactures, constructs and services large utility and industrial power generation systems, including boilers used to generate steam in electric power plants, pulp and paper making, chemical and process applications and other industrial uses.

Properties

B&W s headquarters are located in Barberton, Ohio.

B&W s principal manufacturing facilities are located in:

- West Point, Mississippi;
- Lancaster, Ohio;
- Cambridge, Ontario, Canada;
- Esbjerg, Denmark;
- Melville, Saskatchewan, Canada; and
- Jingshan, Hubei, China.

B&W owns each of these facilities.

B&W s facility in West Point, Mississippi specializes in the fabrication of products used in the power generation

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industry, including furnace wall panels, complete cyclone furnace assemblies, longflow economizers and generating banks, heat recovery steam generators, package boilers and related mechanical and structural components. In addition, the products fabricated at this facility serve the electric utility, pulp and paper, and other industries.

The Lancaster, Ohio facility is the headquarters of Diamond Power International, Inc. (DPII), a wholly owned subsidiary of B&W. DPII is the largest supplier of boiler-cleaning equipment in the world. This facility supplies cleaning systems for heat transfer surfaces in boilers of all sizes and for the burning of all fossil fuels.

B&W s Cambridge, Ontario, Canada facility specializes in the production of steam generation products and services for nuclear utilities, as well as Canadian fossil fuel utility and industrial markets. The Cambridge facility encompasses approximately 520,780 square feet of office and manufacturing space with plate, machine, header, tube and boiler shops. In addition, the Cambridge facility contains a 37,000 square foot nuclear assembly clean room built specifically for the assembly of nuclear steam generators. The Cambridge facility houses a modern welding and Industrial Skills Training Service Center, a licensed private career college and testing center.

The Melville, Saskatchewan, Canada facility produces steam generation products and custom engineering services for the Canadian fossil fuel utilities and industrial markets in western Canada and the U.S. This plant fabricates boiler components, including pressure parts, heater elements, economizer tube elements, hoppers and ducts.

B&W s Esbjerg, Denmark facility is the principal facility of Babcock & Wilcox Volund. This facility is equipped with a wide variety of heavy-duty fabrication equipment, including welding equipment, machine tools and other automated equipment. The primary focus of this facility is on new plant equipment for waste-to-energy plants.

The Jingshan, Hubei, China facility is a leading supplier of boiler cleaning equipment to China s utility power market. In addition, it is also a supplier of ash handling products and systems for domestic and export markets.

In addition to the above, B&W has several smaller facilities in different locations around the world. It also has a significant boiler manufacturing joint venture in China.

Operations

B&W and its subsidiaries:

- provide engineered-to-order services, products and systems for energy conversion worldwide and related auxiliary equipment, such as burners, pulverizer mills, soot blowers and ash handlers;
- manufacture heavy-pressure equipment for energy conversion, such as boilers fueled by coal, oil, bitumen, natural gas, solid municipal waste, biomass and other fuels;
- fabricate steam generators and reactor heads for nuclear power plants;
- design and supply environmental control systems, including both wet and dry scrubbers for flue gas desulfurization, modules for selective catalytic reduction of nitrous oxides and electrostatic precipitators and similar devices;
- construct power plant equipment and provide related heavy mechanical erection services;
- support operating plants with a wide variety of services, including the installation of new systems and replacement parts, engineered upgrades, construction, maintenance and field technical services, such as condition assessments;
- provide inventory services to help customers respond quickly to plant interruptions and construction crews to assist in maintaining and repairing operating equipment; and
- provide power through cogeneration, refuse-fueled power plants and other independent power-producing facilities and participate in this market as contractors for engineer-procure-construct services, as equipment suppliers, as operations and maintenance contractors and as an owner.

B&W s revenues, net of intersegment revenues, and its segment income derived from operations located outside of the United States, as well as the approximate percentages to our total consolidated revenues and total consolidated

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segment income, respectively, for the year ended December 31, 2006 were as follows (dollars in thousands):

	Revenues		*Segment Income*	
	Amount	*Percent*	*Amount*	*Percent*
Year ended December 31, 2006	$415,995	10%	$32,050	8%

Customers

Our Power Generation Systems segment s principal customers are government- and investor-owned utilities and independent power producers, businesses in various process industries, such as pulp and paper mills, petrochemical plants, oil refineries and steel mills and other steam-using businesses and governmental units. Customers normally purchase services, equipment or systems from B&W after an extensive evaluation process based on competitive bids.

B&W s five largest customers during the year ended December 31, 2006 were American Electric Power Company, Inc., Duke Energy Corporation, Bechtel Power Group Incorporated, Bruce Power Limited and First Energy Corporation, which accounted for 5.3%, 4.0%, 2.7%, 2.6% and 1.5% of our total consolidated revenues, respectively.

Contracts

We have historically performed work on a fixed-price or cost-plus basis or a combination of these methods. Most of our long-term contracts have provisions for progress payments. We attempt to cover anticipated increases in costs of labor, material and service costs of our long-term contracts, either through an estimate of such charges, which is reflected in the original price, or through price escalation clauses. Most of those long-term contracts contain provisions for progress payments.

We generally recognize our contract revenues and related costs on a percentage-of-completion basis. Accordingly, we review contract price and cost estimates periodically as the work progresses and reflect adjustments in income proportionate to the percentage of completion in the period when we revise those estimates. To the extent that these adjustments result in a reduction or an elimination of previously reported profits with respect to a project, we would recognize a charge against current earnings, which could be material.

Our arrangements with customers frequently require us to provide letters of credit or bid and performance bonds to secure bids or performance under contracts. While these letters of credit and bonds may involve significant dollar amounts, historically, there have been no material payments to our customers under these arrangements.

In the event of a contract deferral or cancellation, we are generally entitled to recover costs incurred, settlement expenses and profit on work completed prior to deferral or termination. Significant or numerous contract cancellations could adversely affect our business, financial condition and results of operations.

Backlog

As of December 31, 2006, our Power Generation Systems segment s consolidated backlog amounted to approximately $2.2 billion, or approximately 29% of our total consolidated backlog. At December 31, 2005, B&W s consolidated backlog amounted to approximately $2.1 billion, which was not included in our total consolidated backlog due to B&W s then pending Chapter 11 proceedings. Of the December 31, 2006 backlog in our Power Generation Systems segment, we expect to recognize revenues as follows (in approximate millions):

	Amount
Quarter Ended:	
March 31, 2007	$450
June 30, 2007	$260
September 30, 2007	$300
December 31, 2007	$240
Year Ended December 31, 2008	$560
Thereafter	$400

In June 2006, B&W was awarded separate contracts to supply eight supercritical, coal-fired boilers and selective catalytic reduction (SCR) systems as part of TXU Corp. s solid-fuel power generation program in Texas. The expected revenues from these awards exceeded $1 billion. B&W s backlog at June 30, 2006 and September 30, 2006 reflected all the TXU awards. B&W has received notice from TXU to suspend activity on five of the eight boilers and SCR systems. The notifications did not specify the length of the suspensions. The notifications obligate B&W to suspend performance on these five units. The suspension provisions allow B&W reimbursement of suspension cost and equitable adjustment to the price, schedule and other relevant terms of the contract. Additionally, on February 26, 2007, TXU issued a press release and conducted an investor conference call relating to a proposed buyout transaction involving TXU announced on that date. In the investor conference call, representatives of TXU indicated that it is reducing planned coal-fueled generation units in Texas from eleven to three and that the permitting process for the eight units to be provided by B&W will be suspended. Because we have received no cancellation notices from TXU, we have continued to work on the three remaining units which were not suspended; however, we have excluded the TXU award for the eight units from our ending backlog at December 31, 2006.

Raw Materials

Our Power Generation Systems segment uses raw materials, such as carbon and alloy steels in various forms, including plates, forgings, structurals, bars, sheets, strips, heavy wall pipes and tubes. We also purchase many components and accessories for assembly. We generally purchase these raw materials and components as needed for individual contracts. Although shortages of some raw materials have existed from time to time, no serious shortage exists at the present time. Our Power Generation Systems segment does not depend on a single source of supply for any significant raw materials.

Competition

B&W primarily competes with:

- a number of domestic and foreign-based companies specializing in steam-generating systems, equipment and services, including Alstom S.A., Mitsui Babcock Energy Limited, Babcock Power, Foster Wheeler Corporation, Mitsubishi Heavy Industries and Hitachi, Ltd.;
- a number of additional companies in the markets for environmental control equipment and related specialized industrial equipment and in the independent power-producing business; and
- other suppliers of replacement parts, repair and alteration services and other services required to backfit and maintain existing steam systems.

Factors Affecting Demand

Our Power Generation Systems segment s overall activity depends mainly on the capital expenditures of electric power generating companies and other steam-using industries. Several factors influence these expenditures, including:

- prices for electricity, along with the cost of production and distribution;
- prices for coal and natural gas and other sources used to produce electricity;

demand for electricity, paper and other end products of steam-generating facilities;

availability of other sources of electricity, paper or other end products;

requirements for environmental improvements;

level of capacity utilization at operating power plants, paper mills and other steam-using facilities;

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requirements for maintenance and upkeep at operating power plants and paper mills to combat the accumulated effects of wear and tear;

ability of electric generating companies and other steam users to raise capital; and

relative prices of fuels used in boilers, compared to prices for fuels used in gas turbines and other alternative forms of generation.

Our Power Generation Systems segment s products and services are capital intensive. As such, customer demand is heavily affected by the variations in customer s business cycles and by the overall economies of the countries in which they operate.

See Section 1A, Risk Factors, for further information on factors affecting demand.

E. PATENTS AND LICENSES

We currently hold a large number of U.S. and foreign patents and have numerous patent applications pending. We have acquired patents and licenses and granted licenses to others when we have considered it advantageous for us to do so. Although in the aggregate our patents and licenses are important to us, we do not regard any single patent or license or group of related patents or licenses as critical or essential to our business as a whole. In general, we depend on our technological capabilities and the application of know-how, rather than patents and licenses, in the conduct of our various businesses.

F. RESEARCH AND DEVELOPMENT ACTIVITIES

We conduct our principal research and development activities through individual business units at our various manufacturing plants and engineering and design offices. Our research and development activities cost approximately $45.2 million, $34.1 million and $29.7 million in the years ended December 31, 2006, 2005 and 2004, respectively. Contractual arrangements for customer-sponsored research and development can vary on a case-by-case basis and include contracts, cooperative agreements and grants. Of our total research and development expenses, our customers paid for approximately $26.5 million, $30.8 million and $25.1 million in the years ended December 31, 2006, 2005 and 2004, respectively.

G. INSURANCE

We maintain liability and property insurance in amounts we consider adequate for those risks we consider appropriate to insure. Some risks are not insurable or insurance to cover them is available only at rates that we consider uneconomical. These risks include war and confiscation of property in some areas of the world, pollution liability, business interruption, asbestos liability and other liabilities related to occupational health exposures. Depending on competitive conditions and other factors, we endeavor to obtain contractual protection against some uninsured risks from our customers. Insurance or contractual indemnity protection, when obtained, may not be sufficient or effective under all circumstances or against all hazards to which we may be subject.

Coverage to insure against liability and property damage losses resulting from nuclear accidents at reactor facilities of our utility customers is not available in the commercial insurance marketplace, but we do have some protection against claims based on such losses. To protect against liability for damage to a customer s property, we endeavor to obtain waivers of subrogation from the customer and its insurer and are usually named as an additional insured under the utility customer s nuclear property policy. We also attempt to cap our overall liability in our contracts. To protect against liability from claims brought by third parties, we are insured under the utility customer s nuclear liability policies and have the benefit of the indemnity and limitation of any applicable liability provision of the Price-Anderson Act. The Price-Anderson Act limits the public liability of manufacturers and operators of licensed nuclear facilities and other parties who may be liable in respect of, and indemnifies them against, all claims in excess of a certain amount. This amount is determined by the sum of commercially available liability insurance plus certain retrospective premium assessments payable by operators of commercial nuclear reactors. For those sites where we provide environmental remediation services, we seek the same protection from our customers as we do for our other nuclear activities. The Price-Anderson Act, as amended, includes a sunset provision and requires renewal each time that it expires. Contracts that were entered into during a period of time that Price-Anderson was in full force and effect continue to receive the benefit of the Price-Anderson Act s nuclear indemnity. The Price-Anderson Act was set to expire on December 31,

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2006; however, Congress re-enacted and extended the Price-Anderson Act in 2005 for 20 years through December 31, 2025. BWXT currently has no contracts involving nuclear materials that are not covered by and subject to the nuclear indemnity provisions of the Price-Anderson Act.

