NORTHWEST PIPE CO
Form 10-K
March 13, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended: December 31, 2008

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: 0-27140

NORTHWEST PIPE COMPANY

(Exact name of registrant as specified in its charter)

OREGON	**93-0557988**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

5721 SE Columbia Way, Suite 200

Vancouver, WA 98661

(Address of principal executive offices and zip code)

360-397-6250

(Registrant s telephone number including area code)

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

Title of Each Class of Stock	Name of Each Exchange on Which Registered
Common Stock, par value $0.01 per share	NASDAQ Global Select Market
Preferred Stock Purchase Rights	NASDAQ Global Select Market

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

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

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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

The aggregate market value of the common equity that was held by non-affiliates of the Registrant was $498,810,206 as of June 30, 2008 based upon the last sales price as reported by Nasdaq.

The number of shares outstanding of the Registrant s Common Stock as of March 10, 2009 was 9,236,493 shares.

Documents Incorporated by Reference

The Registrant has incorporated into Parts II and III of Form 10-K by reference portions of its Proxy Statement for its 2009 Annual Meeting of Shareholders.

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NORTHWEST PIPE COMPANY

2008 ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. Business

We are a leading North American manufacturer of large-diameter, high-pressure steel pipeline systems for use in water infrastructure applications, primarily related to drinking water systems. Our pipeline systems are also used for hydroelectric power systems, wastewater systems and other applications. With a history that dates back more than 100 years, we have established a leading position based on a strong, widely recognized reputation for quality and service and an extensive array of product offerings. Our manufacturing facilities are strategically located throughout North America to provide us with broad geographic coverage of our target markets, giving us competitive advantages in serving our customers.

We manufacture water infrastructure products through our Water Transmission Group, which in 2008 generated approximately 62% of our net sales. We market our water infrastructure products through an in-house sales force comprised of sales representatives, engineers and support personnel who work closely with public water agencies, contractors and engineering firms, often years in advance of projects being bid. This allows us to identify and evaluate planned projects at early stages and participate in the engineering and design process to promote the advantages of our systems. Our sales have historically been driven by the need for new water infrastructure, which is based primarily on overall population growth and population movement between regions. We believe the need for new water infrastructure will continue to be a significant growth driver for us and, importantly, will be accompanied by the increasing need for water infrastructure upgrades, repairs and replacements due to the aging and outdated water infrastructure systems throughout North America.

In addition to manufacturing water infrastructure products, we also manufacture other welded steel products through our Tubular Products Group, which in 2008 generated approximately 38% of our net sales. Our Tubular Products Group has the capability to manufacture a broad array of small-diameter, electric resistance welded (ERW) steel pipe for use in a wide range of applications, including energy, construction, agricultural, industrial, and traffic signpost systems.

Our Industries

Water Transmission. The U.S. market for water delivery equipment and systems is estimated to be approximately $13 billion annually. Within this market, we focus on engineered pipeline systems that utilize large-diameter, high-pressure steel pipe. In addition to these water infrastructure applications, our Water Transmission Group manufactures products for certain structural piling applications and in-plant pipeline systems for power plants and other industrial applications. We believe the current addressable market for the products sold by our Water Transmission Group will total approximately $3 billion over the next three years. Our core market is the large-diameter, high-pressure portion of the pipeline that is typically at the upper end of a pipeline system. This is the portion of the overall water pipeline that generally transports water from the source to a treatment plant or from a treatment plant into the distribution system, rather than the small lines that deliver water directly into households.

A combination of population growth, movement to new population centers, dwindling supplies from developed water sources, substantial underinvestment in water infrastructure over the past several decades, and an increasingly stringent regulatory environment are driving considerable and growing demand for water infrastructure projects in the United States. These trends are increasing the need for new water infrastructure as well as the need to upgrade, repair and replace existing water infrastructure, which we believe will significantly increase the demand for our water infrastructure products and other products related to water transmission and distribution.

The primary drivers of growth in new water infrastructure installation are population growth and movement. According to the U.S. Census Bureau, the population of the United States will increase by over 100 million people between 2010 and 2050. The resulting increase in demand will require substantial new infrastructure, as

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the existing U.S. water infrastructure is not equipped to provide water to millions of new residents. The combination of population growth and movement is projected to result in more than 70 million new residents in the southern and western regions of the United States. In addition, many current water supply sources are in danger of being exhausted. The development of new sources of water at greater distances from population centers will drive the demand for new water transmission lines. Our manufacturing facilities are well located to take advantage of the anticipated growth and demand in these regions.

Many authorities, including the U.S. Environmental Protection Agency (EPA), believe the U.S. water infrastructure is in critical need of an update. With the average age of water transmission pipes in the United States approximately 70 years, much of the U.S. water infrastructure is antiquated and requires upgrade, repair or replacement. Some water transmission pipelines in the United States are over 100 years old, and the American Society of Civil Engineers has given poor ratings to many aspects of the U.S. water infrastructure in their 2009 Report Card for America s Infrastructure. By 2020, approximately 44% of the water pipe in the United States will be classified as poor to life-elapsed if renewal or replacement of the existing infrastructure does not occur. In its third national assessment of public water system infrastructure, the EPA in 2005 estimated that a total investment of approximately $277 billion will be needed to install, upgrade and replace infrastructure over the next 20 years. The EPA estimates that approximately $184 billion of this needed investment applies to the rehabilitation or replacement of deteriorated or undersized water transmission and distribution infrastructure.

Increased public awareness of problems with the quality of drinking water and efficient water usage has resulted in more stringent application of federal and state environmental regulations. The need to comply with these regulations in an environment of heightened public awareness towards water issues is expected to contribute significantly to growth in the water infrastructure industry over the next several years. Water systems will need to be installed, upgraded and replaced in order to satisfy these water quality laws and regulations while overall demand for water continues to increase.

Tubular Products. The tubular products industry encompasses a wide variety of products serving a diverse group of end markets. We have been active in several of these markets, including mechanical tubing, agriculture, energy, traffic signpost systems, fire protection sprinkler systems and structural tubing. Within our focus markets, we believe traffic signpost systems, energy products, fire protection sprinkler systems and agricultural products offer significant growth opportunities. Our sales to the energy market have grown substantially in the past few years, and we believe this market will continue to provide growth opportunities going forward. We are relocating a pipe mill from our Portland, Oregon facility to Bossier City, Louisiana in order to expand our production of products for the energy market. We manufacture several different signpost systems and believe this business will also grow over the next several years as our systems are adopted in additional states and jurisdictions.

Products

Water Transmission Products. Water transmission pipe is used for high-pressure applications, typically requiring pipe to withstand pressures in excess of 150 pounds per square inch. Most of our water transmission products are made to custom specifications and are for fully engineered, large diameter, high-pressure water infrastructure systems. Other uses include pipe for piling and hydroelectric projects, wastewater transmission, treatment plants and other applications. Our primary manufacturing process has the capability to manufacture water transmission pipe in diameters ranging from 4.5 inches to 156 inches with wall thickness of 0.135 inches to 1.00 inches. We also have the ability to manufacture even larger and heavier pipe with other processes. We can coat and/or line these products with cement mortar, polyethylene tape, polyurethane, paints, epoxies, Pritec®, and coal tar enamel according to our customers specifications. We maintain fabrication facilities that provide installation contractors with custom fabricated sections as well as straight pipe sections. We typically deliver a complete pipeline system to the installation contractor.

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Tubular Products. Our tubular products range in size from 0.50 inches to 16 inches in diameter with wall thickness from 0.035 inches to 0.315 inches. These products are typically sold to distributors or OEMs and are used for a wide variety of applications, including water well casing, fire protection, energy, traffic signpost systems, and agricultural products.

Marketing

Water Transmission. The primary customers for water transmission products are installation contractors for projects funded by public water agencies. Our plant locations in Oregon, Colorado, California, West Virginia, Texas, Utah and Mexico allow us to efficiently serve customers throughout the United States, as well as Canada and Mexico. Our water transmission marketing strategy emphasizes early identification of potential water projects, promotion of specifications consistent with our capabilities and close contact with the project designers and owners throughout the design phase. Our in-house sales force is comprised of sales representatives, engineers and support personnel who work closely with public water agencies, contractors and engineering firms, often years in advance of projects being bid. This allows us to not only identify and evaluate planned projects at early stages, but also to participate in the engineering and design process and ultimately promote the advantages of our systems. After an agency completes a design, they publicize the upcoming bid for a water transmission project. We then obtain detailed plans and develop our estimate for the pipe portion of the project. We typically bid to installation contractors who include our bid in their proposals to public water agencies. A public water agency generally awards the entire project to the contractor with the lowest responsive bid.

Tubular Products. Our tubular products are marketed through a network of direct sales force personnel, sales agents, and independent distributors in the United States, Canada and Mexico. Our tubular product facilities are located in Kansas, Texas, and Louisiana. Our marketing strategy focuses on quality, customer service and customer relationships. For example, we are willing to sell in small lot sizes and are able to provide mixed truckloads of finished products to our customers. Our tubular products are primarily sold to distributors, although we also sell to OEMs to a lesser extent. Our sales effort emphasizes regular personal contact with current and potential customers. We supplement this effort with targeted advertising and brochures and participation in trade shows.

