HALLIBURTON CO
Form 10-Q
July 28, 2006

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

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the quarterly period ended June 30, 2006

OR

[ ] 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 1-3492

HALLIBURTON COMPANY

(a Delaware Corporation)
75-2677995

5 Houston Center
1401 McKinney, Suite 2400
Houston, Texas 77010
(Address of Principal Executive Offices)

Telephone Number - Area Code (713) 759-2600

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 at least the past 90 days.
Yes X No _____

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

Large accelerated filer X Accelerated filer _____ Non-accelerated filer _____

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

As of July 24, 2006, 1,031,152,062 shares of Halliburton Company common stock, $2.50 par value per share, were outstanding.

HALLIBURTON COMPANY

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

HALLIBURTON COMPANY
Condensed Consolidated Statements of Operations
(Unaudited)

(Millions of dollars and shares except per share data)	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Revenue:				
Services	$ 4,720	$ 4,318	$ 9,170	$ 8,520
Product sales	804	656	1,547	1,213
Equity in earnings (losses) of unconsolidated affiliates, net	21	(1)	12	23
Total revenue	5,545	4,973	10,729	9,756
Operating costs and expenses:				
Cost of services	4,080	3,744	7,806	7,486
Cost of sales	654	540	1,267	1,014
General and administrative	100	96	200	197
Gain on sale of business assets, net	(7)	(3)	(17)	(112)
Total operating costs and expenses	4,827	4,377	9,256	8,585
Operating income	718	596	1,473	1,171
Interest expense	(43)	(51)	(90)	(103)
Interest income	38	9	66	21
Foreign currency losses, net	(10)	(7)	(2)	(7)
Other, net	(4)	(3)	(1)	(5)
Income from continuing operations before income taxes and minority interest	699	544	1,446	1,077
Provision for income taxes	(226)	(150)	(481)	(316)
Minority interest in net (income) loss of subsidiaries	36	(10)	25	(18)
Income from continuing operations	509	384	990	743
Income from discontinued operations, net of tax provision of $46, $5, $49, and $7	82	8	89	14
Net income	$ 591	$ 392	$ 1,079	$ 757
Basic income per share:				
Income from continuing operations	$ 0.50	$ 0.38	$ 0.97	$ 0.74
Income from discontinued operations, net	0.08	0.01	0.08	0.01
Net income	$ 0.58	$ 0.39	$ 1.05	$ 0.75
Diluted income per share:				
Income from continuing operations	$ 0.48	$ 0.37	$ 0.93	$ 0.73
Income from discontinued operations, net	0.07	0.01	0.08	0.01
Net income	$ 0.55	$ 0.38	$ 1.01	$ 0.74
Cash dividends per share	$ 0.075	$ 0.0625	$ 0.15	$ 0.125

Basic weighted average common shares outstanding	1,026	1,006	1,025	1,004
Diluted weighted average common shares outstanding	1,070	1,026	1,069	1,024

See notes to condensed consolidated financial statements.

HALLIBURTON COMPANY
Condensed Consolidated Balance Sheets
(Unaudited)

(Millions of dollars and shares except per share data)	June 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and equivalents	$ 3,673	$ 2,391
Receivables:		
Notes and accounts receivable (less allowance for bad debts of $81 and $90)	3,225	3,345
Unbilled work on uncompleted contracts	1,581	1,456
Total receivables	4,806	4,801
Inventories	1,128	953
Current deferred income taxes	582	645
Other current assets	462	522
Total current assets	10,651	9,312
Property, plant, and equipment, net of accumulated depreciation of $3,993 and $3,838	2,774	2,648
Goodwill	774	765
Noncurrent deferred income taxes	476	784
Equity in and advances to related companies	383	382
Other assets	1,116	1,119
Total assets	$ 16,174	$ 15,010
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 1,817	$ 1,967
Advanced billings on uncompleted contracts	1,123	661
Accrued employee compensation and benefits	523	648
Current maturities of long-term debt	360	361
Short-term notes payable	6	22
Other current liabilities	934	768
Total current liabilities	4,763	4,427
Long-term debt	2,772	2,813
Employee compensation and benefits	694	718
Other liabilities	524	535
Total liabilities	8,753	8,493
Minority interest in consolidated subsidiaries	93	145
Shareholders' equity:		
Common shares, par value $2.50 per share - authorized 2,000 shares, issued 1,059 and 1,054 shares	2,647	2,634
Paid-in capital in excess of par value	1,526	1,501
Deferred compensation	-	(98)
Accumulated other comprehensive income	(224)	(266)
Retained earnings	3,899	2,975
	7,848	6,746
Less 30 and 26 shares of treasury stock, at cost	520	374
Total shareholders' equity	7,328	6,372

Total liabilities and shareholders' equity	$	16,174	$	15,010

See notes to condensed consolidated financial statements.

HALLIBURTON COMPANY
Condensed Consolidated Statements of Cash Flows
(Unaudited)

(Millions of dollars)	Six Months Ended June 30 2006	2005
Cash flows from operating activities:		
Net income	$ 1,079	$ 757
Adjustments to reconcile net income to net cash from operations:		
Depreciation, depletion, and amortization	257	252
Provision for deferred income taxes	367	126
Distribution from (advances to) related companies, net of equity in (earnings) losses	(16)	20
Gain on sale of assets	(113)	(112)
Asbestos and silica liability payment related to Chapter 11 filing	-	(2,345)
Collection of asbestos- and silica-related receivables	91	1,028
Other changes:		
Receivables and unbilled work on uncompleted contracts	(72)	250
Accounts receivable facilities transactions	-	(6)
Inventories	(164)	(141)
Accounts payable	(163)	(411)
Contributions to pension plans	(142)	(38)
Advanced billings	464	(68)
Other	(1)	25
Total cash flows from operating activities	1,587	(663)
Cash flows from investing activities:		
Capital expenditures	(381)	(289)
Sales of property, plant, and equipment	69	59
Dispositions (acquisitions) of business assets, net of cash disposed	283	201
Proceeds from sales of securities	10	-
Sales (purchases) of short-term investments in marketable securities, net	-	891
Other investing activities	(17)	(19)
Total cash flows from investing activities	(36)	843
Cash flows from financing activities:		
Proceeds from long-term debt, net of offering costs	30	12
Proceeds from exercises of stock options	117	126
Payments to reacquire common stock	(190)	(9)
Borrowings (repayments) of short-term debt, net	(10)	29
Payments of long-term debt	(66)	(541)
Payments of dividends to shareholders	(155)	(126)
Other financing activities	(5)	(5)
Total cash flows from financing activities	(279)	(514)
Effect of exchange rate changes on cash	10	(8)
Increase (decrease) in cash and equivalents	1,282	(342)
Cash and equivalents at beginning of period	2,391	1,917
Cash and equivalents at end of period	$ 3,673	$ 1,575
Supplemental disclosure of cash flow information:		
Cash payments during the period for:		
Interest	$ 91	$ 112

Income taxes	$ 156	$ 150

See notes to condensed consolidated financial statements.

HALLIBURTON COMPANY
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1. Basis of Presentation and Description of Company

The accompanying unaudited condensed consolidated financial statements were prepared using generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Regulation S-X. Accordingly, these financial statements do not include all information or footnotes required by generally accepted accounting principles for annual financial statements and should be read together with our 2005 Annual Report on Form 10-K.

Certain prior period amounts have been reclassified to be consistent with the current presentation. See Note 4 for further information.

Our accounting policies are in accordance with generally accepted accounting principles in the United States of America. The preparation of financial statements in conformity with these accounting principles requires us to make estimates and assumptions that affect:

- the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; and
- the reported amounts of revenue and expenses during the reporting period.

Ultimate results could differ from our estimates.

In our opinion, the condensed consolidated financial statements included herein contain all adjustments necessary to present fairly our financial position as of June 30, 2006, the results of our operations for the three and six months ended June 30, 2006 and 2005, and our cash flows for the six months ended June 30, 2006 and 2005. Such adjustments are of a normal recurring nature. The results of operations for the three and six months ended June 30, 2006 may not be indicative of results for the full year.

Common share and earnings per share amounts have been restated for all periods presented to reflect the increased number of common shares outstanding resulting from the two-for-one common stock split, in the form of a stock dividend, paid on July 14, 2006 to stockholders of record as of June 23, 2006.

We intend to completely separate KBR, Inc. from Halliburton as expeditiously as possible through a tax-free dividend distribution of KBR, Inc. stock to Halliburton stockholders. The distribution will be preceded by the filing of a Form 10 registration statement with the United States Securities and Exchange Commission (SEC) to register the shares of KBR, Inc. stock under the Securities Exchange Act of 1934. After the distribution, KBR, Inc. will be a separately traded public company.

The distribution of KBR, Inc. stock may be preceded by an initial public offering (IPO) of less than 20% of KBR, depending on market conditions for initial public offerings, valuations for publicly-traded engineering and construction companies, and KBR-specific business conditions and results of operations. In April 2006, KBR, Inc. filed a Registration Statement on Form S-1 with the SEC for an IPO of less than 20% of KBR, Inc. Since the initial filing, however, the market for initial public offerings has become less favorable, which has resulted in many offerings being postponed or withdrawn. In addition, recently announced operating results on KBR's Escravos project and the outcome of ongoing discussions with our customer on the Escravos project about mitigating future risk could impact the desirability or timing of a KBR, Inc. IPO. We do not intend to delay the complete separation of KBR to wait on favorable conditions for an IPO of KBR, Inc.

Before making the distribution of KBR, Inc. stock, we intend to seek a ruling from the Internal Revenue Service that, among other things, no gain or loss will be recognized by Halliburton or its stockholders as a result of a distribution of KBR, Inc. stock, a process that could be completed within approximately nine months. Prior to the IPO or separation occurring, we will enter into various agreements to govern the separation of KBR from us, including, among others, a master separation agreement, transition services agreements, and a tax sharing agreement. The master separation agreement will provide for, among other things, KBR's responsibility for liabilities relating to its business and Halliburton's responsibility for liabilities unrelated to KBR's business. Halliburton expects to provide indemnification in favor of KBR under the master separation agreement for certain contingent liabilities. The Halliburton performance guarantees and letter of credit guarantees that are currently in place in favor of KBR's customers or lenders will continue after the separation of KBR until these guarantees expire by their terms, although KBR will compensate Halliburton for these guarantees and indemnify Halliburton if Halliburton is required to perform under any of these guarantees. The tax sharing agreement will provide for allocations of United States income tax liabilities and other agreements between us and KBR with respect to tax matters. Under the transition services agreements, we expect to continue providing various interim corporate support services to KBR, and KBR will continue to provide various interim corporate support services to us.

Any sale of KBR, Inc. stock under a Form S-1 would be registered under the Securities Act of 1933, and such shares of common stock would only be offered and sold by means of a prospectus. This quarterly report does not constitute an offer to sell or the solicitation of any offer to buy any securities of KBR, and there will not be any sale of any such securities in any state in which such offer, solicitation, or sale would be unlawful prior to registration or qualification under the securities laws of such state.

Note 2. Percentage-of-Completion Contracts

Unapproved claims

The amounts of unapproved claims included in determining the profit or loss on contracts and the amounts booked to "Unbilled work on uncompleted contracts" or "Other assets" as of June 30, 2006 and December 31, 2005 are as follows:

Millions of dollars	June 30, 2006	December 31, 2005
Probable unapproved claims	$ 186	$ 175
Probable unapproved claims accrued revenue	183	172
Probable unapproved claims from unconsolidated related companies	93	92

As of June 30, 2006, the probable unapproved claims, including those from unconsolidated related companies, relate to seven contracts, most of which are complete or substantially complete. See Note 11 for a discussion of United States government contract claims, which are not included in the table above.

A significant portion of the probable unapproved claims as of June 30, 2006 ($150 million related to our consolidated entities and $45 million related to our unconsolidated related companies) arose from three completed projects with Petroleos Mexicanos (PEMEX) that are currently subject to arbitration proceedings. In addition, we have "Other assets" of $64 million for previously approved services that are unpaid by PEMEX and have been included in these arbitration proceedings. Actual amounts we are seeking from PEMEX in the arbitration proceedings are in excess of these amounts. The arbitration proceedings are expected to extend through 2007. PEMEX has asserted unspecified counterclaims in each of the three arbitrations; however, it is premature based upon our current understanding of those counterclaims to make any assessment of their merits. As of June 30, 2006, we had not accrued any amounts related to the counterclaims in the arbitrations.

At June 30, 2006, $174 million of the amount classified as probable unapproved claims accrued revenue included in the table above is reflected as “Other assets” on the condensed consolidated balance sheets since the contracts will likely not be settled within one year. The remaining $9 million is included in “Unbilled work on uncompleted contracts” since the contracts are expected to be settled within one year. Our unconsolidated related companies include probable unapproved claims as revenue to determine the amount of profit or loss for their contracts. Probable unapproved claims from our related companies are included in “Equity in and advances to related companies.”

Unapproved change orders

We have contracts for which we are negotiating change orders to the contract scope and have agreed upon the scope of work but not the price. These change orders amount to $251 million at June 30, 2006. Unapproved change orders at December 31, 2005 were $61 million. Our share of change orders from unconsolidated related companies totaled $3 million at June 30, 2006 and $5 million at December 31, 2005.

Included in the $251 million of change orders is $200 million for our consolidated 50% owned gas-to-liquids project in Escravos, Nigeria. In the second quarter of 2006, we recorded a $148 million charge, before income taxes and minority interest, related to this project. This charge was primarily attributable to increases in the overall estimated cost to complete the project. The project is approximately 30% complete as of June 30, 2006. The project has experienced delays relating to civil unrest and security on the Escravos River, near the project site. Further delays have resulted from scope changes and engineering and construction modifications. We are currently discussing with the majority owner of our customer several contract changes to mitigate our construction risk associated with this contract. We have reached a preliminary agreement with our customer and are working on a final agreement to fund the $200 million in change orders. We are continuing discussions regarding additional contract changes related to scheduled completion, site access and security, and other factors to mitigate our future risks on this project.

Barracuda-Caratinga project

Following is the status, as of June 30, 2006, of our Barracuda-Caratinga project, a multiyear construction project to develop the Barracuda and Caratinga crude oilfields located off the coast of Brazil:

- the Barracuda and Caratinga vessels are both fully operational. In April 2006, we executed an agreement with Petrobras that enabled us to achieve conclusion of the Lenders’ Reliability Test and final acceptance of the FPSOs. These acceptances eliminate any further risk of liquidated damages being assessed but do not address the bolt arbitration discussed below;
- in the first quarter of 2006, we recorded a loss of $15 million related to additional costs to finalize the project and warranty matters. We have recorded inception-to-date losses on this project of approximately $785 million; and
    - our remaining obligation under the April 2006 agreement is primarily for warranty on the two vessels.

In addition, at Petrobras’ direction, we have replaced certain bolts located on the subsea flowlines that have failed through mid-November 2005, and we understand that additional bolts have failed thereafter, which have been replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. The original design specification for the bolts was issued by Petrobras, and as such, we believe the cost resulting from any replacement is not our responsibility. Petrobras has indicated, however, that they do not agree with our conclusion. We have notified Petrobras that this matter is in dispute. We believe several possible solutions may exist, including replacement of the bolts. Estimates indicate that costs of these various solutions range up to $140 million. Should Petrobras instruct us to replace the subsea bolts, the prime contract terms and conditions regarding change orders require that Petrobras make progress payments of our reasonable costs incurred. Petrobras could, however, perform any replacement of the bolts and seek reimbursement from KBR. In March 2006, Petrobras notified KBR that they have submitted this matter to arbitration claiming $220 million plus interest for the cost of monitoring and replacing the defective stud bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys fees. We disagree with the Petrobras claim since the bolts met Petrobras’ design specification, and we do not believe there is any basis for the amount claimed by Petrobras. We intend to vigorously defend ourselves and pursue recovery of the costs we have incurred to date through the arbitration process. As of June 30, 2006, we have not accrued any amounts related to this arbitration.

Note 3. Dispositions

Production Services

In the second quarter of 2006, we completed the sale of KBR's Production Services group, which was part of our Energy and Chemicals segment. In connection with the sale, we received net proceeds of $265 million. The sale of Production Services resulted in a pretax gain of $123 million in the second quarter of 2006, which is reflected in discontinued operations. As a result of the sale agreement in March 2006, Production Services operations and assets and liabilities were classified as discontinued operations, and all prior periods presented were reclassified as well. At December 31, 2005, Production Services assets were $207 million, of which $140 million were classified as current, and liabilities were $64 million, of which $54 million were classified as current.

Subsea 7, Inc.

In January 2005, we completed the sale of our 50% interest in Subsea 7, Inc. to our joint venture partner, Siem Offshore (formerly DSND Subsea ASA), for approximately $200 million in cash. As a result of the transaction, we recorded a gain of approximately $110 million during the first quarter of 2005. We accounted for our 50% ownership of Subsea 7, Inc. using the equity method in our Production Optimization segment.

Note 4. Business Segment Information

We have six business segments: Production Optimization, Fluid Systems, Drilling and Formation Evaluation, Digital and Consulting Solutions, Government and Infrastructure, and Energy and Chemicals.

We refer to the combination of the Production Optimization, Fluid Systems, Drilling and Formation Evaluation, and Digital and Consulting Solutions segments as the Energy Services Group and the combination of our Government and Infrastructure and our Energy and Chemicals segments as KBR.

During the second quarter of 2006, we moved slickline services, tubing conveyed perforating, and underbalanced applications from the Production Optimization segment to the Drilling and Formation Evaluation segment, as these services are more closely aligned with the Drilling and Formation Evaluation segment. Prior period balances have been reclassified to reflect this change. In addition, for internal management purposes we have combined our Drilling and Formation Evaluation and Digital and Consulting Solutions divisions, forming three Energy Services Group internal divisions. However, we will continue to disclose four segments for the Energy Services Group.

KBR's Production Services operations were moved into discontinued operations for reporting purposes in the first quarter of 2006. All prior period amounts have been reclassified to discontinued operations.

The table below presents information on our segments.

	Three Months Ended June 30		Six Months Ended June 30	
Millions of dollars	2006	2005	2006	2005
Revenue:				
Production Optimization	$ 1,292	$ 971	$ 2,488	$ 1,805
Fluid Systems	870	699	1,706	1,330
Drilling and Formation Evaluation	774	641	1,499	1,196
Digital and Consulting Solutions	180	160	361	324
Total Energy Services Group	3,116	2,471	6,054	4,655
Government and Infrastructure	1,881	2,035	3,589	4,123
Energy and Chemicals	548	467	1,086	978
Total KBR	2,429	2,502	4,675	5,101
Total revenue	$ 5,545	$ 4,973	$ 10,729	$ 9,756
Operating income (loss):				
Production Optimization	$ 357	$ 231	$ 681	$ 511
Fluid Systems	193	135	375	248
Drilling and Formation Evaluation	189	140	361	231
Digital and Consulting Solutions	52	16	101	45
Total Energy Services Group	791	522	1,518	1,035
Government and Infrastructure	68	72	88	125
Energy and Chemicals	(109)	39	(67)	80
Total KBR	(41)	111	21	205
General corporate	(32)	(37)	(66)	(69)
Total operating income	$ 718	$ 596	$ 1,473	$ 1,171

Intersegment revenue was immaterial. Our equity in pretax earnings and losses of unconsolidated affiliates that are accounted for on the equity method is included in revenue and operating income of the applicable segment.
Total revenue for the three and six months ended June 30, 2006 included $1.6 billion and $2.9 billion or 28% and 27% of consolidated revenue from the United States Government, which was derived almost entirely by the Government and Infrastructure segment. Revenue from the United States Government during the three and six months ended June 30, 2005 represented 33% and 34% of consolidated revenue. No other customer represented more than 10% of consolidated revenue in any period presented.

Note 5. Accounts Receivable Facilities

Under our Energy Services Group accounts receivable securitization facility, we had the ability to sell up to $300 million in undivided ownership interest in a pool of receivables. During the fourth quarter of 2005, $256 million in undivided ownership interest that had been sold to unaffiliated companies was collected and the balance retired. No further receivables were sold, and the facility was terminated in the first quarter of 2006.
In May 2004, we entered into an agreement to sell, assign, and transfer the entire title and interest in specified United States government accounts receivable of KBR to a third party. The face value of the receivables sold to the third party was reflected as a reduction of accounts receivable in our condensed consolidated balance sheets. The total amount of receivables outstanding under this agreement was approximately $257 million as of June 30, 2005. As of December 31, 2005, these receivables were collected, the balance was retired, and the facility was terminated.

Note 6. Inventories

Inventories are stated at the lower of cost or market. We manufacture in the United States certain finished products and have parts inventories for drill bits, completion products, bulk materials, and other tools that are recorded using the last-in, first-out method totaling $59 million at June 30, 2006 and $42 million at December 31, 2005. If the average cost method had been used, total inventories would have been $24 million higher than reported at June 30, 2006 and $21 million higher than reported at December 31, 2005. Inventories consisted of the following:

Millions of dollars	June 30, 2006	December 31, 2005
Finished products and parts	$ 801	$ 715
Raw materials and supplies	236	181
Work in process	91	57
Total	$ 1,128	$ 953

Finished products and parts are reported net of obsolescence accruals of $98 million at both June 30, 2006 and December 31, 2005.

Note 7. Restricted and Committed Cash

At June 30, 2006, we had restricted cash of $129 million, which primarily consisted of:

- $102 million as collateral for potential future insurance claim reimbursements included in “Other assets”; and
- $23 million related to cash collateral agreements for outstanding letters of credit for various construction projects included in “Other assets.”

At December 31, 2005, we had restricted cash of $123 million in “Other assets,” which primarily consisted of similar items as above.

Cash and equivalents include cash from advanced payments related to contracts in progress held by ourselves or our joint ventures that we consolidate for accounting purposes. The use of these cash balances is limited to the specific projects or joint venture activities and is not available for other projects, general cash needs, or distribution to us without approval of the board of directors of the respective joint venture or subsidiary. At June 30, 2006 and December 31, 2005, cash and equivalents include approximately $585 million and $223 million, respectively, in cash from advanced payments held by ourselves or our joint ventures that we consolidate for accounting purposes.

Note 8. Debt

The stock conversion rate for the $1.2 billion of 3.125% convertible senior notes issued in June 2003 has changed as a result of the recent stock split and an increase to our quarterly dividend. As of June 30, 2006, the stock conversion rate is 53.15 shares of common stock per $1,000 principal amount of notes with a conversion price of approximately $18.825.