Although we do not own or operate any nuclear reactors, we have coverage under commercially available nuclear liability and property insurance for two of our three locations that are licensed to possess special nuclear materials. Of the three locations, two are located at our Lynchburg, Virginia site. These facilities are insured under a nuclear liability policy that also insures the facility of Framatome Cogema Fuel Company (FCFC), formerly B&W Fuel Company, which we sold during the fiscal year ended March 31, 1993. The two licensed facilities share the same nuclear liability insurance limit, as the commercial insurer would not allow FCFC to obtain a separate nuclear liability insurance policy. Due to the type or quantity of nuclear material present under contract with the U.S. Government, the two facilities in Lynchburg have statutory indemnity and limitation of liability under the Price-Anderson Act. In addition, our contracts to manufacture and supply nuclear components to the U.S. Government contain statutory indemnity clauses under which the U.S. Government has assumed the risks of public liability claims related to nuclear incidents.

BWXT, through two of its dedicated limited liability companies, has management and operating agreements with the U.S. Government for the Pantex and Y-12 facilities. Most insurable liabilities arising from these sites are not protected in our corporate insurance program but rely on government contractual agreements and certain specialized self-insurance programs funded by the U.S. Government. The U.S. Government has historically fulfilled its contractual agreement to reimburse for insurable claims, and we expect it to continue this process during our administration of these two facilities. However, in most of these situations in which the U. S. Government is contractually obligated to pay, the payment obligation is subject to the availability of authorized government funds.

B&W, principally through its manufacture of heavy-pressure equipment for energy conversion, such as boilers, and its fabrication of nuclear steam generators, is subject to risks such as accidents resulting in the loss of life or property and potential environmental issues. While we attempt to obtain adequate insurance to cover these risks, it is possible that insurance against these risks might be unavailable or available only at rates we consider uneconomical. See Note 10 to our consolidated financial statements included in this report for additional information.

JRM s offshore construction business is subject to the usual risks of operations at sea, including accidents resulting in the loss of life or property, pollution or other environmental mishaps, adverse weather conditions, mechanical failures, collisions, property losses to our vessels, business interruption due to damage to the equipment or political action in foreign countries and labor stoppages. JRM has additional exposure because it uses expensive construction equipment, sometimes under extreme weather conditions, often in remote areas of the world. In many cases, JRM also operates on or in proximity to existing offshore facilities. These facilities are subject to damage that could result in the escape of oil and gas into the sea. Litigation arising from any such event may result in our being named as a defendant in lawsuits asserting large claims. Depending on competitive conditions and other factors, we have endeavored to obtain contractual protection against uninsured risks from our customers. When obtained, such contractual indemnification protection may not in all cases be supported by adequate insurance maintained by the customer. These contractual protections are not available in many cases. In addition, in recent years, we have been named as a defendant in litigation concerning exposure to lead-based paint, silica, asbestos and welding rod fumes. While we are vigorously defending these claims, it is possible that existing insurance will not be sufficient to cover all potential exposure should these proceedings result in an adverse decision for us. See Note 10 to our consolidated financial statements included in this report for additional information on these issues.

We have several wholly owned insurance subsidiaries that provide workers compensation, employer s liability, general and automotive liability insurance and, from time to time, builder s risk within certain limits, marine hull and workers compensation insurance to our companies. We may also have business reasons in the future to have these insurance subsidiaries accept other risks which we cannot or do not wish to transfer to outside insurance companies. These insurance subsidiaries have not provided significant amounts of insurance to unrelated parties. Claims as a result of our operations could adversely impact the ability of these captive insurers to respond to all claims presented, although we believe such a result is unlikely.

Additionally, upon the February 22, 2006 effectiveness of the settlement of the Chapter 11 proceedings of B&W and its affiliated debtor subsidiaries, MII and most of its subsidiaries contributed substantial insurance rights to the asbestos personal injury trust, including rights to (1) certain B&W pre-1979 primary and excess insurance

coverages and (2) certain 1979-1986 excess insurance coverage of MII and its affiliates, including JRM, MHI, BWXT and B&W, which 1979-1986 excess policies had an aggregate face value of available limits of coverage of approximately $1.15 billion. These insurance rights provided cover for, among other things, asbestos and other personal injury claims, subject to the terms and conditions of the policies. With the contribution of these insurance rights to the asbestos personal injury trust, MII and its affiliates, including JRM, MHI, BWXT and B&W, may have underinsured or uninsured exposure for non-B&W-derivative asbestos claims or other personal injury or other claims that would have been insured under these coverages had the insurance rights not been contributed to the asbestos personal injury trust.

H. EMPLOYEES

At December 31, 2006, we employed approximately 27,800 persons, including employees of B&W, which was not consolidated at December 31, 2005, compared with 14,200 at December 31, 2005. Approximately 11,100 of our employees were members of labor unions at December 31, 2006, compared with approximately 3,100 at December 31, 2005. The increase in employees that are members of labor unions was primarily attributable to an increase in labor workforce for JRM and the reconsolidation of B&W. Many of our operations are subject to union contracts, which we customarily renew periodically. Currently, we consider our relationships with our employees to be satisfactory.

I. GOVERNMENTAL REGULATIONS AND ENVIRONMENTAL MATTERS

General

Many aspects of our operations and properties are affected by political developments and are subject to both domestic and foreign governmental regulations, including those relating to:

- construction and equipping of offshore production platforms and other offshore facilities;
- construction and equipping of electric power and other industrial facilities;
- possessing and processing special nuclear materials;
- marine vessel safety;
- workplace health and safety;
- currency conversions and repatriation;
- taxation of foreign earnings and earnings of expatriate personnel; and
- protecting the environment.

In addition, we depend on the demand for our offshore construction services from the oil and gas industry and, therefore, are affected by changing taxes, price controls and other laws and regulations relating to the oil and gas industry generally. The adoption of laws and regulations curtailing offshore exploration and development drilling for oil and gas for economic and other policy reasons would adversely affect our operations by limiting demand for our services.

We are required by various other governmental and quasi-governmental agencies to obtain certain permits, licenses and certificates with respect to our operations. The kinds of permits, licenses and certificates required in our operations depend upon a number of factors.

The exploration and development of oil and gas properties on the continental shelf of the United States is regulated primarily under the U.S. Outer Continental Shelf Lands Act and related regulations. These laws require the construction, operation and removal of offshore production facilities located on the outer continental shelf of the United States to meet stringent engineering and construction specifications. Similar regulations govern the plugging and abandoning of wells located on the outer continental shelf of the United States and the removal of all production facilities. Violations of regulations issued pursuant to the U.S. Outer Continental Shelf Lands Act and related laws can

result in substantial civil and criminal penalties, as well as injunctions curtailing operations.

We cannot determine the extent to which new legislation, new regulations or changes in existing laws or regulations may affect our future operations.

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Environmental

Our operations and properties are subject to a wide variety of increasingly complex and stringent foreign, federal, state and local environmental laws and regulations, including those governing discharges into the air and water, the handling and disposal of solid and hazardous wastes, the remediation of soil and groundwater contaminated by hazardous substances and the health and safety of employees. Sanctions for noncompliance may include revocation of permits, corrective action orders, administrative or civil penalties and criminal prosecution. Some environmental laws provide for strict, joint and several liability for remediation of spills and other releases of hazardous substances, as well as damage to natural resources. In addition, companies may be subject to claims alleging personal injury or property damage as a result of alleged exposure to hazardous substances. Such laws and regulations may also expose us to liability for the conduct of or conditions caused by others or for our acts that were in compliance with all applicable laws at the time such acts were performed.

These laws and regulations include the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as amended (CERCLA), the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act and similar laws that provide for responses to, and liability for, releases of hazardous substances into the environment. These laws and regulations also include similar foreign, state or local counterparts to these federal laws, which regulate air emissions, water discharges, hazardous substances and waste and require public disclosure related to the use of various hazardous substances. Our operations are also governed by laws and regulations relating to workplace safety and worker health, primarily, in the United States, the Occupational Safety and Health Act and regulations promulgated thereunder.

We are currently in the process of investigating and remediating some of our former operating sites. Although we have recorded reserves in connection with certain of these matters, due to the uncertainties associated with environmental remediation, we cannot assure you that the actual costs resulting from these remediation matters will not exceed the recorded reserves.

Our compliance with U.S. federal, state and local environmental control and protection regulations resulted in pretax charges of approximately $11.8 million in the year ended December 31, 2006. In addition, compliance with existing environmental regulations necessitated capital expenditures of $5.0 million in the year ended December 31, 2006. We expect to spend another $10.5 million on such capital expenditures over the next five years. We cannot predict all of the environmental requirements or circumstances that will exist in the future but anticipate that environmental control and protection standards will become increasingly stringent and costly. Based on our experience to date, we do not currently anticipate any material adverse effect on our business or consolidated financial position as a result of future compliance with existing environmental laws and regulations. However, future events, such as changes in existing laws and regulations or their interpretation, more vigorous enforcement policies of regulatory agencies or stricter or different interpretations of existing laws and regulations, may require additional expenditures by us, which may be material. Accordingly, we can provide no assurance that we will not incur significant environmental compliance costs in the future.

In addition, offshore construction and drilling in some areas have been opposed by environmental groups and, in some areas, have been restricted. To the extent laws are enacted or other governmental actions are taken that prohibit or restrict offshore construction and drilling or impose environmental protection requirements that result in increased costs to the oil and gas industry in general and the offshore construction industry in particular, our business and prospects could be adversely affected.

We have been identified as a potentially responsible party at various cleanup sites under CERCLA. CERCLA and other environmental laws can impose liability for the entire cost of cleanup on any of the potentially responsible parties, regardless of fault or the lawfulness of the original conduct. Generally, however, where there are multiple responsible parties, a final allocation of costs is made based on the amount and type of wastes disposed of by each party and the number of financially viable parties, although this may not be the case with respect to any particular site. We have not been determined to be a major contributor of wastes to any of these sites. On the basis of our relative contribution of waste to each site, we expect our share of the ultimate liability for the various sites will not have a material adverse effect on our consolidated financial position, results of operations or liquidity in any given year.

Environmental remediation projects have been and continue to be undertaken at certain of our current and former plant sites. During the fiscal year ended March 31, 1995, we decided to close B&W s nuclear manufacturing facilities in Parks Township, Armstrong County, Pennsylvania (the Parks Facilities), and B&W proceeded to decommission the facilities in accordance with its then-existing license from the Nuclear Regulatory Commission (the NRC). B&W subsequently transferred the facilities to BWXT in the fiscal year ended March 31, 1998. During the fiscal year ended March 31, 1999, BWXT reached an agreement with the NRC on a plan that provided for the completion of facilities dismantlement and soil restoration by 2001 and license termination in 2003. BWXT filed its application to terminate the NRC license for the Parks Township facility, and the NRC terminated the license in 2004 and released the facility for unrestricted use. For a discussion of certain civil litigation we are involved in concerning the Parks Facilities, see Note 10 to our consolidated financial statements included in this report.

We perform significant amounts of work for the U.S. Government under both prime contracts and subcontracts and operate certain facilities that are licensed to possess and process special nuclear materials. As a result of these activities, we are subject to continuing reviews by governmental agencies, including the Environmental Protection Agency and the NRC.

The NRC s decommissioning regulations require BWXT to provide financial assurance that it will be able to pay the expected cost of decommissioning its facilities at the end of their service lives. BWXT will continue to provide financial assurance aggregating $24.5 million during the year ending December 31, 2007 with existing letters of credit for the ultimate decommissioning of all its licensed facilities, except one. This one facility, which represents the largest portion of BWXT s eventual decommissioning costs, has provisions in its government contracts pursuant to which all of its decommissioning costs and financial assurance obligations are covered by the DOE.