Manufacturing

Water Transmission. Water transmission manufacturing begins with the preparation of engineered drawings of each unique piece of pipe in a project. These drawings are prepared on our proprietary computer-aided design system and are used as blueprints for the manufacture of the pipe. After the drawings are completed and approved, manufacturing begins by feeding steel coil continuously at a specified angle into a spiral weld mill which cold forms the band into a tubular configuration with a spiral seam. Automated arc welders, positioned on both the inside and the outside of the tube, are used to weld the seam. The welded tube is then cut at the specified length. After completion of the forming and welding phases, the finished cylinder is tested and inspected in accordance with project specifications, which may include 100% radiographic analysis of the weld seam. The cylinders are then coated and lined as specified. Possible coatings include coal tar enamel, polyethylene tape, polyurethane paint, epoxies, Pritec® and cement mortar. Linings may be cement mortar, polyurethane or epoxies. Following coating and lining, certain pieces may be custom fabricated as required for the project. This process is performed in our fabrication facilities. Upon final inspection, the pipe is prepared for shipment. We ship our products to project sites principally by truck and rail.

Tubular Products. Tubular products are manufactured by an ERW process in diameters ranging from 0.50 inches to 16 inches. This process begins by unrolling and slitting steel coils into narrower bands sized to the circumference of the finished product. Each band is re-coiled and fed into the material handling equipment at the front end of the ERW mill and fed through a series of rolls that cold-form it into a tubular configuration. The resultant tube is welded by high-frequency electric resistance welders. Some products are reconfigured into rectangular and square shapes and then cut into the appropriate lengths. After exiting the mill, the products are straightened, inspected, tested and end-finished. Certain products are coated.

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Technology. Advances in technology help us produce high quality products at competitive prices. We continue to invest in technological improvements, which include the addition of a state of the art pipe blasting and coating facility, and two new spiral weld mills, which will provide faster speeds, utilize larger and wider coils, and increase yield. In addition, we have installed a new water based coating system that has set the standard for the fire protection pipe market. To stay current with technological developments in the United States and abroad, we participate in trade shows, industry associations, research projects and vendor trials of new products.

Quality Assurance. We have quality management systems in place that assure we consistently provide products that meet or exceed customer and applicable regulatory requirements. The Quality Assurance department reports directly to the chief executive officer. All of our quality management systems in the United States are registered by the International Organization for Standardization, or ISO, under a multi-site registration. In addition to ISO qualification, the American Institute of Steel Construction, American Petroleum Institute, American Society for Mechanical Engineers, Factory Mutual, National Sanitary Foundation, and Underwriters Laboratory have certified us for specific products or operations. The Quality Assurance department is responsible for monitoring and measuring characteristics of the product. Inspection capabilities include, but are not limited to, visual, dimensional, liquid penetrant, magnetic particle, hydrostatic, ultrasonic, phased array ultrasonics, real-time imaging enhancement, real-time radioscopic, base material tensile, yield and elongation, sand sieve analysis, coal-tar penetration, concrete compression, lining and coating dry film thickness, adhesion, absorption, guided bend, charpy impact, hardness, metallurgical examinations, chemical analysis, spectrographic analysis and finished product final inspection. Product is not released for shipment to our customers until there is verification that all product requirements have been met.

Product Liability. The manufacturing and use of our products involves a variety of risks. Certain losses may result, or be alleged to result, from defects in our products, thereby subjecting us to claims for damages, including consequential damages. We warrant our products to be free of certain defects for one year. We maintain insurance coverage against potential product liability claims in the amount of $51 million, which we believe to be adequate. However, there can be no assurance that product liability claims exceeding our insurance coverage will not be experienced in the future or that we will be able to maintain such insurance with adequate coverage.

Backlog

Our backlog includes confirmed orders, including the balance of projects in process, and projects for which we have been notified we are the successful bidder even though a binding agreement has not been executed. Projects for which a binding contract has not been executed could be canceled. Binding orders received by us may also be subject to cancellation or postponement; however, cancellation would generally obligate the customer to pay the costs incurred by us. As of December 31, 2008 and 2007, our backlog of orders was approximately $190 million and $211 million, respectively. Backlog as of December 31, 2008 includes projects having a value of approximately $5 million for which binding contracts had not yet been executed as of March 10, 2009. Backlog as of any particular date may not be indicative of actual operating results for any fiscal period. There can be no assurance that any amount of backlog ultimately will be realized.

Competition

Water Transmission. We have several competitors in the water transmission business. Most water transmission projects are competitively bid and price competition is vigorous. Price competition may reduce the gross margin on sales, which may adversely affect overall profitability. Other competitive factors include timely delivery, ability to meet customized specifications and high freight costs which may limit the ability of manufacturers located in other market areas to compete with us. With water transmission manufacturing facilities in Oregon, Colorado, California, West Virginia, Texas, Utah and Mexico, we believe we can more effectively compete throughout the United States, Canada and Mexico. Our primary competitor in the water transmission

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business in the western United States and southwestern Canada is Ameron International, Inc. East of the Rocky Mountains, our primary competition includes: American Cast Iron Pipe Company and Mueller Water Products, both of which manufacture ductile iron pipe; American Spiral Weld Pipe Company, which manufactures spiral welded steel pipe; and Hanson Pipe & Precast, which manufactures concrete pressure pipe and spiral welded steel pipe.

No assurance can be given that other new or existing competitors will not establish new facilities or expand capacity within our market areas. New or expanded facilities or new competitors could have a material adverse effect on our ability to capture market share and maintain product pricing.

Tubular Products. The market for tubular products is highly fragmented and diversified with over 100 manufacturers in the United States and a number of foreign-based manufacturers that export such pipe into the United States. Manufacturers compete with one another primarily on the basis of price, established business relationships, customer service and delivery. In some of the sectors within the tubular products industry, competition may be less vigorous due to the existence of a relatively small number of companies with the capabilities to manufacture certain products. In particular, we operate in a variety of different markets that require pipe with lighter wall thickness in relation to diameter than many of our competitors can manufacture. In our markets, we typically compete with Valmont Industries, Inc., Lindsay Manufacturing Co., Tenaris, U.S. Steel, Allied Tube and Conduit Corp. and John Maneely Company, as well as foreign competitors.

Raw Materials and Supplies

We purchase hot rolled and galvanized steel coil from both domestic and foreign steel mills. Domestic suppliers include California Steel Industries, Inc., Beta Steel Corp., ArcelorMittal, Nucor Corporation, Gallatin Steel Company, Steel Dynamics, Inc., SSAB, SeverStal, and U.S. Steel Corporation. Foreign suppliers include BlueScope Steel and Ternium. We order steel according to our business forecasts for our Tubular Products business. Steel for the Water Transmission business is normally purchased only after a project has been awarded to us. From time to time, we may purchase additional steel when it is available at favorable prices. Purchased steel represents a substantial portion of our cost of sales. The steel industry is highly cyclical in nature and steel prices are influenced by numerous factors beyond our control, including general economic conditions, availability of raw materials, energy costs, import duties, other trade restrictions and currency exchange rates.

We also rely on certain suppliers of coating materials, lining materials and certain custom fabricated items. We have at least two suppliers for most of our raw materials. We believe our relationships with our suppliers are positive and have no indication that we will experience shortages of raw materials or components essential to our production processes or that we will be forced to seek alternative sources of supply. Any shortages of raw materials may result in production delays and costs, which could have a material adverse effect on our financial position, results of operations or cash flows.

Environmental and Occupational Safety and Health Regulation

We are subject to federal, state, local and foreign environmental and occupational safety and health laws and regulations, violation of which could lead to fines, penalties, other civil sanctions or criminal sanctions. These environmental laws and regulations govern emissions to air; discharges to water (including stormwater); and the generation, handling, storage, transportation, treatment and disposal of waste materials. We are also subject to environmental laws requiring the investigation and cleanup of environmental contamination at properties we presently own or operate and at third-party disposal or treatment facilities to which these sites send or arrange to send hazardous waste. For example, we have been identified as a potentially responsible party at the Portland Harbor Site discussed under Legal Proceedings below. We believe we are in material compliance with these laws and regulations and do not currently believe that future compliance with such laws and regulations will have a material adverse effect on our financial position, results of operations or cash flows.

Based on our assessment of potential liability, we have no reserves for environmental investigations and cleanup. However, estimating liabilities for environmental investigations and cleanup is complex and dependent upon a number of factors beyond our control and which may change dramatically. Accordingly, although we believe maintaining no reserve is appropriate based on current information, we cannot assure you that our future environmental investigation and cleanup costs and liabilities will not result in a material expense. During 2008, we did not make any material capital expenditures relating primarily to environmental compliance.

We could be subject to various enforcement matters with federal, state, local and foreign regulators regarding our compliance with environmental and occupational safety and health laws and regulations. We are not aware of any current material enforcement matters.

We operate under numerous governmental permits and licenses relating to air emissions, stormwater run-off and other matters. We are not aware of any current material violations or citations relating to any of these permits or licenses. We have a practice of reducing consumption of hazardous materials in our operations by substituting non-hazardous materials when possible.

Employees

As of December 31, 2008, we had 1,217 full-time employees. Approximately 26% were salaried and approximately 74% were employed on an hourly basis. A union represents all of the hourly employees at our Monterrey, Mexico facility. All other employees are non-union. We consider our relations with our employees to be good.

Available Information

Our internet website address is www.nwpipe.com. Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 are available through our internet website as soon as reasonably practical after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Our internet website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K.