Note 9. Comprehensive Income

The components of other comprehensive income included the following:

	Three Months Ended June 30		Six Months Ended June 30	
Millions of dollars	2006	2005	2006	2005
Net income	$ 591	$ 392	$ 1,079	$ 757
Cumulative translation adjustments	43	(19)	37	(29)
Realization of (gains) losses included in net income	(19)	-	(16)	3
Net cumulative translation adjustments	24	(19)	21	(26)
Unrealized net gains (losses) on investments and derivatives	15	2	21	(1)
Realization of gains on investments and derivatives included in net income	(2)	(3)	-	(13)
Net unrealized gains (losses) on investments and derivatives	13	(1)	21	(14)
Total comprehensive income	$ 628	$ 372	$ 1,121	$ 717

Accumulated other comprehensive income consisted of the following:

Millions of dollars	June 30, 2006	December 31, 2005
Cumulative translation adjustments	$ (51)	$ (72)
Pension liability adjustments	(184)	(184)
Unrealized gains (losses) on investments and derivatives	11	(10)
Total accumulated other comprehensive income	$ (224)	$ (266)

Note 10. Asbestos Insurance Recoveries

Several of our subsidiaries, particularly DII Industries and Kellogg Brown & Root, had been named as defendants in a large number of asbestos- and silica-related lawsuits. Effective December 31, 2004, we resolved all open and future claims in the prepackaged Chapter 11 proceedings of DII Industries, Kellogg Brown & Root, and our other affected subsidiaries (which were filed on December 16, 2003) when the plan of reorganization became final and nonappealable.

During 2004, we settled insurance disputes with substantially all the insurance companies for asbestos- and silica-related claims and all other claims under the applicable insurance policies and terminated all the applicable insurance policies. Under the terms of our insurance settlements, we would receive cash proceeds with a nominal amount of approximately $1.5 billion and with a then present value of approximately $1.4 billion for our asbestos- and silica-related insurance receivables. The present value was determined by discounting the expected future cash payments with a discount rate implicit in the settlements, which ranged from 4.0% to 5.5%. This discount is being accreted as interest income (classified as discontinued operations) over the life of the expected future cash payments. Cash payments of approximately $91 million related to these receivables were received in the first six months of 2006. Under the terms of the settlement agreements, we will receive cash payments of the remaining amounts, totaling $337 million at June 30, 2006, in several installments through 2010.

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The following table presents a rollforward of our asbestos- and silica-related insurance receivables.

Millions of dollars		
Insurance for asbestos- and silica-related liabilities:		
December 31, 2005 balance (of which $193 was current)	$	396
Payments received		(91)
Accretion		9
Insurance for asbestos- and silica-related liabilities - June 30, 2006 balance (of which $120 is current)	$	314

A significant portion of the insurance coverage applicable to Worthington Pump, a former division of DII Industries, was alleged by Federal-Mogul (and others who formerly were associated with Worthington Pump prior to its acquisition by DII Industries) to be shared with them. During 2004, we reached an agreement with Federal-Mogul, our insurance companies, and another party sharing in the insurance coverage to obtain their consent and support of a partitioning of the insurance policies. Under the terms of the agreement, DII Industries was allocated 50% of the limits of any applicable insurance policy, and the remaining 50% of limits of the insurance policies were allocated to the remaining policyholders. As part of the settlement, DII Industries agreed to pay $46 million in three installment payments. In 2004, we accrued $44 million, which represents the present value of the $46 million to be paid. The discount is accreted as interest expense (classified as discontinued operations) over the life of the expected future cash payments beginning in the fourth quarter of 2004. The first payment of $16 million was paid in January 2005, and the second payment of $15 million was paid in January 2006. The third and final payment of $15 million will be made in January 2007.

DII Industries and Federal-Mogul agreed to share equally in recoveries from insolvent London-based insurance companies. To the extent that Federal-Mogul's recoveries from certain insolvent London-based insurance companies received on or before January 1, 2006 did not equal at least $4.5 million, DII Industries agreed to also pay to Federal-Mogul the difference between their recoveries from the insolvent London-based insurance companies and $4.5 million. Accordingly, DII Industries paid Federal-Mogul $1.6 million in January 2006. This amount is expected to be received back from Federal-Mogul following recoveries received by Federal-Mogul from the insolvent London-based insurance companies.

Under the insurance settlements entered into as part of the resolution of our Chapter 11 proceedings, we have agreed to indemnify our insurers under certain historic general liability insurance policies in certain situations. We have concluded that the likelihood of any claims triggering the indemnity obligations is remote, and we believe any potential liability for these indemnifications will be immaterial. At June 30, 2006, we had not recorded any liability associated with these indemnifications.

Note 11. United States Government Contract Work

We provide substantial work under our government contracts to the United States Department of Defense (DoD) and other governmental agencies. These contracts include our worldwide United States Army logistics contracts, known as LogCAP, and contracts to rebuild Iraq's petroleum industry, such as PCO Oil South. Our government services revenue related to Iraq totaled approximately $1.3 billion and $2.4 billion for the three and six months ended June 30, 2006 compared to $1.4 billion and $2.9 billion for the three and six months ended June 30, 2005.

Given the demands of working in Iraq and elsewhere for the United States government, we expect that from time to time we will have disagreements or experience performance issues with the various government customers for which we work. If performance issues arise under any of our government contracts, the government retains the right to pursue remedies which could include threatened termination or termination, under any affected contract. If any contract were so terminated, we may not receive award fees under the affected contract, and our ability to secure future contracts could be adversely affected, although we would receive payment for amounts owed for our allowable costs under cost-reimbursable contracts. Other remedies that could be sought by our government customers for any improper activities or performance issues include sanctions such as forfeiture of profits, suspension of payments, fines, and suspensions or debarment from doing business with the government. Further, the negative publicity that could arise from disagreements with our customers or sanctions as a result thereof could have an adverse effect on our reputation in the industry, reduce our ability to compete for new contracts, and may also have a material adverse effect on our business, financial condition, results of operations, and cash flow.

DCAA audit issues

Our operations under United States government contracts are regularly reviewed and audited by the Defense Contract Audit Agency (DCAA) and other governmental agencies. The DCAA serves in an advisory role to our customer. When issues are found during the governmental agency audit process, these issues are typically discussed and reviewed with us. The DCAA then issues an audit report with its recommendations to our customer's contracting officer. In the case of management systems and other contract administrative issues, the contracting officer is generally with the Defense Contract Management Agency (DCMA). We then work with our customer to resolve the issues noted in the audit report. If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable, or, if already reimbursed, the costs must be refunded to the customer. Our revenue recorded for government contract work is reduced for our estimate of costs that may be categorized as disputed or unallowable as a result of cost overruns or the audit process.

Laundry. Prior to the fourth quarter of 2005, we received notice from the DCAA that it recommended withholding $18 million of subcontract costs related to the laundry service for one task order in southern Iraq for which it believed we and our subcontractors have not provided adequate levels of documentation supporting the quantity of the services provided. In the fourth quarter of 2005, the DCAA issued a notice to disallow costs totaling approximately $12 million, releasing $6 million of amounts previously withheld. In the second quarter of 2006, we successfully resolved this matter with the DCAA and received payment of the remaining $12 million.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCAA recommended that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. As of June 30, 2006, the DCAA had issued notices to disallow $56 million of the withheld amounts, of which $17 million has been withheld from our subcontractors. We will continue working with the government and our subcontractors to resolve this issue.

Dining facilities. In September 2005, Eurest Support Services (Cyprus) International Limited, or ESS, filed suit against us alleging various claims associated with its performance as a subcontractor in conjunction with our LogCAP contract in Iraq. The case was settled during the first quarter of 2006 without material impact to us.

Other issues. The DCAA is continuously performing audits of costs incurred for the foregoing and other services provided by us under our government contracts. During these audits, there are likely to be questions raised by the DCAA about the reasonableness or allowability of certain costs or the quality or quantity of supporting documentation. The DCAA might recommend withholding some portion of the questioned costs while the issues are being resolved with our customer. Because of the intense scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve. We do not believe any potential withholding will have a significant or sustained impact on our liquidity.

Investigations

In the first quarter of 2005, the United States Department of Justice (DOJ) issued two indictments associated with overbilling issues we previously reported to the Department of Defense Inspector General's office as well as to our customer, the Army Materiel Command, against a former KBR procurement manager and a manager of La Nouvelle Trading & Contracting Company, W.L.L.

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In October 2004, we reported to the Department of Defense Inspector General's office that two former employees in Kuwait may have had inappropriate contacts with individuals employed by or affiliated with two third-party subcontractors prior to the award of the subcontracts. The Inspector General's office may investigate whether these two employees may have solicited and/or accepted payments from these third-party subcontractors while they were employed by us.

In October 2004, a civilian contracting official in the Army Corps of Engineers (COE) asked for a review of the process used by the COE for awarding some of the contracts to us. We understand that the Department of Defense Inspector General's office may review the issues involved.

We understand that the DOJ, an Assistant United States Attorney based in Illinois, and others are investigating these and other individually immaterial matters we have reported related to our government contract work in Iraq. If criminal wrongdoing were found, criminal penalties could range up to the greater of $500,000 in fines per count for a corporation or twice the gross pecuniary gain or loss. We also understand that current and former employees of KBR have received subpoenas and have given or may give grand jury testimony related to some of these matters.

Claims

In addition, we had probable unapproved claims totaling $42 million at June 30, 2006 for the LogCAP contract. These unapproved claims related to this contract are where our costs have exceeded the customer's funded value of the task order.

DCMA system reviews

Report on estimating system. In December 2004, the DCMA granted continued approval of our estimating system, stating that our estimating system is "acceptable with corrective action." We are in the process of completing these corrective actions. Specifically, based on the unprecedented level of support that our employees are providing the military in Iraq, Kuwait, and Afghanistan, we needed to update our estimating policies and procedures to make them better suited to such contingency situations. Additionally, we have completed our development of a detailed training program and have made it available to all estimating personnel to ensure that employees are adequately prepared to deal with the challenges and unique circumstances associated with a contingency operation.

Report on purchasing system. As a result of a Contractor Purchasing System Review by the DCMA during the fourth quarter of 2005, the DCMA granted the continued approval of our government contract purchasing system. The DCMA's October 2005 approval letter stated that our purchasing system's policies and practices are "effective and efficient, and provide adequate protection of the Government's interest."

Report on accounting system. We received two draft reports on our accounting system, which raised various issues and questions. We have responded to the points raised by the DCAA, but this review remains open. Once the DCAA finalizes the report, it will be submitted to the DCMA, who will make a determination of the adequacy of our accounting systems for government contracting.

The Balkans

We have had inquiries in the past by the DCAA and the civil fraud division of the DOJ into possible overcharges for work performed during 1996 through 2000 under a contract in the Balkans, for which inquiry has not yet been completed by the DOJ. Based on an internal investigation, we credited our customer approximately $2 million during 2000 and 2001 related to our work in the Balkans as a result of billings for which support was not readily available. We believe that the preliminary DOJ inquiry relates to potential overcharges in connection with a part of the Balkans contract under which approximately $100 million in work was done. We believe that any allegations of overcharges would be without merit. Amounts accrued related to this matter as of June 30, 2006 are not material.

Note 12. Other Commitments and Contingencies

Foreign Corrupt Practices Act investigations

The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which we are furnishing, regarding current and former agents used in connection with multiple projects over the past 20 years located both in and outside of Nigeria in which The M .W. Kellogg Company, M. W. Kellogg, Ltd., Kellogg Brown & Root or their joint ventures, as well as the Halliburton energy services business, were participants.

TSKJ is a private limited liability company registered in Madeira, Portugal whose members are Technip SA of France, Snamprogetti Netherlands B.V. (a subsidiary of Saipem SpA of Italy), JGC Corporation of Japan, and Kellogg Brown & Root (a subsidiary of ours and successor to The M.W. Kellogg Company), each of which has a 25% interest in the venture. TSKJ and other similarly owned entities entered into various contracts to build and expand the liquefied natural gas project for Nigeria LNG Limited, which is owned by the Nigerian National Petroleum Corporation, Shell Gas B.V., Cleag Limited (an affiliate of Total), and Agip International B.V. (an affiliate of ENI SpA of Italy). M.W. Kellogg Limited is a joint venture in which we have a 55% interest; and M.W. Kellogg Limited and The M.W. Kellogg Company were subsidiaries of Dresser Industries before our 1998 acquisition of Dresser Industries. The M.W. Kellogg Company was later merged with a subsidiary of ours to form Kellogg Brown & Root, one of our subsidiaries.

The SEC and the DOJ have been reviewing these matters in light of the requirements of the United States Foreign Corrupt Practices Act (FCPA). In addition to performing our own investigation, we have been cooperating with the SEC and the DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. Our Board of Directors has appointed a committee of independent directors to oversee and direct the FCPA investigations.

The matters under investigation related to the Bonny Island project cover an extended period of time (in some cases significantly before our 1998 acquisition of Dresser Industries). We have produced documents to the SEC and the DOJ both voluntarily and pursuant to company subpoenas from the files of numerous officers of Halliburton and KBR, including current and former executives of Halliburton and KBR, and we are making our employees available to the SEC and the DOJ for interviews. In addition, we understand that the SEC has issued a subpoena to A. Jack Stanley, who formerly served as a consultant and chairman of KBR, and to others, including certain of our current and former KBR employees, former executive officers of KBR, and at least one subcontractor of KBR. We further understand that the DOJ has invoked its authority under a sitting grand jury to issue subpoenas for the purpose of obtaining information abroad, and we understand that other partners in TSKJ have provided information to the DOJ and the SEC with respect to the investigations, either voluntarily or under subpoenas.

The SEC and DOJ investigations include an examination of whether TSKJ’s engagements of Tri-Star Investments as an agent and a Japanese trading company as a subcontractor to provide services to TSKJ were utilized to make improper payments to Nigerian government officials. In connection with the Bonny Island project, TSKJ entered into a series of agency agreements, including with Tri-Star Investments, of which Jeffrey Tesler is a principal, commencing in 1995 and a series of subcontracts with a Japanese trading company commencing in 1996. We understand that a French magistrate has officially placed Mr. Tesler under investigation for corruption of a foreign public official. In Nigeria, a legislative committee of the National Assembly and the Economic and Financial Crimes Commission, which is organized as part of the executive branch of the government, are also investigating these matters. Our representatives have met with the French magistrate and Nigerian officials. In October 2004, representatives of TSKJ voluntarily testified before the Nigerian legislative committee.

As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made to Nigerian officials.

We notified the other owners of TSKJ of information provided by the investigations and asked each of them to conduct their own investigation. TSKJ has suspended the receipt of services from and payments to Tri-Star Investments and the Japanese trading company and has considered instituting legal proceedings to declare all agency agreements with Tri-Star Investments terminated and to recover all amounts previously paid under those agreements. In February 2005, TSKJ notified the Attorney General of Nigeria that TSKJ would not oppose the Attorney General's efforts to have sums of money held on deposit in banks in Switzerland transferred to Nigeria and to have the legal ownership of such sums determined in the Nigerian courts.

In June 2004, all relationships with Mr. Stanley and another consultant and former employee of M. W. Kellogg, Ltd. were terminated. The terminations occurred because of violations of our Code of Business Conduct that allegedly involved the receipt of improper personal benefits from Mr. Tesler in connection with TSKJ's construction of the Bonny Island project.

We have also suspended the services of another agent who has worked for KBR outside of Nigeria on several current projects and on numerous older projects going back to the early 1980's until such time, if ever, as we can satisfy ourselves regarding the agent's compliance with applicable law and our Code of Business Conduct. In addition, we are actively reviewing the compliance of an additional agent on a separate current Nigerian project with respect to which we have recently received from a joint venture partner on that project allegations of wrongful payments made by such agent.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss. Both the SEC and the DOJ could argue that continuing conduct may constitute multiple violations for purposes of assessing the penalty amounts per violation. Agreed dispositions for these types of matters sometimes result in a monitor being appointed by the SEC and/or the DOJ to review future business and practices with the goal of ensuring compliance with the FCPA. Fines and civil and criminal penalties could be mitigated, in the government's discretion, depending on the level of the cooperation in the investigations.

Potential consequences of a criminal indictment arising out of any of these investigations could include suspension by the DoD or another federal, state, or local government agency of KBR and its affiliates from their ability to contract with United States, state or local governments, or government agencies. If a criminal or civil violation were found, KBR and its affiliates could be debarred from future contracts or new orders under current contracts to provide services to any such parties. During 2005, KBR and its affiliates had revenue of approximately $6.6 billion from its government contracts work with agencies of the United States or state or local governments. If necessary, we would seek to obtain administrative agreements or waivers from the DoD and other agencies to avoid suspension or debarment. Suspension or debarment from the government contracts business would have a material adverse effect on the business, results of operations, and cash flows of KBR and Halliburton.

These investigations could also result in third-party claims against us, which may include claims for special, indirect, derivative or consequential damages, damage to our business or reputation, loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, adverse consequences on our ability to obtain or continue financing for current or future projects or claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us or our subsidiaries. In addition, we could incur costs and expenses for any monitor required by or agreed to with governmental authority to review our continued compliance with FCPA law.

As of June 30, 2006, we have not accrued any amounts related to these investigations other than our current legal expenses.

Bidding practices investigation

In connection with the investigation into payments related to the Bonny Island project in Nigeria, information has been uncovered suggesting that Mr. Stanley and other former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects, and that such coordination possibly began as early as the mid-1980s.

On the basis of this information, we and the DOJ have broadened our investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former

employees may have received payments in connection with bidding practices on some foreign projects.

If violations of applicable United States antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by, or relationship issues with customers, are also possible.

As of June 30, 2006, we had not accrued any amounts related to this investigation other than our current legal expenses.

Securities and related litigation

In June 2002, a class action lawsuit was filed against us in federal court on behalf of purchasers of our common stock during the period of approximately May 1998 until approximately May 2002 alleging violations of the federal securities laws in connection with the accounting change and disclosures involved in the SEC investigation related to a change in accounting for revenue on long-term construction projects and related disclosures, which we settled with the SEC in the second quarter of 2004. In addition, the plaintiffs allege that we overstated our revenue from unapproved claims by recognizing amounts not reasonably estimable or probable of collection. In the weeks that followed, approximately twenty similar class actions were filed against us. Several of those lawsuits also named as defendants Arthur Andersen LLP, our independent accountants for the period covered by the lawsuits, and several of our present or former officers and directors. The class action cases were later consolidated, and the amended consolidated class action complaint, styled *Richard Moore, et al. v. Halliburton Company, et al.,* was filed and served upon us in April 2003 (the "*Moore* class action").

In early May 2003, we announced that we had entered into a written memorandum of understanding setting forth the terms upon which the *Moore* class action would be settled. In June 2003, the lead plaintiffs in the *Moore* class action filed a motion for leave to file a second amended consolidated complaint, which was granted by the court. In addition to restating the original accounting and disclosure claims, the second amended consolidated complaint includes claims arising out of the 1998 acquisition of Dresser Industries, Inc. by Halliburton, including that we failed to timely disclose the resulting asbestos liability exposure (the "Dresser claims"). The Dresser claims were included in the settlement discussions leading up to the signing of the memorandum of understanding and were among the claims the parties intended to have resolved by the terms of the proposed settlement of the consolidated *Moore* class action and the derivative action. The memorandum of understanding called for Halliburton to pay $6 million, which would be funded by insurance proceeds.

In June 2004, the court entered an order preliminarily approving the settlement. Following the transfer of the case to another district judge and a final hearing on the fairness of the settlement the court entered an order in September 2004 holding that evidence of the settlement's fairness was inadequate, denying the motion for final approval of the settlement in the *Moore* class action, and ordering the parties, among other things, to mediate. After the court's denial of the motion to approve the settlement, we withdrew from the settlement as we believe we are entitled to do by its terms. The mediation was held in January 2005, but was declared by the mediator to be at an impasse with no settlement having been reached.

In April 2005, the court appointed new co-lead counsel and a new lead plaintiff, directed that they file a third consolidated amended complaint, and that we file our motion to dismiss. The court held oral arguments on that motion in August 2005, at which time the court took the motion under advisement. On March 14, 2006, the court entered an order in which it granted the motion to dismiss with respect to claims arising prior to June 1999 and granted the motion with respect to certain other claims while permitting the plaintiffs to replead those claims to correct deficiencies in their earlier complaint. On April 4, 2006, the plaintiffs filed their fourth amended consolidated complaint. We have filed a motion to dismiss those portions of the complaint that have been replead. The court has scheduled the hearing on that motion for the end of July 2006.

As of June 30, 2006, we had not accrued any amounts related to this matter.

Newmont Gold

In July 1998, Newmont Gold, a gold mining and extraction company, filed a lawsuit over the failure of a blower manufactured and supplied to Newmont by Roots, a former division of Dresser Equipment Group. The plaintiff alleges that during the manufacturing process, Roots had reversed the blades of a component of the blower known as the inlet guide vane assembly, resulting in the blower's failure and the shutdown of the gold extraction mill for a period of approximately one month during 1996. In January 2002, a Nevada trial court granted summary judgment to Roots on all counts, and Newmont appealed. In February 2004, the Nevada Supreme Court reversed the summary judgment and remanded the case to the trial court, holding that fact issues existed requiring a trial. Based on pretrial reports, the damages claimed by the plaintiff are in the range of $33 million to $39 million. We believe that we have valid defenses to Newmont Gold's claims and intend to vigorously defend the matter. After certain procedural filings, the case will proceed to trial.

As of June 30, 2006, we had not accrued any amounts related to this matter.

Improper payments reported to the SEC

During the second quarter of 2002, we reported to the SEC that one of our foreign subsidiaries operating in Nigeria made improper payments of approximately $2.4 million to entities owned by a Nigerian national who held himself out as a tax consultant, when in fact he was an employee of a local tax authority. The payments were made to obtain favorable tax treatment and clearly violated our Code of Business Conduct and our internal control procedures. The payments were discovered during our audit of the foreign subsidiary. We conducted an investigation assisted by outside legal counsel, and, based on the findings of the investigation, we terminated several employees. None of our senior officers were involved. We are cooperating with the SEC in its review of the matter. We took further action to ensure that our foreign subsidiary paid all taxes owed in Nigeria. A preliminary assessment of approximately $4 million was issued by the Nigerian tax authorities in the second quarter of 2003. We are cooperating with the Nigerian tax authorities to determine the total amount due as quickly as possible.

Operations in Iran

We received and responded to an inquiry in mid-2001 from the Office of Foreign Assets Control (OFAC) of the United States Treasury Department with respect to operations in Iran by a Halliburton subsidiary incorporated in the Cayman Islands. The OFAC inquiry requested information with respect to compliance with the Iranian Transaction Regulations. These regulations prohibit United States citizens, including United States corporations and other United States business organizations, from engaging in commercial, financial, or trade transactions with Iran, unless authorized by OFAC or exempted by statute. Our 2001 written response to OFAC stated that we believed that we were in compliance with applicable sanction regulations. In the first quarter of 2004, we responded to a follow-up letter from OFAC requesting additional information. We understand this matter has now been referred by OFAC to the DOJ. In July 2004, we received a grand jury subpoena from an Assistant United States District Attorney requesting the production of documents. We are cooperating with the government's investigation and have responded to the subpoena by producing documents in September 2004.