The demand for power generation services and products can be influenced by state and federal governmental legislation setting requirements for utilities related to operations, emissions and environmental impacts. The legislative process is unpredictable and includes a platform that continuously seeks to increase the restrictions on power producers. Potential legislation limiting emissions from power plants, including carbon dioxide, could affect our markets and the demand for our products and services in our Power Generation Systems segment.

At December 31, 2006 and 2005, we had total environmental reserves (including provisions for the facilities discussed above) of $18.6 million and $14.9 million, respectively. Of our total environmental reserves at December 31, 2006 and 2005, $9.7 million and $5.8 million, respectively, were included in current liabilities. Inherent in the estimates of those reserves and recoveries are our expectations regarding the levels of contamination, decommissioning costs and recoverability from other parties, which may vary significantly as decommissioning activities progress. Accordingly, changes in estimates could result in material adjustments to our operating results, and the ultimate loss may differ materially from the amounts we have provided for in our consolidated financial statements.

J. CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect our company and to take advantage of the safe harbor protection for forward-looking statements that applicable federal securities law affords.

From time to time, our management or persons acting on our behalf make forward-looking statements to inform existing and potential security holders about our company. These statements may include projections and estimates concerning the timing and success of specific projects and our future backlog, revenues, income and capital spending. Forward-looking statements are generally accompanied by words such as estimate, project, predict, believe, expec anticipate, plan, goal or other words that convey the uncertainty of future events or outcomes. In addition, sometimes we will specifically describe a statement as being a forward-looking statement and refer to this cautionary statement.

In addition, various statements in this Annual Report on Form 10-K, including those that express a belief, expectation or intention, as well as those that are not statements of historical fact, are forward-looking statements. Those forward-looking statements appear in Item 1 Business in Part I of this report and in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and in the notes to our

consolidated financial statements in Item 8 of Part II of this report and elsewhere in this report. These forward-looking statements speak only as of the date of this report; we disclaim any obligation to update these statements unless required by securities law, and we caution you not to rely on them unduly. We have based these forward-looking statements on our current expectations and assumptions about future events. While our management considers these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, competitive, regulatory and other risks, contingencies and uncertainties, most of which are difficult to predict and many of which are beyond our control. These risks, contingencies and uncertainties relate to, among other matters, the following:

- general economic and business conditions and industry trends;
- general developments in the industries in which we are involved;
- decisions about offshore developments to be made by oil and gas companies;
- decisions on spending by the U.S. Government and electric power generating companies;
- the highly competitive nature of most of our businesses;
- the ability of our suppliers to deliver raw materials in sufficient quantities and in a timely manner;
- our future financial performance, including compliance with covenants in our credit agreements and other debt instruments and availability, terms and deployment of capital;
- the continued availability of qualified personnel;
- the operating risks normally incident to offshore construction operations and nuclear operations;
- changes in, or our failure or inability to comply with, government regulations and adverse outcomes from legal and regulatory proceedings;
- changes in, and liabilities relating to, existing or future environmental regulatory matters;
- rapid technological changes;
- the realization of deferred tax assets, including through the reorganization we completed in December 2006;
- the consequences of significant changes in interest rates and currency exchange rates;
- difficulties we may encounter in obtaining regulatory or other necessary approvals of any strategic transactions;
- social, political and economic situations in foreign countries where we do business, including countries in the Middle East and Asia Pacific and the former Soviet Union;
- the possibilities of war, other armed conflicts or terrorist attacks;
- the effects of asserted and unasserted claims;
- our ability to obtain surety bonds and letters of credit;

our ability to maintain builder s risk, liability, property and other insurance in amounts and on terms we consider adequate and at rates that we consider economical;

the aggregated risks retained in our insurance captives; and

the impact of the insurance coverage surrendered as part of the B&W Chapter 11 Settlement.

We believe the items we have outlined above are important factors that could cause estimates in our financial statements to differ materially from actual results and those expressed in a forward-looking statement made in this report or elsewhere by us or on our behalf. We have discussed many of these factors in more detail elsewhere in this report. These factors are not necessarily all the important factors that could affect us. Unpredictable or unknown factors we have not discussed in this report could also have material adverse effects on actual results of matters that are the subject of our forward-looking statements. We do not intend to update our description of important factors each time a potential important factor arises, except as required by applicable securities laws and regulations. We advise our security holders that they should (1) be aware that important factors not referred to above could affect the accuracy of our forward-looking statements and (2) use caution and common sense when considering our forward-looking statements.

K. AVAILABLE INFORMATION

Our website address is *www.mcdermott.com*. We make available through this website under SEC Filings, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, statements of beneficial ownership of securities on Forms 3, 4 and 5 and amendments to those reports as soon as reasonably practicable after we electronically file those materials with, or furnish those materials to, the Securities and Exchange Commission (the SEC). We have also posted on our website our: Corporate Governance

Guidelines; Code of Ethics for our Chief Executive Officer and Senior Financial Officers; Board of Directors Conflicts of Interest Policies and Procedures; Officers, Board Members and Contact Information; By-laws; and charters for the Audit, Governance, Compensation and Finance Committees of our Board.

Item 1A. RISK FACTORS

Our Offshore Oil and Gas Construction segment derives substantially all its revenues from companies in the oil and gas exploration and production industry, a historically cyclical industry with levels of activity that are significantly affected by the levels and volatility of oil and gas prices.

The demand for offshore construction services has traditionally been cyclical, depending primarily on the capital expenditures of oil and gas companies for construction of development projects. These capital expenditures are influenced by such factors as:

- prevailing oil and gas prices;
- expectations about future prices;
- the cost of exploring for, producing and delivering oil and gas;
- the sale and expiration dates of available offshore leases;
- the discovery rate of new oil and gas reserves in offshore areas;
- domestic and international political, military, regulatory and economic conditions;
- technological advances; and
- the ability of oil and gas companies to generate funds for capital expenditures.

Prices for oil and gas have historically been extremely volatile and have reacted to changes in the supply of and demand for oil and natural gas (including changes resulting from the ability of the Organization of Petroleum Exporting Countries to establish and maintain production quotas), domestic and worldwide economic conditions and political instability in oil producing countries. We anticipate prices for oil and natural gas will continue to be volatile and affect the demand for and pricing of our offshore construction services. A material decline in oil or natural gas prices or activities over a sustained period of time could materially adversely affect the demand for our offshore construction services and, therefore, our results of operations and financial condition.

Our Power Generation Systems segment derives substantially all its revenues from electric power generating companies and other steam-using industries, with demand for its services and products depending on capital expenditures in these historically cyclical industries.

The demand for power generation services and products depends primarily on the capital expenditures of electric power generating companies, paper companies and other steam-using industries. These capital expenditures are influenced by such factors as:

- prices for electricity, along with the cost of production and distribution;
- prices for natural resources such as coal and natural gas;
- demand for electricity, paper and other end products of steam-generating facilities;
- availability of other sources of electricity, paper or other end products;
- requirements for environmental improvements;
- level of capacity utilization at operating power plants, paper mills and other steam-using facilities;

- requirements for maintenance and upkeep at operating power plants and paper mills to combat the accumulated effects of wear and tear;
- ability of electric generating companies and other steam users to raise capital; and
- relative prices of fuels used in boilers, compared to prices for fuels used in gas turbines and other alternative forms of generation.

A material decline in capital expenditures by electric power generating companies, paper companies and other steam-using industries over a sustained period of time could materially and adversely affect the demand for our power generation services and products and our results of operations and financial condition.

War, other armed conflicts or terrorist attacks could have a material adverse effect on our business.

The war in Iraq and subsequent terrorist attacks and unrest have caused instability in the world s financial and commercial markets, have significantly increased political and economic instability in some of the geographic areas in which we operate and have contributed to high levels of volatility in prices for oil and gas. The continuing instability and unrest in Iraq, as well as threats of war or other armed conflict elsewhere, may cause further disruption to financial and commercial markets and contribute to even higher levels of volatility in prices for oil and gas. In addition, the continued unrest in Iraq could lead to acts of terrorism in the United States or elsewhere, and acts of terrorism could be directed against companies such as ours. Also, acts of terrorism and threats of armed conflicts in or around various areas in which we operate, such as the Middle East and Indonesia, could limit or disrupt our markets and operations, including disruptions from evacuation of personnel, cancellation of contracts or the loss of personnel or assets. Armed conflicts, terrorism and their effects on us or our markets may significantly affect our business and results of operations in the future.

We are subject to risks associated with contractual pricing in our industries, including the risk that, if our actual costs exceed the costs we estimate on our fixed-price contracts, our profitability will decline, and we may suffer losses.

Because of the highly competitive nature of the industries in which our Offshore Oil and Gas Construction and Power Generation Systems segments perform, these segments have a substantial number of their projects on a fixed-price basis. We attempt to cover increased costs of anticipated changes in labor, material and service costs of long-term contracts, either through estimates of cost increases, which are reflected in the original contract price, or through price escalation clauses. Despite these attempts, however, the cost and gross profit we realize on a fixed-price contract could vary from the estimated amounts because of changes in job conditions, variations in labor and equipment productivity and increases in the cost of raw materials, particularly steel, over the term of the contract. These variations and the risks generally inherent in these industries may result in actual revenues or costs being different from those we originally estimated and may result in reduced profitability or losses on projects.

In addition, we recognize revenues under our long-term contracts in our segments on a percentage-of-completion basis. Accordingly, we review contract price and cost estimates periodically as the work progresses and reflect adjustments proportionate to the percentage of completion in income in the period when we revise those estimates. To the extent these adjustments result in a reduction or an elimination of previously reported profits with respect to a project, we would recognize a charge against current earnings, which could be material. Our current estimates of our contract costs and the profitability of our long-term projects could change, and adjustments to overall contract costs may continue to be significant in future periods.

We face risks associated with investing in foreign subsidiaries and joint ventures, including the risk that we may be restricted in our ability to access the cash flows or assets of these entities.

We conduct some operations through foreign subsidiaries and joint ventures. We do not manage all of these entities. Even in those joint ventures that we manage, we are often required to consider the interests of our joint venture partners in connection with decisions concerning the operations of the joint ventures. Arrangements involving these subsidiaries and joint ventures may restrict us from gaining access to the cash flows or assets of these entities. In addition, these foreign subsidiaries and joint ventures sometimes face governmentally imposed restrictions on their abilities to transfer funds to us. At December 31, 2006, JRM had approximately $28 million in accounts and notes receivable due from its former joint venture in Mexico. A note receivable is attributable to the sale of JRM s DB17 vessel during the quarter ended September 30, 2004. This joint venture has experienced liquidity problems. Recognition of a gain of approximately $5.4 million on the sale of the DB17 is currently being deferred. On October 17, 2006, JRM reached an agreement with its partner and terminated JRM s interest in this joint venture. The financial impact of this transaction is included in our consolidated results of operations. JRM expects to collect all net accounts and notes receivable currently owed from this joint venture. In the year ended December 31, 2006, JRM recorded an impairment loss totaling approximately $16.4 million attributable to currency translation losses recorded in accumulated other comprehensive loss.

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Our international operations are subject to political, economic and other uncertainties not encountered in our domestic operations.

We derive a significant portion of our revenues from international operations, including customers in the Middle East. Our international operations are subject to political, economic and other uncertainties not generally encountered in our U.S. operations. These include:

- risks of war, terrorism and civil unrest;
- expropriation, confiscation or nationalization of our assets;
- renegotiation or nullification of our existing contracts;
- changing political conditions and changing laws and policies affecting trade and investment;
- the overlap of different tax structures; and
- the risks associated with the assertion of foreign sovereignty over areas in which our operations are conducted.

Our Offshore Oil and Gas Construction segment may be particularly susceptible to regional conditions that may adversely affect its operations. Its major marine construction vessels typically require relatively long periods of time to mobilize over long distances, which could affect our ability to withdraw them from areas of conflict.

Various foreign jurisdictions have laws limiting the right and ability of foreign subsidiaries and joint ventures to pay dividends and remit earnings to affiliated companies. Our international operations sometimes face the additional risks of fluctuating currency values, hard currency shortages and controls of foreign currency exchange.

Our operations are subject to operating risks and limits on insurance coverage, which could expose us to potentially significant liability costs.