Additionally, the public may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 100 F Street, N.W., Washington D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

Item 1A. Risk Factors

Following are the key risk factors that have affected our net sales and net income in the past and could materially impact our future net sales and net income:

The success of our business is affected by general economic conditions, and our business may be adversely affected by an economic slowdown or recession. Periods of economic slowdown or recession in the United States, or the public perception that one may occur, could decrease the demand for our products, affect the price of our products and adversely impact our business. We have been impacted in the past by the general slowing of the economy, and the current economic slowdown could have an adverse impact on our business, financial position, results of operations or cash flows. In particular, our tubular products group is exposed to the non-residential construction, agriculture, energy exploration, and highway spending markets, and a significant downturn in any one of these markets could cause a reduction in our revenues that could be difficult to offset.

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A downturn in government spending related to public water transmission projects would adversely affect our business. Our water transmission business accounted for approximately 62% of our net sales in 2008. Our water transmission business is primarily dependent upon spending on public water transmission projects, including water infrastructure upgrades, repairs and replacement and new water infrastructure spending, which, in turn, depends on, among other things:

- the need for new or replacement infrastructure;
- the priorities placed on various projects by governmental entities;
- federal, state and local government spending levels, including budgetary constraints related to capital projects and the ability to obtain financing; and
- the ability of governmental entities to obtain environmental approvals, right-of-way permits and other required approvals and permits.

Decreases in the number of, or government funding of, public water transmission projects would adversely affect our business, financial position, results of operations, or cash flows.

Project delays in public water transmission projects could adversely affect our business. The public water agencies constructing water transmission projects generally announce the projects well in advance of the bidding and construction process. It is not unusual for projects to be delayed and rescheduled. Projects are delayed and rescheduled for a number of reasons, including changes in project priorities, difficulties in complying with environmental and other government regulations and additional time required to acquire rights-of-way or property rights. Delays in public water transmission projects may occur with too little notice to allow us to replace those projects in our manufacturing schedules. As a result, our business, financial position, results of operations or cash flows may be adversely affected by unplanned downtime.

We operate in highly competitive industries, and increased competition could reduce our gross profit and net income. We face significant competition in all of our businesses. Orders in the water transmission business are competitively bid, and price competition can be vigorous. Price competition may reduce the gross margin on sales, which may adversely affect overall profitability. Other competitive factors include timely delivery, ability to meet customized specifications and high freight costs. Although our water transmission manufacturing facilities in Oregon, Colorado, California, West Virginia, Texas, Utah and Mexico allow us to compete effectively throughout the United States, Canada and Mexico, we cannot assure you that new or existing competitors will not establish new facilities or expand capacity within our market areas. New or expanded facilities or new competitors could have a material adverse effect on our ability to capture market share and maintain product pricing in our water transmission business. There are many competitors in the tubular products business, and price is often a prime consideration for purchase of our products. Price competition may reduce our gross profit, which may adversely affect our net income. Some of our competitors have greater financial, technical and marketing resources than we do. We cannot assure you that we will be able to compete successfully with our competitors. Failure to compete successfully could reduce our gross profit and net income, as well as have a material adverse effect on our business, financial position, results of operations or cash flows.

Operating problems in our business could adversely affect our business, financial position, results of operations or cash flows. Our manufacturing operations are subject to typical hazards and risks relating to the manufacture of similar products such as:

- explosions, fires, inclement weather and natural disasters;
- mechanical failure;
- unscheduled downtime;

labor difficulties;

an inability to obtain or maintain required licenses or permits; and

environmental hazards such as chemical spills, discharges or releases of toxic or hazardous substances or gases into the environment or workplace.

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The occurrence of any of these operating problems at our facilities may have a material adverse effect on the productivity and profitability of a particular manufacturing facility or on our operations as a whole, during and after the period of these operating difficulties. These operating problems may also cause personal injury and loss of life, severe damage to or destruction of property and equipment, and environmental damage. In addition, individuals could seek damages for alleged personal injury or property damage. Furthermore, we could be subject to present and future claims with respect to workplace exposure, workers compensation and other matters. Although we maintain property and casualty insurance of the types and in the amounts that we believe are customary for our industries, we cannot assure you that our insurance coverage will be adequate for liability that may be ultimately incurred or that such coverage will continue to be available to us on commercially reasonable terms. Any claims that result in liability exceeding our insurance coverage could have an adverse effect on our business, financial position, results of operations or cash flows.

Our water transmission business faces competition from concrete and ductile iron pipe manufacturers. Water transmission pipe is manufactured generally from steel, concrete or ductile iron. Each pipe material has advantages and disadvantages. Steel and concrete are more common materials for larger diameter water transmission pipelines because ductile iron pipe generally is limited in diameter due to its manufacturing process. The public agencies and engineers who determine the specifications for water transmission projects analyze these pipe materials for suitability for each project. Individual project circumstances normally dictate the preferred material. If we experience cost increases in raw materials, labor and overhead specific to our industry or the location of our facilities, while competing products or companies do not experience similar changes, we could experience an adverse change in the demand, price and profitability of our products, which could have a material adverse effect on our business, financial position, results of operations or cash flows.

Our quarterly results of operations are subject to significant fluctuation. Our net sales and operating results may fluctuate significantly from quarter to quarter due to a number of factors, including:

- the schedule of production of water transmission orders, including the timing of raw material receipts or unplanned down time due to project delays;
- the commencement, completion or termination of contracts during any particular quarter;
- the seasonal variation in demand for tubular products;
- fluctuations in the cost of steel and other raw materials; and
- competitive pressures.

Results of operations in any period are not indicative of results for any future period, and comparisons between any two periods may not be meaningful.

We depend on our senior management team, and the loss of any member could adversely affect our operations. Our success depends on the management and leadership skills of our senior management team. The loss of any of these individuals, particularly Brian W. Dunham, our president and chief executive officer, or our inability to attract, retain and maintain additional personnel, could prevent us from fully implementing our business strategy. We cannot assure you that we will be able to retain our existing senior management personnel or to attract qualified personnel when needed. We have not entered into employment agreements with any of our senior management personnel.

Fluctuations in steel prices may affect our future results of operations. Purchased steel represents a substantial portion of our cost of sales, particularly in our tubular products business. The steel industry is highly cyclical in nature, and, at times, pricing can be highly volatile due to a number of factors beyond our control, including general economic conditions, import duties, other trade restrictions and currency exchange rates. This volatility can significantly affect our gross profit. Although we seek to recover increases in steel prices through

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price increases in our products, we have not always been completely successful. Any increase in steel prices that is not offset by an increase in our prices could have an adverse effect on our business, financial position, results of operations or cash flows.

We may be subject to claims for damages for defective products, which could adversely affect our business, financial position, results of operations or cash flows. We warrant our products to be free of certain defects. We have, from time to time, had claims alleging defects in our products. While these claims have generally not been material, we cannot assure you that we will not experience material product liability losses in the future or that we will not incur significant costs to defend such claims. While we currently have product liability insurance, we cannot assure you that our product liability insurance coverage will be adequate for liability that may be incurred in the future or that such coverage will continue to be available to us on commercially reasonable terms. Any claims relating to defective products that result in liability exceeding our insurance coverage could have an adverse effect on our business, financial position, results of operations or cash flows.

Sustained increases in fuel costs could have an adverse impact on our profitability. We have recently experienced significant fluctuations in fuel costs primarily as a result of macro-economic factors beyond our control. The price of fuel fluctuates significantly over time, and events beyond our control could adversely affect the supply and cost of fuel. Although we seek to recover increases in fuel costs through price increases in our products, we have not always been completely successful. Any increase in fuel costs that is not offset by increases in our prices could have an adverse impact on our business, financial position, results of operations or cash flows.

Our products might not obtain necessary approvals or achieve market acceptance, which could adversely affect our growth. We will continue to actively seek to develop new products and to expand our existing products into new markets, but we cannot assure you that we will be successful in these efforts. If we are unsuccessful in developing and marketing new products, expanding into new markets, or we do not obtain or maintain requisite approvals for our products, the demand for our products could be adversely affected, which could affect our business, financial position, results of operations or cash flows.

We have foreign operations, which exposes us to the risks of doing business abroad. Our fabrication facility in Monterrey, Mexico primarily exports products to the United States. Any material changes in the quotas, regulations or duties on imports imposed by the U.S. government and its agencies or on exports imposed by Mexico and its agencies could adversely affect our operations in Mexico.

We also sell some of our products internationally, and part of our business strategy contemplates international growth. Our foreign activities are also subject to various other risks of doing business in a foreign country, including:

- currency fluctuations;
- transportation delays and interruptions;
- political, social and economic instability and disruptions;
- government embargoes or foreign trade restrictions;
- the imposition of duties, tariffs and other trade barriers;
- import and export controls;
- labor unrest and current and changing regulatory environments;

limitations on our ability to enforce legal rights and remedies; and

potentially adverse tax consequences.

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Although our operations have not been materially affected by any such factors to date, no assurance can be given that our operations may not be adversely affected in the future. Any of these events could have an adverse effect on our operations in the future by reducing the demand for our products and services, decreasing the prices at which we can sell our products or otherwise having an adverse effect on our business, financial position, results of operations or cash flows. We cannot assure you that we will continue to operate in compliance with applicable customs, currency exchange control regulations, transfer pricing regulations or any other laws or regulations to which we may be subject. We also cannot assure you that these customs, regulations or laws will not be modified.

We have a significant amount of outstanding debt. We have financed our operations through cash flow from operations, available borrowings and other financing arrangements. As of December 31, 2008, we had approximately $121.0 million of outstanding debt.