As of June 30, 2006, we had not accrued any amounts related to this investigation.

Separate from the OFAC inquiry, we completed a study in 2003 of our activities in Iran during 2002 and 2003 and concluded that these activities were in compliance with applicable sanction regulations. These sanction regulations require isolation of entities that conduct activities in Iran from contact with United States citizens or managers of United States companies. Notwithstanding our conclusions that our activities in Iran were not in violation of United States laws and regulations, we announced that, after fulfilling our current contractual obligations within Iran, we intend to cease operations within that country and to withdraw from further activities there.

David Hudak and International Hydrocut Technologies Corp.

In October 2004, David Hudak and International Hydrocut Technologies Corp. (collectively, Hudak) filed suit against us in the United States District Court alleging civil Racketeer Influenced and Corporate Organizations Act violations, fraud, breach of contract, unfair trade practices, and other torts. The action, which seeks unspecified damages, arises out of Hudak's alleged purchase in early 1994 of certain explosive charges that were later alleged by the DOJ to be military ordnance, the possession of which by persons not possessing the requisite licenses and registrations is unlawful. As a result of that allegation by the government, Hudak was charged with, but later acquitted of, certain criminal offenses in connection with his possession of the explosive charges. As mentioned above, the alleged transaction(s) took place more than 10 years ago. The fact that most of the individuals that may have been involved, as well as the entities themselves, are no longer affiliated with us will complicate our investigation. For those reasons and because the litigation is in its most preliminary stages, it is premature to assess the likelihood of an adverse result. We filed a motion to dismiss and, alternatively, a motion to transfer venue. Those motions were denied during the first quarter of 2006. It is our intention to vigorously defend this action.

Amounts accrued related to this matter as of June 30, 2006 are not material.

Convoy ambush litigation

Several of the families of truck drivers, employed by KBR and killed when a fuel convoy was ambushed in Iraq in April 2004, have filed suit against us. These suits allege that we are responsible for the deaths of these drivers for a variety of reasons and assert legal claims for fraud, wrongful death, civil rights violations, and violations of the Racketeer Influenced and Corrupt Organizations Act. We deny the allegations of wrongdoing and fully intend to vigorously defend the actions. We believe that our conduct was entirely lawful and that our liability is limited by federal law. In July 2005, the federal court in Houston, Texas denied our motion to dismiss based upon a narrow exception to the Defense Base Act.

As of June 30, 2006, we had not accrued any amounts related to these matters.

Iraq overtime litigation

During the fourth quarter of 2005, a group of present and former employees working on the LogCAP contract in Iraq and elsewhere filed a class action lawsuit alleging that KBR wrongfully failed to pay time and a half for hours worked in excess of 40 per work week and that "uplift" pay, consisting of a foreign service bonus, an area differential, and danger pay, was only applied to the first 40 hours worked in any work week. The class alleged by plaintiffs consists of all current and former employees on the LogCAP contract from December 2001 to present. The basis of plaintiffs' claims is their assertion that they are intended third-party beneficiaries of the LogCAP contract, and that the LogCAP contract obligated KBR to pay time and a half for all overtime hours. We have moved to dismiss the case on a number of bases, and that motion remains pending at this time. In the event the motion to dismiss is denied, we intend to vigorously defend this case. It is premature to assess the probability of an adverse result in this action. However, because the LogCAP contract is cost-reimbursable, we could charge any overtime and "uplift" pay to the customer in the event of an adverse judgment.

As of June 30, 2006, we had not accrued any amounts related to this matter.

Environmental

We are subject to numerous environmental, legal, and regulatory requirements related to our operations worldwide. In the United States, these laws and regulations include, among others:

- the Comprehensive Environmental Response, Compensation, and Liability Act;
- the Resources Conservation and Recovery Act;
- the Clean Air Act;
- the Federal Water Pollution Control Act; and
- the Toxic Substances Control Act.

In addition to the federal laws and regulations, states and other countries where we do business often have numerous environmental, legal, and regulatory requirements by which we must abide. We evaluate and address the environmental impact of our operations by assessing and remediating contaminated properties in order to avoid future liabilities and comply with environmental, legal, and regulatory requirements. On occasion, we are involved in specific environmental litigation and claims, including the remediation of properties we own or have operated, as well as efforts to meet or correct compliance-related matters. Our Health, Safety and Environment group has several

programs in place to maintain environmental leadership and to prevent the occurrence of environmental contamination.

We do not expect costs related to these remediation requirements to have a material adverse effect on our consolidated financial position or our results of operations. Our accrued liabilities for environmental matters were $41 million as of June 30, 2006 and $50 million as of December 31, 2005. The liability covers numerous properties, and no individual property accounts for more than $5 million of the liability balance. We have subsidiaries that have been named as potentially responsible parties along with other third parties for 14 federal and state superfund sites for which we have established a liability. As of June 30, 2006, those 14 sites accounted for approximately $13 million of our total $41 million liability. In some instances, we have been named a potentially responsible party by a regulatory agency, but, in each of those cases, we do not believe we have any material liability.

Letters of credit

In the normal course of business, we have agreements with banks under which approximately $1.1 billion of letters of credit or bank guarantees were outstanding as of June 30, 2006, including $564 million that relate to our joint ventures' operations. Also included in letters of credit outstanding as of June 30, 2006 were $8 million of performance letters of credit and $56 million of retainage letters of credit related to the Barracuda-Caratinga project. Some of the outstanding letters of credit have triggering events which would entitle a bank to require cash collateralization.

Other commitments

As of June 30, 2006, we had commitments to fund approximately $124 million to related companies. These commitments arose primarily during the start-up of these entities or due to losses incurred by them. We expect approximately $7 million of the commitments to be paid during the next year.

Liquidated damages

Many of our engineering and construction contracts have milestone due dates that must be met or we may be subject to penalties for liquidated damages if claims are asserted and we were responsible for the delays. These generally relate to specified activities within a project by a set contractual date or achievement of a specified level of output or throughput of a plant we construct. Each contract defines the conditions under which a customer may make a claim for liquidated damages. However, in most instances, liquidated damages are not asserted by the customer, but the potential to do so is used in negotiating claims and closing out the contract. We had not accrued for liquidated damages of $62 million at June 30, 2006 and $70 million at December 31, 2005 (including amounts related to unconsolidated subsidiaries) that we could incur based upon completing the projects as forecasted.

Note 13. Accounting for Stock-Based Compensation

Our 1993 Stock and Incentive Plan, as amended (1993 Plan), provides for the grant of any or all of the following types of stock-based awards:

- stock options, including incentive stock options and nonqualified stock options;
- restricted stock awards;
- restricted stock unit awards;
- stock appreciation rights; and
- stock value equivalent awards.

There are currently no stock appreciation rights or stock value equivalent awards outstanding.

Under the terms of the 1993 Plan, 98 million shares of common stock have been reserved for issuance to key employees. The plan specifies that no more than 32 million shares can be awarded as restricted stock. At June 30, 2006, approximately 21 million shares were available for future grants under the 1993 Plan, of which approximately 12 million shares remained available for restricted stock awards. The stock to be offered pursuant to the grant of an award under the 1993 Plan may be authorized but unissued common shares or treasury shares.

In addition to the provisions of the 1993 Plan, we also have stock-based compensation provisions under our Restricted Stock Plan for Non-Employee Directors and our 2002 Employee Stock Purchase Plan (ESPP).

Effective January 1, 2006, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)), using the modified prospective application. Accordingly, we are recognizing compensation expense for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006. Compensation cost for the unvested portion of awards that are outstanding as of January 1, 2006 is recognized ratably over the remaining vesting period based on the fair value at date of grant. Also, beginning with the January 1, 2006 purchase period, compensation expense for our ESPP is being recognized. The cumulative effect of this change in accounting principle related to stock-based awards was immaterial. Prior to January 1, 2006, we accounted for these plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Under APB No. 25, no compensation expense was recognized for stock options or the ESPP. Compensation expense was recognized for restricted stock awards.

Total stock-based compensation expense, net of related tax effects, was $13 million in the second quarter of 2006 and $28 million in the first six months of 2006. Total income tax benefit recognized in net income for stock-based compensation arrangements was $6 million in the second quarter of 2006 and $15 million in the first six months of 2006, compared to $2 million in the second quarter of 2005 and $10 million in the first six months of 2005. Total incremental compensation cost resulting from modifications of previously granted stock-based awards was $2 million and $8 million for the three and six months ended June 30, 2006, compared to $1 million and $13 million for the three and six months ended June 30, 2005. These modifications allowed certain employees to retain their awards after leaving the company.

The following table summarizes the pro forma effect on net income and income per share for the three and six months ended June 30, 2005 as if we had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

Millions of dollars except per share data	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	$ 392	$ 757
Add: Total stock-based compensation expense included in net income, net of related tax effects	5	19
Less: Total stock-based compensation expense determined under fair-value-based method for all awards, net of related tax effects	(13)	(33)
Net income, pro forma	$ 384	$ 743
Basic income per share:		
As reported	$ 0.39	$ 0.75
Pro forma	$ 0.38	$ 0.74
Diluted income per share:		
As reported	$ 0.38	$ 0.74
Pro forma	$ 0.38	$ 0.73

Each of the active stock-based compensation arrangements is discussed below.

Stock options

All stock options under the 1993 Plan are granted at the fair market value of the common stock at the grant date. Employee stock options vest ratably over a three- or four-year period and generally expire 10 years from the grant date. Stock options granted to non-employee directors vest after six months. No further stock option grants are being made under the stock plans of acquired companies.

The fair value of options at the date of grant was estimated using the Black-Scholes option pricing model. The expected volatility is a blended rate based upon implied volatility calculated on actively traded options on our common stock and upon the historical volatility of our stock. The expected term is based upon observation of actual

time elapsed between date of grant and exercise of options for all employees. The assumptions and resulting fair values of options granted are as follows:

	Six months ended June 30	
	2006	2005
Expected term (in years)	5.24	5.00
Expected volatility	42.20%	51.71 - 52.79%
Expected dividend yield	0.76 - 0.91%	1.05 - 1.16%
Risk-free interest rate	4.30 - 5.03%	3.77 - 4.27%
Weighted average grant-date fair value per share	$ 14.43	$ 10.08

The following table represents our stock options granted, exercised, and forfeited during the first six months of 2006, and includes exercised and forfeited shares from our acquired companies' stock plans.

Stock Options	Number of Shares *(in millions)*	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term *(years)*	Aggregate Intrinsic Value *(in millions)*
Outstanding at January 1, 2006	22.4	$ 16.81		
Granted	1.4	34.73		
Exercised	(5.2)	17.70		
Forfeited/expired	(0.2)	16.47		
Outstanding at June 30, 2006	18.4	$ 17.99	6.05	$ 353
Exercisable at June 30, 2006	13.3	$ 15.43	4.99	$ 289

The total intrinsic value of options exercised was $40 million in the second quarter of 2006 and $104 million in the first six months of 2006, compared to $24 million in the second quarter of 2005 and $50 million in the first six months of 2005. As of June 30, 2006, there was $43 million of unrecognized compensation cost, net of estimated forfeitures, related to nonvested stock options, which is expected to be recognized over a weighted average period of approximately 2.1 years.

Cash received from option exercises was $28 million and $117 million during the three and six months ended June 30, 2006, compared to $37 million and $126 million during the three and six months ended June 30, 2005. As a result of our net operating loss position at June 30, 2006, our $36 million tax benefit from exercise of stock options will not be realized until such time as the net operating loss carryforwards are fully utilized.

Restricted stock

Restricted shares issued under the 1993 Plan are restricted as to sale or disposition. These restrictions lapse periodically over an extended period of time not exceeding 10 years. Restrictions may also lapse for early retirement and other conditions in accordance with our established policies. Upon termination of employment, shares on which restrictions have not lapsed must be returned to us, resulting in restricted stock forfeitures. The fair market value of the stock on the date of grant is amortized and ratably charged to income over the period during which the restrictions lapse.

Our Restricted Stock Plan for Non-Employee Directors (Directors Plan) allows for each non-employee director to receive an annual award of 800 restricted shares of common stock as a part of compensation. These awards have a minimum restriction period of six months and the restrictions lapse upon termination of Board service. The fair market value of the stock on the date of grant is amortized and ratably charged to income over the period during which the restriction lapses. We reserved 200,000 shares of common stock for issuance to non-employee directors, which may be authorized but unissued shares or treasury shares. At June 30, 2006, 98,400 shares had been issued to non-employee directors under this plan. There were no awards of restricted stock under the Directors Plan in the first half of 2006 or the first half of 2005.

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The following table represents our 1993 Plan and Directors Plan restricted stock awards granted, vested, and forfeited during the first six months of 2006.

Restricted Stock	Number of Shares *(in millions)*	Weighted Average Grant-Date Fair Value per Share
Nonvested shares at January 1, 2006	7.5	$ 17.07
Granted	2.0	35.04
Vested	(1.3)	15.76
Forfeited	(0.2)	19.93
Nonvested shares at June 30, 2006	8.0	$ 21.56

The weighted average grant-date fair value of shares granted during the first six months of 2005 was $22.14. The total fair value of shares vested during the three and six months ended June 30, 2006 was $34 million and $48 million, compared to $13 million and $30 million during the three and six months ended June 30, 2005. As of June 30, 2006, there was $148 million of unrecognized compensation cost, net of estimated forfeitures, related to nonvested restricted stock, which is expected to be recognized over a period of 4.4 years.

2002 Employee Stock Purchase Plan

Under the ESPP, eligible employees may have up to 10% of their earnings withheld, subject to some limitations, to be used to purchase shares of our common stock. Unless the Board of Directors shall determine otherwise, each six-month offering period commences on January 1 and July 1 of each year. The price at which common stock may be purchased under the ESPP is equal to 85% of the lower of the fair market value of the common stock on the commencement date or last trading day of each offering period. Under this plan, 24 million shares of common stock have been reserved for issuance. They may be authorized but unissued shares or treasury shares. As of June 30, 2006, 10.6 million shares have been sold through the ESPP.

The fair value of ESPP shares was estimated using the Black-Scholes option pricing model. The expected volatility is a one-year historical volatility of our stock. The assumptions and resulting fair values of options granted are as follows:

	Six months ended June 30	
	2006	2005
Expected term (in years)	0.5	0.5
Expected volatility	35.65%	26.93%
Expected dividend yield	0.75%	1.16%
Risk-free interest rate	4.38%	3.15%
Weighted average grant-date fair value per share	$ 7.91	$ 4.15

Note 14. Income per Share

Basic income per share is based on the weighted average number of common shares outstanding during the period. Diluted income per share includes additional common shares that would have been outstanding if potential common shares with a dilutive effect had been issued. A reconciliation of the number of shares used for the basic and diluted income per share calculation is as follows:

	Three Months Ended June 30		Six Months Ended June 30	
Millions of shares	2006	2005	2006	2005
Basic weighted average common shares outstanding	1,026	1,006	1,025	1,004
Dilutive effect of:				

Stock options	9	10	10	10
Convertible senior notes premium	32	8	31	8
Restricted stock	3	2	3	2
Diluted weighted average common shares outstanding	1,070	1,026	1,069	1,024

All the share numbers included in the tables above have been adjusted to reflect the two-for-one common stock split. See Note 16 for further information.

Excluded from the computation of diluted income per share are options to purchase one million shares of common stock that were outstanding during the three and six months ended June 30, 2006 and five million shares during the three months ended June 30, 2005 and four million shares during the six months ended June 30, 2005. These options were outstanding during these quarters but were excluded because the option exercise price was greater than the average market price of the common shares.

Note 15. Retirement Plans

The components of net periodic benefit cost related to pension benefits for the three and six months ended June 30, 2006 and June 30, 2005 are as follows:

	Three Months Ended June 30			
	2006		2005	
Millions of dollars	United States	International	United States	International
Components of net periodic benefit cost:				
Service cost	$ -	$ 18	$ -	$ 16
Interest cost	3	44	3	43
Expected return on plan assets	(3)	(49)	(3)	(46)
Settlements/curtailments	-	-	-	-
Recognized actuarial loss	1	7	1	4
Net periodic benefit cost	$ 1	$ 20	$ 1	$ 17

	Six Months Ended June 30			
	2006		2005	
Millions of dollars	United States	International	United States	International
Components of net periodic benefit cost:				
Service cost	$ -	$ 35	$ -	$ 39
Interest cost	5	87	5	86
Expected return on plan assets	(5)	(97)	(5)	(92)
Settlements/curtailments	-	-	-	5
Recognized actuarial loss	3	13	2	9
Net periodic benefit cost	$ 3	$ 38	$ 2	$ 47

In the first quarter of 2005, we amended the terms and conditions of one of our foreign defined benefit plans and ceased future service and benefit accruals for all plan participants. This action is defined as a curtailment under SFAS No. 88 and, therefore, during the first quarter of 2005, we recognized a curtailment loss of approximately $5 million. We currently expect to contribute approximately $158 million to our international pension plans and no more than $4 million to our domestic plans in 2006. As of June 30, 2006, we contributed $142 million of the $158 million to our international pension plans. As part of the $142 million, ESG contributed $43 million, and KBR contributed $94 million to the United Kingdom pension plans in the first six months of 2006. We do not have a required minimum contribution for our domestic plans; however, we may make additional discretionary contributions.

The components of net periodic benefit cost related to other postretirement benefits for the three and six months ended June 30, 2006 and June 30, 2005 are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
Millions of dollars	2006	2005	2006	2005
Components of net periodic benefit cost:				
Service cost	$ 1	$ -	$ 1	$ -
Interest cost	2	2	4	5
Net periodic benefit cost	$ 3	$ 2	$ 5	$ 5

Note 16. Common Stock

In February 2006, our Board of Directors approved a share repurchase program of up to $1.0 billion. During the first half of 2006, we repurchased approximately five million shares of our common stock for approximately $178 million, or an average price per share of $35.55.

In May 2006, the stockholders increased the number of authorized shares of common stock to two billion. Also in May 2006, our Board of Directors finalized the terms of a two-for-one common stock split, effected in the form of a stock dividend. As a result, the split was paid in the form of a stock dividend on July 14, 2006 to stockholders of record on June 23, 2006. The effect on the balance sheet was to reduce “Paid-in capital in excess of par value” by $1.3 billion and to increase “Common shares” by $1.3 billion. All prior period common stock and applicable share and per share amounts were retroactively adjusted to reflect the split.

Note 17. Related Companies

During the first quarter of 2006, included in Government and Infrastructure operating income was a $30 million impairment charge and loss recorded on an equity investment in an Australian railroad operation. Of the $30 million, $26 million relates to the impairment charge. We will receive no tax benefit from this charge as this is a capital loss in Australia for which we have no capital gains to offset. We own a 36.7% interest in the joint venture that is the holder of a 50-year concession contract with the Australian government to operate and maintain the railway. We account for this investment on the equity method of accounting. Construction on the railway was completed in late 2003, and operations commenced in early 2004. This joint venture has sustained losses since the railway commenced operations in early 2004 and is now likely to violate certain of the joint venture’s loan covenants in the future. These loans are non-recourse to us. We received revised financial forecasts from the joint venture during the first quarter of 2006. These forecasts took into account decreases, as compared to prior forecasts, in anticipated freight volume related to delays in mining of minerals, as well as a slowdown in the planned expansion of the Port of Darwin. Because of this new information, we recorded an impairment charge during the first quarter of 2006 in our equity investment. As of June 30, 2006, our investment in this joint venture and the related company that performed the construction of the railroad was $60 million. In addition, we have a remaining commitment to purchase an additional $3 million subordinated operating note.

In 2006, we invested in a development company that has an indirect interest in an ammonia plant project (the EBIC project) located in Egypt. We are performing the engineering, procurement, and construction (EPC) work for the project. We consolidate the development company for financial reporting purposes within our Energy and Chemicals segment. The development company owns a 25% ownership interest in Egypt Basic Industries Corporation (EBIC), which in turn owns the ammonia plant. EBIC is considered a variable interest entity. The development company accounts for its investment in EBIC using the equity method of accounting. EBIC is funded through debt and equity. We are not the primary beneficiary of EBIC. As of June 30, 2006, EBIC had total assets of $285 million and total liabilities of $130 million. Our maximum exposure to loss is limited to our equity investments totaling $17 million and our commitment to fund an additional $3 million of stand-by-equity as of June 30, 2006. In June 2006, the lenders of the project construction debt issued a “draw stop” which effectively prevents the project from making additional borrowings until such time as certain security interest in the ammonia plant assets can be perfected. Subsequently, the lenders granted EBIC additional time to perfect the security and approved funding through July. EBIC now has until August 16, 2006 to perfect the lender’s security or find an alternative solution, which would likely increase the cost estimates. Any solution resulting in additional costs could require EBIC to raise additional financing, some of which could be from the current stakeholders. We are continuing work on the project pursuant to the EPC contract. In the event the draw stop is reinstated and not ultimately removed, the project may not have access to sufficient financing to continue which could in turn result in an impairment of our investment.

In April 2006, we invested in a private financing initiative project (the Allenby and Connaught project) to upgrade certain infrastructure accommodations and provide related support services in the United Kingdom over 35 years. We indirectly own a 45% interest in Aspire Defence, the project company that is the holder of the 35-year concession contract with the Ministry of Defence in the United Kingdom. We also own a 50% interest in each of two joint ventures that provide the construction and the related support services to Aspire Defence. The project is funded through equity and subordinated debt provided by the project sponsors and the issuance of publicly held senior bonds. The entities we hold an interest in are considered variable interest entities. We are not the primary beneficiary of these entities. We account for our interests in each of the entities using the equity method of accounting. As of June 30, 2006, the aggregate total assets and total liabilities of the variable interest entities were $2.9 billion each. Our maximum exposure to project company losses as of June 30, 2006 is limited to our equity investments totaling $4 million and our commitment to fund debt totaling approximately $100 million. Our maximum exposure to construction and operating joint venture losses is limited to the funding of any future losses incurred by those entities.

Note 18. New Accounting Standards

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109.” This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” The interpretation prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for fiscal years beginning after December 31, 2006. We are currently evaluating what impact, if any, this statement will have on our financial statements.

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

EXECUTIVE OVERVIEW

During the first half of 2006, the Energy Services Group (ESG) produced revenue of $6.1 billion and operating income of $1.5 billion, reflecting an operating margin of 25.1%. Revenue increased $1.4 billion or 30% over the prior year period, primarily driven by higher activity in North America, the Middle East, the North Sea, and Russia. In the second quarter of 2006, ESG generated record revenue and operating income. In the first half of 2006, operating income increased $483 million or 47% compared to the first half of 2005. Internationally, ESG experienced 23% revenue growth and 45% operating income growth during the first half of 2006 as compared to the first half of 2005. Increased customer drilling and production activity, higher utilization of assets, and continued price increases have allowed us to consistently produce improved revenue and operating income.