We are subject to a number of risks inherent in our operations, including:

- accidents resulting in injury to or the loss of life or property;
- environmental or toxic tort claims, including delayed manifestation claims for personal injury or loss of life;
- pollution or other environmental mishaps;
- hurricanes, tropical storms and other adverse weather conditions;
- mechanical failures;
- collisions;
- property losses;
- business interruption due to political action in foreign countries; and
- labor stoppages.

We have been, and in the future we may be, named as defendants in lawsuits asserting large claims as a result of litigation arising from events such as these. Insurance against some of the risks inherent in our operations is either unavailable or available only at rates that we consider uneconomical. Also, catastrophic events, such as the September 11, 2001 terrorist attacks and the hurricane losses of 2005, customarily result in decreased coverage limits, more limited coverage, additional exclusions in coverage, increased premium costs and increased deductibles and self-insured retentions. Risks that are difficult to insure include, among others, the risk of war and confiscation of property in some areas of the world, losses or liability resulting from acts of terrorism, certain risks relating to

construction and pollution liability, property located in certain areas of the world and business interruption. Depending on competitive conditions and other factors, we endeavor to obtain contractual protection against certain uninsured risks from our customers. When obtained, such contractual indemnification protection may not be as broad as we desire or may not be supported by adequate insurance maintained by the customer. Such insurance or contractual indemnity protection may not be sufficient or effective under all circumstances or against all hazards to which we may be subject. A successful claim for which we are not fully insured could have a material adverse effect on us.

Additionally, upon the February 22, 2006 effectiveness of the settlement of the Chapter 11 proceedings of B&W and its affiliated debtor subsidiaries, MII and most of its subsidiaries contributed substantial insurance rights to the asbestos personal injury trust, including rights to (1) certain B&W pre-1979 primary and excess insurance coverages and (2) certain 1979-1986 excess insurance coverage of MII and its affiliates, including JRM, MHI, BWXT and B&W, which 1979-1986 excess policies had an aggregate face value of available limits of coverage of approximately $1.15 billion. These insurance rights provided cover for, among other things, asbestos and other

personal injury claims, subject to the terms and conditions of such policies. With the contribution of these insurance rights to the asbestos personal injury trust, MII and its affiliates, including JRM, MHI, BWXT and B&W, may have underinsured or uninsured exposure for non-B&W-derivative asbestos claims or other personal injury or other claims that would have been insured under these coverages had the insurance rights not been contributed to the asbestos personal injury trust.

BWXT, through two of its dedicated limited liability companies, has management and operating agreements with the U.S. Government for the Y-12 and Pantex facilities. Most insurable liabilities arising from these sites are not protected in our corporate insurance program but rely on government contractual agreements and certain specialized self-insurance programs funded by the U.S. Government. The U. S. Government has historically fulfilled its contractual agreement to reimburse for insurable claims, and we expect it to continue this process during our administration of these two facilities. However, it should be noted that, in most situations, the U. S. Government is contractually obligated to pay, subject to the availability of authorized government funds.

We have captive insurers which provide certain coverages for our subsidiary entities and related coverages. Claims as a result of our operations, could adversely impact the ability of these captive insurers to respond to all claims presented, although we believe such a result is unlikely.

We depend on significant customers, including the U.S. Government.

Our three segments derive a significant amount of their revenues and profits from a relatively small number of customers. The inability of these segments to continue to perform services for a number of their large existing customers, if not offset by contracts with new or other existing customers, could have a material adverse effect on our business and operations.

Our significant customers include federal government agencies and utilities. In particular, our Government Operations segment derives substantially all its revenue from the U.S. Government. Some of our large multi-year contracts with the U.S. Government are subject to annual funding determinations. U.S. Government budget restraints and other factors affecting these governments may adversely affect our business.

We may not be able to compete successfully against current and future competitors.

Most industry segments in which we operate are highly competitive. Some of our competitors or potential competitors have greater financial or other resources than we have. Our operations may be adversely affected if our current competitors or new market entrants introduce new products or services with better features, performance, prices or other characteristics than those of our products and services. This factor is significant to our segments businesses, particularly in the Offshore Oil and Gas Construction segment, where capital investment is critical to our ability to compete.

The loss of the services of one or more of our key personnel, or our failure to attract, assimilate and retain trained personnel in the future, could disrupt our operations and result in loss of revenues.

Our success depends on the continued active participation of our executive officers and key operating personnel. The unexpected loss of the services of any one of these persons could adversely affect our operations.

Our operations require the services of employees having the technical training and experience necessary to obtain the proper operational results. As a result, our operations depend, to a considerable extent, on the continuing availability of such personnel. If we should suffer any material loss of personnel to competitors or be unable to employ additional or replacement personnel with the requisite level of training and experience to adequately operate our equipment, our operations could be adversely affected. While we believe our wage rates are competitive and our relationships with our employees are satisfactory, a significant increase in the wages paid by other employers could result in a reduction in our workforce, increases in wage rates, or both. If either of these events occurred for a significant period of time, our financial condition and results of operations could be adversely impacted.

A substantial number of our employees are members of labor unions. Although we expect to renew our current union contracts without incident, if we are unable to negotiate acceptable new contracts with our unions in the future,

we could experience strikes or other work stoppages by the affected employees, and new contracts could result in increased operating costs attributable to both union and non-union employees. If any such strikes or other work stoppages were to occur, or if our other employees were to become represented by unions, we could experience a significant disruption of our operations and higher ongoing labor costs.

We are subject to government regulations that may adversely affect our future operations.

Many aspects of our operations and properties are affected by political developments and are subject to both domestic and foreign governmental regulations, including those relating to:

- construction and equipping of production platforms and other offshore facilities;
- marine vessel safety;
- currency conversions and repatriation;
- oil exploration and development;
- clean air and environmental protection legislation;
- taxation of foreign earnings and earnings of expatriate personnel; and
- use of local employees and suppliers by foreign contractors.

In addition, our Offshore Oil and Gas Construction segment depends on the demand for its services from the oil and gas industry and, therefore, is affected by changing taxes, price controls and other laws and regulations relating to the oil and gas industry generally. The adoption of laws and regulations curtailing offshore exploration and development drilling for oil and gas for economic and other policy reasons would adversely affect the operations of our Offshore Oil and Gas Construction segment by limiting the demand for its services.

Our Power Generation Systems segment depends primarily on the demand for its services from electric power generating companies and other steam-using customers. The demand for power generation services and products can be influenced by state and federal governmental legislation setting requirements for utilities related to operations, emissions and environmental impacts. The legislative process is unpredictable and includes a platform that continuously seeks to increase the restrictions on power producers. Potential legislation limiting emissions from power plants, including carbon dioxide, could affect our markets and the demand for our products and services in our Power Generation Systems segment.

We cannot determine the extent to which our future operations and earnings may be affected by new legislation, new regulations or changes in existing regulations.

Environmental laws and regulations and civil liability for contamination of the environment or related personal injuries may result in increases in our operating costs and capital expenditures and decreases in our earnings and cash flow.

Governmental requirements relating to the protection of the environment, including solid waste management, air quality, water quality, the decontamination and decommissioning of former nuclear manufacturing and processing facilities and cleanup of contaminated sites, have had a substantial impact on our operations. These requirements are complex and subject to frequent change. In some cases, they can impose liability for the entire cost of cleanup on any responsible party without regard to negligence or fault and impose liability on us for the conduct of others or conditions others have caused, or for our acts that complied with all applicable requirements when we performed them. Our compliance with amended, new or more stringent requirements, stricter interpretations of existing requirements or the future discovery of contamination may require us to make material expenditures or subject us to liabilities that we currently do not anticipate. Such expenditures and liabilities may adversely affect our business, results of operations or financial condition. See Section H in Item 1 above for further information. In addition, some of our operations and the operations of predecessor owners of some of our properties have exposed us to civil claims by third parties for liability resulting from contamination of the environment or personal injuries caused by releases of

hazardous substances into the environment. For a discussion of legal proceedings of this nature in which we are currently involved, see Note 10 to our consolidated financial statements included in this report.

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Our internal controls may not be sufficient to achieve all stated goals and objectives.

Our internal controls and procedures were developed through a process in which our management applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding the control objectives. You should note that the design of any system of internal controls and procedures is based in part upon various assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

We are subject to other risks including legal proceedings that we discuss in other sections of this annual report.

For discussions of various factors that affect the demand for our products and services in our segments, see the discussions under the heading Factors Affecting Demand in each of Sections B, C, and D of Item 1 above. For a discussion of our insurance coverages and uninsured exposures, see Section G of Item 1 above. For discussions of various legal proceedings in which we are involved, in addition to those we refer to above, see Note 10 to our consolidated financial statements included in this report. In addition to the risks we describe or refer to above, we are subject to other risks, contingencies and uncertainties, including those we have referred to under the heading Cautionary Statement Concerning Forward-Looking Statements in Section J of Item 1 above.

Item 1B. UNRESOLVED STAFF COMMENTS

None

Item 2. PROPERTIES

For a description of our significant properties, see Item 1, Section B., Offshore Oil and Gas Construction Offshore Oil and Gas Construction Vessels and Properties, Section C., Government Operations Properties, and Section D., Power Generation Systems Properties. We consider each of our significant properties to be suitable for its intended use.

Item 3. LEGAL PROCEEDINGS

The information set forth under the heading Investigations and Litigation in Note 10, Contingencies and Commitments, to our consolidated financial statements included in this report is incorporated by reference into this Item 3.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We did not submit any matter to a vote of security holders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2006.

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PART II

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

Our common stock is traded on the New York Stock Exchange. In accordance with Section 303A.12(a) of the New York Stock Exchange Listed Company s Manual, we submitted the Annual CEO Certification to the New York Stock Exchange in 2006. Additionally, we filed certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 as Exhibits 32.1 and 32.2, respectively, included in this report. High and low stock prices by quarter in the years ended December 31, 2006 and 2005, as adjusted for the three-for-two stock split effected in May 2006, were as follows:

YEAR ENDED DECEMBER 31, 2006

	SALES PRICE	
QUARTER ENDED	*HIGH*	*LOW*
March 31, 2006	$37.53	$29.73
June 30, 2006	$49.33	$35.99
September 30, 2006	$51.35	$38.44
December 31, 2006	$53.36	$37.70

YEAR ENDED DECEMBER 31, 2005

	SALES PRICE	
QUARTER ENDED	*HIGH*	*LOW*
March 31, 2005	$13.59	$11.33
June 30, 2005	$15.59	$12.13
September 30, 2005	$25.49	$13.57
December 31, 2005	$29.90	$21.17

We have not paid cash dividends on MII s common stock since the second quarter of 2000 and do not have any plans to reinstate a cash dividend at this time. Our Board of Directors will evaluate our cash dividend policy from time to time.

As of December 31, 2006, there were approximately 3,120 record holders of our common stock.

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The following table provides information on our equity compensation plans as of December 31, 2006:

Equity Compensation Plan Information

Plan Category	*Number of securities to be issued upon exercise of outstanding options and rights*	*Weighted-average exercise price of outstanding options and rights*	*Number of securities remaining available for future issuance*
Equity compensation plans approved by security holders	2,838,409	$ 9.04	4,116,418
Equity compensation plans not approved by security holders[(1)]	690,394	$ 7.09	
Total	3,528,803	$ 8.65	4,116,418

(1) Reflects information on our 1992 Senior Management Stock Plan, which is our only equity compensation plan that has not been approved by our stockholders and that has any outstanding awards that have not been exercised. We are no longer authorized to grant new awards under our 1992 Senior Management Stock Plan. See Note 9 to our consolidated financial statements included in this report for more

information regarding this plan.

The following graph provides a comparison of our five-year, cumulative total shareholder return from December 2001 through December 2006 to the return of S&P 500 and a peer group:

The peer group used for the five-year comparison was comprised of the following companies:

Acergy S.A.;

Alliant Techsystems, Inc.;

Fluor Corporation;

Global Industries, Ltd.;

GlobalSantaFe Corporation;

Goodrich Corporation;

Halliburton Company;

Jacobs Engineering Group, Inc.;

Rockwell Collins, Inc.;

The Shaw Group, Inc.;

Technip; and

Washington Group International, Inc.