Our debt and our debt service obligations could:

- limit our ability to obtain additional financing for working capital or other purposes in the future;
- reduce the amount of funds available to finance our operations, capital expenditures and other activities;
- increase our vulnerability to economic downturns, illiquid capital markets, and adverse industry conditions;
- limit our flexibility in responding to changing business and economic conditions, including increased competition;
- place us at a disadvantage when compared to our competitors that have less debt; and
- with respect to our borrowings that bear interest at variable rates, cause us to be vulnerable to increases in interest rates.

Our ability to make scheduled payments on our debt will depend on our future operating performance and cash flow, which are subject to prevailing economic conditions, prevailing interest rate levels and other financial, competitive and business factors, many of which are beyond our control.

Additionally, the agreements governing our outstanding debt include financial and other restrictive covenants that impose certain requirements with respect to our financial condition and results of operations and general business activities. These covenants could adversely affect us by limiting our ability to plan for or react to market conditions or to meet our capital needs. These covenants require us to maintain certain financial ratios and place restrictions on, among other things, our ability to incur certain additional debt and to create liens or other encumbrances on assets. A failure to comply with the requirements of these covenants, if not waived or cured, could permit acceleration of the related debt and acceleration of debt under other instruments that include cross-acceleration or cross-default provisions. If any of our debt is accelerated, we cannot assure you that we would have sufficient assets to repay such debt or that we would be able to refinance such debt on commercially reasonable terms or at all.

Our backlog is subject to reduction and cancellation. Backlog represents products or services that our customers have committed to purchase from us. Our backlog as of December 31, 2008 was $190 million. Our backlog is subject to fluctuations; moreover, cancellations of purchase orders or reductions of product quantities could materially reduce our backlog and, consequently, future revenues. Our failure to replace canceled or reduced backlog could result in lower revenues, which could adversely affect our business, financial position, results of operations or cash flows.

Our tubular products business has faced intense competition from imports in the past. The level of imports of tubular products has historically impacted the domestic tubular products market. High levels of imports may reduce the volume of tubular products sold by domestic producers and depress selling prices of

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tubular products. We believe import levels are affected by, among other things, overall worldwide demand for tubular products, the trade practices of foreign governments, government subsidies to foreign producers and governmentally imposed trade restrictions in the United States. Increased imports of tubular products in the United States and Canada could adversely affect our business, financial position, results of operations or cash flows.

We are subject to stringent environmental and health and safety laws, which may require us to incur substantial compliance and remediation costs, thereby reducing our profits. We are subject to many federal, state, local and foreign environmental and health and safety laws and regulations, particularly with respect to the use, handling, treatment, storage, discharge and disposal of substances and hazardous wastes used or generated in our manufacturing processes. Compliance with these laws and regulations is a significant factor in our business. We have incurred, and expect to continue to incur, significant expenditures to comply with applicable environmental laws and regulations. Our failure to comply with applicable environmental laws and regulations and permit requirements could result in civil or criminal fines or penalties or enforcement actions, including regulatory or judicial orders enjoining or curtailing operations or requiring corrective measures, installation of pollution control equipment or remedial actions.

We are currently, and may in the future be, required to incur costs relating to the investigation or remediation of property, and for addressing environmental conditions, including, but not limited to, the issues associated with our Portland, Oregon facility as discussed in Business Legal Proceedings below. Some environmental laws and regulations impose liability and responsibility on present and former owners, operators or users of facilities and sites for contamination at such facilities and sites without regard to causation or knowledge of contamination. Consequently, we cannot assure you that existing or future circumstances, the development of new facts or the failure of third parties to address contamination at current or former facilities or properties will not require significant expenditures by us.

We expect to continue to be subject to increasingly stringent environmental and health and safety laws and regulations. It is difficult to predict the future interpretation and development of environmental and health and safety laws and regulations or their impact on our future earnings and operations. We anticipate that compliance will continue to require capital expenditures and operating costs. Any increase in these costs, or unanticipated liabilities arising, for example, out of discovery of previously unknown conditions or more aggressive enforcement actions, could adversely affect our results of operations, and there is no assurance that they will not have a material adverse effect on our business, financial position, results of operations or cash flows.

We face risks in connection with potential acquisitions. Acquiring businesses that complement or expand our operations has been an important element of our business strategy, and we continue to evaluate potential acquisitions that may expand and complement our business. We may not be able to successfully identify attractive acquisition candidates or negotiate favorable terms in the future. Furthermore, our ability to effectively integrate any future acquisitions will depend on, among other things, the adequacy of our implementation plans, the ability of our management to oversee and operate effectively the combined operations and our ability to achieve desired operational efficiencies. If we are unable to successfully integrate the operations of any businesses that we may acquire in the future, our business, financial position, results of operations or cash flows could be adversely affected.

The relatively low trading volume of our common stock may limit your ability to sell your shares. Although our shares of common stock are listed on the Nasdaq Global Select Market, we have historically experienced a relatively low trading volume. If we have a low trading volume in the future, holders of our shares may have difficulty selling a large number of shares of our common stock in the manner or at a price that might otherwise be attainable.

The market price of our common stock could be subject to significant fluctuations. Among the factors that could affect our stock price are:

- our operating and financial performance and prospects;
- quarterly variations in the rate of growth of our financial indicators, such as earnings per share, net income and sales;
- changes in revenue or earnings estimates or publication of research reports by analysts;
- loss of any member of our senior management team;
- speculation in the press or investment community;
- strategic actions by us or our competitors, such as acquisitions or restructuring;
- sales of our common stock by shareholders;
- relatively low trading volume;
- general market conditions and market expectations for our industry and the financial health of our customers; and
- domestic and international economic, legal and regulatory factors unrelated to our performance.

The stock markets in general have experienced broad fluctuations that have often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

Certain provisions of our governing documents and Oregon law could discourage potential acquisition proposals. Our articles of incorporation contain provisions that:

- classify the board of directors into three classes, each of which serves for a three-year term with one class elected each year;
- provide that directors may be removed by shareholders only for cause and only upon the affirmative vote of 75% of the outstanding shares of common stock; and
- permit the board of directors to issue preferred stock in one or more series, fix the number of shares constituting any such series and determine the voting powers and all other rights and preferences of any such series, without any further vote or action by our shareholders.

In addition, we are subject to the Oregon Business Combination Act, which imposes certain restrictions on business combination transactions and may encourage parties interested in acquiring us to negotiate in advance with our board of directors. We also have a shareholder rights plan that acts to discourage any person or group from making a tender offer for, or acquiring, more than 15% of our common stock without the approval of our board of directors. Any of these provisions could discourage potential acquisition proposals, could deter, delay or prevent a change in control that our shareholders consider favorable and could depress the market value of our common stock.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

Properties

The following table provides certain information about our nine operating facilities as of December 31, 2008:

Location	Manufacturing Space (approx. sq. ft.)	Property Size (approx. acres)	Products	Number and Type of Mills
Portland, Oregon	300,000	25	Water transmission	3 spiral mills
Atchison, Kansas	100,000	60	Tubular products	2 electric resistance mills
Adelanto, California	200,000	100	Water transmission	3 spiral mills
Denver, Colorado	155,000	40	Water transmission	2 spiral mills
Houston, Texas	175,000	15	Tubular products	4 electric resistance mills
Parkersburg, West Virginia	145,000	90	Water transmission	2 spiral mills
Saginaw, Texas	170,000	50 (2 facilities)	Water transmission	1 spiral mill
Pleasant Grove, Utah	95,000	40	Water transmission	1 spiral mill
Monterrey, Mexico	40,000	5	Water transmission	multiple line fabrication capability

As of December 31, 2008, we owned all of our facilities except for our Pleasant Grove facility and one of our Saginaw, Texas facilities, which are leased. We also own an electric resistance mill in Portland, Oregon and a facility in Bossier City, Louisiana, which are not currently operating; however, we are in the process of moving the mill and reopening the Bossier City facility.

We have available manufacturing capacity from time to time at each of our facilities. To take advantage of market opportunities, we may identify capital projects that will allow us to expand our manufacturing facilities to meet expected growth opportunities. We believe the quality and productive capacity of our facilities are sufficient to maintain our competitive position for the foreseeable future.

Item 3. Legal Proceedings

On December 1, 2000, a section of the lower Willamette River known as the Portland Harbor was included on the National Priorities List (NPL) at the request of the U.S. Environmental Protection Agency (EPA). While our Portland, Oregon manufacturing facility does not border the Willamette River, an outfall from the facility s storm water system drains into a neighboring property s privately owned slip. We and 68 other parties were notified by EPA and the Oregon Department of Environmental Quality (ODEQ) of potential liability under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). As of the end of 2008 more than 200 potentially responsible parties (PRPs) on and nearby the river have been asked to file information disclosure reports with EPA. By agreement with EPA, ODEQ is charged with ensuring that all upland sites have source control to prevent future contamination to the river. A remedial investigation and feasibility study (RI/FS) of the Portland Harbor is currently being directed by a group of PRPs known as the Lower Willamette Group (LWG). We made a payment of $175,000 to the LWG in June 2007 as part of an interim settlement, and we are under no obligation to any make further payment. The RI/FS is expected to be completed by the LWG in 2009.