For the first six months of 2006, KBR revenue was down $426 million to $4.7 billion with operating income decreasing $184 million to $21 million. The revenue decline was primarily due to decreased military support activities in Iraq.

In July 2006, the United States Army announced it would rebid the LogCAP III contract for logistical support that KBR provided in Iraq. KBR is eligible to bid on the future work, as the Army has determined it wants multiple service providers to perform the work currently provided entirely by us. In the first six months of 2006, Iraq-related work contributed approximately $2.4 billion to consolidated revenue and $74 million to consolidated operating income, resulting in a 3.1% margin before corporate costs and taxes. KBR was awarded $68 million in LogCAP award fees during the first quarter of 2006 as a result of our performance rating. During the almost five-year period we have worked under this contract, we have been awarded 42 "excellent" ratings out of 54 total ratings.

In the second quarter of 2006, we recorded a $148 million charge, before income taxes and minority interest, related to our consolidated 50% owned gas-to-liquids project in Escravos, Nigeria. This charge was primarily attributable to increases in the overall estimated cost to complete the project. The project is approximately 30% complete as of June 30, 2006. The project has experienced delays relating to civil unrest and security on the Escravos River, near the project site. Further delays have resulted from scope changes and engineering and construction modifications. We are currently discussing with the majority owner of our customer several contract changes to mitigate our construction risk associated with this contract. We have reached a preliminary agreement with our customer and are working on a final agreement to fund the $200 million in change orders. We are continuing discussions regarding additional contract changes related to scheduled completion, site access and security, and other factors to mitigate our future risks on this project.

In May 2006, we completed the sale of KBR's Production Services group, which was part of our Energy and Chemicals segment. In connection with the sale, we received net proceeds of $265 million. The sale of Production Services resulted in a pretax gain of $123 million in the second quarter of 2006. As a result of the sale agreement in March 2006, Production Services operations and assets and liabilities were classified as discontinued operations, and all prior periods presented were reclassified as well.

We intend to completely separate KBR, Inc. from Halliburton as expeditiously as possible through a tax-free dividend distribution of KBR, Inc. stock to Halliburton stockholders. The distribution will be preceded by the filing of a Form 10 registration statement with the United States Securities and Exchange Commission (SEC) to register the shares of KBR, Inc. stock under the Securities Exchange Act of 1934. After the distribution, KBR, Inc. will be a separately traded public company.

The distribution of KBR, Inc. stock may be preceded by an initial public offering (IPO) of less than 20% of KBR, depending on market conditions for initial public offerings, valuations for publicly-traded engineering and construction companies, and KBR-specific business conditions and results of operations. In April 2006, KBR, Inc. filed a Registration Statement on Form S-1 with the SEC for an IPO of less than 20% of KBR, Inc. Since the initial filing, however, the market for initial public offerings has become less favorable, which has resulted in many offerings being postponed or withdrawn. In addition, recently announced operating results on KBR's Escravos project and the outcome of ongoing discussions with our customer on the Escravos project about mitigating future risk could impact the desirability or timing of a KBR, Inc. IPO. We do not intend to delay the complete separation of KBR to wait on

favorable conditions for an IPO of KBR, Inc.

Before making the distribution of KBR, Inc. stock, we intend to seek a ruling from the Internal Revenue Service that, among other things, no gain or loss will be recognized by Halliburton or its stockholders as a result of a distribution of KBR stock, a process that could be completed within approximately nine months. Prior to the IPO or separation occurring, we will enter into various agreements to govern the separation of KBR from us, including, among others, a master separation agreement, transition services agreements, and a tax sharing agreement. The master separation agreement will provide for, among other things, KBR's responsibility for liabilities relating to its business and Halliburton's responsibility for liabilities unrelated to KBR's business. Halliburton expects to provide indemnification in favor of KBR under the master separation agreement for certain contingent liabilities. The Halliburton performance guarantees and letter of credit guarantees that are currently in place in favor of KBR's customers or lenders will continue after the separation of KBR until these guarantees expire by their terms, although KBR will compensate Halliburton for these guarantees and indemnify Halliburton if Halliburton is required to perform under any of these guarantees. The tax sharing agreement will provide for allocations of United States income tax liabilities and other agreements between us and KBR with respect to tax matters. Under the transition services agreements, we expect to continue providing various interim corporate support services to KBR, and KBR will continue to provide various interim corporate support services to us.

Any sale of KBR, Inc. stock under a Form S-1 would be registered under the Securities Act of 1933, and such shares of common stock would only be offered and sold by means of a prospectus. This quarterly report does not constitute an offer to sell or the solicitation of any offer to buy any securities of KBR, and there will not be any sale of any such securities in any state in which such offer, solicitation, or sale would be unlawful prior to registration or qualification under the securities laws of such state.

In the first quarter of 2006, KBR recorded a $26 million impairment charge and $4 million in losses related to our investment in a railway joint venture in Australia. This joint venture has sustained losses since the railway commenced operations in early 2004 and is now likely to violate certain of the joint venture's financial loan covenants in the future. We received revised financial forecasts from the joint venture during the first quarter. As compared to prior forecasts, these forecasts took into account decreases in anticipated freight volume related to delays in mining of minerals, as well as a slowdown in the planned expansion of the Port of Darwin. Because of this new information, we recorded an impairment charge during the first quarter.

In April 2006, KBR, Petrobras, and the project lenders agreed to technical and operational acceptance of the completed Barracuda and Caratinga production vessels. This agreement will not affect the bolt arbitration.

In March 2006, Petrobras submitted to arbitration a $220 million claim related to the Barracuda-Caratinga project. The submission claimed that certain subsea flowline bolts failed and that the replacement of these bolts was our responsibility. We disagree with the Petrobras claim since the bolts met Petrobras' design specification, and we do not believe there is any basis for the amount claimed by Petrobras. We have examined possible solutions to the problem and determined the cost would not exceed $140 million. We are defending ourselves in the arbitration process and will pursue recovery of our costs associated with this defense.

In May 2006, our Board of Directors approved a dividend for the second quarter of 2006 to shareholders of record at the close of business on June 1, 2006 of $0.075 per share, payable on June 22, 2006. The Board of Directors also finalized the terms of a two-for-one common stock split, following the shareholder approval at the 2006 annual shareholders meeting of a proposal to increase the number of authorized shares of common stock from one billion shares to two billion shares. On July 14, 2006, each shareholder of record as of June 23, 2006, received one additional share for each outstanding share held. All periods presented have been adjusted to reflect the stock common split.

In February 2006, our Board of Directors approved a share repurchase program of up to $1.0 billion. For the three and six months ended June 30, 2006, we repurchased approximately 3.8 million and 5 million shares of our common stock at an average price of $35.94 and $35.55, respectively. The total cost of repurchasing the 5 million shares was approximately $178 million.

In January 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)) and began expensing the cost of our employee stock option awards and our employee stock purchase plan. These costs totaled approximately $20 million in the first six months of 2006 and are in addition to $15 million in costs we have historically expensed related to other equity compensation and $8 million of incremental compensation cost related to modifications of previously granted stock-based awards retained when

certain employees left the company. All expense related to stock compensation awards was charged to the segments to which each affected employee is assigned.

The outlook for our business remains favorable. Stronger than historical commodity prices, a lack of oil in storage compared to other periods when prices have been historically high, and continuing strong cash flow are driving increased spending plans for our exploration and production customers. We believe oil and gas prices will fluctuate in the future. United States natural gas prices have declined during the first six months of 2006 driven by record storage levels and are predicted to continue to be volatile during the second half of 2006. If this trend continues, it could have a negative impact on North American operations. We expect the energy services sector in regions outside North America to grow. Therefore, we are investing resources in Russia, Libya, Angola, the North Sea, and Saudi Arabia. These investments are consistent with our initiative to increase our Eastern Hemisphere growth.

For the remainder of 2006, we will continue to focus on:

- improving the utilization of our equipment and deploying additional resources to address the growing demand for our services and products, in particular, our pressure pumping services and directional drilling and formation evaluation tools;
- increasing pricing and reducing discounts, as the market allows, for ESG's services and products due to expected labor and material cost increases and high demand from customers;
- leveraging our technologies to provide our customers with the ability to more efficiently drill and complete their wells and to increase their productivity;
- capitalizing on the liquefied natural gas (LNG) and gas-to-liquids (GTL) markets. Forecasted LNG market growth remains strong and is expected to grow further. Significant numbers of new LNG liquefaction plant and LNG receiving terminal projects are proposed worldwide and are in various stages of development. We are currently in the bidding process for several LNG and GTL projects, and expect to receive decisions on those in the next few quarters;
- diversifying the services of our Government and Infrastructure segment. With the expected rebid of the LogCAP contract, we are focused on diversifying the Government and Infrastructure project portfolio. We continue to expand our work for the United States Navy under the CONCAP construction contingency contract and are positioned for future contingency work for the United States Air Force under the AFCAP contract. In addition, we have strengthened our position with the United Kingdom Ministry of Defence, as we were awarded in April 2006, along with our joint venture partner, the $13.9 billion 35-year Allenby and Connaught project, and
- maintaining our ESG growth initiative both domestically and internationally through capital expenditures of approximately $850 million during 2006 and between $1.0 and $1.2 billion in 2007.

Detailed discussions of the Foreign Corrupt Practices Act investigations and our liquidity and capital resources follow. Our operating performance is described in "Business Environment and Results of Operations" below.

Foreign Corrupt Practices Act investigations

The United States Securities and Exchange Commission (SEC) is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The United States Department of Justice (DOJ), is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which we are furnishing, regarding current and former agents used in connection with multiple projects over the past 20 years located both in and outside of Nigeria in which The M .W. Kellogg Company, M. W. Kellogg, Ltd., Kellogg Brown & Root or their joint ventures, as well as the Halliburton energy services business, were participants.

TSKJ is a private limited liability company registered in Madeira, Portugal whose members are Technip SA of France, Snamprogetti Netherlands B.V. (a subsidiary of Saipem SpA of Italy), JGC Corporation of Japan, and Kellogg Brown & Root (a subsidiary of ours and successor to The M.W. Kellogg Company), each of which has a 25% interest in the venture. TSKJ and other similarly owned entities entered into various contracts to build and expand the liquefied natural gas project for Nigeria LNG Limited, which is owned by the Nigerian National Petroleum Corporation, Shell Gas B.V., Cleag Limited (an affiliate of Total), and Agip International B.V. (an affiliate of ENI SpA of Italy). M.W. Kellogg Limited is a joint venture in which we have a 55% interest; and M.W. Kellogg Limited and The M.W. Kellogg Company were subsidiaries of Dresser Industries before our 1998 acquisition of Dresser Industries. The M.W. Kellogg Company was later merged with a subsidiary of ours to form Kellogg Brown & Root, one of our subsidiaries.

The SEC and the DOJ have been reviewing these matters in light of the requirements of the United States Foreign Corrupt Practices Act (FCPA). In addition to performing our own investigation, we have been cooperating with the SEC and the DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. Our Board of Directors has appointed a committee of independent directors to oversee and direct the FCPA investigations.

The matters under investigation related to the Bonny Island project cover an extended period of time (in some cases significantly before our 1998 acquisition of Dresser Industries). We have produced documents to the SEC and the DOJ both voluntarily and pursuant to company subpoenas from the files of numerous officers of Halliburton and KBR, including current and former executives of Halliburton and KBR, and we are making our employees available to the SEC and the DOJ for interviews. In addition, we understand that the SEC has issued a subpoena to A. Jack Stanley, who formerly served as a consultant and chairman of KBR, and to others, including certain of our current and former KBR employees, former executive officers of KBR, and at least one subcontractor of KBR. We further understand that the DOJ has invoked its authority under a sitting grand jury to issue subpoenas for the purpose of obtaining information abroad, and we understand that other partners in TSKJ have provided information to the DOJ and the SEC with respect to the investigations, either voluntarily or under subpoenas.

The SEC and DOJ investigations include an examination of whether TSKJ’s engagements of Tri-Star Investments as an agent and a Japanese trading company as a subcontractor to provide services to TSKJ were utilized to make improper payments to Nigerian government officials. In connection with the Bonny Island project, TSKJ entered into a series of agency agreements, including with Tri-Star Investments, of which Jeffrey Tesler is a principal, commencing in 1995 and a series of subcontracts with a Japanese trading company commencing in 1996. We understand that a French magistrate has officially placed Mr. Tesler under investigation for corruption of a foreign public official. In Nigeria, a legislative committee of the National Assembly and the Economic and Financial Crimes Commission, which is organized as part of the executive branch of the government, are also investigating these matters. Our representatives have met with the French magistrate and Nigerian officials. In October 2004, representatives of TSKJ voluntarily testified before the Nigerian legislative committee.

As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made to Nigerian officials.

We notified the other owners of TSKJ of information provided by the investigations and asked each of them to conduct their own investigation. TSKJ has suspended the receipt of services from and payments to Tri-Star Investments and the Japanese trading company and has considered instituting legal proceedings to declare all agency agreements with Tri-Star Investments terminated and to recover all amounts previously paid under those agreements. In February 2005, TSKJ notified the Attorney General of Nigeria that TSKJ would not oppose the Attorney General’s efforts to have sums of money held on deposit in banks in Switzerland transferred to Nigeria and to have the legal ownership of such sums determined in the Nigerian courts.

In June 2004, all relationships with Mr. Stanley and another consultant and former employee of M. W. Kellogg, Ltd. were terminated. The terminations occurred because of violations of our Code of Business Conduct that allegedly involved the receipt of improper personal benefits from Mr. Tesler in connection with TSKJ’s construction of the Bonny Island project.

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We have also suspended the services of another agent who has worked for KBR outside of Nigeria on several current projects and on numerous older projects going back to the early 1980's until such time, if ever, as we can satisfy ourselves regarding the agent's compliance with applicable law and our Code of Business Conduct. In addition, we are actively reviewing the compliance of an additional agent on a separate current Nigerian project with respect to which we have recently received from a joint venture partner on that project allegations of wrongful payments made by such agent.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss. Both the SEC and the DOJ could argue that continuing conduct may constitute multiple violations for purposes of assessing the penalty amounts per violation. Agreed dispositions for these types of matters sometimes result in a monitor being appointed by the SEC and/or the DOJ to review future business and practices with the goal of ensuring compliance with the FCPA. Fines and civil and criminal penalties could be mitigated, in the government's discretion, depending on the level of the cooperation in the investigations.

Potential consequences of a criminal indictment arising out of any of these investigations could include suspension by the United States Department of Defense (DoD) or another federal, state, or local government agency of KBR and its affiliates from their ability to contract with United States, state or local governments, or government agencies. If a criminal or civil violation were found, KBR and its affiliates could be debarred from future contracts or new orders under current contracts to provide services to any such parties. During 2005, KBR and its affiliates had revenue of approximately $6.6 billion from its government contracts work with agencies of the United States or state or local governments. If necessary, we would seek to obtain administrative agreements or waivers from the DoD and other agencies to avoid suspension or debarment. Suspension or debarment from the government contracts business would have a material adverse effect on the business, results of operations, and cash flows of KBR and Halliburton.

These investigations could also result in third-party claims against us, which may include claims for special, indirect, derivative or consequential damages, damage to our business or reputation, loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, adverse consequences on our ability to obtain or continue financing for current or future projects or claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us or our subsidiaries. In addition, we could incur costs and expenses for any monitor required by or agreed to with governmental authority to review our continued compliance with FCPA law.

As of June 30, 2006, we have not accrued any amounts related to these investigations other than our current legal expenses.

Bidding practices investigation

In connection with the investigation into payments related to the Bonny Island project in Nigeria, information has been uncovered suggesting that Mr. Stanley and other former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects, and that such coordination possibly began as early as the mid-1980s.

On the basis of this information, we and the DOJ have broadened our investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former employees may have received payments in connection with bidding practices on some foreign projects.

If violations of applicable United States antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by, or relationship issues with customers, are also possible.

As of June 30, 2006, we had not accrued any amounts related to this investigation other than our current legal expenses.

LIQUIDITY AND CAPITAL RESOURCES

We ended the second quarter of 2006 with cash and equivalents of $3.7 billion compared to $2.4 billion at December 31, 2005.

Significant sources of cash

Cash flows from operations contributed $1.6 billion to cash in the first six months of 2006. In the second quarter of 2006, we completed the sale of KBR's Production Services group, which was part of our Energy and Chemicals segment. In connection with the sale, we received net proceeds of $265 million. Our working capital requirements for our Iraq-related work, excluding cash and equivalents, decreased from $495 million at December 31, 2005 to $404 million at June 30, 2006.

We received approximately $91 million in asbestos- and silica-related insurance proceeds in the first six months of 2006 and expect to receive additional amounts as follows:

Millions of dollars		
July 1 through December 31, 2006	$	76
2007		68
2008		46
2009		131
2010		16
Total	$	337

During the first quarter of 2005, we sold $891 million in investments in marketable securities and received approximately $200 million from the sale of our 50% interest in Subsea 7, Inc.

Further available sources of cash. In the first quarter of 2005, we entered into an unsecured $1.2 billion five-year revolving credit facility for general working capital purposes. The credit facility has a letter of credit issued under it with a balance of $49 million as of June 30, 2006. There were no cash drawings under the unsecured $1.2 billion revolving credit facility as of June 30, 2006.

KBR entered into an unsecured $850 million five-year revolving credit facility in the fourth quarter of 2005. Letters of credit that totaled $33 million were subsequently issued under the KBR revolving credit facility, thus reducing the availability under the credit facility to approximately $817 million at June 30, 2006. There were no cash drawings under the unsecured $850 million revolving credit facility as of June 30, 2006.

Significant uses of cash

Capital expenditures of $381 million in the first six months of 2006 were 32% higher than in the first six months of 2005. Capital spending in the first six months of 2006 was primarily directed to the Energy Services Group for the Production Optimization, Drilling and Formation Evaluation, and Fluid Systems segments.

In February 2006, our Board of Directors approved a share repurchase program of up to $1.0 billion. During the first six months of 2006, we repurchased approximately five million shares of our common stock at a cost of approximately $178 million, or an average price per share of $35.55. The Board of Directors also approved a dividend for the second quarter of 2006 to shareholders of record at the close of business on June 1, 2006 of $0.075 per share, payable on June 22, 2006. We paid $155 million in dividends to our shareholders in the first six months of 2006. We repurchased $41 million of debt at a total cost of $49 million in the first six months of 2006.

In the first six months of 2006, we contributed a total of $142 million to our international pension plans, which included ESG contributing $43 million, and KBR contributing $94 million to the United Kingdom pension plans. We expect the total amount contributed in 2006 for all pension plans to be approximately $162 million.

We also continued to fund operating cash shortfalls on the Barracuda-Caratinga project, a multiyear construction project to develop the Barracuda and Caratinga crude oilfields off the coast of Brazil. During the first six months of 2006, we funded approximately $34 million, net of revenue received.

Future uses of cash. Capital spending for 2006 is expected to be approximately $850 million and approximately $1.0 to $1.2 billion for 2007. The capital expenditures budget for 2006 includes a steady level of activities related to our DML shipyard and increased spending in the Energy Services Group to accommodate higher activity levels.

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In future periods, we expect to make $1.0 billion to $2.0 billion annually in acquisitions in order to add to our oilfield products and technologies.

As of June 30, 2006, we had commitments to fund approximately $124 million to related companies. These commitments arose primarily during the start-up of these entities or due to losses incurred by them. We expect approximately $7 million of the commitments to be paid during the remainder of 2006.

In the third quarter of 2006, our $275 million medium-term notes will mature. At June 30, 2006, these notes were included in “Current maturities of long-term debt” in the condensed consolidated balance sheet.

Other factors affecting liquidity

Accounts receivable securitization facilities. In April 2002, we entered into an agreement to sell eligible United States Energy Services Group accounts receivable to a bankruptcy-remote limited-purpose funding subsidiary. As of December 31, 2004, we had sold $256 million of undivided ownership interest to unaffiliated companies. During the fourth quarter of 2005, these receivables were collected and the balance retired. No further receivables were sold, and the facility was terminated in the first quarter of 2006.

In May 2004, we entered into an agreement to sell, assign, and transfer the entire title and interest in specified United States government accounts receivable of KBR to a third party. The face value of the receivables sold to the third party was reflected as a reduction of accounts receivable in our condensed consolidated balance sheets. The total amount of receivables outstanding under this agreement was approximately $257 million as of June 30, 2005. As of December 31, 2005, these receivables were collected, the balance was retired, and the facility was terminated.

Letters of credit. In the normal course of business, we have agreements with banks under which approximately $1.1 billion of letters of credit or bank guarantees were outstanding as of June 30, 2006, including $564 million that relate to our joint ventures’ operations. Also included in the letters of credit outstanding as of June 30, 2006 were $8 million of performance letters of credit and $56 million of retainage letters of credit related to the Barracuda-Caratinga project. Some of the outstanding letters of credit have triggering events that would entitle a bank to require cash collateralization.

Credit ratings. Our current ratings are BBB+ on Standard & Poor’s and Baa1 on Moody’s Investors Service. In the second quarter of 2006, Standard & Poor’s revised its long-term senior unsecured debt rating from BBB to BBB+ with a “stable” outlook due to the significant improvement in ESG operating performance and the considerable reduction in debt over the past year. In the fourth quarter of 2005, Moody’s revised its long-term senior unsecured debt rating from Baa2 to Baa1 with a “stable” outlook. In the first quarter of 2005, Standard & Poor’s revised its credit watch listing for us from “developing” to “stable” and its short-term credit and commercial paper rating from A-3 to A-2. Our Moody’s Investors Service short-term credit and commercial paper rating is P-2.

Debt covenants. Letters of credit related to our Barracuda-Caratinga project and our $1.2 billion revolving credit facility contain restrictive covenants, including covenants that require us to maintain financial ratios as defined by the agreements. For the letters of credit related to our Barracuda-Caratinga project, we are required to maintain interest coverage and leverage ratios. We are also required to maintain a minimum debt-to-capitalization ratio under our $1.2 billion revolving credit facility. At June 30, 2006, we were in compliance with these requirements.

In addition, the unsecured $850 million five-year revolving credit facility entered into by KBR contains covenants including a limitation on the amount KBR can invest in unconsolidated subsidiaries. KBR must also maintain financial ratios including a debt-to-capitalization ratio, a leverage ratio, and a fixed charge coverage ratio. At June 30, 2006, KBR was in compliance with these requirements.