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Item 6. SELECTED FINANCIAL DATA

	For the Years Ended				
	2006[(2)]	*2005[(3)]*	*2004[(3)]*	*2003[(3)]*	*2002[(3)]*
	(In thousands, except for per share amounts)				
Revenues	$4,120,141	$1,839,740	$1,912,910	$2,329,486	$1,720,851
Income (Loss) from Continuing Operations before Cumulative Effect of Accounting Change[(1)]	$ 329,405	$ 197,873	$ 64,843	$ (88,424)	$ (766,061)
Income (Loss) before Cumulative Effect of Accounting Change	$ 342,299	$ 197,977	$ 61,639	$ (98,939)	$ (776,394)
Net Income (Loss)	$ 342,299	$ 197,977	$ 61,639	$ (95,229)	$ (776,394)
Basic Earnings (Loss) per Common Share:					
Income (Loss) from Continuing Operations before Cumulative Effect of Accounting Change	$ 3.02	$ 1.93	$ 0.66	$ (0.92)	$ (8.26)
Income (Loss) before Cumulative Effect of Accounting Change	$ 3.14	$ 1.93	$ 0.63	$ (1.03)	$ (8.37)
Net Income (Loss)	$ 3.14	$ 1.93	$ 0.63	$ (0.99)	$ (8.37)
Diluted Earnings (Loss) per Common Share:					
Income (Loss) from Continuing Operations before Cumulative Effect of Accounting Change	$ 2.90	$ 1.81	$ 0.63	$ (0.92)	$ (8.26)
Income (Loss) before Cumulative Effect of Accounting Change	$ 3.01	$ 1.81	$ 0.60	$ (1.03)	$ (8.37)
Net Income (Loss)	$ 3.01	$ 1.81	$ 0.60	$ (0.99)	$ (8.37)
Total Assets	$3,594,187	$1,668,286	$1,386,932	$1,248,874	$1,278,171
Current Maturities of Long-Term Debt	$ 257,492	$ 4,250	$ 12,009	$ 37,217	$ 55,577
Long-Term Debt	$ 15,242	$ 207,861	$ 268,011	$ 279,682	$ 86,104

(1) Cumulative effect of accounting change is due to the adoption of Statement of Financial Accounting

Standards No. 143, Accounting for Asset Retirement Obligations during the year ended December 31, 2003.

(2) *Results for the year ended December 31, 2006 include approximately ten months of B&W, which was reconsolidated into our results effective February 22, 20006. We did not consolidate the results of operations of B&W and its subsidiaries in our consolidated financial statements from February 22, 2000 through February 22, 2006. See Note 20 to our consolidated financial statements included in this report for information on B&W and its subsidiaries.*

(3) *Financial data for the years ended December 31,*

2005, 2004, 2003 and 2002 have been restated to reflect the impact of discontinued operations and the stock split, as discussed in Notes 2 and 8 to our consolidated financial statements included in this report, respectively.

See Note 18 to our consolidated financial statements included in this report for significant items included in the years ended December 31, 2006 and 2005.

Results for the year ended December 31, 2004 include a before- and after-tax gain on the settlement of our U.K. pension plan of $27.7 million.

Results for the year ended December 31, 2003 include losses on JRM s three SPAR contracts, the *Carina Aries* project and the *Belanak* FPSO project totaling approximately $120 million.

Results for the year ended December 31, 2002 include: impairment charges of $224.7 million, to write off our net investment in B&W of $187.0 million and other related assets totaling $37.7 million, and of $313.0 million related to JRM s goodwill; a provision for the estimated costs of the settlement of B&W Chapter 11 proceedings of $110.0 million, including associated tax expense of $23.6 million; and a gain on the sale of a subsidiary of $9.4 million, net of taxes of $5.7 million, which is reported in discontinued operations.

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

Statements we make in the following discussion which express a belief, expectation or intention, as well as those that are not historical fact, are forward-looking statements that are subject to risks, uncertainties and assumptions. Our actual results, performance or achievements, or industry results, could differ materially from those we express in

the following discussion as a result of a variety of factors, including the risks and uncertainties we have referred to under the headings Cautionary Statement Concerning Forward-Looking Statements and Risk Factors in Items 1 and 1A of Part I of this report.

GENERAL

In general, our business segments are composed of capital-intensive businesses that rely on large contracts for a substantial amount of their revenues. Each of our business segments is financed on a stand-alone basis. Our debt covenants limit using the financial resources or the movement of excess cash from one segment for the benefit of the other. For further discussion, see Liquidity and Capital Resources, below.

We are currently exploring growth strategies across our segments through acquisitions to expand and complement our existing businesses. As we pursue these opportunities, we expect they would be funded by cash on hand, external financing or both.

Offshore Oil and Gas Construction Segment Recent Operating Results and Outlook

JRM produced strong financial results in 2006. Based on JRM s current backlog and the potential for new contract awards, we expect JRM s strong results to continue in 2007. JRM s backlog of approximately $4.1 billion at December 31, 2006 is expected to produce revenues for 2007 of approximately $2.1 billion, not including any change orders or new contracts that may be awarded during the year. JRM is actively bidding on and (in some cases) beginning preliminary work on projects that we expect will be awarded to JRM in 2007, subject to successful contract negotiations. In the year ended December 31, 2006, JRM incurred approximately $7 million of expense to mobilize its DB101 vessel.

Currently, JRM s fabrication yard in Morgan City, Louisiana is not operating at full capacity. In addition, JRM will near completion of its current Caspian operation s backlog in 2007. The projects in the Caspian region have represented a substantial portion of JRM s revenue and operating income in recent years. JRM is actively seeking new contracts and awards in all regions in which it operates.

The decision-making process for oil and gas companies in making capital expenditures on offshore construction services for a development project differs depending on whether the project involves new or existing development. In the case of new development projects, the demand for offshore construction services generally follows the exploratory drilling and, in some cases, initial development drilling activities. Based on the results of these activities and evaluations of field economics, customers determine whether to install new platforms and new infrastructure, such as subsea gathering lines and pipelines. For existing development projects, demand for offshore construction services is generated by decisions to, among other things, expand development in existing fields and expand existing infrastructure.

Government Operations Segment Recent Operating Results and Outlook

BWXT produced strong financial results in 2006. BWXT s commitment to cost containment, in addition to the potential for new service contract awards, leads management to believe operating results should remain strong in 2007. BWXT s backlog of approximately $1.3 billion at December 31, 2006 is expected to produce revenues for 2007 of approximately $500 million, not including any change orders or new contracts that may be awarded during the year.

The revenues of our Government Operations segment are largely a function of defense spending by the U.S. Government. As a supplier of major nuclear components for certain U.S. Government programs, BWXT is a significant participant in the defense industry. With BWXT s unique capability of full life-cycle management of special nuclear materials, facilities and technologies, BWXT is well positioned to continue to participate in the continuing cleanup, operation and management of the DOE s nuclear sites and weapons complexes.

Power Generation Systems Segment Recent Operating Results and Outlook

The Power Generation Systems segment consists primarily of the operations of B&W, which were not consolidated in our financial results from February 22, 2000 through February 22, 2006, while B&W and three of its subsidiaries were in Chapter 11 Bankruptcy proceedings. We have included the results of B&W effective from February, 22, 2006, the date on which it exited Chapter 11, in our consolidated financial statements. See Note 20 to our consolidated financial statements included in this report for further information regarding B&W.

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B&W produced strong financial results in 2006. Based on B&W s backlog and potential for new contract awards, we expect operating results for our Power Generation Systems segment to remain strong in 2007. B&W s backlog of approximately $2.2 billion at December 31, 2006 is expected to produce revenues for 2007 of approximately $1.3 billion, not including any change orders or new contracts that may be awarded during the year. B&W is actively bidding on and (in some cases) beginning preliminary work on projects that we expect will be awarded to B&W in 2007, subject to successful contract negotiations.

B&W s overall activity depends mainly on the capital expenditures of electric power generating companies and other steam-using industries. B&W s products and services are capital intensive. As such, customer demand is heavily affected by the variations in customer s business cycles and by the overall economies of the countries in which they operate.

Stock-Based Compensation

We have several stock-based employee compensation plans, which are described more fully in Note 9 to our consolidated financial statements included in this report. Prior to January 1, 2006, we accounted for these plans using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and related interpretations. Effective January 1, 2006, we adopted the provisions of the revised Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment (SFAS No. 123(R)), on a modified prospective application basis. SFAS No. 123(R) eliminates the alternative permitted under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), to use APB No. 25 s intrinsic value method of accounting, under which issuing stock options to employees generally did not result in recognition of compensation. Under the provisions of SFAS No. 123(R) and using the modified prospective application method, we recognize stock-based compensation, net of an estimated forfeiture rate, for all share-based awards granted after December 31, 2005 and granted prior to, but not yet vested as of, December 31, 2005 on a straight-line basis over the requisite service periods of the awards, which is generally equivalent to the vesting term. Under the modified prospective application, the results of prior periods are not restated.

Pursuant to the adoption of SFAS No. 123(R), we recognized stock-based compensation expense of $4.4 million related to employee stock options during the year ended December 31, 2006. During the years ended December 31, 2005 and 2004, there was no stock-based compensation expense for employee stock options, other than for stock options subject to variable accounting. These stock options subject to variable accounting resulted from the cancellation and reissuance of stock options during the year ended December 31, 2000. Under APB No. 25 and its related interpretations, the cancellation and reissuance of stock options within six months of each other triggered mark-to-market accounting. For our other stock-based compensation awards, such as restricted stock and performance units, the adoption of SFAS No. 123(R) did not significantly change our accounting policies for the recognition of compensation expense, as we have recognized expense for those awards in prior periods. Total compensation expense recognized for the years ended December 31, 2006, 2005 and 2004 was as follows:

	Compensation Expense	Tax Benefit	Net Impact
		(In thousands)	
	Year Ended December 31, 2006		
Stock Options	$ 4,352	$ (971)	$ 3,381
Restricted Stock	1,199	(122)	1,077
Performance Shares	4,826	(1,329)	3,497
Performance and Deferred Stock Units	8,434	(2,195)	6,239
TOTAL	$ 18,811	$ (4,617)	$ 14,194

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	Compensation Expense	Tax Benefit	Net Impact
		(in thousands)	
	Year Ended December 31, 2005		
Repriced Stock Options	$ 279	$ (59)	$ 220
Restricted Stock	561	(133)	428
Performance and Deferred Stock Units	812	(209)	603
TOTAL	$ 1,652	$ (401)	$ 1,251
	Year Ended December 31, 2004		
Repriced Stock Options	$ 2,959	$ (737)	$ 2,222
Restricted Stock	3,415	(865)	2,550
Performance and Deferred Stock Units	270	(74)	196
TOTAL	$ 6,644	$ (1,676)	$ 4,968

The impact on basic earnings per share of stock-based compensation expense recognized for the years ended December 31, 2006, 2005 and 2004 was $0.13, $0.01 and $0.05 per share, respectively, and on diluted earnings per share was $0.12, $0.01 and $0.05 per share, respectively.

As of December 31, 2006, total unrecognized estimated compensation expense related to nonvested awards was $14.7 million, net of estimated tax benefits of $6.9 million. The total gross unrecognized estimated compensation expense of $21.6 million consists of $3.6 million for stock options, $0.2 million for restricted stock and $17.8 million for performance shares, which are expected to be recognized over weighted average periods of 0.9 years, 0.2 years and 2.4 years, respectively. Performance and deferred stock units are marked-to-market at the end of each quarter, so there was no unrecognized compensation expense as of December 31, 2006.

The determination of the fair value of a share-based payment award on the date of grant using an option-pricing model requires the input of highly subjective assumptions, such as the expected life of the award and stock price volatility. Prior to the adoption of SFAS No. 123(R), we used the Black-Scholes option-pricing model (Black-Scholes) for the pro forma information required to be disclosed under SFAS No. 123, as originally issued, and we believe this model will continue to provide appropriate fair values under the provisions of SFAS No. 123(R). See Note 9 to our consolidated financial statements included in this report for further discussion on stock-based compensation.