In 2001, groundwater containing elevated volatile organic compounds (VOCs) was identified in one localized area of our property furthest from the river. Assessment work in 2002 and 2003 to further characterize the groundwater is consistent with the initial conclusion that the source of the VOCs is located off of our property. On January 25, 2005 we entered into a Voluntary Agreement for Remedial Investigation and Source Control Measures (Agreement) with ODEQ related to the 2001 discovery. We performed Remedial Investigation (RI) work required under the Agreement and submitted a Remedial Investigation/Source Control

Evaluation Report to ODEQ on December 30, 2005. The conclusions of the report indicate that VOCs in groundwater do not present an unacceptable risk to human or ecological receptors in the Willamette River. The report also indicates there is no evidence at this time showing a connection between detected VOCs in groundwater and Willamette River sediments. ODEQ has recommended further RI work on groundwater, soil and storm water at the site. That work is ongoing.

Based on the RI and reporting required under our Portland, Oregon manufacturing facility s National Pollutant Discharge Elimination System permit for storm water, the Company and ODEQ have identified a possible source of small amounts of polynuclear aromatic compounds (PAHs) and polychlorinated biphenyls (PCBs) and have periodically identified trace amounts of zinc in storm water. Storm water from the Portland, Oregon manufacturing facility site is discharged to a neighboring property s privately owned slip, as is storm water from surrounding industrial properties. The slip was historically used for shipbuilding and subsequently for ship breaking and metal recycling. Studies of the river sediments in the slip have revealed concentration of PAHs, PCBs and zinc which are common constituents in urban storm water discharges. To minimize the zinc traces in the storm water, we have undertaken a program to coat the roofs of a substantial part of our facility.

Concurrent with the activities of EPA and ODEQ, the Portland Harbor Natural Resources Trustee Council (Trustees) sent some or all of the same parties, including us, a notice of intent to perform an Injury Assessment for the Portland Harbor Site to determine the nature and extent of natural resource damages under CERCLA section 107. Natural resource damages focus on site restoration as opposed to actions to remove or remediate hazardous substances. The Trustees for the Portland Harbor Site consist of representatives from six Northwest Indian Tribes and three federal agencies. The Trustees act independently of EPA and ODEQ but we expect their assessment will be coordinated with the RI/FS work underway at the Portland Harbor Site. The Trustees have encouraged potentially responsible parties to voluntarily participate in the funding of their injury assessment. We have not assumed any payment obligation or liability related to the Trustee s assessment.

The extent of our participation in these various matters in not known, and no further adjustment to our financial statements has been recorded as of December 31, 2008.

We operate our facilities under numerous governmental permits and licenses relating to air emissions, storm water run-off, and other matters. Our operations are also governed by many other laws and regulations, including those relating to workplace safety and worker health, principally the Occupational Safety and Health Act and regulations there under which, among other requirements, establish noise and dust standards. We believe we are in material compliance with our permits and licenses and these laws and regulations, and we do not believe that future compliance with such laws and regulations will have a material adverse effect on our financial position, results of operations or cash flows. To assist with environmental compliance programs, we have employed an environmental specialist.

From time to time, we are involved in litigation relating to claims arising out of our operations in the normal course of our business. We maintain insurance coverage against potential claims in amounts that we believe to be adequate. Management believes that it is not presently a party to any other litigation, the outcome of which would have a material adverse effect on our business, financial condition, results of operations or cash flows.

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

No matters were submitted to a vote of our shareholders during the quarter ended December 31, 2008.

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PART II

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

Attendance and Compensation of Directors

Attendance: 6 meetings of the Board of Directors and 25 meetings of the Board committees were held in 2005. All incumbent directors attended at least 75 percent of the total number of meetings of the Board of Directors and Board committees on which they served. The Company s policy generally is for all members of the Board of Directors to attend the Annual Meeting of Shareholders. All nominees for director, except one, attended the 2005 Annual Meeting of Shareholders.

We believe that attendance at meetings is only one means by which directors may contribute to the effective management of the Company and that the contributions of all directors have been substantial and are highly valued.

Summary of Director Annual Compensation

Compensation for our directors during fiscal year 2005 was determined by the Corporate Governance Committee, as consistent with a plan recommended to it by independent consultant Frederic W. Cook & Co., Inc., and approved by the Board of Directors. Directors receive a retainer payable semi-annually in advance for service on the Board of Directors, with additional retainers for serving on the Audit Committee or for serving as a committee chairman. All retainers are paid 50% in cash and 50% in the form of Deferred Stock Units (DSUs). For the cash portion of their compensation, directors have the option to either receive cash on a current basis, defer receipt under the existing Deferred Compensation Plan for Directors, or receive additional DSUs in lieu of cash. DSUs are a bookkeeping entry that represents the right to receive one share of the Company s Common Stock at a future date, currently at the earlier of one year after termination of Board service or the date of death. DSUs include the right to receive dividend equivalents, which are credited in the form of additional DSUs, at the same time and in the same amounts that an equivalent number of shares of Common Stock would be entitled to receive dividends. The DSUs are issued under the 2004 Equity Compensation Plan for Non-Employee Directors (2004 Director Plan), a plan that was approved by the Xerox shareholders at the 2004 Annual Meeting.

During fiscal year 2005, the annual retainer for all of our directors was $130,000; Audit Committee members received an additional $10,000; the chairman of the Audit Committee received an additional $30,000; the chairman of the Compensation Committee received an additional $20,000; and the chairmen of the Corporate Governance and the Finance Committees received an additional $15,000. Directors who join the Board at a time other than at the annual meeting of shareholders receive pro-rated retainers in the form of both cash and DSUs, and directors who do not serve for a complete fiscal year receive a pro-rated portion of any retainer awarded in the form of DSUs and any cash retainers already awarded. Directors also receive reimbursement for out-of-pocket expenses incurred in connection with their service on the Board.

Each non-employee director is required to maintain a meaningful ownership requirement in the Company, equivalent to five times the annual cash fees that such director receives for service on the Board of Directors, other than committee related fees. Newly appointed directors have up to five years to reach this ownership threshold. Directors who are our employees receive no compensation for service as a director.

Individually, the compensation for each director during fiscal year 2005 was as follows:

Name of Director(1)	Total ($)	Fees earned or paid in cash ($)(2)	Stock Awards ($)(3)	Option Awards ($)	Non-Stock Incentive Plan Compensation ($)	All Other Compensation ($)(4)
Glenn A. Britt	135,000	0	135,000			
Richard J. Harrington	150,000	75,000	75,000			
William Curt Hunter	140,000	0	140,000			
Vernon E. Jordan, Jr.	145,000	72,500	72,500			
Hilmar Kopper	130,000	65,000	65,000			
Ralph S. Larsen	150,000	0	150,000			
Robert A. McDonald	70,000	35,000	35,000			
N. J. Nicholas, Jr.	155,000	0	77,500			77,500
John E. Pepper	73,333	40,000	33,333			
Ann N. Reese	130,000	0	130,000			
Stephen Robert	130,000	0	130,000			

(1) *Directors:* Mr. McDonald was elected at the 2005 Annual Meeting. Mr. Pepper did not stand for reelection at the 2005 Annual Meeting.

(2) *Cash:* Cash compensation deferred under the Deferred Compensation Plan for Directors is reflected in the All Other Compensation column of this table. Cash compensation elected in the form of DSUs under the 2004 Director Plan is reflected in the Stock Awards column of this table.

(3) *DSUs:* Compensation awarded in the form of DSUs or DSUs elected in lieu of cash compensation are reflected in this column. Each of Mr. Britt, Mr. Hunter, Mr. Larsen, Ms. Reese and Mr. Robert, elected to take their 2005 cash compensation in the form of DSUs under the 2004 Director Plan.

The total number and value of all DSUs held by each director as of the end of 2005 (based on the year-end closing market price of our Common Stock of $14.65) is as follows: Mr. Britt, 13,139 ($192,486); Mr. Harrington, 10,276 ($150,543); Mr. Hunter, 14,634 ($214,388); Mr. Jordan, 10,265 ($150,382); Mr. Kopper, 9,392 ($137,593); Mr. Larsen, 15,680 ($229,712); Mr. McDonald, 2,548 ($37,328); Mr. Nicholas, 10,974 ($160,769); Mr. Pepper, 8,001 ($117,215); Ms. Reese 13,589 ($199,079); and Mr. Robert, 13,589 ($199,079).

(4) *Deferred Compensation:* Mr. Nicholas deferred his cash compensation for 2005 under the Deferred Compensation Plan for Directors. Amounts deferred under the Deferred Compensation Plan for Directors are assumed to be invested, without charge, in a stock fund established under the Xerox Corporation Savings Plan or a prime rate fixed income return investment fund. The value of each of these deferred accounts reflect all gains, losses and rates of return from such hypothetical investments. The value of each of these deferred accounts is generally determined on each business day. Amounts deemed invested in the prime rate fixed income return investment fund would have accrued interest at rates ranging from 5.25% to 7.00% per annum in fiscal year 2005.

Terms Used in Biographies

To help you consider the nominees, we provide summary biographical information. Certain terms used in the biographies may be unfamiliar to you, so we are defining them here.

Xerox securities owned means the Company s Common Stock, including restricted shares of Common Stock issued under the Restricted Stock Plan For Directors, which was terminated upon shareholder approval of the 2004 Directors Plan at the 2004 Annual Meeting, DSUs issued under the 2004 Directors Plan and Common Stock owned through the individual s ESOP account. None of the nominees owns any of the Company s other securities.

Immediate family means the spouse, the minor children and any relatives sharing the same home as the nominee.