BUSINESS ENVIRONMENT AND RESULTS OF OPERATIONS

We currently operate in about 100 countries throughout the world. We provide a comprehensive range of discrete and integrated services and products to the energy industry and to other industrial and governmental customers. The majority of our consolidated revenue is derived from the sale of services and products to major, national, and independent oil and gas companies and governments around the world. The services and products provided to major, national, and independent oil and gas companies are used throughout the energy industry from the earliest phases of exploration, development, and production of oil and gas through refining, processing, and marketing. We have six business segments: Production Optimization, Fluid Systems, Drilling and Formation Evaluation, Digital and Consulting Solutions, Government and Infrastructure, and Energy and Chemicals. We refer to the combination of Production Optimization, Fluid Systems, Drilling and Formation Evaluation, and Digital and Consulting Solutions segments as ESG, and the combination of Government and Infrastructure and Energy and Chemicals as KBR.

The industries we serve are highly competitive with many substantial competitors for each segment. In the first six months of 2006, based upon the location of the services provided and products sold, 33% of our consolidated revenue was from the United States, and 19% of our consolidated revenue was from Iraq, primarily related to work for the United States Government. In the first six months of 2005, 29% of our consolidated revenue was from Iraq, and 26% of our consolidated revenue was from the United States. No other country accounted for more than 10% of our revenue during these periods.

Operations in some countries may be adversely affected by unsettled political conditions, acts of terrorism, civil unrest, force majeure, war or other armed conflict, expropriation or other governmental actions, inflation, exchange controls, or currency devaluation. Except for our government services work in Iraq discussed above, we believe the geographic diversification of our business activities reduces the risk that loss of operations in any one country would be material to our consolidated results of operations.

Halliburton Company

Activity levels within our business segments are significantly impacted by the following:

- spending on upstream exploration, development, and production programs by major, national, and independent oil and gas companies;
- capital expenditures for downstream refining, processing, petrochemical, gas monetization, and marketing facilities by major, national, and independent oil and gas companies; and
- government spending levels.

Also impacting our activity is the status of the global economy, which impacts oil and gas consumption, demand for petrochemical products, and investment in infrastructure projects.

Energy Services Group

Some of the more significant indicators of current and future spending levels of oil and gas companies are oil and gas prices, exploration and production spending by international and national oil companies, the world economy, and global stability, which together drive worldwide drilling activity. Our ESG financial performance is significantly affected by oil and gas prices and worldwide rig activity, which are summarized in the following tables.

This table shows the average oil and gas prices for West Texas Intermediate (WTI) crude oil, United Kingdom Brent, and Henry Hub natural gas:

	Three Months Ended June 30		Year Ended December 31
Average Oil Prices (dollars per barrel)	2006	2005	2005
West Texas Intermediate	$ 70.52	$ 52.86	$ 56.30
United Kingdom Brent	69.58	51.58	54.45
Average United States Gas Prices (dollars per million British thermal units, or mmBtu)			
Henry Hub	$ 6.59	$ 6.95	$ 8.79

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The quarterly and yearly average rig counts based on the Baker Hughes Incorporated rig count information were as follows:

	Three Months Ended June 30		Six Months Ended June 30	
Land vs. Offshore	2006	2005	2006	2005
United States:				
Land	1,536	1,243	1,487	1,211
Offshore	97	93	89	97
Total	1,633	1,336	1,576	1,308
Canada:				
Land	279	238	471	378
Offshore	3	3	3	3
Total	282	241	474	381
International (excluding Canada):				
Land	643	590	636	584
Offshore	270	269	269	253
Total	913	859	905	837
Worldwide total	2,828	2,436	2,955	2,526
Land total	2,458	2,071	2,594	2,173
Offshore total	370	365	361	353

	Three Months Ended June 30		Six Months Ended June 30	
Oil vs. Gas	2006	2005	2006	2005
United States:				
Oil	268	156	250	171
Gas	1,365	1,180	1,326	1,137
Total	1,633	1,336	1,576	1,308
Canada:				
Oil	65	61	95	77
Gas	217	180	379	304
Total	282	241	474	381
International (excluding Canada):				
Oil	698	658	694	635
Gas	215	201	211	202
Total	913	859	905	837
Worldwide total	2,828	2,436	2,955	2,526

Our customers' cash flows, in many instances, depend upon the revenue they generate from the sale of oil and gas. Higher oil and gas prices usually translate into higher exploration and production budgets. Higher prices also improve the economic attractiveness of marginal exploration areas. This drives additional investment by our customers in the sector, which benefits us. The opposite is true for lower oil and gas prices.

Oil prices for both Brent and WTI crude continued to trend upward in the second quarter of 2006, averaging approximately $70 per barrel. In July 2006, oil prices continued to rise to record levels. Oil prices continue to remain high due to a combination of the following factors:

- growth in worldwide petroleum demand remains robust, despite high oil prices;
- projected growth in non-Organization of Petroleum Exporting Countries supplies is not expected to accommodate worldwide demand growth;
- worldwide spare crude oil production capacity continues to remain low;
- downstream sectors, such as refining and shipping, are expected to keep the level of uncertainty in world oil markets high as there is limited refining capacity available, particularly in the United States; and
- fear of possible supply disruptions from Organization of Petroleum Exporting Countries Iran, Iraq, Nigeria, and Venezuela due to political or social circumstances.

It is common practice in the United States oilfield services industry to sell services and products based on a price book and then apply discounts to the price book based upon a variety of factors. The discounts applied typically increase to partially or substantially offset price book increases in the weeks immediately following a price increase. The discount applied normally decreases over time if the activity levels remain strong. During periods of reduced activity, discounts normally increase, reducing the revenue for our services and, conversely, during periods of higher activity, discounts normally decline resulting in revenue increasing for our services.

During the first half of 2006, the price increases we implemented during the fourth quarter of 2005 increased revenue and operating income across all segments. Additionally, an average price book increase of 5% for software products in our Digital and Consulting Solutions segment was implemented in January 2006. We are now focused on continuing to implement the recent price book increases when our customers' contracts renew and on working down customer discounts. From April 2006 to July 2006, we implemented several United States price book increases ranging from 5% to 12%, led by our pressure pumping services. We will continue to evaluate future United States price book increases.

Overall outlook. The outlook for world oil demand continues to remain strong, with China and North America accounting for approximately 38% of the expected demand growth in 2006. The Chinese rate of demand growth rebounded in the second quarter of 2006, and oil demand growth is continuing in other populous countries, including India. Excess oil production capacity is expected to remain constrained and that, along with strong demand, is expected to keep supplies tight. Thus, any unexpected supply disruption or change in demand could lead to fluctuating prices. The International Energy Agency continues to forecast world petroleum demand growth in 2006 to increase 2% over 2005. Our customers have indicated they intend to continue their increased spending patterns throughout 2006. The increasing duration of contracts being signed for drilling rigs indicates that the strong market in the oil service sector is likely to continue.

On a geographic basis, our business is well-positioned in North America, where our revenue grew over $28 million since the first quarter of 2006. One of our fastest growing operations in this region is production enhancement, where we help our customers optimize their wells' production rates by providing stimulation services. Among the other opportunities we expect is the growth of deepwater drilling. Although overall rigs in the Gulf of Mexico are expected to decrease in 2006, demand to drill in the deepwater of the Gulf of Mexico is increasing. Despite having downsized our Gulf of Mexico operations due to its downturn in 2002-2003, we continue to have a significant presence in the area and are positioned to meet increasing customer demand. As a result, our revenue from the Gulf of Mexico was up 19% year-over-year, which contributed to a 67% increase in operating income in the Gulf of Mexico. Despite the significant reduction in rig activity during the spring break-up season, our revenue from Canada compared to the first half of 2005 was up 38%, driven primarily by the Production Optimization segment.

During the first half of 2006, we increased our international revenue by 23% or $622 million compared to the first half of 2005.

In the Middle East/Asia region, Saudi Arabia experienced 57% revenue growth compared to the first half of 2005, due to increased activity, led by the Drilling and Formation Evaluation segment. A tool repair center was opened in Jebel Ali in the United Arab Emirates to help increase tool utilization by decreasing repair times in the Middle East and returning damaged tools back into service. In July 2006, we signed an agreement to provide the oilfield services component for the Saudi Aramco Al Khurais mega project. In the Asia Pacific area, China and Australia led revenue growth compared to the first half of last year, with Brunei and Sakhalin demonstrating large percentage revenue growth.

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In our Europe/Africa/CIS region, North Sea activity has continued to grow with Norway, the United Kingdom, and the Netherlands accounting for almost $62 million of revenue growth compared to the first half of 2005 led by the Production Optimization segment. In the second quarter of 2006, we signed a $193 million contract for cementing services, pumping, and drilling and completion fluids in Norway. Also in the second quarter, we signed an estimated $100 million contract to provide completion products and services for oil and gas operations in the United Kingdom, the Netherlands, Norway, and Ireland. In July 2006, we signed a $150 million contract to provide integrated drilling and well services in Norway. Russia experienced strong revenue and operating income growth compared to a slow first quarter due to extreme winter weather conditions. Activity in Africa has been volatile, but has experienced overall revenue growth of $92 million, representing a 21% increase compared to the first half of 2005. Fluid Systems growth in both Nigeria and Angola, coupled with Production Optimization growth across the region, accounted for the largest part of the revenue growth. We are continuing to deploy additional logging and cementing equipment and personnel into Libya where we expect to see growth later this year.

In Latin America, we experienced 9% revenue growth during the first six months of 2006 compared to the first six months of 2005, despite a decrease in revenue from Mexico. This came from growth in excess of 40% from both Colombia and Ecuador, both aided by the Fluid Systems contract start-ups that began in 2005, as well as double digit growth in Brazil, Argentina, and Venezuela. The revenue decline in Mexico resulted from lower activity on the turnkey drilling project, which began in 2004 and was completed in July of 2006.

As drilling activity remains strong, demand for Sperry Drilling Services is high in most regions of the world. As these services have high margins associated with them, we have made the decision to increase our capital spending in this area, especially for international markets.

Finally, technology is an important aspect of our business, and we continue to focus on the development, introduction, and application of new technologies. We expect our 2006 investment in new technology to increase compared to our 2005 investment of $220 million in research and development costs.

KBR

KBR provides a wide range of services to energy, chemical, and industrial customers and government entities worldwide. KBR’s customer base includes leading national and international oil and gas companies, independent refiners, petrochemical producers, fertilizer producers, and domestic and foreign government entities. KBR projects are generally longer-term in nature than our ESG work and are impacted by more diverse drivers than short-term fluctuations in oil and gas prices and drilling activities, such as local economic cycles, introduction of new governmental regulation, and governmental outsourcing of services. Demand for KBR’s services depends primarily on its customers’ capital expenditures for construction and defense services. KBR is currently benefiting from increased capital expenditures by our petroleum and petrochemical customers driven by high crude oil and natural gas prices and general global economic expansion. Additionally, the heightened focus on global security and major military force realignments, as well as, a global expansion in government outsourcing have all contributed to increased demand for KBR’s services.

Our Government and Infrastructure segment provides support services to military and civilian branches of governments throughout the world. The Government and Infrastructure segment's most significant contract is the worldwide United States Army logistics contract, known as LogCAP. We were awarded the competitively bid LogCAP III contract in December 2001 from the Army Materiel Command (AMC) to provide worldwide United States Army logistics services. The contract is a one-year contract with nine one-year renewal options. We are currently in year five of the contract.

During the second quarter of 2005, a large task order was assigned for the next phase of work under the LogCAP III contract in Iraq and replaces several task orders that are nearing completion. Our government services revenue related to Iraq under our LogCAP III and other contracts totaled approximately $2.4 billion in the six months ended June 30, 2006, $5.4 billion in 2005, and $7.1 billion in 2004. We expect the volume of work under our LogCAP III contract to continue to decline in 2006 as our customer scales back the amount of services we provide under this contract. The DoD has also announced that it will solicit competitive bids for a new multiple provider LogCAP IV contract to replace the current LogCAP III contract, under which we are the sole provider. A decrease in the magnitude of governmental spending and outsourcing for military and logistical support of the type that we provide could have a material adverse affect on our business, results of operations, and cash flow. Work related to the United States Navy under the CONCAP construction contingency contract was also lower during the quarter as hurricane reconstruction neared completion. In order to diversify our government services portfolio, we continue to expand our work for the United States Air Force under the AFCAP contract and for the United Kingdom Ministry of Defence. In addition, KBR was recently awarded the competitively bid Indefinite Delivery/Indefinite Quantity contract to support the Department of Homeland Security's United States Immigration and Customs Enforcement facilities in the event of an emergency. This contract has a five-year term, consisting of a one-year base period and four one-year options.

In the first quarter of 2006, a $13.9 billion private finance initiative contract was signed with the United Kingdom Ministry of Defence for the Allenby and Connaught project. This project will be operated by a joint venture in which we have a 45% ownership interest. The project is for 35 years and consists of a nine-year construction project to upgrade the British Army's garrisons at Aldershot and the Salisbury Plain in the United Kingdom. The contract also includes provisions for additional services to be performed over the 35-year period, including catering, transportation, office services and maintenance services.

In the civil infrastructure sector, we believe there has been a general trend of historic under-investment. In particular, infrastructure related to the quality of water, wastewater, roads and transportation, airports, and educational facilities has declined while demand for expanded and improved infrastructure continues to outpace funding. As a result, we expect increased opportunities for our engineering and construction services and for our privately financed project activities as our knowledge of financing structures make us an attractive partner for state and local governments undertaking important infrastructure projects.

Our Energy and Chemicals segment develops energy and chemical projects throughout the world, including LNG and GTL gas monetization facilities, refineries, petrochemical plants, offshore oil and gas production platforms, and synthesis gas facilities. The major focus is on our gas monetization work. For the global market, forecasted LNG growth remains strong and is expected to grow rapidly. Significant numbers of new LNG liquefaction plants and LNG receiving terminal projects are proposed worldwide and are in various stages of development. Committed LNG liquefaction engineering, procurement, and construction (EPC) projects will yield substantial growth in worldwide LNG liquefaction capacity. This trend is expected to continue through 2007 and beyond.

At June 30, 2006, we had $3.5 billion in backlog related to major gas monetization projects.

In the first quarter of 2006, we signed a $400 million contract for the construction of the EBIC ammonia project in Egypt. This contract is a turnkey engineering, procurement, construction, commissioning, and testing contract to design and construct an ammonia plant. In July 2006, we signed a lump-sum services contract for engineering, procurement, and construction management of a 1.35 million ton-per-year ethylene plant to be built in Saudi Arabia.

In March 2006, we signed an agreement to sell KBR's Production Services group, which was part of our Energy and Chemicals segment. In the second quarter of 2006, we completed the sale of KBR's Production Services group. Under the terms of the agreement, we received net proceeds of $265 million resulting in a pretax gain of approximately $123 million. As a result of the sale agreement, Production Services operations and assets and liabilities have been classified as discontinued operations for all periods presented.

In order to meet growing energy demands, oil and gas companies are increasing their exploration, production, and transportation spending to increase production capacity and supply. KBR is currently targeting reimbursable EPC and engineering, procurement, and construction management opportunities in northern and western Africa, the Caspian area, Asia Pacific, Latin America, and the North Sea.

Outsourcing of operations and maintenance work by industrial and energy companies has been increasing worldwide. Opportunities in this area are anticipated as the aging infrastructure in United States refineries and chemical plants requires more maintenance and repairs to minimize production downtime. More stringent industry safety standards and environmental regulations also lead to higher maintenance standards and costs.

Contract structure. Engineering and construction contracts can be broadly categorized as either cost-reimbursable or fixed-price, sometimes referred to as lump sum. Some contracts can involve both fixed-price and cost-reimbursable elements.

Fixed-price contracts are for a fixed sum to cover all costs and any profit element for a defined scope of work. Fixed-price contracts entail more risk to us as we must predetermine both the quantities of work to be performed and the costs associated with executing the work. While fixed-price contracts involve greater risk, they also are potentially more profitable for the contractor, since the owner/customer pays a premium to transfer many risks to the contractor.

Cost-reimbursable contracts include contracts where the price is variable based upon our actual costs incurred for time and materials, or for variable quantities of work priced at defined unit rates. Profit on cost-reimbursable contracts may be based upon a percentage of costs incurred and/or a fixed amount. Cost-reimbursable contracts are generally less risky, since the owner/customer retains many of the risks.

We are continuing with our strategy to move away from offshore fixed-price engineering, procurement, installation, and commissioning (EPIC) contracts within our Energy and Chemicals segment. We have only two remaining major fixed-price EPIC offshore projects. As of June 30, 2006, they were substantially complete.

RESULTS OF OPERATIONS IN 2006 COMPARED TO 2005

Three Months Ended June 30, 2006 Compared with Three Months Ended June 30, 2005

	Three Months Ended June 30			
REVENUE:			Increase	Percentage
Millions of dollars	2006	2005	(Decrease)	Change
Production Optimization	$ 1,292	$ 971	$ 321	33%
Fluid Systems	870	699	171	24
Drilling and Formation Evaluation	774	641	133	21
Digital and Consulting Solutions	180	160	20	13
Total Energy Services Group	3,116	2,471	645	26
Government and Infrastructure	1,881	2,035	(154)	(8)
Energy and Chemicals	548	467	81	17
Total KBR	2,429	2,502	(73)	(3)
Total revenue	$ 5,545	$ 4,973	$ 572	12%
Geographic - Energy Services Group segments only:				
Production Optimization:				
North America	$ 771	$ 545	$ 226	41%
Latin America	95	85	10	12
Europe/Africa/CIS	250	199	51	26
Middle East/Asia	176	142	34	24
Subtotal	1,292	971	321	33
Fluid Systems:				
North America	450	346	104	30
Latin America	100	97	3	3
Europe/Africa/CIS	201	162	39	24
Middle East/Asia	119	94	25	27
Subtotal	870	699	171	24
Drilling and Formation Evaluation:				
North America	260	203	57	28
Latin America	114	102	12	12
Europe/Africa/CIS	179	167	12	7
Middle East/Asia	221	169	52	31
Subtotal	774	641	133	21
Digital and Consulting Solutions:				
North America	60	43	17	40
Latin America	46	49	(3)	(6)
Europe/Africa/CIS	44	37	7	19
Middle East/Asia	30	31	(1)	(3)
Subtotal	180	160	20	13
Total Energy Services Group revenue by region:				
North America	1,541	1,137	404	36
Latin America	355	333	22	7
Europe/Africa/CIS	674	565	109	19
Middle East/Asia	546	436	110	25
	$ 3,116	$ 2,471	$ 645	26%

Total Energy Services Group revenue

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OPERATING INCOME (LOSS):	Three Months Ended June 30		Increase	Percentage
Millions of dollars	2006	2005	(Decrease)	Change
Production Optimization	$ 357	$ 231	$ 126	55%
Fluid Systems	193	135	58	43
Drilling and Formation Evaluation	189	140	49	35
Digital and Consulting Solutions	52	16	36	225
Total Energy Services Group	791	522	269	52
Government and Infrastructure	68	72	(4)	(6)
Energy and Chemicals	(109)	39	(148)	NM
Total KBR	(41)	111	(152)	NM
General corporate	(32)	(37)	5	14
Total operating income	$ 718	$ 596	$ 122	20%
Geographic - Energy Services Group segments only:				
Production Optimization:				
North America	$ 252	$ 155	$ 97	63%
Latin America	19	14	5	36
Europe/Africa/CIS	41	31	10	32
Middle East/Asia	45	31	14	45
Subtotal	357	231	126	55
Fluid Systems:				
North America	120	82	38	46
Latin America	18	15	3	20
Europe/Africa/CIS	33	25	8	32
Middle East/Asia	22	13	9	69
Subtotal	193	135	58	43
Drilling and Formation Evaluation:				
North America	70	45	25	56
Latin America	20	14	6	43
Europe/Africa/CIS	40	41	(1)	(2)
Middle East/Asia	59	40	19	48
Subtotal	189	140	49	35
Digital and Consulting Solutions:				
North America	28	7	21	300
Latin America	8	(4)	12	NM
Europe/Africa/CIS	11	8	3	38
Middle East/Asia	5	5	-	-
Subtotal	52	16	36	225
Total Energy Services Group operating income by region:				
North America	470	289	181	63
Latin America	65	39	26	67
Europe/Africa/CIS	125	105	20	19
Middle East/Asia	131	89	42	47
Total Energy Services Group operating income	$ 791	$ 522	$ 269	52%

NM - Not Meaningful

Note 1 - All periods presented reflect the reclassification of KBR's Production Services operations to discontinued operations, as well as the

reorganization of tubing conveyed perforating, slickline, and underbalanced applications operations from Production Optimization

into the Drilling and Formation Evaluation segment.

The increase in consolidated revenue in the second quarter of 2006 compared to the second quarter of 2005 was attributable to increased revenue from our Energy Services Group, predominantly resulting from increased activity, higher utilization of our equipment, and our ability to raise prices due to higher exploration and production spending by our customers. This was partially offset by reduced activity in our government services projects, primarily in the Middle East. International revenue was 68% of consolidated revenue in the second quarter of 2006 and 73% of consolidated revenue in the second quarter of 2005, with the decrease primarily due to the decline of our government services projects abroad. Revenue from the United States Government for all geographic areas was approximately $1.6 billion or 28% of consolidated revenue in the second quarter of 2006 compared to $1.6 billion or 33% of consolidated revenue in the second quarter of 2005.

The increase in consolidated operating income was due to stronger performance in our Energy Services Group resulting from improved demand due to increased rig activity and improved pricing and asset utilization. KBR's operating income declined primarily due to a $148 million loss recorded on the Escravos, Nigeria GTL project.

In the second quarter of 2006, Iraq-related work contributed approximately $1.3 billion to consolidated revenue and $47 million to consolidated operating income, a 3.7% margin before corporate costs and taxes.

Following is a discussion of our results of operations by reportable segment.

Production Optimization increase in revenue compared to the second quarter of 2005 was driven by production enhancement services revenue, which increased 38%. The improvement spanned all geographic regions and resulted primarily from higher demand for onshore and offshore stimulation services and increased equipment utilization in North America, new contracts in Russia, and pipeline projects and additional sales and services in the North Sea. Revenue from completion tools increased 17% due to higher demand for completions and service tool products in the United States and contract start-ups and increased sales of drill stem test and sand control tool projects in Africa and Asia Pacific. International revenue was 43% of total segment revenue in the second quarter of 2006 compared to 47% in the second quarter of 2005.

The increase in operating income for the segment compared to the second quarter of 2005 was led by production enhancement services operating income, which grew 65%. The improvement spanned all regions, particularly driven by strong demand for stimulation services offshore, increased utilization of crews and assets on higher activity, and improved pricing in the United States. Completion tools operating income increased 23% due to higher sales in the United States, Asia Pacific, and Africa.