Other

The results of Talleres Navales del Golfo, S.A. de C.V. (TNG), previously a component of our Offshore Oil and Gas Construction segment, are reported in discontinued operations. We sold TNG in April 2006. See Note 2 to our consolidated financial statements included in this report for further information on discontinued operations.

Effective December 31, 2006, in accordance with SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, we recorded an additional pension and post-retirement liability of approximately $145 million and a reduction in intangible assets of approximately $24 million.

Effective March 31, 2006, benefit accruals under all of our domestic qualified pension plans other than the JRM qualified pension plan (which was frozen in March 2003) ceased for salaried employees hired on or after April 1, 2001. Any pension benefits earned to that date continue to be payable pursuant to the plans upon retirement, but no future benefits will accrue, other than the annual increase in line with the consumer price index, up to 8%, during each year the participants remain employed by us. All affected salaried employees participating in these plans as of March 31, 2006 became fully vested at that time. We will provide future retirement benefits to affected employees by making additional contributions to our thrift plan. While these benefit changes will shift costs from our pension plans to our

thrift plan, the overall cost of the retirement program is not expected to change materially from our current contribution or expense levels.

As part of our strategy to continue to provide a competitive compensation package to reward, motivate and retain our employees, we are providing employees (other than participants in the JRM pension plan) with five to 10 years of service as of January 1, 2007 with a one-time, irrevocable opportunity to choose whether to earn benefits under our existing retirement plans or to receive enhanced company contributions under our thrift plan. From February 1, 2007 through March 15, 2007, these employees may choose to do one of the following:

- receive automatic, service-based company contributions under our thrift plan and stop earning benefits under our defined benefit retirement plan as of March 31, 2007. For employees who choose this option, the retirement plan benefit will not reflect any service after March 31, 2007, or any changes in their salary after that date. However, it will escalate in line with the cost of living, as measured by the Consumer Price Index, up to a maximum eight percent a year, for each year the employee remains with us; or

- remain in our defined benefit retirement plan and continue earning future benefits under this plan. Participation in our retirement and thrift plans will remain unchanged under this option.

These employees will have until March 15, 2007 to elect how they wish to earn future pension benefits. If no action is taken, the employee will continue to accrue pension benefits through our defined benefit retirement plan. We do not expect this election to have a material impact on our financial position, results of operations or cash flows.

At December 31, 2006, in accordance with SFAS No. 87, Employers Accounting for Pensions, we decreased our minimum pension liability by approximately $124.8 million, primarily due to the increasing of our discount rate in 2006 to 6.0% from 5.75%. At December 31, 2005, we increased our minimum pension liability by approximately $87 million, primarily due to the lowering of our discount rate in 2005 to 5.75% from 6.0%.

Effective December 31, 2004, benefit accruals under the McDermott International, Inc. Supplemental Executive Retirement Plan, amended and restated effective December 1, 1999 (the Old SERP Plan), ceased and we adopted the McDermott International, Inc. Supplemental Executive Retirement Plan effective January 1, 2005 (the New SERP Plan). The Old SERP Plan was a defined benefit plan, while the New SERP Plan is a defined contribution plan. The cessation of benefits of the Old SERP Plan generally did not affect the rights of retired or disabled participants (or their spouses) who were receiving benefits under that plan as of December 31, 2004. However, some of the retired participants elected to receive a discounted lump-sum distribution in lieu of any future entitlements under the Old SERP Plan. All active participants in the Old SERP Plan on December 31, 2004 became participants in the New SERP Plan on January 1, 2005. We recorded a settlement and curtailment gain of approximately $4.6 million in connection with the cessation of benefits. We also recorded expenses related to the New SERP Plan of approximately $2.9 million, $1.3 million and $1.4 million in the years ended December 31, 2006, 2005 and 2004, respectively.

We derive a significant portion of our revenues from foreign operations. As a result, international factors, including variations in local economies and changes in foreign currency exchange rates, affect our revenues and operating results. We attempt to limit our exposure to changes in foreign currency exchange rates by attempting to match anticipated foreign currency contract receipts with like foreign currency disbursements. To the extent that we are unable to match the foreign currency receipts and disbursements related to our contracts, we enter into foreign currency derivative instruments to reduce the impact of foreign exchange rate movements on our operating results. Because we generally do not hedge beyond our exposure, we believe this practice minimizes the impact of foreign exchange rate movements on our operating results.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We believe the following are our most critical accounting policies that we apply in the preparation of our financial statements. These policies require our most difficult, subjective and complex judgments, often as a result of the need to make estimates of matters that are inherently uncertain.

Restricted Cash. We record cash as restricted when we are unable to use such cash and cash equivalents freely for general operating purposes.

Contracts and Revenue Recognition. We determine the appropriate accounting method for each of our long-term contracts before work on the project begins. We generally recognize contract revenues and related costs on a percentage-of-completion method for individual contracts or combinations of contracts under the guidelines of the Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts

(SOP 81-1). The use of this method is based on our experience and history of being able to prepare reasonably

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dependable estimates of the cost to complete our projects. Under this method, we recognize estimated contract revenue and resulting income based on costs incurred to date as a percentage of total estimated costs. Total estimated costs, and resulting contract income, are affected by changes in the expected cost of materials and labor, productivity, scheduling and other factors. Additionally, external factors such as weather, customer requirements and other factors outside of our control, may affect the progress and estimated cost of a project s completion and, therefore, the timing of revenue and income recognition. We routinely review estimates related to our contracts, and revisions to profitability are reflected in the quarterly and annual earnings we report. SOP 81-1 provides that the use of percentage-of-completion accounting requires the ability to make reasonably dependable estimates.

For contracts as to which we are unable to estimate the final profitability except to assure that no loss will ultimately be incurred, we recognize equal amounts of revenue and cost until the final results can be estimated more precisely. For these deferred profit recognition contracts, we recognize revenue and cost equally and only recognize gross margin when probable and reasonably estimable, which we generally determine to be when the contract is approximately 70% complete. We treat long-term construction contracts that contain such a level of risk and uncertainty that estimation of the final outcome is impractical except to assure that no loss will be incurred as deferred profit recognition contracts. We accounted for JRM s *Dolphin Upstream Facilities* project as a deferred recognition contract until its completion during 2006. At December 31, 2006, we have no contracts being accounted for using the deferred profit recognition basis.

Fixed-price contracts are required to be accounted for under the completed-contract method if we are unable to reasonably forecast cost to complete at start-up. For example, if we have no experience in performing the type of work on a particular project and were unable to develop reasonably dependable estimates of total costs to complete, we would follow the completed-contract method of accounting for such projects. Our management s policy is not to enter into fixed-price contracts without an accurate estimate of cost to complete. However, it is possible that in the time between contract execution and the start of work on a project, we could lose confidence in our ability to forecast cost to complete based on intervening events, including but not limited to experience on similar projects, civil unrest, strikes and volatility in our expected costs. In such a situation, we would use the completed-contract method of accounting for that project. No such contracts were executed in 2006.

For all contracts, if a current estimate of total contract cost indicates a loss on a contract, the projected loss is recognized in full when determined.

Although we continually strive to improve our ability to estimate our contract costs and profitability, adjustments to overall contract costs due to unforeseen events could be significant in future periods. We recognize claims for extra work or for changes in scope of work in contract revenues, to the extent of costs incurred, when we believe collection is probable and can be reasonably estimated. We recognize income from contract change orders or claims when formally agreed with the customer. We reflect any amounts not collected as an adjustment to earnings. We regularly assess the collectibility of contract revenues and receivables from customers.

Inventories. We carry our inventories (principally in B&W, which was not consolidated at December 31, 2005) at the lower of cost or market. We determine cost principally on the first-in-first-out basis, except for certain materials inventories, for which we use the last-in-first-out method.

Property, Plant and Equipment. We carry our property, plant and equipment at depreciated cost, reduced by provisions to recognize economic impairment when we determine impairment has occurred. Factors that impact our determination of impairment include forecasted utilization of equipment and estimates of cash flow from projects to be performed in future periods. Our estimates of cash flow may differ from actual cash flow due to, among other things, technological changes, economic conditions or changes in operating performance. Any changes in such factors may negatively affect our business segments and result in future asset impairments.

Except for major marine vessels, we depreciate our property, plant and equipment using the straight-line method, over estimated economic useful lives of eight to 40 years for buildings and two to 28 years for machinery and equipment. We depreciate major marine vessels using the units-of-production method based on the utilization of each vessel. Our depreciation expense calculated under the units-of-production method may be less than, equal to or greater than depreciation expense calculated under the straight-line method in any period. The annual depreciation based on

utilization of each vessel will not be less than the greater of 25% of annual straight-line depreciation and 50% of cumulative straight-line depreciation.

We expense the costs of maintenance, repairs and renewals, which do not materially prolong the useful life of an asset, as we incur them, except for drydocking costs. Through December 31, 2006, we accrued estimated drydocking costs for our marine fleet over the period of time between drydockings, generally three to five years. We accrued drydocking costs in advance of the anticipated future drydocking, commonly known as the accrue-in-advance method. We charged actual drydocking costs against the liability when incurred, and we recognized any differences between actual costs and accrued costs over the remaining months of the drydocking cycle. Our actual drydocking costs often differ from our estimates due to the long period between drydockings and the inherent difficulties in estimating cost of vessel repairs and renewals until the drydocking occurs. Pursuant to FSP AUG AIR-1, Accounting for Planned Major Maintenance Activities, issued by the Financial Accounting Standards Board (the FASB) during September 2006, we will change our accounting policy from the accrue-in-advance method to the deferral method, effective January 1, 2007, as more fully discussed in Note 1 to our consolidated financial statements included in this report.

Self-Insurance. We have several wholly owned insurance subsidiaries that provide workers compensation, employer s liability, general and automotive liability and workers compensation insurance and from time to time, builder s risk within certain limits and marine hull to our companies. We may also have business reasons in the future to have these insurance subsidiaries accept other risks which we can not or do not wish to transfer to outside insurance companies. Reserves related to these insurance programs are based on the facts and circumstances specific to the insurance claims, our past experience with similar claims, loss factors and the performance of the outside insurance market for the type of risk at issue. The actual outcome of insured claims could differ significantly from estimated amounts. We maintain actuarially determined accruals in our consolidated balance sheets to cover self-insurance retentions for the coverage discussed above. These accruals are based on certain assumptions developed utilizing historical data to project future losses. Loss estimates in the calculation of these accruals are adjusted as required based upon actual claim settlements and reported claims. These loss estimates and accruals recorded in our financial statements for claims have historically been reasonable in light of the actual amount of claims paid.

Pension Plans and Postretirement Benefits. We estimate income or expense related to our pension and postretirement benefit plans based on actuarial assumptions, including assumptions regarding discount rates and expected returns on plan assets. We determine our discount rate based on a review of published financial data and discussions with our actuary regarding rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of our pension obligations. Based on historical data and discussions with our actuary, we determine our expected return on plan assets based on the expected long-term rate of return on our plan assets and the market-related value of our plan assets. Changes in these assumptions can result in significant changes in our estimated pension income or expense and our consolidated financial position. We revise our assumptions on an annual basis based upon changes in current interest rates, return on plan assets and the underlying demographics of our workforce. These assumptions are reasonably likely to change in future periods and may have a material impact on future earnings. Effective December 31, 2006, we adopted SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS No. 158), which resulted in the recognition of the funded status of our defined benefit pension plans and postretirement plans in our consolidated balance sheets included in this report. See Note 6 to our consolidated financial statements included in this report for additional information related to SFAS No. 158.

Loss Contingencies. We estimate liabilities for loss contingencies when it is probable that a liability has been incurred and the amount of loss is reasonably estimable. We provide disclosure when there is a reasonable possibility that the ultimate loss will exceed the recorded provision or if such loss is not reasonably estimable. We are currently involved in some significant litigation, as discussed in Note 10 to our consolidated financial statements included in this report. We have accrued our estimates of the probable losses associated with these matters. However, our losses are typically resolved over long periods of time and are often difficult to estimate due to the possibility of multiple actions by third parties. Therefore, it is possible future earnings could be affected by changes in our estimates related to these matters.