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Unless otherwise noted, all Xerox securities held are owned beneficially by the nominee. This means he or she has or shares voting power and/or investment power with respect to the securities, even though another name that of a broker, for example appears in the Company s records. All ownership figures are as of March 15, 2006.

For information on compensation for officers, see the Executive Compensation section starting on page 15.

Glenn A. Britt
Age: 57 Director since: 2004
Xerox securities owned: 1,000 common shares and 17,692 DSUs
Options/Rights: none
Occupation: President and Chief Executive Officer, Time Warner Cable
Education: BA, Dartmouth College; MBA, Amos Tuck School of Business Administration
Other Directorships: None

Other Background: Joined Time Inc. in 1972. Elected Vice President of Time Inc. in 1986, Treasurer in 1986 and Vice President-Finance of Time Inc. in 1988. Became Senior Vice President and Treasurer of Time Warner Inc. and then President and CEO of Time Warner Cable Ventures. Appointed President of Time Warner Cable in 1999, Chairman and CEO in 2001, President and CEO in 2006. Member of the Audit and Corporate Governance Committees of Xerox.

Richard J. Harrington
Age: 59 Director since: 2004
Xerox securities owned: 856 common shares and 12,878 DSUs
Options/Rights: none
Occupation: President and Chief Executive Officer, The Thomson Corporation
Education: BA, University of Rhode Island
Other Directorships: The Thomson Corporation

Other Background: Joined Thomson in 1982 and held a number of leadership positions including President and CEO of Thomson Newspapers: President and CEO of Thomson Professional Publishing; President and CEO of Mitchell International and President of Thomson & Thomson. Employed as a Certified Public Accountant for Arthur Young & Co for six years prior to joining Thomson. Chairman of the Audit Committee of Xerox.

William Curt Hunter
Age: 58 Director since: 2004
Xerox securities owned: 16,911 DSUs and an indirect interest in approximately 3,716 common shares through the Deferred Compensation Plan for Directors
Options/Rights: none
Occupation: Dean and Distinguished Professor Finance, University of Connecticut School of Business
Education: BA, Hampton University; MBA, Northwestern University; PhD, Northwestern University
Other Directorships: Trustee of Nuveen Investments

Other Background: Joined the Federal Reserve Bank of Chicago in 1995 and most recently held the position of Senior Vice President and Director of Research. Member of the Bank s management committee, served as the Bank s chief economic advisor and oversaw the Statistical Reports and Consumer and Community Affairs units. Also served as Associate Economist on the Federal Open Market Committee, the Federal Reserve System s primary monetary policy group. US Treasury advisor to the Bulgarian National Bank. Held faculty positions at University of Georgia, Atlanta University, Emory University, Chicago State University and Northwestern University. Member of the Audit and the Corporate Governance Committees of Xerox.

Vernon E. Jordan, Jr.
Age: 70 Director since: 1974
Xerox securities owned: 40,019 common shares, 12,623 DSUs and an indirect interest in approximately 6,685 common shares through the Deferred Compensation Plan for Directors
Options/Rights: 40,000 common shares
Occupation: Senior Managing Director, Lazard Freres & Co. LLC; Of Counsel, Akin, Gump, Strauss, Hauer & Feld, LLP
Education: BA, DePauw University; JD, Howard University Law School
Other Directorships: American Express Company; Asbury Automotive Group; J.C. Penney Company, Inc.; and Lazard, Ltd.

Other Background: Joined Lazard Freres & Co. LLC in January 2000. Became a partner in the law firm of Akin, Gump, Strauss, Hauer & Feld in 1982, following ten years as President of the National Urban League, Inc. Member of the Bar of Arkansas, Georgia and the District of Columbia as well as the U.S. Supreme Court Bar. Member of the Council on Foreign Relations, The American Law Institute, the American Bar Association, the National Bar Association and the Bilderberg Meetings. Chairman of the Corporate Governance Committee and member of the Compensation Committee of Xerox.

Hilmar Kopper
Age: 71 Director since: 1991
Xerox securities owned: 37,452 common shares and 11,506 DSUs
Options/Rights: 35,050 common shares
Occupation: Former Chairman and Chief Executive Officer, Deutsche Bank AG
Education: High school diploma
Other Directorships: DaimlerChrysler AG; Unilever NV/PLC

Other Background: Apprenticeship with Rheinisch-Westfalischen Bank AG in Cologne, 1954. Management trainee at J. Henry Schroder Banking Corporation, New York. Foreign Department, Deutsche Bank s Central Office in Dusseldorf and Manager, Leverkusen branch, 1969. Appointed to the Board of Managing Directors of Deutsche Bank subsidiary European Asian Bank AG in Hamburg, 1972. Executive Vice President, Deutsche Bank AG, 1975; and Member of the Board of Managing Directors, Deutsche Bank AG, 1977. Spokesman of the Board of Managing Directors, December 1989 to May 1997. Member of the Compensation and Finance Committees of Xerox.

Ralph S. Larsen
Age: 67 Director since: 1990
Xerox securities owned: 33,689 common shares, 20,559 DSUs and an indirect interest in approximately 49,942 common shares through the Deferred Compensation Plan for Directors
Options/Rights: 40,000 common shares
Occupation: Former Chairman and Chief Executive Officer, Johnson & Johnson
Education: BBA, Hofstra University
Other Directorships: General Electric Company

Other Background: Joined Johnson & Johnson in 1962, named Vice President of Marketing, McNeil Consumer Products Company in 1980. President of Becton Dickinson s Consumer Products Division, 1981 to 1983. Returned to Johnson & Johnson as President of its Chicopee subsidiary in 1983. Named a company Group Chairman in 1986, and Chairman of the Board and Chief Executive Officer in 1989. Retired in 2002. Served two years in the U.S. Navy. Member of the Nominating and Corporate Governance and Management Development and Compensation Committees and the presiding director of General Electric. Chairman of the Compensation Committee and member of the Corporate Governance Committee of Xerox.

Robert A. McDonald
Age: 52 Director since: 2005
Xerox securities owned: 4,825 DSUs
Options/Rights: None
Occupation: Vice Chairman, Global Operations, The Procter & Gamble Company
Education: U.S. Military Academy, B.S., 1975; University of Utah, M.B.A., 1978
Other Directorships: None

Other Background: Joined Procter & Gamble in 1980. Named Vice President and General Manager Philippines, Asia/Pacific-South, Procter & Gamble Far East in 1994; Regional Vice President Japan, Procter & Gamble Asia in 1996; President, Northeast Asia in 1999; President, Global Fabric & Home Care in 2001; and Vice Chairman Global Operations in 2004. He is a non-voting member of the Board of Directors of The Procter & Gamble Company. Member of the Audit Committee.

Anne M. Mulcahy
Age: 53 Director since: 2000
Xerox securities owned: 597,951 common shares including ESOP account; 70,000 common shares held indirectly in a GRAT; and an indirect interest in approximately 35,635 shares through the Deferred Compensation Plan for Executives; immediate family owns 282 common shares in an ESOP account and an additional 3,770 shares
Options/Rights: 4,770,249 common shares
Occupation: Chairman and Chief Executive Officer, Xerox Corporation
Education: BA, Marymount College
Other Directorships: Citigroup, Inc.; Target Corporation

Other Background: Joined Xerox in 1976 as a sales representative and held various sales and senior management positions. Named Vice President for Human Resources in 1992; Senior Vice President in 1998; and Executive Vice

President in 1999. Elected President and Chief Operating Officer in May 2000, Chief Executive Officer in August 2001, and assumed the additional role of Chairman on January 1, 2002.

N. J. Nicholas, Jr.
Age: 66 Director since: 1987
Xerox securities owned: 106,700 common shares, 15,690 DSUs and an indirect interest in approximately 58,453 common shares through the Deferred Compensation Plan for Directors; immediate family owns 1,400 shares
Options/Rights: 40,000 common shares
Occupation: Investor
Education: BA, Princeton University; MBA, Harvard University Graduate School of Business Administration
Other Directorships: Boston Scientific Corporation; Time Warner Cable

Other Background: President of Time, Inc. from 1986 to 1990 and President and Co-Chief Executive Officer, Time-Warner Inc. from 1990 to 1992. Former member of the President s Advisory Committee on Trade Policy and Negotiations and the President s Commission on Environmental Quality. Trustee Chairman of Environmental Defense. Chairman of the Finance Committee and member of the Compensation Committee of Xerox.

Ann N. Reese
Age: 53 Director since: 2003
Xerox securities owned: 6,654 common shares and 17,817 DSUs

Options/Rights: 5,000

Occupation: Executive Director, Center for Adoption Policy Studies
Education: BA, University of Pennsylvania; MBA, New York University Graduate School of Business
Other Directorships: CBS Corporation; Jones Apparel Group; Sears Holdings; Merrill Lynch & Co., Inc.

Other Background: Co-founded the Center for Adoption Policy Studies in 2001. Principal, Clayton, Dubilier & Rice, 1999 2000. Executive Vice President and Chief Financial Officer, ITT Corporation, 1995 1998; Treasurer, ITT Corporation, 1992 1995; Assistant Treasurer, ITT Corporation, 1987 1992. Member of the Finance and Governance Committees of Xerox.

Mary Agnes Wilderotter
Age: 51 Director since: 2006
Xerox securities owned: None
Options/Rights: None
Occupation: Chairman and Chief Executive Officer, Citizens Communications
Education: BA, College of the Holy Cross
Other Directorships: The McClatchy Co.