Fluid Systems revenue improvement in the second quarter of 2006 compared to the second quarter of 2005 resulted from a 26% increase in revenue from sales of cementing services, primarily due to improved activity and pricing in the United States and new contracts, higher equipment sales, and improved pricing in Asia Pacific. Cementing also benefited from increased activity in Russia and the North Sea. Completion of contracts since the second quarter of 2005 and recent project delays in Mexico adversely impacted the cementing services revenue comparison. Baroid Fluid Services contributed 23% growth in revenue, spanning all regions, largely due to improved activity and pricing in North America and west Africa and increased sales in Russia, partially offset by decreased activity in Indonesia and Mexico. International revenue was 51% of total segment revenue in the second quarter of 2006 compared to 54% in the second quarter of 2005.

The segment operating income improvement compared to the second quarter of 2005 was led by a 43% increase from cementing services, due to higher drilling activity and improved pricing in the United States and improved sales and service activity in Russia, the North Sea, and Asia Pacific. These results were partially offset by lower offshore activity in Mexico. Baroid Fluid Services operating income grew 44% on strong drilling activity and pricing improvements in the United States and higher activity in Latin America and Russia. Partially offsetting these results was lower activity in the North Sea.

Drilling and Formation Evaluation revenue growth for the second quarter of 2006 compared to the second quarter of 2005 came from all regions, with all product service lines benefiting from increased drilling activity in the United States. Drilling services contributed a 19% increase, with 59% growth in the Gulf of Mexico and 51% growth in Asia Pacific driven by new contracts, higher rig activity, and sales of tools. Logging services revenue increased 21%, additionally benefiting from deployment of tools to high demand areas of the Middle East and increased activity in the United States and Asia Pacific, partially offset by activity decline in the North Sea. Drill bits revenue increased 30%, largely derived from the United States, the Middle East, Canada, and Australia due to heightened drilling activity.

International revenue was 70% of total segment revenue in the second quarter of 2006 compared to 72% in the second quarter of 2005.

The increase in segment operating income was led by a 28% improvement in drilling services results, which benefited from increased directional drilling activity in the United States, Australia, and the North Sea. These results were partially offset by completion of contracts in Africa and lower margin work in the Middle East. Logging services operating income increased 42% due to improved pricing and increased activity in the United States, Latin America, Saudi Arabia, and Asia Pacific. Drill bit sales operating income grew 39% over the prior year second quarter, reflecting increased drilling activity in Canada and higher sales of coring services in Australia and the Middle East.

Digital and Consulting Solutions revenue improvement for the second quarter of 2006 compared to the second quarter of 2005 was led by a 21% increase in Landmark, primarily reflecting higher software sales and consulting and customer support services in all four regions. Segment revenue growth was partially offset by two fixed-price integrated solutions projects in southern Mexico nearing completion. International revenue was 69% of total segment revenue in the second quarter of 2006 compared to 75% in the second quarter of 2005.

The segment operating income improvement primarily reflects a 55% increase in Landmark results due to improved sales of software and consulting and customer support services, primarily in the United States, Latin America, and northern Africa. Second quarter of 2005 results included a $15 million loss on the integrated solutions projects in southern Mexico.

Government and Infrastructure revenue for the second quarter of 2006 totaled $1.9 billion, a $154 million decrease compared to the second quarter of 2005. Revenue from Iraq-related work decreased $155 million primarily due to lower activities on the LogCAP contract. Also contributing to the decrease was lower revenue earned by the DML shipyard and other government support services projects, partially offset by remaining activities related to the hurricane relief effort in the United States. In addition, we received revenue from our newly awarded Allenby and Connaught project in the United Kingdom.

Segment operating income for the second quarter of 2006 decreased $4 million compared to the second quarter of 2005. Results in the second quarter of 2006 were positively impacted by a $6 million gain on sale of part of our interest in a United Kingdom government project. In addition, operating income was positively impacted by better performance from our DML operations and various other projects. These increases were offset by a $17 million loss on an equity investment joint venture road project in the United Kingdom and lower operating margins on various other projects.

Energy and Chemicals revenue for the second quarter of 2006 totaled $548 million, an $81 million increase compared to the second quarter of 2005. Increased revenue from a GTL project in Nigeria and recently awarded projects including a GTL project in Qatar, an LNG project in Yemen, joint venture activities in Mexico, and a new ammonia plant construction project in Egypt contributed $165 million. In addition, an oil and gas project in Africa and a refining fabrication project in Canada contributed a combined $26 million to the second quarter revenue comparison. These increases were partially offset by lower revenue on a crude oil facility in Canada and on an offshore engineering and project management contract in Angola, totaling $85 million. In addition, revenue from a substantially complete LNG project and an offshore engineering and design project in Nigeria decreased by an aggregate $24 million.

Segment operating income declined $148 million in the second quarter of 2006 compared to the second quarter of 2005, primarily reflecting a $148 million charge on the Escravos, Nigeria GTL project. The charge related to schedule delays and cost increases arising from site issues and scope changes encountered on the project.

General corporate expenses were $32 million in the second quarter of 2006 compared to $37 million in the second quarter of 2005. The decrease largely reflects a $7 million legal settlement in the second quarter of 2005.

NONOPERATING ITEMS

Interest expense decreased $8 million in the second quarter of 2006 compared to the second quarter of 2005, primarily due to the redemption in April 2005 of $500 million of our floating rate senior notes and the repayment in October 2005 of $300 million of our floating rate senior notes.

Interest income increased $29 million in the second quarter of 2006 compared to the second quarter of 2005 due to higher interest rate driven earnings on higher cash balances.

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Foreign currency losses, net increased $3 million from $7 million in net losses in the second quarter of 2005. The increase was primarily due to the impact of United States dollar proceeds from the sale of Production Services that were received by our United Kingdom-based subsidiary, which uses British sterling as its functional currency.

Provision for income taxes from continuing operations in the second quarter of 2006 of $226 million resulted in an effective tax rate of 32% compared to an effective tax rate of 28% in the second quarter of 2005. The lower rate for 2005 was primarily attributable to the release of a portion of the valuation allowance from our United States net operating loss carryforward.

Minority interest in net (income) loss of subsidiaries increased $46 million compared to the second quarter of 2005 primarily due to the loss from the consolidated 50%-owned gas-to-liquids project in Escravos, Nigeria.

Income from discontinued operations, net of tax provision in the second quarter of 2006 primarily consisted of a $123 million pretax gain on the sale of KBR's Production Services group and $5 million of pretax income related to Production Services operations. Income from discontinued operations in the second quarter of 2005 primarily consisted of $10 million of pretax income related to Production Services operations.

RESULTS OF OPERATIONS IN 2006 COMPARED TO 2005

Six Months Ended June 30, 2006 Compared with Six Months Ended June 30, 2005

	Six Months Ended June 30			
REVENUE:			Increase	Percentage
Millions of dollars	2006	2005	(Decrease)	Change
Production Optimization	$ 2,488	$ 1,805	$ 683	38%
Fluid Systems	1,706	1,330	376	28
Drilling and Formation Evaluation	1,499	1,196	303	25
Digital and Consulting Solutions	361	324	37	11
Total Energy Services Group	6,054	4,655	1,399	30
Government and Infrastructure	3,589	4,123	(534)	(13)
Energy and Chemicals	1,086	978	108	11
Total KBR	4,675	5,101	(426)	(8)
Total revenue	$ 10,729	$ 9,756	$ 973	10%
Geographic - Energy Services Group segments only:				
Production Optimization:				
North America	$ 1,505	$ 1,032	$ 473	46%
Latin America	189	172	17	10
Europe/Africa/CIS	465	354	111	31
Middle East/Asia	329	247	82	33
Subtotal	2,488	1,805	683	38
Fluid Systems:				
North America	897	666	231	35
Latin America	194	185	9	5
Europe/Africa/CIS	384	300	84	28
Middle East/Asia	231	179	52	29
Subtotal	1,706	1,330	376	28
Drilling and Formation Evaluation:				
North America	533	405	128	32
Latin America	222	192	30	16
Europe/Africa/CIS	336	296	40	14
Middle East/Asia	408	303	105	35
Subtotal	1,499	1,196	303	25
Digital and Consulting Solutions:				
North America	119	93	26	28
Latin America	101	98	3	3
Europe/Africa/CIS	84	78	6	8
Middle East/Asia	57	55	2	4
Subtotal	361	324	37	11
Total Energy Services Group revenue by region:				
North America	3,054	2,196	858	39
Latin America	706	647	59	9
Europe/Africa/CIS	1,269	1,028	241	23
Middle East/Asia	1,025	784	241	31
	$ 6,054	$ 4,655	$ 1,399	30%

Total Energy Services Group revenue	46

OPERATING INCOME (LOSS):	Six Months Ended June 30		Increase	Percentage
Millions of dollars	2006	2005	(Decrease)	Change
Production Optimization	$ 681	$ 511	$ 170	33%
Fluid Systems	375	248	127	51
Drilling and Formation Evaluation	361	231	130	56
Digital and Consulting Solutions	101	45	56	124
Total Energy Services Group	1,518	1,035	483	47
Government and Infrastructure	88	125	(37)	(30)
Energy and Chemicals	(67)	80	(147)	NM
Total KBR	21	205	(184)	(90)
General corporate	(66)	(69)	3	4
Total operating income	$ 1,473	$ 1,171	$ 302	26%
Geographic - Energy Services Group segments only:				
Production Optimization:				
North America	$ 496	$ 385	$ 111	29%
Latin America	34	34	-	-
Europe/Africa/CIS	74	44	30	68
Middle East/Asia	77	48	29	60
Subtotal	681	511	170	33
Fluid Systems:				
North America	240	151	89	59
Latin America	32	31	1	3
Europe/Africa/CIS	60	43	17	40
Middle East/Asia	43	23	20	87
Subtotal	375	248	127	51
Drilling and Formation Evaluation:				
North America	151	92	59	64
Latin America	38	26	12	46
Europe/Africa/CIS	67	51	16	31
Middle East/Asia	105	62	43	69
Subtotal	361	231	130	56
Digital and Consulting Solutions:				
North America	63	14	49	350
Latin America	14	(6)	20	NM
Europe/Africa/CIS	17	29	(12)	(41)
Middle East/Asia	7	8	(1)	(13)
Subtotal	101	45	56	124
Total Energy Services Group operating income by region:				
North America	950	642	308	48
Latin America	118	85	33	39
Europe/Africa/CIS	218	167	51	31
Middle East/Asia	232	141	91	65
Total Energy Services Group operating income	$ 1,518	$ 1,035	$ 483	47%

NM - Not Meaningful

Note 1 - All periods presented reflect the reclassification of KBR's Production Services operations to discontinued operations, as well as the reorganization of tubing conveyed perforating, slickline, and underbalanced applications operations from Production Optimization into the Drilling and Formation Evaluation segment.

The increase in consolidated revenue in the first six months of 2006 compared to the first six months of 2005 was attributable to increased revenue from our Energy Services Group, predominantly arising from increased drilling activity, higher utilization of our equipment, and our ability to raise prices due to higher exploration and production spending by our customers. This was partially offset by reduced revenue from KBR primarily on government services projects in the Middle East. International revenue was 67% of consolidated revenue in the first six months of 2006 and 74% of consolidated revenue in the first six months of 2005, with the decrease primarily due to the decline of our government services projects abroad. Revenue from the United States Government for all geographic areas was approximately $2.9 billion or 27% of consolidated revenue in the first six months of 2006 compared to $3.3 billion or 34% of consolidated revenue in the first six months of 2005.

The increase in consolidated operating income was primarily due to stronger performance in our Energy Services Group resulting from improved demand due to increased customer drilling and production activity and improved pricing and asset utilization. KBR's operating income declined chiefly due to a $148 million loss recorded on the Escravos, Nigeria GTL project and reduced activity on government services projects, particularly in the Middle East. In the first six months of 2006, Iraq-related work contributed approximately $2.4 billion to consolidated revenue and $74 million to consolidated operating income, resulting in a 3.1% margin before corporate costs and taxes.

Following is a discussion of our results of operations by reportable segment.

Production Optimization revenue increase compared to the first six months of 2005 was driven by a 44% increase in revenue from production enhancement services and an 18% increase from completion tools sales and services. Both product service lines had increases in all geographic areas, with 63% of the segment revenue increase from the United States due to higher drilling activity, improved pricing, and equipment utilization. Production enhancement services had additional revenue uplift from expanded operations in Russia and higher activity in the Middle East. Sales of completion tools and services further benefited from increased completions, drill stem test, and reservoir performance monitoring activities, primarily in Africa and the Middle East. International revenue was 44% of total segment revenue in the first six months of 2006 compared to 47% in the first six months of 2005.

The increase in segment operating income in the first six months of 2006 compared to the first six months of 2005 was led by production enhancement services operating income, which increased 84% and spanned all regions. The increase in production enhancement services operating income was largely driven by higher activity, stronger utilization, and improved pricing in the United States. Additionally, production enhancement services results doubled internationally compared to the first half of 2005, in part due to expanded worldwide operations. Completion tools operating income increased 20% compared to the first six months of 2005, primarily on higher activity in the Middle East/Asia region and the United States, partially offset by an unfavorable change in product mix in Latin America. Operating income in the first six months of 2005 included a $110 million gain on the sale of our Subsea 7, Inc. equity interest.

Fluid Systems revenue increase compared to the first six months of 2005 was derived from all regions but primarily from the United States due to increased activity and pricing improvements. A 29% increase in revenue from cementing services also benefited from increased service activity and improved sales in Indonesia, Russia, and the United Kingdom. Completion of contracts in Mexico since the first six months of 2005 adversely impacted the cementing services revenue comparison. Baroid Fluid Services revenue grew 28% largely on increased sales in Russia and Sakhalin, higher rig activity in Angola, and increased operations in Venezuela, which was partially offset by contracts expiring in Mexico and Indonesia. International revenue was 52% of total segment revenue in the first six months of 2006 compared to 54% in the first six months of 2005.

Fluid Systems segment operating income increase compared to the first six months of 2005 was led by a 53% increase from cementing services due to higher drilling activity and pricing improvements in the United States and improved product mix in Angola, Norway, and Saudi Arabia. These results were partially offset by lower offshore activity in Mexico. Baroid Fluid Services operating income increased 46% compared to the first half of 2005 due primarily to continued strong activity, pricing improvements, and hurricane insurance proceeds in North America, increased operations in Venezuela, and improved results from a joint venture in the Netherlands. Partially offsetting these results was the completion of a contract in Mexico.

Drilling and Formation Evaluation revenue increase in the first six months of 2006 compared to the first six months of 2005 was derived from a 31% increase in drill bits revenue, a 26% increase in drilling services revenue, which spanned all four regions, and a 23% increase in logging service revenue, which also spanned all four regions. Sales of drill bits largely benefited from increased fixed cutter sales in the United States and increased drilling activity in Canada, the Middle East, and the North Sea. The drilling services revenue increase is primarily due to heightened drilling activity, improved pricing, and introduction of new technology in North America and increased activity and sales of tools in Asia Pacific. Negatively impacting drilling services revenue in the first six months of 2006 compared to the first six months of 2005 was a decline in activity in Indonesia. Logging services revenue grew largely due to improved pricing and increased cased-hole activity in the United States, new contracts in the Middle East, and continued success with our reservoir description tool. A lost contract in Malaysia decreased results. International revenue was 70% of total segment revenue in the first six months of 2006 compared to 72% in the first six months of 2005.

The segment operating income increase compared to the first six months of 2005 spanned all geographic regions, with North America as the predominant contributor due to improved pricing, increased rig activity, and higher equipment utilization. Drill bits operating income increased 72%, with international operating income more than doubling. Contributing to drill bits international operating income increase were improvements in Canada, Saudi Arabia, and Australia. Drilling services operating income increased 62% on increased activity, partially offset by increased costs in Russia, Kazakhstan, and the Middle East. Logging services operating income increased 44% largely due to increased activity, improved product mix, and reservoir description tool deployment in the Middle East/Asia region, where operating income increased 72%.

Digital and Consulting Solutions revenue increase in the first six months of 2006 was led by Landmark, with a 16% revenue increase compared to the first six months of 2005 and increases in all four regions due to increased sales of software and maintenance and support services. Project management revenue in the first six months of 2006 decreased 5% compared to the first six months of 2005 due to two fixed-price integrated solutions projects in southern Mexico nearing completion. International revenue was 69% of total segment revenue in the first six months of 2006 compared to 73% in the first six months of 2005.

The segment operating income improvement stemmed in part from a 90% increase in Landmark operating income. Project management recorded $23 million in losses in the first half of 2005 on two fixed-price integrated solutions projects in Mexico. These losses reflected increased costs to complete the projects and longer drilling times than originally anticipated, chiefly due to unfavorable geological conditions. The first six months of 2006 included a gain of $10 million from the sale of an investment accounted for under the cost method. Included in the 2005 results was a $17 million favorable insurance settlement related to a pipe fabrication and laying project in the North Sea.

Government and Infrastructure revenue for the first six months of 2006 was $3.6 billion, a $534 million decrease compared to the first six months of 2005. The majority of the decrease resulted from lower activities on government projects, primarily on the LogCAP contract in the Middle East and the DML shipyard. Partially offsetting the decreases were activities on the hurricane relief work project in the United States on the CONCAP contract for $92 million. In addition, revenue was negatively impacted by a $26 million impairment charge recorded on an equity investment in an Australian railroad operation and a $17 million impairment charge recorded on an equity investment in a joint venture road project in the United Kingdom.

Segment operating income for the first six months of 2006 was $88 million compared to $125 million in the first six months of 2005, a decrease of $37 million. Operating income from Iraq-related work decreased $12 million primarily due to lower activities on the LogCAP contract. Iraq-related results in the first six months of 2005 were positively impacted by DFAC settlement and award fees on definitized task orders. In addition, the first six months of 2006 operating income was negatively impacted by a $26 million impairment charge recorded on an equity investment in an Australian railroad operation and a $17 million impairment charge recorded on an equity investment in a joint venture road project in the United Kingdom, partially offset by a $6 million gain on sale of part of our interest in a United Kingdom government project. Operating income in the first six months of 2005 included a one-time $11 million cash distribution from a joint venture investment in a United States toll road that had been fully reserved.

Energy and Chemicals revenue for the first six months of 2006 was $1.1 billion compared to $978 million for the first six months of 2005. The increase in revenue was primarily due to activities on GTL projects located in Nigeria and Qatar, a recently awarded ammonia plant construction project in Egypt, and LNG projects in Algeria and Yemen, totaling $325 million. Partially offsetting the segment revenue improvement were decreases from a substantially completed LNG project in Nigeria, crude oil facility projects in Canada, and an olefins project in the United States, totaling $215 million.

Energy and Chemicals posted a $67 million loss for the first six months of 2006 compared to $80 million operating income in the first six months of 2005. The $147 million decrease was primarily due to a $148 million charge on the Escravos, Nigeria GTL project. In addition, segment results in the first six months of 2006 were impacted by a $15 million loss provision on the Barracuda-Caratinga project in Brazil and an aggregate $31 million decrease in operating income due to lower recovery of costs on a crude oil facility in Canada and lower progress on an offshore engineering and project management project in the Caspian. Substantially offsetting these declines were $45 million of income from a newly awarded EBIC ammonia plant construction project in Egypt, in which KBR holds an equity position, and an early works award on an engineering, procurement, and construction project in Algeria.

General corporate expenses were $66 million in the first six months of 2006 compared to $69 million in the first six months of 2005. The first half of 2005 included costs of a $7 million legal settlement. In addition, general corporate expenses in the first six months of 2006 were impacted by increases in executive compensation and legal costs.

NONOPERATING ITEMS

Interest expense decreased $13 million in the first six months of 2006 compared to the first six months of 2005, primarily due to the redemption in April 2005 of $500 million of our floating rate senior notes and the repayment in October 2005 of $300 million of our floating rate senior notes.

Interest income increased $45 million in the first six months of 2006 compared to the first six months of 2005 due to higher interest rate driven earnings on higher cash balances.

Foreign currency losses, net decreased $5 million from $7 million in net losses in the first six months of 2005, primarily due to gains on the British pound sterling and Norwegian kroner. These gains were offset by the impact of United States dollar proceeds from the sale of Production Services that were received by our United Kingdom-based subsidiary, which uses British sterling as its functional currency.

Provision for income taxes from continuing operations in the first six months of 2006 of $481 million resulted in an effective tax rate of 33% compared to an effective tax rate of 29% in the first six months of 2005. The lower rate for 2005 was primarily attributable to the release of a portion of the valuation allowance from our United States net operating loss carryforward.

Minority interest in net (income)loss of subsidiaries increased $43 million compared to the first six months of 2005 primarily due to the loss from the consolidated 50%-owned gas-to-liquids project in Escravos, Nigeria.

Income from discontinued operations, net of tax in the first six months of 2006 primarily consisted of a $123 million pretax gain on the sale of KBR’s Production Services group and $14 million of pretax income related to Production Services operations. Income from discontinued operations in the first six months of 2005 primarily consisted of $22 million of pretax income related to Production Services operations.

OFF BALANCE SHEET RISK

Under our Energy Services Group accounts receivable securitization facility we had the ability to sell up to $300 million in undivided ownership interest in a pool of receivables. During the fourth quarter of 2005, $256 million in undivided ownership interest that had been sold to unaffiliated companies was collected and the balance retired. No further receivables were sold, and the facility was terminated in the first quarter of 2006.

In May 2004, we entered into an agreement to sell, assign, and transfer the entire title and interest in specified United States government accounts receivable of KBR to a third party. The face value of the receivables sold to the third party was reflected as a reduction of accounts receivable in our condensed consolidated balance sheets. The total amount of receivables outstanding under this agreement was approximately $257 million as of June 30, 2005. As of December 31, 2005, these receivables were collected, the balance was retired, and the facility was terminated.

ENVIRONMENTAL MATTERS

We are subject to numerous environmental, legal, and regulatory requirements related to our operations worldwide. In the United States, these laws and regulations include, among others:

- the Comprehensive Environmental Response, Compensation, and Liability Act;
- the Resources Conservation and Recovery Act;
- the Clean Air Act;
- the Federal Water Pollution Control Act; and
- the Toxic Substances Control Act.

In addition to the federal laws and regulations, states and other countries where we do business often have numerous environmental, legal, and regulatory requirements by which we must abide. We evaluate and address the environmental impact of our operations by assessing and remediating contaminated properties in order to avoid future liabilities and comply with environmental, legal, and regulatory requirements. On occasion, we are involved in specific environmental litigation and claims, including the remediation of properties we own or have operated, as well as efforts to meet or correct compliance-related matters. Our Health, Safety and Environment group has several programs in place to maintain environmental leadership and to prevent the occurrence of environmental contamination.