Goodwill. SFAS No. 142, Goodwill and Other Intangible Assets, requires us to perform periodic testing for impairment. It requires a two-step impairment test to identify potential goodwill impairment and measure the amount of a goodwill impairment loss. The first step of the test compares the fair value of a reporting unit with its carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of the impairment loss, if any. Both steps of goodwill impairment testing involve significant estimates.

Asset Retirement Obligations and Environmental Clean-up Costs. We accrue for future decommissioning of our nuclear facilities that will permit the release of these facilities to unrestricted use at the end of each facility s life, which is a requirement of our licenses from the Nuclear Regulatory Commission. In accordance with SFAS No. 143, Accounting for Asset Retirement Obligations (SFAS No. 143), we record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When we initially record such a liability, we capitalize a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of a liability, we will settle the obligation for its recorded amount or incur a gain or loss. SFAS No. 143 applies to environmental liabilities associated with assets that we currently operate and are obligated to remove from service. For environmental liabilities associated with assets that we no longer operate, we have accrued amounts based on the estimated costs of clean-up activities, net of the anticipated effect of any applicable cost-sharing arrangements. We adjust the estimated costs as further information develops or circumstances change. An exception to this accounting treatment relates to the work we perform for one facility, for which the U.S. Government is obligated to pay all the decommissioning costs.

Deferred Taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We believe that the deferred tax asset recorded as of December 31, 2006 is realizable through carrybacks, future reversals of existing taxable temporary differences and future taxable income. If we were to subsequently determine that we would be able to realize deferred tax assets in the future in excess of our net recorded amount, an adjustment to deferred tax assets would increase earnings for the period in which such determination was made. We will continue to assess the adequacy of the valuation allowance on a quarterly basis. Any changes to our estimated valuation allowance could be material to our consolidated financial condition and results of operations. In June 2006, FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), to clarify the accounting for uncertainty in income taxes recognized in an entity s financial statement in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006, as more fully discussed in Notes 1 and 4 to our consolidated financial statements included in this report.

Warranty. We account for warranty costs to satisfy contractual warranty requirements as a component of our total contract cost estimate on the related contracts for our Offshore Oil and Gas Construction segment or as an accrued estimated expense recognized in conjunction with the associated revenue on the related contracts for our Government Operations and Power Generation Systems segments. In addition, we make specific provisions where we expect the actual warranty costs to significantly exceed the accrued estimates. In our Offshore Oil and Gas Construction segment, warranty periods are generally limited, and we have had minimal warranty cost in prior years. Factors that impact our estimate of warranty costs include prior history of warranty claims and our estimates of future costs of materials and labor. Our future warranty provisions may vary from what we have experienced in the past.

Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of the revised SFAS No. 123, Share-Based Payment (SFAS No. 123(R)), on a modified prospective application basis. Under the provisions of SFAS No. 123(R) and using the modified prospective application method, we recognize stock-based compensation, net of an estimated forfeiture rate, for all share-based awards granted after December 31, 2005 and granted prior to, but not yet vested as of, December 31, 2005 on a straight-line basis over the requisite service periods of the awards, which is generally equivalent to the vesting term.

For further discussion of recently adopted accounting standards, see Note 1 to our consolidated financial statements included in this report.

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YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

Offshore Oil and Gas Construction

Revenues increased 30.0%, or $371.4 million, to $1.6 billion in 2006, primarily due to increased activities in our Middle East region, an increase in offshore projects worldwide and increased activities in our Asia Pacific region. These increases were partially offset by a decrease in activities in the Caspian region and a decrease in fabrication activities in our Americas region.

Segment operating income, which is before equity in income (loss) of investees and gains (losses) on asset disposals and impairments-net, increased $60.2 million from $149.7 million in 2005 to $209.9 million in 2006. Approximately $15.0 million of this increase is attributable to profit deferred since the inception of a project with Dolphin Energy Ltd., which we accounted for under our deferred profit recognition policy, as discussed above. As of December 31, 2006, the project was substantially complete and the profit earned since inception to date was recognized. In addition, segment operating income increased in the year ended December 31, 2006 compared to the year ended December 31, 2005 due to increased activities in our Middle East and Asia Pacific regions, increased offshore projects worldwide and higher margins from the Caspian and Asia Pacific regions. These increases were partially offset by a decrease in fabrication activities in our Americas region and a decrease in all other operations. In addition, general and administrative expenses increased in the year ended December 31, 2006 due to increases in departmental expenses.

Gains (losses) on asset disposals and impairments net decreased $22.6 million to a loss of $16.2 million in the year ended December 31, 2006 from a gain of $6.4 million in the year ended December 31, 2005. This reduction was primarily attributable to an impairment of $16.4 million associated with our terminated joint venture in Mexico in the year ended December 31, 2006 and gains on sales of various non-strategic assets in the year ended December 31, 2005.

Equity in income (loss) of investees decreased $5.7 million from a gain of $2.8 million in the year ended December 31, 2005 to a loss of $2.9 million in the year ended December 31, 2006, primarily attributable to our share of expenses in our deepwater solutions joint venture.

Government Operations

Revenues increased approximately 4.8%, or $29.0 million, to $630.1 million in the year ended December 31, 2006, primarily due to higher volumes in the manufacture of nuclear components for certain U.S. Government programs along with higher volumes from our other government operations producing fuel for research test reactors and DOE fuel development for commercial reactors. Also, contributing to this increase was higher volume from our management and operating contract for U.S. Government-owned facilities in New Mexico, along with higher volumes in commercial nuclear environmental services work including additional environmental engineering work at our Pennsylvania location. These increases were partially offset by lower commercial downblending work due to the completion of our contract to downblend 50 metric tons of highly enriched uranium to low enriched uranium. We also experienced lower revenues in the year ended December 31, 2006 from our fuel cell development project, which we terminated in 2006.

Segment operating income, which is before equity income of investees and gains on asset disposals and impairments net, increased $14.8 million to $82.8 million in the year ended December 31, 2006, primarily attributable to cost and efficiency improvements resulting from our consolidation of two operating divisions into BWXT s Nuclear Operations Division and continued productivity improvements. In addition, we experienced an increase in volumes and margins of our other government operations producing fuel for research test reactors and DOE fuel development for commercial reactors. We also experienced an increase in our commercial nuclear environmental services activity, including additional environmental engineering work, and improved performance from our environmental labs. Also, contributing to this increase was lower spending on research and development activity in the year ended December 31, 2006, and increased fees for a management and operating contract for U.S. Government-owned facilities in New Mexico. These increases were partially offset by lower fees from subcontracting activity at a DOE site cleanup in Ohio

and lower commercial downblending work due to the completion of our contract, as discussed above. In addition, we experienced higher pension expense, higher selling, general and administrative expenses and an increase to our provision for an environmental liability in Pennsylvania in the year ended December 31, 2006.

Gains on asset disposals and impairments net increased $1.0 million in the year ended December 31, 2006, attributable to the sale of noncore machinery.

Equity in income of investees decreased $3.5 million to $27.8 million in the year ended December 31, 2006, primarily due to our decision to terminate our research and development joint venture, along with decreased scope at our joint venture in Idaho. These decreases were partially offset by improved fees at our sites in Tennessee and Texas in the year ended December 31, 2006.

Power Generation Systems

Our Power Generation Systems segment consists primarily of B&W, which was not consolidated in the year ended December 31, 2005. The revenues and segment operating income of this segment for the year ended December 31, 2006 were substantially all attributable to B&W, which was reconsolidated into our results effective February 22, 2006 and include approximately ten months results in the year ended December 31, 2006. B&W s revenues and segment operating income in the year ended December 31, 2006 resulted primarily from utility steam system fabrication, fabrication and construction of plant enhancement projects, replacement parts, boiler cleaning equipment, nuclear services and replacement nuclear steam generators.

Equity in income of investees increased $6.1 million to $12.5 million in the year ended December 31, 2006, primarily due to income recognized from a joint venture in China, which was placed on the equity method of accounting during the year ended December 31, 2006.

Corporate

Unallocated Corporate expenses decreased $10.0 million in the year ended December 31, 2006 from $39.9 million to $29.9 million, primarily attributable to lower legal expenses related to B&W s Chapter 11 proceedings in 2006 compared to 2005. This decrease was partially offset by higher qualified pension plan expense in 2006 compared to 2005. We also experienced lower departmental expenses in 2006, and we recorded a favorable adjustment related to the settlement of prior-year litigation in 2006. In addition, we experienced favorable results from our captive insurers in the year ended December 31, 2006, compared to the year ended December 31, 2005.

Other Income Statement Items

Interest income increased by $32.5 million to $53.6 million in the year ended December 31, 2006, primarily due to an increase in average cash equivalents and investments and higher interest rates, as well as settlement from the Canadian taxing authorities with respect to audit issues.

Interest expense decreased by $1.5 million to $30.3 million in the year ended December 31, 2006, primarily due to the retirement of the JRM Secured Notes in June 2006, partially offset by higher interest and associated amortization and costs on our credit facilities.

We recorded other income from an IRS interest expense adjustment for the year ended December 31, 2006, totaling approximately $13.2 million, attributable to a settlement MI reached with U.S. and Canadian tax authorities related to transfer pricing issues. This income was partially offset by an increase in interest expense during the year ended December 31, 2006 totaling approximately $7.5 million for potential U.S. tax deficiencies.

On June 6, 2006, JRM completed a tender offer and used current cash on hand to purchase the entire $200 million in aggregate principal amount outstanding of its secured notes for approximately $249.0 million, including accrued interest of approximately $10.9 million. As a result of this early retirement of debt, we recognized $49.0 million of expense during the year ended December 31, 2006. In addition, in December 2006, B&W retired its $250 million promissory note issued in 2005, as part of its Chapter 11 bankruptcy settlement. This note was recorded in Accrued Cost of The Babcock & Wilcox Company Bankruptcy Settlement on our consolidated balance sheets at its

fair value of approximately $245.3 million. As a result of this retirement, we recognized approximately $4.7 million of expense.

Other-net expense increased by $13.1 million to $13.8 million in the year ended December 31, 2006, primarily due to currency exchange losses in 2006, compared to gains in 2005.

Provision for Income Taxes

For the year ended December 31, 2006, our provision for income taxes increased $10.3 million to $19.2 million, while income before provision for income taxes increased $141.9 million to $348.6 million. Our effective tax rate for the year ended December 31, 2006 was approximately 5.5%, which was primarily due to the valuation allowance adjustment discussed below.

For the year ended December 31, 2006, we reversed $94.1 million of the deferred tax asset valuation allowance recorded against the JRMH deferred tax assets. SFAS No. 109, Accounting for Income Taxes (SFAS No. 109), provides that a valuation allowance must be established for deferred tax assets when it is more likely than not that the assets will not be realized. SFAS No. 109 also provides that all positive and negative evidence must be evaluated in determining the need for a valuation allowance. As a result of the reorganization of our U.S. legal entities discussed more fully below, we have reevaluated all the positive and negative evidence available to us and have determined that we no longer require a federal deferred tax asset valuation allowance. Accordingly, under the guidelines of SFAS No. 109, we reversed the majority of the JRMH federal deferred tax asset valuation allowance through current period earnings in 2006 by recording a credit to our provision for income taxes.

We completed a reorganization of our MI and JRMH groups of U.S. legal entities into a single consolidated U.S. group effective December 31, 2006. This reorganization provides us with administrative efficiencies, the opportunity to increase the flexibility of our financial structure and returns us to a more tax-efficient legal structure. Prior to 1995, substantially all of the operations of JRMH (formerly our U.S. offshore oil and gas construction business) were combined with MI in a single consolidated U.S. group. In 1995, substantially all our offshore oil and gas construction assets were acquired by JRM in conjunction with JRM s acquisition of Offshore Pipelines, Inc. (OPI). As a result of the acquisition of OPI, MII s ownership interest in the common stock of JRM was reduced to approximately 64%, with the remaining 36% being publicly traded. The results of JRMH were consequently no longer part of MI s consolidated U.S. group. In 1999, MII acquired all of the remaining publicly held common stock of JRM, such that MII owned 100% of JRM. A restructuring to achieve the reconsolidation of the JRMH and MI groups was not feasible until 2006, attributable in part to long-running asbestos liability claims against B&W, which ultimately lead B&W to file for Chapter 11 bankruptcy protection. In February 2006, B&W emerged from Chapter 11 bankruptcy protection and was reconsolidated into our results. Subsequent to B&W s emergence from bankruptcy, action was taken to recombine our JRMH and MI groups, with the final reorganization being completed effective December 31, 2006. Although we will continue to file a separate U.S. tax return for each U.S. group for the year ended December 31, 2006, the current earnings reflect a tax benefit for the JRMH U.S. group, as a result of the reorganization. Beginning with the taxable period commencing January 1, 2007, the results of the former separate U.S. groups will be consolidated, and a single U.S. tax return will be filed. As a consequence, we do not expect to make any federal tax payments in 2007.