Other Background: Joined Citizens Communications in 2004 as President and Chief Executive Officer, named Chairman in 2006. Senior Vice President of Worldwide Public Sector, Microsoft, 2002-2004; President and Chief Executive Officer, Wink Communications Inc., 1996-2002; Executive Vice President, National Operations, AT&T Wireless and Chief Executive Officer Aviation Communication Division 1995-1996; Senior Vice President, McCaw

Cellular Communications Inc., 1990-1995.

Ownership of Company Securities

We do not know of any person who, or group which, owns beneficially more than 5% of any class of the Company s equity securities as of December 31, 2005, except as set forth below(1).

Title of Class	Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership		Percent of Class
Common Stock	Dodge & Cox 555 California Street, 40th Floor San Francisco, CA 94104	123,035,083	(2)	12.8 %
Common Stock	State Street Bank and Trust Company, as Trustee under other plans and accounts 225 Franklin Street Boston, MA 02110	73,739,270	(3)	7.7 %
Common Stock	Brandes Investment Partners, L.P. 11988 El Camino Real, Suite 500 San Diego, CA 92130	55,001,395	(4)	5.7 %

(1) The words group and beneficial are as defined in regulations issued by the SEC. Beneficial ownership under such definition means possession of sole voting power, shared voting power, sole dispositive power or shared dispositive power. The information provided in this table is based solely upon the information contained in the Form 13G filed by the named entity with the SEC. All of the firms named in the table, other than State Street Bank and Trust Company, are registered investment advisers under the Investment Advisers Act of 1940, as amended.

(2) Within the total reported, as to certain of the shares, Dodge & Cox has sole voting power for 115,518,083 shares, shared voting power for 1,222,500 shares, sole dispositive power for 123,035,083 shares and no shared dispositive power for any of the shares.

(3) Within this total as to certain of the shares, State Street Bank and Trust Company has sole voting power for 29,180,743 shares, shared voting power for 44,558,527 shares, shared dispositive power for 73,739,270 shares and no sole dispositive power for any of the shares. State Street Bank and Trust Company holds 24,740,828 of the total reported shares as ESOP Trustee under the Xerox ESOP. Each ESOP participant may direct the ESOP Trustee as to the manner in which shares allocated to his or her ESOP account shall be voted. The ESOP Trust Agreement provides that the ESOP Trustee shall vote any shares allocated to participants ESOP accounts as to which it has not received voting instructions in the same proportions as shares in participants ESOP accounts as to which voting instructions are received. Shares which have not been allocated are voted in the same proportion. The power to dispose of shares is governed by the terms of the ESOP Plan and elections made by ESOP participants.

(4) Brandes Investment Partners, L.P. and its affiliate companies and partners own these shares in aggregate and have shared voting power for 45,052,313 shares and shared dispositive power for 55,001,395 shares, and have no sole voting or dispositive power for any of the shares.

Shares of Common Stock of the Company owned beneficially by its directors and nominees for director, each of the current executive officers named in the Summary Compensation Table below and directors and all current executive officers as a group, as of March 15, 2006, were as follows:

Name of Beneficial Owner	Amount Beneficially Owned	Total Stock Interest
Glenn A. Britt	1,000	18,692
Ursula M. Burns	744,139	978,643
James A. Firestone	765,539	934,306
Richard J. Harrington	856	13,734
William Curt Hunter		20,627
Vernon E. Jordan, Jr.	80,019	99,327
Hilmar Kopper	72,502	84,008
Ralph S. Larsen	73,689	144,190
Michael C. Mac Donald	444,979	583,968
Robert A. McDonald		4,825
Anne M. Mulcahy	3,904,152	5,477,887
N. J. Nicholas, Jr.	148,100	222,243
Ann N. Reese	11,654	29,471
Stephen Robert	50,000	72,553
Mary Agnes Wilderotter		
Lawrence A. Zimmerman	756,744	875,511
All directors and executive officers as a group (27)	9,775,545	12,801,789

Percent Owned by Directors and Executive Officers: Less than 1% of the aggregate number of shares of Common Stock outstanding at March 15, 2006 is owned by any director or executive officer. The amount beneficially owned by all directors and executive officers as a group amounted to approximately 1%.

Amount Beneficially Owned: The numbers shown are the shares of Common Stock considered beneficially owned by the directors and executive officers in accordance with SEC rules. Shares of Common Stock which executive officers and directors had a right, within 60 days, to acquire upon the exercise of options or rights are included. Shares held in a GRAT or by family members, shares held in the Xerox Corporation Employee Stock Ownership Plan accounts, and vested restricted shares the receipt of which has been deferred under one or more equity compensation plans (which plans have been superseded by the Xerox Corporation 2004 Performance Incentive Plan approved by the shareholders at the 2004 Annual Meeting) are also included. All these are counted as outstanding for purposes of computing the percentage of Common Stock outstanding and beneficially owned.

Total Stock Interest: The numbers shown include the amount shown in the Amount Beneficially Owned column plus options held by directors and executive officers not exercisable within 60 days, incentive stock units, deferred stock units, performance shares and restricted shares. The numbers also include the interests of executive officers and directors in the Xerox Stock Fund under the Xerox Corporation Savings Plan and the Deferred Compensation Plans.

Executive Compensation

Report of the Compensation Committee of the Board of Directors

The Board of Directors created the Compensation Committee (the Committee) to fulfill the Board s responsibilities relating to compensation of the Company s officers. Specific Committee responsibilities include reviewing and approving performance goals of the Chief Executive Officer and all other officers, overseeing the performance evaluation of all officers, reviewing and approving executive compensation plans, setting the compensation for the Chief Executive Officer and all other officers, and consulting with the Chief Executive Officer and the Board on management succession. The Committee Charter can be found attached to this proxy

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statement as Exhibit III, or by visiting our website at *http://www.xerox.com/investor* and then clicking on Corporate Governance, and is also available to any shareholder who requests it by writing to Xerox Corporation, 800 Long Ridge Road, Stamford, Connecticut 06904, Attention: Corporate Secretary.

The Committee is comprised of four independent directors.

Actions Taken by the Committee

The Company s executive compensation policies, plans and programs provide opportunities for competitive levels of compensation that align pay with the Company s annual and long-term performance objectives. They include incentives necessary to reward contributions and leadership to increase profitability, revenue and operating cash flow of the Company, enhancing confidence in the financial stewardship of the Company, creating and maintaining the high morale and commitment of the Company s employees and furthering the Company s values as a responsible corporate citizen. The Company seeks to be recognized as a leader in corporate social responsibility. These leadership goals are encompassed within our environmental, diversity, and ethics programs and are supported by the Company s corporate governance process and extensive community outreach. They also support the Company objectives of attracting, motivating and retaining high-performing executives and allowing for recognition of superior corporate and individual achievement.

Our pay policy is to target compensation levels for officers at the midpoint of a range determined from the median compensation levels paid by other companies for comparable positions.

In connection with our duties, the Committee met five times during 2005.

To meet compensation policy objectives, we reviewed Xerox executive officer compensation and compared it to relevant external data. The Committee reviewed the reported compensation data of firms that were part of the *Business Week* Computers and Peripherals Industry Group. The Committee also reviewed a broader group of organizations with which the Company is likely to compete for executive expertise as well as companies of similar size and scope. The latter group includes global companies in technology, office equipment and other related industries. During 2005, the Committee, following an extensive review, revised this grouping of companies. The new grouping is slightly larger in median total revenues and slightly better performing as measured by total shareholder return when compared to the former grouping. The revised grouping also has a greater representation of services companies. Taken as a whole, we believe the new grouping to be a more relevant group to compare performance and executive compensation.

The Committee sets base salaries based on competitive data and each executive s performance. In addition, a substantial portion of each executive officer s total compensation, generally two-thirds or more, is at risk and variable from year to year.

During 2005, the Company generated significant positive operating cash flow, increased sales of new equipment and services as measured on a constant currency basis, and continued its disciplined cost and expense management, which resulted in positive growth in earnings per share. During 2005, total shareholder return was -13.9% for the calendar year. This compares against total shareholder return of over 23% in 2004. Based on the 2005 performance, the Company ranked below the median in total shareholder return in 2005 and in the upper quartile over the past three years when compared to the latter group mentioned above.

Goals for the Company in 2005 focused on Financial and Leadership Effectiveness. Financial goals emphasized improved earnings per share, revenue generation and cash flow from operations. Leadership Effectiveness goals concentrated on effective development and communication of the Company s strategy and execution of short and long-term business plans. The principal pay programs for officers in 2005 and 2006 are briefly described below:

Base Salary Adjustments: After reviewing competitive data in early 2005, the Committee approved base salary adjustments for select officers. The approved adjustments averaged approximately 3% on an annualized basis. Certain officers received an additional adjustment to their base salary during 2005 as a result of new responsibilities and/or to address specific retention concerns.

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Annual Performance Incentive Plan (APIP): Under APIP, executive officers of the Company are eligible to receive performance-related cash payments if Committee-established annual performance objectives are met. The Committee approved an annual incentive target and maximum opportunity for 2005, expressed as a percentage of base salary, for each participating officer.

The Committee also set overall threshold, target and maximum measures of performance for the 2005 APIP. The performance measures and weightings for 2005 were revenue (30%), earnings per share (40%) and cash flow from operations (30%). Additional goals for each officer addressed business-unit specific and/or individual performance goals and objectives, including new product launches and executing business growth plans. The weightings associated with these additional performance goals vary.