We do not expect costs related to these remediation requirements to have a material adverse effect on our consolidated financial position or our results of operations. Our accrued liabilities for environmental matters were $41 million as of June 30, 2006 and $50 million as of December 31, 2005. The liability covers numerous properties, and no individual property accounts for more than $5 million of the liability balance. We have subsidiaries that have been named as potentially responsible parties along with other third parties for 14 federal and state superfund sites for which we have established a liability. As of June 30, 2006, those 14 sites accounted for approximately $13 million of our total $41 million liability. In some instances, we have been named a potentially responsible party by a regulatory agency, but, in each of those cases, we do not believe we have any material liability.

NEW ACCOUNTING STANDARDS

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), "Share-Based Payment," (SFAS No. 123(R)). SFAS No. 123(R) is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. In April 2005, the SEC adopted a rule that defers the required effective date of SFAS No. 123(R). The SEC rule provides that SFAS No. 123(R) is now effective for registrants as of the beginning of the first fiscal year beginning after June 15, 2005. Effective January 1, 2006, we adopted the provisions of SFAS No. 123(R) using the modified prospective application. Accordingly, we recorded compensation expense for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006. Compensation cost for the unvested portion of awards that are outstanding as of January 1, 2006 is recognized ratably over the remaining vesting period based on the fair value at date of grant as calculated for our pro forma disclosure under SFAS No. 123. We also recognized compensation expense for our employee stock purchase plan beginning with the January 1, 2006 purchase period. See Note 13 to the condensed consolidated financial statements for further information.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109." This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." The interpretation prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for fiscal years beginning after December 31, 2006. We are currently evaluating what impact, if any, this statement will have on our financial statements.

FORWARD-LOOKING INFORMATION AND RISK FACTORS

The Private Securities Litigation Reform Act of 1995 provides safe harbor provisions for forward-looking information. Forward-looking information is based on projections and estimates, not historical information. Some statements in this Form 10-Q are forward-looking and use words like "may," "may not," "believes," "do not believe," "expects" "do not expect," "anticipates," "do not anticipate," and other expressions. We may also provide oral or written forward-looking information in other materials we release to the public. Forward-looking information involves risk and uncertainties and reflects our best judgment based on current information. Our results of operations can be affected by inaccurate assumptions we make or by known or unknown risks and uncertainties. In addition, other factors may affect the accuracy of our forward-looking information. As a result, no forward-looking information can be guaranteed. Actual events and the results of operations may vary materially.

We do not assume any responsibility to publicly update any of our forward-looking statements regardless of whether factors change as a result of new information, future events, or for any other reason. You should review any additional disclosures we make in our press releases and Forms 10-K, 10-Q, and 8-K filed with or furnished to the SEC. We also suggest that you listen to our quarterly earnings release conference calls with financial analysts.

While it is not possible to identify all factors, we continue to face many risks and uncertainties that could cause actual results to differ from our forward-looking statements and potentially materially and adversely affect our financial condition and results of operations, including the risks related to:

United States Government Contract Work

We provide substantial work under our government contracts to the United States Department of Defense and other governmental agencies. These contracts include our worldwide United States Army logistics contracts, known as LogCAP, and contracts to rebuild Iraq's petroleum industry, such as PCO Oil South. Our government services revenue related to Iraq totaled approximately $1.3 billion and $2.4 billion for the three and six months ended June 30, 2006 compared to $1.4 billion and $2.9 billion for the three and six months ended June 30, 2005.

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Given the demands of working in Iraq and elsewhere for the United States government, we expect that from time to time we will have disagreements or experience performance issues with the various government customers for which we work. If performance issues arise under any of our government contracts, the government retains the right to pursue remedies which could include threatened termination or termination, under any affected contract. If any contract were so terminated, we may not receive award fees under the affected contract, and our ability to secure future contracts could be adversely affected, although we would receive payment for amounts owed for our allowable costs under cost-reimbursable contracts. Other remedies that could be sought by our government customers for any improper activities or performance issues include sanctions such as forfeiture of profits, suspension of payments, fines, and suspensions or debarment from doing business with the government. Further, the negative publicity that could arise from disagreements with our customers or sanctions as a result thereof could have an adverse effect on our reputation in the industry, reduce our ability to compete for new contracts, and may also have a material adverse effect on our business, financial condition, results of operations, and cash flow.

DCAA audit issues

Our operations under United States government contracts are regularly reviewed and audited by the Defense Contract Audit Agency (DCAA) and other governmental agencies. The DCAA serves in an advisory role to our customer. When issues are found during the governmental agency audit process, these issues are typically discussed and reviewed with us. The DCAA then issues an audit report with its recommendations to our customer's contracting officer. In the case of management systems and other contract administrative issues, the contracting officer is generally with the Defense Contract Management Agency (DCMA). We then work with our customer to resolve the issues noted in the audit report. If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable, or, if already reimbursed, the costs must be refunded to the customer.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCAA recommended that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. As of June 30, 2006, the DCAA had issued notices to disallow $56 million of the withheld amounts, of which $17 million has been withheld from our subcontractors. We will continue working with the government and our subcontractors to resolve this issue.

Other issues. The DCAA is continuously performing audits of costs incurred for the foregoing and other services provided by us under our government contracts. During these audits, there are likely to be questions raised by the DCAA about the reasonableness or allowability of certain costs or the quality or quantity of supporting documentation. The DCAA might recommend withholding some portion of the questioned costs while the issues are being resolved with our customer. Because of the intense scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve. We do not believe any potential withholding will have a significant or sustained impact on our liquidity.

Investigations

In the first quarter of 2005, the United States Department of Justice (DOJ) issued two indictments associated with overbilling issues we previously reported to the Department of Defense Inspector General's office as well as to our customer, the Army Materiel Command, against a former KBR procurement manager and a manager of La Nouvelle Trading & Contracting Company, W.L.L.

In October 2004, we reported to the Department of Defense Inspector General's office that two former employees in Kuwait may have had inappropriate contacts with individuals employed by or affiliated with two third-party subcontractors prior to the award of the subcontracts. The Inspector General's office may investigate whether these two employees may have solicited and/or accepted payments from these third-party subcontractors while they were employed by us.

In October 2004, a civilian contracting official in the Army Corps of Engineers (COE) asked for a review of the process used by the COE for awarding some of the contracts to us. We understand that the Department of Defense Inspector General's office may review the issues involved.

We understand that the DOJ, an Assistant United States Attorney based in Illinois, and others are investigating these and other individually immaterial matters we have reported related to our government contract work in Iraq. If criminal wrongdoing were found, criminal penalties could range up to the greater of $500,000 in fines per count for a corporation or twice the gross pecuniary gain or loss. We also understand that current and former employees of KBR have received subpoenas and have given or may give grand jury testimony related to some of these matters.

Claims

In addition, we had probable unapproved claims totaling $42 million at June 30, 2006 for the LogCAP contract. These unapproved claims related to this contract are where our costs have exceeded the customer's funded value of the task order.

DCMA system reviews

Report on estimating system. In December 2004, the DCMA granted continued approval of our estimating system, stating that our estimating system is "acceptable with corrective action." We are in the process of completing these corrective actions. Specifically, based on the unprecedented level of support that our employees are providing the military in Iraq, Kuwait, and Afghanistan, we needed to update our estimating policies and procedures to make them better suited to such contingency situations. Additionally, we have completed our development of a detailed training program and have made it available to all estimating personnel to ensure that employees are adequately prepared to deal with the challenges and unique circumstances associated with a contingency operation.

Report on purchasing system. As a result of a Contractor Purchasing System Review by the DCMA during the fourth quarter of 2005, the DCMA granted the continued approval of our government contract purchasing system. The DCMA's October 2005 approval letter stated that our purchasing system's policies and practices are "effective and efficient, and provide adequate protection of the Government's interest."

Report on accounting system. We received two draft reports on our accounting system, which raised various issues and questions. We have responded to the points raised by the DCAA, but this review remains open. Once the DCAA finalizes the report, it will be submitted to the DCMA, who will make a determination of the adequacy of our accounting systems for government contracting.

The Balkans

We have had inquiries in the past by the DCAA and the civil fraud division of the DOJ into possible overcharges for work performed during 1996 through 2000 under a contract in the Balkans, for which inquiry has not yet been completed by the DOJ. Based on an internal investigation, we credited our customer approximately $2 million during 2000 and 2001 related to our work in the Balkans as a result of billings for which support was not readily available. We believe that the preliminary DOJ inquiry relates to potential overcharges in connection with a part of the Balkans contract under which approximately $100 million in work was done. We believe that any allegations of overcharges would be without merit. Amounts accrued related to this matter as of June 30, 2006 are not material.

Development Fund for Iraq

We have some task orders issued and executed under the PCO Oil contract that are funded under the Development Fund for Iraq (DFI). We received notification in the third quarter of 2005 that United States government personnel have decided to cease all administration of DFI funded contracts after December 31, 2005. In December 2005, we received notification that this deadline was deferred until December 31, 2006. If not deferred again at year end 2006, that could mean that we may be required to obtain payment for all services provided under the affected task orders after that date and for all invoices submitted and not paid prior to that date from the sovereign Republic of Iraq. As our PCO Oil contract is with the United States government, it is unclear what the ramifications of such a change in funding, if implemented, would have or what the financial implications would be. We currently have approximately $9 million in receivables recorded from the United States government related to this issue.

Foreign Corrupt Practices Act investigations

The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which we are furnishing, regarding current and former agents used in connection with multiple projects over the past 20 years located both in and outside of Nigeria in which The M .W. Kellogg Company, M. W. Kellogg, Ltd., Kellogg Brown & Root or their joint ventures, as well as the Halliburton energy services business, were participants.

TSKJ is a private limited liability company registered in Madeira, Portugal whose members are Technip SA of France, Snamprogetti Netherlands B.V. (a subsidiary of Saipem SpA of Italy), JGC Corporation of Japan, and Kellogg Brown & Root (a subsidiary of ours and successor to The M.W. Kellogg Company), each of which has a 25% interest in the venture. TSKJ and other similarly owned entities entered into various contracts to build and expand the liquefied natural gas project for Nigeria LNG Limited, which is owned by the Nigerian National Petroleum Corporation, Shell Gas B.V., Cleag Limited (an affiliate of Total), and Agip International B.V. (an affiliate of ENI SpA of Italy). M.W. Kellogg Limited is a joint venture in which we have a 55% interest; and M.W. Kellogg Limited and The M.W. Kellogg Company were subsidiaries of Dresser Industries before our 1998 acquisition of Dresser Industries. The M.W. Kellogg Company was later merged with a subsidiary of ours to form Kellogg Brown & Root, one of our subsidiaries.

The SEC and the DOJ have been reviewing these matters in light of the requirements of the United States Foreign Corrupt Practices Act (FCPA). In addition to performing our own investigation, we have been cooperating with the SEC and the DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. Our Board of Directors has appointed a committee of independent directors to oversee and direct the FCPA investigations.

The matters under investigation related to the Bonny Island project cover an extended period of time (in some cases significantly before our 1998 acquisition of Dresser Industries). We have produced documents to the SEC and the DOJ both voluntarily and pursuant to company subpoenas from the files of numerous officers of Halliburton and KBR, including current and former executives of Halliburton and KBR, and we are making our employees available to the SEC and the DOJ for interviews. In addition, we understand that the SEC has issued a subpoena to A. Jack Stanley, who formerly served as a consultant and chairman of KBR, and to others, including certain of our current and former KBR employees, former executive officers of KBR, and at least one subcontractor of KBR. We further understand that the DOJ has invoked its authority under a sitting grand jury to issue subpoenas for the purpose of obtaining information abroad, and we understand that other partners in TSKJ have provided information to the DOJ and the SEC with respect to the investigations, either voluntarily or under subpoenas.

The SEC and DOJ investigations include an examination of whether TSKJ’s engagements of Tri-Star Investments as an agent and a Japanese trading company as a subcontractor to provide services to TSKJ were utilized to make improper payments to Nigerian government officials. In connection with the Bonny Island project, TSKJ entered into a series of agency agreements, including with Tri-Star Investments, of which Jeffrey Tesler is a principal, commencing in 1995 and a series of subcontracts with a Japanese trading company commencing in 1996. We understand that a French magistrate has officially placed Mr. Tesler under investigation for corruption of a foreign public official. In Nigeria, a legislative committee of the National Assembly and the Economic and Financial Crimes Commission, which is organized as part of the executive branch of the government, are also investigating these matters. Our representatives have met with the French magistrate and Nigerian officials. In October 2004, representatives of TSKJ voluntarily testified before the Nigerian legislative committee.

As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made to Nigerian officials.

We notified the other owners of TSKJ of information provided by the investigations and asked each of them to conduct their own investigation. TSKJ has suspended the receipt of services from and payments to Tri-Star Investments and the Japanese trading company and has considered instituting legal proceedings to declare all agency agreements with Tri-Star Investments terminated and to recover all amounts previously paid under those agreements. In February 2005, TSKJ notified the Attorney General of Nigeria that TSKJ would not oppose the Attorney General's efforts to have sums of money held on deposit in banks in Switzerland transferred to Nigeria and to have the legal ownership of such sums determined in the Nigerian courts.

In June 2004, all relationships with Mr. Stanley and another consultant and former employee of M. W. Kellogg, Ltd. were terminated. The terminations occurred because of violations of our Code of Business Conduct that allegedly involved the receipt of improper personal benefits from Mr. Tesler in connection with TSKJ's construction of the Bonny Island project.

We have also suspended the services of another agent who has worked for KBR outside of Nigeria on several current projects and on numerous older projects going back to the early 1980's until such time, if ever, as we can satisfy ourselves regarding the agent's compliance with applicable law and our Code of Business Conduct. In addition, we are actively reviewing the compliance of an additional agent on a separate current Nigerian project with respect to which we have recently received from a joint venture partner on that project allegations of wrongful payments made by such agent.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss. Both the SEC and the DOJ could argue that continuing conduct may constitute multiple violations for purposes of assessing the penalty amounts per violation. Agreed dispositions for these types of matters sometimes result in a monitor being appointed by the SEC and/or the DOJ to review future business and practices with the goal of ensuring compliance with the FCPA. Fines and civil and criminal penalties could be mitigated, in the government's discretion, depending on the level of the cooperation in the investigations.

Potential consequences of a criminal indictment arising out of any of these investigations could include suspension by the DoD or another federal, state, or local government agency of KBR and its affiliates from their ability to contract with United States, state or local governments, or government agencies. If a criminal or civil violation were found, KBR and its affiliates could be debarred from future contracts or new orders under current contracts to provide services to any such parties. During 2005, KBR and its affiliates had revenue of approximately $6.6 billion from its government contracts work with agencies of the United States or state or local governments. If necessary, we would seek to obtain administrative agreements or waivers from the DoD and other agencies to avoid suspension or debarment. Suspension or debarment from the government contracts business would have a material adverse effect on the business, results of operations, and cash flows of KBR and Halliburton.

These investigations could also result in third-party claims against us, which may include claims for special, indirect, derivative or consequential damages, damage to our business or reputation, loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, adverse consequences on our ability to obtain or continue financing for current or future projects or claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us or our subsidiaries. In addition, we could incur costs and expenses for any monitor required by or agreed to with governmental authority to review our continued compliance with FCPA law.

As of June 30, 2006, we have not accrued any amounts related to these investigations other than our current legal expenses.

Bidding practices investigation

In connection with the investigation into payments related to the Bonny Island project in Nigeria, information has been uncovered suggesting that Mr. Stanley and other former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects, and that such coordination possibly began as early as the mid-1980s.

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On the basis of this information, we and the DOJ have broadened our investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former employees may have received payments in connection with bidding practices on some foreign projects.

If violations of applicable United States antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by, or relationship issues with customers, are also possible.

As of June 30, 2006, we had not accrued any amounts related to this investigation other than our current legal expenses.

Operations in Iran

We received and responded to an inquiry in mid-2001 from the Office of Foreign Assets Control (OFAC) of the United States Treasury Department with respect to operations in Iran by a Halliburton subsidiary incorporated in the Cayman Islands. The OFAC inquiry requested information with respect to compliance with the Iranian Transaction Regulations. These regulations prohibit United States citizens, including United States corporations and other United States business organizations, from engaging in commercial, financial, or trade transactions with Iran, unless authorized by OFAC or exempted by statute. Our 2001 written response to OFAC stated that we believed that we were in compliance with applicable sanction regulations. In the first quarter of 2004, we responded to a follow-up letter from OFAC requesting additional information. We understand this matter has now been referred by OFAC to the DOJ. In July 2004, we received a grand jury subpoena from an Assistant United States District Attorney requesting the production of documents. We are cooperating with the government's investigation and have responded to the subpoena by producing documents in September 2004.

Separate from the OFAC inquiry, we completed a study in 2003 of our activities in Iran during 2002 and 2003 and concluded that these activities were in compliance with applicable sanction regulations. These sanction regulations require isolation of entities that conduct activities in Iran from contact with United States citizens or managers of United States companies. Notwithstanding our conclusions that our activities in Iran were not in violation of United States laws and regulations, we announced that, after fulfilling our current contractual obligations within Iran, we intend to cease operations within that country and to withdraw from further activities there.

Geopolitical and International Environment

International and political events

A significant portion of our revenue is derived from our non-United States operations, which exposes us to risks inherent in doing business in each of the countries in which we transact business. The occurrence of any of the risks described below could have a material adverse effect on our consolidated results of operations and consolidated financial condition.

Our operations in countries other than the United States accounted for approximately 67% of our consolidated revenue during the first six months of 2006 and 74% of our consolidated revenue during the first six months of 2005. Based upon the location of services provided and products sold, 19% of our consolidated revenue in the first six months of 2006 and 29% during the first six months of 2005 was from Iraq, primarily related to our work for the United States Government. Operations in countries other than the United States are subject to various risks unique to each country. With respect to any particular country, these risks may include:

- expropriation and nationalization of our assets in that country;
- political and economic instability;
- civil unrest, acts of terrorism, force majeure, war, or other armed conflict;
- natural disasters, including those related to earthquakes and flooding;
- inflation;
- currency fluctuations, devaluations, and conversion restrictions;

- confiscatory taxation or other adverse tax policies;
- governmental activities that limit or disrupt markets, restrict payments, or limit the movement of funds;
- governmental activities that may result in the deprivation of contract rights; and
- governmental activities that may result in the inability to obtain or retain licenses required for operation.

Due to the unsettled political conditions in many oil-producing countries and countries in which we provide governmental logistical support, our revenue and profits are subject to the adverse consequences of war, the effects of terrorism, civil unrest, strikes, currency controls, and governmental actions. Countries where we operate that have significant amounts of political risk include: Afghanistan, Algeria, Indonesia, Iran, Iraq, Nigeria, Russia, Venezuela, and Yemen. In addition, military action or continued unrest in the Middle East could impact the supply and pricing for oil and gas, disrupt our operations in the region and elsewhere, and increase our costs for security worldwide.

In addition, investigations by governmental authorities (see “Foreign Corrupt Practices Act investigations” above), as well as legal, social, economic, and political issues in Nigeria, could materially and adversely affect our Nigerian business and operations.

Our facilities and our employees are under threat of attack in some countries where we operate, including Iraq and Saudi Arabia. In addition, the risks related to loss of life of our personnel and our subcontractors in these areas continue.

We are also subject to the risks that our employees, joint venture partners, and agents outside of the United States may fail to comply with applicable laws.

Military action, other armed conflicts, or terrorist attacks

Military action in Iraq, military tension involving North Korea and Iran, as well as the terrorist attacks of September 11, 2001 and subsequent terrorist attacks, threats of attacks, and unrest, have caused instability or uncertainty in the world’s financial and commercial markets and have significantly increased political and economic instability in some of the geographic areas in which we operate. 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 markets and our operations, including disruptions resulting from the evacuation of personnel, cancellation of contracts, or the loss of personnel or assets.

Such events may cause further disruption to financial and commercial markets and may generate greater political and economic instability in some of the geographic areas in which we operate. In addition, any possible reprisals as a consequence of the war and ongoing military action in Iraq, such as acts of terrorism in the United States or elsewhere, could materially and adversely affect us in ways we cannot predict at this time.

Income taxes

We have operations in about 100 countries other than the United States. Consequently, we are subject to the jurisdiction of a significant number of taxing authorities. The income earned in these various jurisdictions is taxed on differing bases, including net income actually earned, net income deemed earned, and revenue-based tax withholding. The final determination of our tax liabilities involves the interpretation of local tax laws, tax treaties, and related authorities in each jurisdiction, as well as the significant use of estimates and assumptions regarding the scope of future operations and results achieved and the timing and nature of income earned and expenditures incurred. Changes in the operating environment, including changes in tax law and currency/repatriation controls, could impact the determination of our tax liabilities for a tax year.

Foreign exchange and currency risks

A sizable portion of our consolidated revenue and consolidated operating expenses are in foreign currencies. As a result, we are subject to significant risks, including:

- foreign exchange risks resulting from changes in foreign exchange rates and the implementation of exchange controls; and
- limitations on our ability to reinvest earnings from operations in one country to fund the capital needs of our operations in other countries.

We conduct business in countries that have nontraded or “soft” currencies which, because of their restricted or limited trading markets, may be more difficult to exchange for “hard” currency. We may accumulate cash in soft currencies, and we may be limited in our ability to convert our profits into United States dollars or to repatriate the profits from those countries.

We selectively use hedging transactions to limit our exposure to risks from doing business in foreign currencies. For those currencies that are not readily convertible, our ability to hedge our exposure is limited because financial hedge instruments for those currencies are nonexistent or limited. Our ability to hedge is also limited because pricing of hedging instruments, where they exist, is often volatile and not necessarily efficient.

In addition, the value of the derivative instruments could be impacted by:

- adverse movements in foreign exchange rates;
- interest rates;
- commodity prices; or
- the value and time period of the derivative being different than the exposures or cash flows being hedged.

Customers and Business

Exploration and production activity

Demand for our services and products depends on oil and natural gas industry activity and expenditure levels that are directly affected by trends in oil and natural gas prices.

Demand for our services and products is particularly sensitive to the level of exploration, development, and production activity of, and the corresponding capital spending by, oil and natural gas companies, including national oil companies. Prices for oil and natural gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and natural gas, market uncertainty, and a variety of other factors that are beyond our control. Any prolonged reduction in oil and natural gas prices will depress the immediate levels of exploration, development, and production activity, often reflected as changes in rig counts. Perceptions of longer-term lower oil and natural gas prices by oil and gas companies can similarly reduce or defer major expenditures given the long-term nature of many large-scale development projects. Lower levels of activity result in a corresponding decline in the demand for our oil and natural gas well services and products, which could have a material adverse effect on our revenue and profitability. Factors affecting the prices of oil and natural gas include:

- governmental regulations, including the policies of governments regarding the exploration for and production and development of their oil and natural gas reserves;
- global weather conditions and natural disasters;
- worldwide political, military, and economic conditions;
- the level of oil production by non-OPEC countries and the available excess production capacity within OPEC;
- economic growth in China and India;
- oil refining capacity and shifts in end-customer preferences toward fuel efficiency and the use of natural gas;
- the cost of producing and delivering oil and gas;
- potential acceleration of development of alternative fuels; and
- the level of demand for oil and natural gas, especially demand for natural gas in the United States.