As more fully disclosed in Part II of our annual report on Form 10-K for the year ended December 31, 2005, for the year ended December 31, 2005, we reversed our federal deferred tax asset valuation allowance totaling approximately $50.4 million, which eliminated our MI federal deferred tax asset valuation allowance associated with our minimum pension liability. This adjustment recorded for the year ended December 31, 2005 resulted in a benefit in our provision for income taxes of $50.4 million.

We have provided for income taxes based on the tax laws and rates in the countries in which we conduct our operations. MII is a Panamanian corporation that has earned all of its income outside of Panama. As a result, MII is not subject to income tax in Panama. MII and its subsidiaries operate in the United States taxing jurisdiction and various other taxing jurisdictions around the world. Each of these jurisdictions has a regime of taxation that varies from the others. The taxation regimes vary not only with respect to nominal rates but also with respect to the allowability of deductions, credits and other benefits and tax bases (for example, revenue versus income). These variances, along with variances in our mix of income from these jurisdictions, contribute to variability in our effective tax rate.

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Income (loss) from continuing operations before provision for (benefit from) income taxes, provision for (benefit from) income taxes and effective tax rates for MII s major subsidiaries are as follows:

	Income (loss) from Continuing Operations		*Provision for (Benefit from) Income Taxes*		*Effective Tax Rate*	
	2006	*2005*	*2006*	*2005*	*2006*	*2005*
	(In thousands)		*(In thousands)*			
Primarily United States:						
MI	$167,778	$ 67,114	$ 84,594	$(17,666)	50.42%	(26.32)%
JRMH	(79,764)	(14,514)	(109,083)	1,699	136.76%	(11.71)%
Non United States:						
International Subsidiaries	260,543	154,100	43,641	24,794	16.75%	16.09%
Total MII	$348,557	$206,700	$ 19,152	$ 8,827	5.49%	4.27%

MI is subject to United States federal income tax at a rate of 35%. The effective tax rate of MI is primarily affected by applicable state income taxes on its profitable U.S. subsidiaries, as well as the items discussed below. In the year ended December 31, 2006, MI reached a settlement in a tax dispute with United States and Canadian tax authorities, primarily related to transfer pricing matters, resulting in an adjustment to the tax liability and associated accrued interest established for the disputed item. This favorably impacted MI s income before income taxes and provision for income taxes by $13.2 million and $4.7 million, respectively. In addition, offsetting tax adjustments related to open years for federal and certain state tax jurisdictions were recorded in the year ended December 31, 2006, along with approximately $4.9 million of related interest expense. Approximately $18 million in tax expense was recorded for the expiration of certain foreign tax credits and via an increase in valuation allowance for foreign credit carryfowards that may expire in the future prior to being utilized.

The effective tax rate of MI for the year ended December 31, 2005 was impacted by the B&W Chapter 11 settlement adjustment recorded in that period, which generated little or no associated U.S income tax effect, and the valuation allowance adjustment discussed above.

JRMH is subject to United States income tax at a rate of 35%. No current United States income tax is payable by JRMH due to its current year loss; however, a tax benefit was recorded for its 2006 operations, due to the U.S. reorganization discussed above. Further, JRMH s valuation allowance for the realization of deferred tax assets has been adjusted in accordance with SFAS No. 109, as discussed above. In addition, JRMH recorded a net provision for income taxes of approximately $9 million associated with potential U.S. income tax issues.

See Note 4 to our consolidated financial statements included in this report for further information on income taxes.

YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

Offshore Oil and Gas Construction

Revenues decreased 9%, or $118.9 million, to $1.2 billion in 2005, primarily due to decreases in fabrication activity levels in our Americas and Asia Pacific regions. In addition, offshore activity in our Americas region was also reduced. Fabrication manhours in these regions for 2005 were 40% of 2004 levels, while offshore activity in the Americas experienced a moderate decrease in barge days of approximately 19% in 2005 compared to 2004. These reductions contributed to net decreases in revenue totaling approximately $333.5 million. These decreases, along with a $90.6 million decrease related to the completion of our three Spar projects in 2004, were partially offset by increased fabrication activity in our Middle East and Caspian regions ($38.6 million) and substantial increases in our international offshore activities ($275.2 million). Revenues from other activities in JRM decreased by approximately $2.2 million in the year ended December 31, 2005 compared to the year ended December 31, 2004.

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Segment operating income, which is before equity in income of investees and gains on asset disposals and impairments-net, increased $95.9 million from $53.8 million in 2004 to $149.7 million in 2005. This increase was primarily attributable to operating income from offshore construction projects due to the increases in Middle East, Caspian and international offshore activity levels referenced above and improved margins in these regions. These increases were partially offset by decreases in fabrication activity levels in our Americas and Asia Pacific regions and decreases in offshore activity in the Americas region. In addition, general and administrative expenses increased by $7.0 million to $107.3 million, primarily due to increased costs related to systems development and increased legal expenses.

Gains on asset disposals and impairments net decreased $23.9 million to $6.4 million in 2005 from $30.3 million in 2004. This reduction was attributable to gains on sales of nonstrategic assets in 2004, including the *Oceanic 93* and our fabrication facility in Scotland.

Equity in income of investees increased $0.9 million to $2.8 million in 2005, primarily due to the settlement of warranty issues in a joint venture in Europe ($3.1 million). This increase was offset by a decrease in our share of the royalty income recognized in our Spars International Inc. joint venture due to a restructuring of the joint venture.

Government Operations

Revenues increased 8%, or $45.9 million, to $601.0 million in 2005, primarily due to higher volumes in the manufacture of nuclear components for certain U. S. Government programs. Higher volumes in commercial nuclear environmental services work, including the change from equity income recognition to revenue recognition under a subcontract in Idaho, also contributed to this increase. In addition, we experienced higher revenues from downblending of highly enriched uranium to low enriched uranium, which we downblend pursuant to a tolling arrangement. This downblended material is used by U.S. commercial nuclear power plants as fuel to generate electricity. These increases were partially offset by lower revenues at a DOE site in South Carolina and lower revenues associated with the recovery of uranium from process materials for the DOE.

Segment operating income, which is before equity income from investees and gains on asset disposals and impairments-net, decreased $8.7 million to $68.0 million in 2005, primarily due to approximately $18.8 million of pension expense allocated to BWXT in 2005 that was recorded as an unallocated Corporate expense in 2004. In addition, BWXT also experienced higher general and administrative expenses, primarily due to stock-based compensation expense, facility oversight costs, costs related to enterprise system implementation and Sarbanes-Oxley implementation and compliance. These decreases were partially offset by higher volumes and margins from our manufacture of nuclear components for certain U.S. Government programs, our engineering services work for DOE sites and commercial work.

Equity in income from investees decreased $1.3 million to $31.3 million in 2005, primarily due to the change from equity income recognition to revenue recognition under a subcontract in Idaho. This decrease was partially offset by additional fees earned at a site in Tennessee.

Power Generation Systems

Equity in income for investees increased $5.3 million to $6.5 million in 2005, primarily due to income recognized by a joint venture in China.

Corporate

Unallocated Corporate expenses decreased $9.8 million from $49.7 million to $39.9 million, primarily due to the allocation of pension plan expense for the BWXT and B&W pension plans previously recorded as an unallocated Corporate expense in 2004 totaling approximately $60.4 million. In 2005, we recorded expenses associated with these plans totaling approximately $18.8 million in our Government Operations segment and $34.9 million in B&W, respectively. Also, in 2004, we recognized a gain on the curtailment of our pension plan in the United Kingdom totaling $27.7 million. The decrease in pension expense recorded as an unallocated Corporate expense for 2005 compared to 2004 was partially offset by an increase in stock-based compensation expense attributable to the increase in our stock price in the year ended December 31, 2005. In addition, in 2005, we experienced increased legal and professional fees associated with B&W s Chapter 11 proceedings.

Effective January 1, 2005, we began allocating to our Government Operations segment qualified pension plan expense on MI s pension plan that was previously recorded as an unallocated Corporate expense. In 2004, we recorded approximately $21.8 million of pension expense related to BWXT (substantially all of our Government Operations segment) in unallocated Corporate. In addition, effective January 31, 2005, the B&W portion of MI s qualified pension plan was spun off into a new plan sponsored by B&W. As a result, we no longer allocated pension expense associated with B&W s portion of the pension plan to unallocated Corporate. In 2004, pension expense associated with the spun off plan was recorded in unallocated Corporate.

Other Income Statement Items

Interest income increased by $15.5 million to $21.1 million, primarily due to an increase in investments.

Interest expense decreased by $4.2 million, primarily due to a reduction in interest expense attributable to interest on potential tax deficiencies.

Provision for Income Taxes

For the year ended December 31, 2005, we reversed $50.4 million of our federal deferred tax asset valuation allowance (Valuation Allowance Adjustment), eliminating our MI federal deferred tax asset valuation allowance associated with our minimum pension liability discussed below. SFAS No. 109, Accounting for Income Taxes (SFAS No. 109), provides that a valuation allowance must be established for deferred tax assets when it is more likely than not that the assets will not be realized. SFAS No. 109 also provides that all positive and negative evidence must be evaluated in determining the need for a valuation allowance. In the quarter ended June 30, 2005, our BWXT subsidiary received contract extensions on its management contracts for the Y-12 and Pantex sites from the National Nuclear Security Administration. In addition, we evaluated our forecast of pre-tax income at MI on a going-concern basis, and based on cumulative positive pre-tax income at MI in the prior three years, including pre-tax income for 2005, and a forecast of positive pre-tax income in the future, we determined that we no longer required a federal deferred tax asset valuation allowance. This federal deferred tax asset valuation allowance was originally recorded in 2002 as an adjustment to Other Comprehensive Income at MI generated by an increase to MI s Minimum Pension Liability. The gross deferred tax asset on this item was reduced substantially based on the spin-off of the B&W portion of MI s pension plan to B&W. Under the guidelines of SFAS No. 109, we reversed the remaining component of this federal valuation allowance by a credit to our provision for income taxes totaling approximately $50.4 million.

Substantially as a result of the Valuation Allowance Adjustment discussed above, the provision for income taxes decreased $31.2 million to $8.8 million, while income before provision for income taxes increased $101.9 million to $206.7 million. Our effective tax rate for the year ended December 31, 2005 was approximately 4.3%.

MII is a Panamanian corporation that has earned all of its income outside of Panama. Under Panamanian tax law, MII is not subject to income tax in Panama on income earned outside of Panama.

We have provided for income taxes based on the tax laws and rates in the countries in which we conduct our operations. MII and its subsidiaries operate in the U.S. taxing jurisdiction and various other taxing jurisdictions around the world. Each of these jurisdictions has a regime of taxation that varies from the others. The taxation

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regimes vary not only with respect to nominal rates, but also with respect to the allowability of deductions, credits and other benefits and tax bases (for example, revenue versus income). These variances, along with variances in our mix of income from these jurisdictions, are responsible for shifts in our effective tax rate.

Income (loss) from continuing operations before provision for income taxes, provision for income taxes and effective tax rates for MII s major subsidiaries are as follows:

	Income (loss) from Continuing Operations		*Provision for (Benefit from) Income Taxes*		*Effective Tax Rate*	
	2005	*2004*	*2005*	*2004*	*2005*	*2004*
	(In thousands)		*(In thousands)*			
Primarily United States:						
MI	$ 67,114	$22,522	$(17,666)	$17,273	(26.32)%	76.69%
JRMH	(14,514)	(340)	1,699		(11.71)%	0.00%
Non United States:						
International Subsidiaries	154,100	82,658	24,794	22,724	16.09%	27.49%
Total MII						