For 2005, the performance against the overall APIP goals was as follows: Revenue performance was below threshold, earnings per share growth above targeted levels and cash flow from operations exceeded maximum. Accordingly, the Committee approved APIP awards for 2005 to participating officers that on average were less than target, in light of the overall operational results delivered by the Company in 2005. Some individuals received higher or lower bonuses based on their individual and unit performance.

Payments to the named officers for 2005 were paid from a bonus pool established by the Committee early in 2005 under the terms of the Xerox Corporation 2004 Performance Incentive Plan (2004 Plan) approved by shareholders. The pool was funded by 2% of the performance profit achieved during the year. The Committee exercised its discretion in determining the amount of actual bonus paid to each named officer from the available pool. The purpose of the bonus pool was to ensure that bonuses paid to named officers are performance-based and thus fully tax-deductible expenses for the Company.

Long-Term Incentive Awards: As previously disclosed in last year s report, the Committee approved a new approach to long-term incentive awards for executives beginning in 2005. The new Executive Long-Term Incentive Program (E-LTIP) provides strong performance-based incentives that are in full alignment with the interests of all shareholders.

E-LTIP awards made to officers reflect their leadership role in the Company, their individual performance, and competitive award levels. The purpose of E-LTIP is to provide the necessary incentives to retain and reward executives for sustained performance improvements over the next three-year period.

E-LTIP awards made to officers are comprised entirely of performance shares that may be earned based on achieving annual performance targets or three-year cumulative performance between threshold and maximum as determined by the Committee. Performance shares that have been earned vest following Committee certification of the performance results for the applicable three-year period. Executives who retire or are involuntarily terminated prior to the end of the three-year performance period will vest in a portion of the performance shares earned on a pro rata basis.

Performance metrics for E-LTIP are Diluted Earnings Per Share (60%) and Net Cash provided by Operating Activities (40%). The Committee has established annual and cumulative targets for each award. Based on annual or cumulative performance versus targets, the number of performance shares earned by officers under E-LTIP may vary from 0% to 150% of the initial number of shares subject to the grant.

Each share granted provides for the cash payment of dividend equivalents at the same time and in the same amounts that the holder of record of a number of shares of Common Stock would be entitled to receive as dividends.

Each participant of E-LTIP must satisfy a meaningful ownership requirement. For Anne M. Mulcahy, the Chairman and CEO, the ownership requirement is five times her base salary. For Ursula M. Burns, Lawrence A. Zimmerman and James A. Firestone, the requirement is three times base salary. For other officers, the ownership requirement is two times base salary. Non-officer participants in E-LTIP have an ownership requirement equal to their base salary. All awards under E-LTIP are subject to a mandatory holding requirement. As determined by the Committee, executives must retain 50% of the net shares until they achieve their required level of ownership.

Grants for 2005 E-LTIP were made by the Committee effective January 1, 2005. Specific grants made to the named officers are shown in the Long-Term Incentive Plan Awards Table and related footnotes that accompany this report as per current SEC requirements. For the year 2005, Diluted Earnings Per Share and Net Cash provided by Operating Activities performance exceeded target. The Committee, therefore, determined that one-third of the performance shares awarded in 2005 under E-LTIP were earned by participants, including the named executive officers. The number of earned shares and their value (based on the year-end 2005 closing market price of $14.65) is as follows: Anne M. Mulcahy 98,033 ($1,436,183), Ursula M. Burns 35,300 ($517,145), Lawrence A. Zimmerman 31,367 ($459,527), James A. Firestone 31,367 ($459,527) and Michael C. Mac Donald 21,567 ($315,957). Pursuant to the terms of E-LTIP, earned shares do not vest until the end of the three-year period following the grant.

Grants for 2006 E-LTIP were made by the Committee effective April 1, 2006, as follows: Anne M. Mulcahy 444,000 ($6,737,700), Ursula M. Burns 170,800 ($2,591,890), Lawrence A. Zimmerman 109,300 ($1,658,628), James A. Firestone 136,700 ($2,074,423) and Michael C. Mac Donald 75,200 ($1,141,160).

Effective in 2004, the Committee discontinued the granting of stock options because it believes the performance shares in E-LTIP provide for a more effective balance of the performance-based incentives needed to attract and retain executive talent at lower cost and with less dilution. Awards under E-LTIP are reflected as compensation expense in the Company s results of operations.

In order to effectively complete the transition to the new stock-based award programs, the Committee approved accelerating the vesting of approximately 3,616,000 unvested stock options previously granted in 2004 to all employees, including corporate officers. Approximately 2,883,000 of these unvested stock options had been granted to employees who are not corporate officers, and 733,000 to corporate officers including Anne M. Mulcahy (203,000), Ursula M. Burns (46,000), Lawrence A. Zimmerman (40,667), James A. Firestone (40,667) and Michael C. Mac Donald (30,667).

Executive Life Insurance: The Company provides the Xerox Universal Life Plan (XUL) to eligible employees, including the named officers. Under XUL, participants receive Company-paid life insurance equal to their death benefit under the prior program, or three times their base salary, whichever is greater. Executives are the sole owners of their XUL policies and are responsible for any taxes due from Company contributions.

Policy Regarding Tax Deductibility of Executive Compensation

It is the Company s goal to have most compensation paid to its top officers qualify as tax deductible for federal tax purposes under Section 162(m) of the Internal Revenue Code. We believe it is appropriate to provide competitive compensation opportunities even though they may not be fully tax deductible in any given year.

Certain compensation paid to named officers in 2005 does not meet the requirements of Section 162(m), most notably the value of restricted stock awards that vested in 2005, to the extent that compensation exceeds $1 million for a named officer. Certain perquisite compensation, such as personal use of company aircraft, also may not be fully tax deductible. It is expected that E-LTIP awards will be fully tax-deductible compensation.

Chief Executive Officer Compensation

In 2005, the Committee took the following actions with respect to the compensation paid to Mrs. Mulcahy, Chairman and Chief Executive Officer of the Company.

Base Salary: Mrs. Mulcahy s annualized base salary was maintained at the previously disclosed level of $1,320,000.

2005 Bonus: Mrs. Mulcahy s annual target bonus remained at 100% of base salary. Mrs. Mulcahy was awarded an annual bonus of $1,188,000, based on the Company s overall results as discussed above under APIP.

Long-Term Incentives: Effective on January 1, 2005, Mrs. Mulcahy received an award under the 2005 E-LTIP as described earlier. Her 2005 E-LTIP award consisted of a grant of 294,100 performance shares. The grant date fair market value of this grant was $5,001,171. On the basis of Company performance in 2005 as discussed earlier in this report, 98,033 shares ($1,436,183, based on the year-end 2005 closing market price of $14.65) were earned. Earned shares do not vest until the end of the three-year period following the grant.

Effective on April 1, 2006, Mrs. Mulcahy received an award for 2006 under E-LTIP as described above. Her award consisted of 444,000 performance shares at a grant value of ($6,737,700).

Performance shares may be earned based on annual or cumulative performance targets over a three-year period as determined by the Committee. Based on performance, shares actually received may range from 0% to 150%.

Mrs. Mulcahy s 2006 APIP incentive target increased to 150% (from 100%) following the Committee s review of competitive incentive target levels and total compensation levels.

The Committee made these awards to provide the incentives necessary to retain Mrs. Mulcahy and to reward her for her outstanding contributions and leadership in significantly increasing the profitability and operating cash flow of the Company, enhancing confidence in the financial stewardship of the Company, and creating and maintaining the high morale, commitment of the Company s employees and furthering the Company s values as a responsible corporate citizen.

The accompanying charts and tables present detailed information on Mrs. Mulcahy s compensation as well as that of other highly compensated executive officers.

The Committee and the Board believe that the quality of Xerox s leadership and the caliber and motivation of its management make a significant contribution to our performance and ability to create sustaining value for our shareholders. The Committee believes our executive compensation programs are an important component of our ability to create competitive advantage for Xerox in light of global competition.

Ralph S. Larsen, Chairman
Vernon E. Jordan, Jr.
Hilmar Kopper
N.J. Nicholas, Jr.

Summary Compensation Table

The Summary Compensation Table below provides compensation information for the Chief Executive Officer and the four most highly compensated key executive officers (named officers) serving at the end of the fiscal year ended December 31, 2005, for services rendered in all capacities during the fiscal years ended December 31, 2005, 2004, and 2003. The table includes the dollar value of base salary, bonus earned, restricted stock awards, option awards (shown in number of shares) and certain other compensation, whether paid or deferred.

SUMMARY COMPENSATION TABLE

					Long-Term Compensation			
		Annual Compensation			**Awards**		**Payouts**	
Name and Principal Position	**Year**	**Salary ($)(A)**	**Cash Bonus ($)**	**Other Annual Compensation ($)(B)**	**Restricted Stock ($)(C)**	**Underlying Options/SARs (#)(D)**	**LTIP Payouts ($)(E)**	**All Other Compensation ($)(F)**
Anne M. Mulcahy	2005	1,320,000	1,188,000	197,825				57,181
Chief Executive Officer	2004	1,320,000	1,584,000	166,995	5,050,800	609,000		56,464
	2003	1,091,667	1,750,000	332,790	2,012,500	934,600		27,253
Ursula M. Burns	2005	548,625	350,595	13,051				22,404
Senior Vice President	2004	525,000	441,000	20,897	1,145,400	138,000		21,958
	2003	500,000	485,100 &					