Historically, the markets for oil and gas have been volatile and are likely to continue to be volatile. Spending on exploration and production activities and capital expenditures for refining and distribution facilities by large oil and gas companies have a significant impact on the activity levels of our businesses. In the current environment where oil and gas demand exceeds supply, the ability to rebalance supply with demand may be constrained by the global availability of rigs. Full utilization of rigs could lead to limited growth in revenue. In addition, the extent of the growth in oilfield services may be limited by the availability of equipment and manpower.

Governmental and capital spending

Our business is directly affected by changes in governmental spending and capital expenditures by our customers. Some of the changes that may materially and adversely affect us include:

- a decrease in the magnitude of governmental spending and outsourcing for military and logistical support of the type that we provide. For example, the current level of government services being provided in the Middle East will not likely continue for an extended period of time and the current rate of spending has decreased substantially compared to 2005 and 2004. Our government services revenue related to Iraq under our LogCAP III and other contracts totaled approximately $2.4 billion in the six months ended June 30, 2006, $5.4 billion in 2005, and $7.1 billion in 2004. We expect the volume of work under our LogCAP III contract to continue to decline in 2006 as our customer scales back the amount of services we provide under this contract. The DoD has also announced that it will solicit competitive bids for a new multiple provider LogCAP IV contract to replace the current LogCAP III contract, under which we are the sole provider. A decrease in the magnitude of governmental spending and outsourcing for military and logistical support of the type that we provide could have a material adverse effect on our business, results of operations, and cash flow.
- an increase in the magnitude of governmental spending and outsourcing for military and logistical support, which can materially and adversely affect our liquidity needs as a result of additional or continued working capital requirements to support this work;
- a decrease in capital spending by governments for infrastructure projects of the type that we undertake;
- the consolidation of our customers, which could:
- cause customers to reduce their capital spending, which would in turn reduce the demand for our services and products; and
- result in customer personnel changes, which in turn affects the timing of contract negotiations and settlements of claims and claim negotiations with engineering and construction customers on cost variances and change orders on major projects;
- adverse developments in the business and operations of our customers in the oil and gas industry, including write-downs of reserves and reductions in capital spending for exploration, development, production, processing, refining, and pipeline delivery networks; and
- ability of our customers to timely pay the amounts due us.

Customers

Both our Energy Services Group and KBR depend on a limited number of significant customers. While, except for the United States Government, none of these customers represented more than 10% of consolidated revenue in any period presented, the loss of one or more significant customers could have a material adverse effect on our business and our consolidated results of operations.

Acquisitions, dispositions, investments, and joint ventures

We continually seek opportunities to maximize efficiency and value through various transactions, including purchases or sales of assets, businesses, investments, or joint ventures. These transactions are intended to result in the realization of savings, the creation of efficiencies, the generation of cash or income, or the reduction of risk. Acquisition transactions may be financed by additional borrowings or by the issuance of our common stock. These transactions may also affect our consolidated results of operations.

These transactions also involve risks and we cannot ensure that:

- any acquisitions would result in an increase in income;
- any acquisitions would be successfully integrated into our operations and internal controls;
- any disposition would not result in decreased earnings, revenue, or cash flow;
- any dispositions, investments, acquisitions, or integrations would not divert management resources; or
- any dispositions, investments, acquisitions, or integrations would not have a material adverse effect on our results of operations or financial condition.

We conduct some operations through joint ventures, where control may be shared with unaffiliated third parties. As with any joint venture arrangement, differences in views among the joint venture participants may result in delayed decisions or in failures to agree on major issues. We also cannot control the actions of our joint venture partners, including any nonperformance, default, or bankruptcy of our joint venture partners. These factors could potentially materially and adversely affect the business and operations of the joint venture and, in turn, our business and operations.

We own a 36.7% interest in a joint venture that is the holder of a 50-year concession contract with the Australian government to operate and maintain a railway in Australia. We account for this investment on the equity method of accounting. Construction on the railway was completed in late 2003, and operations commenced in early 2004. This joint venture has sustained losses since the railway commenced operations in early 2004 and is now likely to violate certain of the joint venture's loan covenants in the future. These loans are non-recourse to KBR and us. We received revised financial forecasts from the joint venture during the first quarter of 2006. These forecasts took into account decreases, as compared to prior forecasts, in anticipated freight volume related to delays in mining of minerals, as well as a slowdown in the planned expansion of the Port of Darwin. Because of this new information, we recorded a $26 million impairment charge during the first quarter of 2006 in our equity investment. We will receive no tax benefit from this charge as this is a capital loss in Australia for which we have no capital gains to offset. We also recorded a $4 million equity loss related to our investment in this joint venture during the first quarter of 2006. As of June 30, 2006, our investment in this joint venture and the related company that performed the construction of the railroad was $60 million. In addition, we have a remaining commitment to purchase an additional $3 million subordinated operating note.

Risks related to contracts

Our long-term contracts to provide services are either on a cost-reimbursable basis or on a fixed-price basis. Our failure to estimate accurately the resources and time required for a fixed-price project or our failure to complete our contractual obligations within the time frame and costs committed could have a material adverse effect on our business, results of operations, and financial condition. In connection with projects covered by fixed-price contracts, we bear the risk of cost over-runs, operating cost inflation, labor availability and productivity, and supplier and subcontractor pricing and performance. In both our fixed-price contracts and our cost-reimbursable contracts, we generally rely on third parties for many support services, and we are subject to liability for engineering or systems failures. Occasionally we contract to perform work for, as well as take a minority ownership interest in, a developmental entity. We may incur contractually reimbursable costs, make an equity investment prior to this entity achieving operational status or completing its full project financing. Should a developmental project fail to achieve full financial close, we could incur losses including our contractual receivables and our equity investment.

Risks under our fixed-price contracts. Our significant EPC projects may encounter difficulties that may result in additional costs to us, reductions in revenue, claims, or disputes. These projects generally involve complex design and engineering, significant procurement of equipment and supplies, and extensive construction management. Many of these projects involve design and engineering production and construction phases that may occur over extended time periods, often in excess of two years. We could encounter difficulties that may be beyond our control in design, engineering, equipment and supply delivery, schedule changes, and other factors. These factors could impact our ability to complete the project in accordance with the original delivery schedule and cost estimates. For example, the equipment we purchase for a project or that is provided to us by the customer could not perform as expected, and these performance failures may result in delays in completion of the project or additional costs to us or the customer to complete the project and, in some cases, may require us to obtain alternate equipment at additional cost.

In addition, some of our contracts may require that our customers provide us with design or engineering information or with equipment or materials to be used on the project. In some cases, the customer may provide us with deficient design or engineering information or equipment or may provide the information or equipment to us later than required by the project schedule. The customer may also determine, after commencement of the project, to change various elements of the project. Our project contracts generally require the customer to compensate us for additional work or expenses incurred due to customer-requested change orders or failure of the customer to provide us with specified design or engineering information or equipment. Under these circumstances, we generally negotiate with the customer with respect to the amount of additional time required and the compensation to be paid to us. We are subject to the risk that we are unable to obtain, through negotiation, arbitration, litigation, or otherwise, adequate amounts to compensate us for the additional work or expenses incurred by us due to customer-requested change orders or failure by the customer to timely provide required items. A failure to obtain adequate compensation for these matters could require us to record an adjustment to amounts of revenue and gross profit that were recognized in prior periods. Any such adjustments, if substantial, could have a material adverse effect on our results of operations and financial condition.

We may be required to pay liquidated damages upon our failure to meet schedule or performance requirements of our contracts. In certain circumstances, we guarantee facility completion by a scheduled acceptance date or achievement of certain acceptance and performance testing levels. Failure to meet any such schedule or performance requirements could result in additional costs, and the amount of such additional costs could exceed projected profit margins for the project. These additional costs include liquidated damages paid under contractual penalty provisions, which can be substantial and can accrue on a daily basis. In addition, our actual costs could exceed our projections. Performance problems for existing and future contracts could cause actual results of operations to differ materially from those anticipated by us and could cause us to suffer damage to our reputation within our industry and our client base.

Risks under our fixed-price or cost-reimbursable contracts. We generally rely on third-party subcontractors as well as third-party equipment manufacturers to assist us with the completion of our contracts. To the extent that we cannot engage subcontractors or acquire equipment or materials, our ability to complete a project in a timely fashion or at a profit may be impaired. If the amount we are required to pay for these goods and services exceeds the amount we have estimated in bidding for fixed-price work, we could experience losses in the performance of these contracts. Any delay by subcontractors to complete their portion of the project, or any failure by a subcontractor to satisfactorily complete its portion of the project, and other factors beyond our control may result in delays in the overall progress of the project or may cause us to incur additional costs, or both. These delays and additional costs may be substantial, and we may be required to compensate the project customer for these delays. While we may recover these additional costs from the responsible vendor, subcontractor, or other third party, we may not be able to recover all of these costs in all circumstances. In addition, if a subcontractor or a manufacturer is unable to deliver its services, equipment, or materials according to the negotiated terms for any reason, including the deterioration of its financial condition, we may be required to purchase the services, equipment, or materials from another source at a higher price. This may reduce the profit or award fee to be realized or result in a loss on a project for which the services, equipment, or materials were needed.

Our projects expose us to potential professional liability, general and third-party liability, warranty, and other claims. We engineer, construct, and perform services in large industrial facilities in which accidents or system failures can be disastrous. Any catastrophic occurrences in excess of insurance limits at locations engineered or constructed by us or where our services are performed could result in significant professional liability, general and third-party liability, warranty, and other claims against us. The failure of any systems or facilities that we engineer or construct could result in warranty claims against us for significant replacement or reworking costs. In addition, once our construction is complete, we may face claims with respect to the performance of these facilities.

Our contracts generally contain provisions where our customers agree to limitations of our liability resulting from certain events such as damage to underground reservoirs and wells, costs for loss of control of a well, loss of production, damage to existing facilities, and consequential damages. It is also common to have arrangements with the customer and its other contractors that protect us against large exposures for damage to or loss of drilling units and injury to other contractors' personnel. These contract provisions are standard in our industries, and any erosion of these contractual protections in future contracts could result in significant additional liability and associated cost.

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Barracuda-Caratinga project. The Barracuda and Caratinga vessels are both fully operational. In April 2006, we executed an agreement with Petrobras that enabled us to achieve conclusion of the Lenders' Reliability Test and final acceptance of the FPSOs. These acceptances eliminate any further risk of liquidated damages being assessed but do not address the bolt arbitration discussed below.

In addition, at Petrobras' direction, we have replaced certain bolts located on the subsea flowlines that have failed through mid-November 2005, and we understand that additional bolts have failed thereafter, which have been replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. The original design specification for the bolts was issued by Petrobras, and as such, we believe the cost resulting from any replacement is not our responsibility. Petrobras has indicated, however, that they do not agree with our conclusion. We have notified Petrobras that this matter is in dispute. We believe several possible solutions may exist, including replacement of the bolts. Estimates indicate that costs of these various solutions range up to $140 million. Should Petrobras instruct us to replace the subsea bolts, the prime contract terms and conditions regarding change orders require that Petrobras make progress payments of our reasonable costs incurred. Petrobras could, however, perform any replacement of the bolts and seek reimbursement from KBR. In March 2006, Petrobras notified KBR that they have submitted this matter to arbitration claiming $220 million plus interest for the cost of monitoring and replacing the defective stud bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys fees. We disagree with the Petrobras claim since the bolts met Petrobras' design specification, and we do not believe there is any basis for the amount claimed by Petrobras. We intend to vigorously defend ourselves and pursue recovery of the costs we have incurred to date through the arbitration process. See Note 2 to the condensed consolidated financial statements for more information.

Environmental requirements

Our businesses are subject to a variety of environmental laws, rules, and regulations in the United States and other countries, including those covering hazardous materials and requiring emission performance standards for facilities. For example, our well service operations routinely involve the handling of significant amounts of waste materials, some of which are classified as hazardous substances. We also store, transport, and use radioactive and explosive materials in certain of our operations. Environmental requirements include, for example, those concerning:

- the containment and disposal of hazardous substances, oilfield waste, and other waste materials;
- the importation and use of radioactive materials;
- the use of underground storage tanks; and
- the use of underground injection wells.

Environmental and other similar requirements generally are becoming increasingly strict. Sanctions for failure to comply with these requirements, many of which may be applied retroactively, may include:

- administrative, civil, and criminal penalties;
- revocation of permits to conduct business; and
- corrective action orders, including orders to investigate and/or clean-up contamination.

Failure on our part to comply with applicable environmental requirements could have a material adverse effect on our consolidated financial condition. We are also exposed to costs arising from environmental compliance, including compliance with changes in or expansion of environmental requirements, which could have a material adverse effect on our business, financial condition, operating results, or cash flow.

We are exposed to claims under environmental requirements, and, from time to time, such claims have been made against us. In the United States, environmental requirements and regulations typically impose strict liability. Strict liability means that in some situations we could be exposed to liability for clean-up costs, natural resource damages, and other damages as a result of our conduct that was lawful at the time it occurred or the conduct of prior operators or other third parties. Liability for damages arising as a result of environmental laws could be substantial and could have a material adverse effect on our consolidated results of operations.

Changes in environmental requirements may negatively impact demand for our services. For example, oil and natural gas exploration and production may decline as a result of environmental requirements (including land use policies responsive to environmental concerns). A decline in exploration and production, in turn, could materially and adversely affect us.

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Law and regulatory requirements

In the countries in which we conduct business, we are subject to multiple and at times inconsistent regulatory regimes, including those that govern our use of radioactive materials, explosives, and chemicals in the course of our operations. Various national and international regulatory regimes govern the shipment of these items. Many countries, but not all, impose special controls upon the export and import of radioactive materials, explosives, and chemicals. Our ability to do business is subject to maintaining required licenses and complying with these multiple regulatory requirements applicable to these special products. In addition, the various laws governing import and export of both products and technology apply to a wide range of services and products we offer. In turn, this can affect our employment practices of hiring people of different nationalities because these laws may prohibit or limit access to some products or technology by employees of various nationalities. Changes in, compliance with, or our failure to comply with these laws may negatively impact our ability to provide services in, make sales of equipment to, and transfer personnel or equipment among some of the countries in which we operate and could have a material adverse affect on the results of operations.

Raw materials

Raw materials essential to our business are normally readily available. Current market conditions have triggered constraints in the supply chain of certain raw materials, such as, sand, cement, and specialty metals. The majority of our risk associated with the current supply chain constraints occurs in those situations where we have a relationship with a single supplier for a particular resource.

Intellectual property rights

We rely on a variety of intellectual property rights that we use in our services and products. We may not be able to successfully preserve these intellectual property rights in the future, and these rights could be invalidated, circumvented, or challenged. In addition, the laws of some foreign countries in which our services and products may be sold do not protect intellectual property rights to the same extent as the laws of the United States. Our failure to protect our proprietary information and any successful intellectual property challenges or infringement proceedings against us could materially and adversely affect our competitive position.

Technology

The market for our services and products is characterized by continual technological developments to provide better and more reliable performance and services. If we are not able to design, develop, and produce commercially competitive products and to implement commercially competitive services in a timely manner in response to changes in technology, our business and revenue could be materially and adversely affected, and the value of our intellectual property may be reduced. Likewise, if our proprietary technologies, equipment and facilities, or work processes become obsolete, we may no longer be competitive, and our business and revenue could be materially and adversely affected.

Systems

Our business could be materially and adversely affected by problems encountered in the installation of a new SAP financial system to replace some of the current systems for KBR.

Reliance on management

We depend greatly on the efforts of our executive officers and other key employees to manage our operations. The loss or unavailability of any of our executive officers or other key employees could have a material adverse effect on our business.

Technical personnel

Many of the services that we provide and the products that we sell are complex and highly engineered and often must perform or be performed in harsh conditions. We believe that our success depends upon our ability to employ and retain technical personnel with the ability to design, utilize, and enhance these services and products. In addition, our ability to expand our operations depends in part on our ability to increase our skilled labor force. The demand for skilled workers is high, and the supply is limited. A significant increase in the wages paid by competing employers could result in a reduction of our skilled labor force, increases in the wage rates that we must pay, or both. If either of these events were to occur, our cost structure could increase, our margins could decrease, and our growth potential could be impaired.

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Weather

Our businesses could be materially and adversely affected by severe weather, particularly in the Gulf of Mexico where we have operations. Repercussions of severe weather conditions may include:

- evacuation of personnel and curtailment of services;
- weather-related damage to offshore drilling rigs resulting in suspension of operations;
- weather-related damage to our facilities and project work sites;
- inability to deliver materials to jobsites in accordance with contract schedules; and
- loss of productivity.

Because demand for natural gas in the United States drives a significant amount of our Energy Services Group's United States business, warmer than normal winters in the United States are detrimental to the demand for our services to gas producers.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to financial instrument market risk from changes in foreign currency exchange rates, interest rates, and, to a limited extent, commodity prices. We selectively manage these exposures through the use of derivative instruments to mitigate our market risk from these exposures. The objective of our risk management is to protect our cash flows related to sales or purchases of goods or services from market fluctuations in currency rates. Our use of derivative instruments includes the following types of market risk:

- volatility of the currency rates;
- time horizon of the derivative instruments;
- market cycles; and
- the type of derivative instruments used.

We do not use derivative instruments for trading purposes. We do not consider any of these risk management activities to be material.

Item 4. Controls and Procedures

In accordance with the Securities Exchange Act of 1934 Rules 13a-15 and 15d-15, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2006 to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There has been no change in our internal control over financial reporting that occurred during the three months ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information related to various commitments and contingencies is described in "Management's Discussion and Analysis of Financial Condition and Results of Operations," in "Forward-Looking Information and Risk Factors," and in Notes 2, 10, 11, and 12 to the condensed consolidated financial statements.

Item 1(a). Risk Factors

Information related to risk factors is described in "Management's Discussion and Analysis of Financial Condition and Results of Operations" under "Forward-Looking Information and Risk Factors."

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Following is a summary of our repurchases of our common stock during the three-month period ended June 30, 2006.

Period	Total Number of Shares Purchased (a)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (b)
April 1-30	42,476	$ 35.95	-
May 1-31	1,028,760	$ 36.65	950,138
June 1-30	2,916,074	$ 35.74	2,857,200
Total	3,987,310	$ 35.98	3,807,338

(a) Of the 3,987,310 shares purchased during the three-month period ended June 30, 2006, 179,972 shares were acquired from employees in connection with the settlement of income tax and related benefit withholding obligations arising from vesting in restricted stock grants. These share purchases were not part of a publicly announced program to purchase common shares.

(b) In February 2006, our Board of Directors approved a share repurchase program of up to $1.0 billion. During the second quarter of 2006, we repurchased 3,807,338 shares of our common stock at a cost of approximately $137 million, or an average price per share of $35.94. There is $822 million remaining under this program for future repurchases.

Item 3. Defaults Upon Senior Securities

None.

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

At our Annual Meeting of Stockholders held on May 17, 2006, stockholders were asked to consider and act upon:

(1) the election of Directors for the ensuing year;
(2) a proposal to ratify the appointment of KPMG LLP as independent accountants to examine the financial statements and books and records of Halliburton for the year 2006;
(3) a proposal to amend the Certificate of Incorporation;
(4) a proposal on severance agreements;
(5) a stockholder proposal on human rights review;
(6) a stockholder proposal on Director election vote threshold; and
(7) a stockholder proposal on a poison pill.

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The following table sets out, for each matter where applicable, the number of votes cast for, against, or withheld, as well as the number of abstentions and broker non-votes.

(1) Election of Directors:

Name of Nominee	Votes For	Votes Withheld
Alan M. Bennett	435,212,839	3,716,975
James R. Boyd	435,214,516	3,715,298
Robert L. Crandall	418,733,506	20,196,308
Kenneth T. Derr	434,570,231	4,359,583
S. Malcolm Gillis	430,633,870	8,295,944
W. R. Howell	428,927,684	10,002,130
Ray L. Hunt	429,503,307	9,426,507
David J. Lesar	431,483,808	7,446,006
J. Landis Martin	434,641,023	4,288,791
Jay A. Precourt	435,144,181	3,785,633
Debra L. Reed	435,155,440	3,744,374

(2) Proposal for ratification of the selection of auditors:

Number of Votes For	432,611,595
Number of Votes Against	3,626,898
Number of Votes Abstain	2,691,321
Number of Broker Non-Votes	0

(3) Proposal to amend the Certificate of Incorporation:

Number of Votes For	427,779,792
Number of Votes Against	8,267,621
Number of Votes Abstain	2,882,401
Number of Broker Non-Votes	0

(4) Proposal on severance agreements:

Number of Votes For	430,548,704
Number of Votes Against	4,719,022
Number of Votes Abstain	3,662,088
Number of Broker Non-Votes	0

(5) Stockholder proposal on human rights review:

Number of Votes For	77,145,398
Number of Votes Against	253,394,054
Number of Votes Abstain	41,659,479
Number of Broker Non-Votes	66,730,883

(6) Stockholder proposal on Director election vote threshold:

Number of Votes For	217,987,136
Number of Votes Against	150,679,100
Number of Votes Abstain	3,532,695
Number of Broker Non-Votes	66,730,883

(7) Stockholder proposal on a poison pill:

Number of Votes For	22,476,008
Number of Votes Against	346,251,374
Number of Votes Abstain	3,471,549
Number of Broker Non-Votes	66,730,883

Item 5. Other Information

None.

Item 6. Exhibits

	3.1	Restated Certificate of Incorporation of Halliburton Company filed with the Secretary of State of Delaware on May 30, 2006 (incorporated by reference to Exhibit 3.1 to Halliburton's Form 8-K filed June 5, 2006, File No. 1-3492).
	3.2	By-laws of Halliburton revised effective May 17, 2006 (incorporated by reference to Exhibit 3.1 to Halliburton's Form 8-K filed May 22, 2006, File No. 1-3492).
*	12	Statement of Computation of Ratio of Earnings to Fixed Charges.
*	31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*	31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
**	32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
**	32.2	Certification of Chief Financial Officer pursuant to Section 906

of the Sarbanes-Oxley Act of 2002.

*	Filed with this Form 10-Q
**	Furnished with this Form 10-Q

SIGNATURES

As required by the Securities Exchange Act of 1934, the registrant has authorized this report to be signed on behalf of the registrant by the undersigned authorized individuals.

HALLIBURTON COMPANY

/s/ C. Christopher Gaut	/s/ Mark A. McCollum
C. Christopher Gaut	Mark A. McCollum
Executive Vice President and	Senior Vice President and
Chief Financial Officer	Chief Accounting Officer

Date: July 28, 2006