Energy Recovery, Inc.
Form 10-K
March 15, 2011

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

(Mark One)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended December 31, 2010**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to .**

Commission File Number: 001-34112
Energy Recovery, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**01-0616867**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

1717 Doolittle Drive, San Leandro, CA 94577
(Address of Principal Executive Offices)

Registrant s telephone number, including area code:
(510) 483-7370

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of Each Class	Name of Exchange on Which Registered
Common stock, $0.001 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Securities Exchange Act of 1934:
None

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The aggregate market value of the voting stock held by non-affiliates amounted to $133.0 million on June 30, 2010.

The number of shares of the registrant s common stock outstanding as of March 7, 2011 was 52,603,629.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the Registrant s Annual Meeting of Shareholders to be held in June 2011 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

Item 1. *Business*

Overview

Energy Recovery, Inc. develops, manufactures and sells high-efficiency energy recovery devices and pumps primarily for use in seawater desalination. Our products make desalination affordable by reducing energy costs. We have one operating segment, the manufacture and sale of high-efficiency energy recovery products and pumps and related parts and services. Additional information on segment reporting is contained in Note 11 of Notes to the Consolidated Financial Statements in this Form 10-K.

During fiscal year 2010, we successfully integrated the operations of our new subsidiary, Pump Engineering, Inc. (PEI), which we acquired in December 2009. We consolidated our sales, support engineering and corporate services organizations and aligned our manufacturing activities to the same operational and quality standards. We also completed the build-out of our ceramics factory in San Leandro, California, and commissioned all major pieces of equipment. Although the industry down-turn prevented us from ramping up our ceramics production as planned, we still expect to manufacture a substantial portion of our ceramics needs in-house by the end of 2011. We expect our investment in the material science and manufacturing of ceramics to advance product quality and to reduce production costs as production volume increases. For a discussion of risks attendant to our planned in-house manufacture of some ceramic components of our PX devices, see Risk Factors Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing, in Item 1A, which is incorporated herein by reference.

Despite the slow-down in our industry, we continued to strengthen our competitive position as the leading supplier of energy recovery devices for desalination. In 2010, we manufactured and shipped the world s largest turbochargers for the world s largest desalination plant in Magtaa, Algeria. Our newest and most advanced pressure exchanger product to date, the PX-300, also gained market acceptance and was sold for both large and small projects. We expect this product to represent a higher percentage of our net revenue in 2011. In 2010, we continued to focus engineering resources on enhancing our turbochargers, PX devices and pump offerings. We also initiated the development of several new product lines for applications outside desalination. We anticipate that at least one of these products will advance to beta testing in 2011.

In 2011, we expect that the desalination industry will continue to experience the delayed effects of the global economic downturn, which is likely to affect our revenue, especially revenue from sales of products for large desalination projects, manufacturing through-put and profitability for 2011.

Our company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. We became a public company in July 2008. The company has five wholly owned subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, Energy Recovery Iberia, S.L., ERI Energy Recovery Ireland Ltd. and Pump Engineering, Inc. They were incorporated in September 2005, July 2006, September 2006, April 2010 and November 2009, respectively.

The mailing address of our headquarters is 1717 Doolittle Drive, San Leandro, California 94577. Our main telephone number is (510) 483-7370. Additional information about ERI is available on our website at http://www.energyrecovery.com. Information contained in the website is not part of this report.

Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports and the Proxy Statement for our Annual Meeting of Stockholders are made available, free of charge, on our website, http://www.energyrecovery.com, as soon as reasonably practicable after the reports have been filed with or furnished to the Securities and Exchange Commission.

Our Products

We make energy recovery devices and high pressure and circulation pumps primarily for use in seawater desalination plants that use reverse osmosis technology. Our products are sold under the trademarks

AquaBold^{tm}, AquaSpire^{tm}, ERI^{tm}, PX^{tm}, Pressure Exchanger^{tm}, PX Pressure Exchanger^{tm}, PEI^{tm}, Pump Engineering^{tm} and Quadribaric^{tm}. Our energy recovery products reduce plant operating costs by capturing and reusing the otherwise lost pressure energy from the reject stream of the desalination process. Use of energy recovery devices can reduce energy consumption by up to an estimated 60% compared to desalination without energy recovery. By reducing energy costs, our devices increase the cost-competitiveness of reverse osmosis desalination compared to other means of fresh water production, including thermal desalination. Our pumps are designed for high efficiency and complement the operation of our energy recovery devices.

Energy Recovery Devices. We develop and sell two main lines of energy recovery devices: PX Pressure Exchanger devices and turbochargers. Each line includes a range of models and sizes to address the breadth of required process flow rates, plant designs and sizes.

Our current PX offerings include: the PX-300, the 65 series (the PX-260, PX-220 and PX-180); the 4S series (PX-140S, PX-90S, PX-70S, PX-45S and PX-30S) and brackish PX devices (for the desalination of water with a lower concentration of salt than seawater).

Our turbocharger offerings include: the HTCAT series (HTCAT-1800, HTCAT-2400, HTCAT-3600, HTCAT-4800, HTCAT-7200 and HTCAT-9600); the HALO line (HALO-50, HALO-75, HALO-100, HALO-150, HALO-225, HALO-300, HALO-450, HALO-500, HALO-600, HALO-900 and HALO-1200); and the LPT series for brackish water desalination applications (LPT-63, LPT-125, LPT-250, LPT-500, LPT-1000 LPT-2000 and LPT-3200).

High Pressure and Circulation Pumps. We manufacture and sell high pressure feed, circulation and booster pumps for use with our energy recovery devices in reverse osmosis desalination plants. Our current line of pumps includes the AquaBold series (AquaBold 2x3x5, AquaBold 3x4x7 and AquaBold 4x6x9); the AquaSpire series (AquaSpire-300, AquaSpire-450, AquaSpire-600, AquaSpire-900, AquaSpire-1200, AquaSpire-1800, AaquaSpire-2400, AquaSpire-3600, AquaSpire-4800, AquaSpire-7200 and AquaSpire-9600) and a line of small circulation pumps.

Technical Support and Replacement Parts. We provide engineering and technical support to customers during product installation and plant commissioning. We also offer replacement parts and services for our PX devices and turbochargers . Our PX devices and turbochargers are also used to retrofit or replace older energy recovery devices in existing desalination plants.

Customers

Our customers include a limited number of major international engineering, procurement and construction firms which design and build large desalination plants, and a number of original equipment manufacturers (OEMs), companies that supply equipment and packaged solutions for small to medium-sized desalination plants.

Large engineering, procurement and construction firms. Historically, most of our revenue has come from sales of products to the large engineering, procurement and construction firms worldwide that have the required desalination expertise to engineer, undertake procurement for, construct and sometimes own and operate large desalination plants or mega-projects. We work with these firms to specify our products for their plants. The time between project tender to product shipment can range from six to 16 months. Each mega-project typically represents a revenue opportunity of between $2 million to $10 million.

A limited number of these engineering, procurement and construction firms account for 10% or more of our net revenue. For the year ended December 31, 2010, two customers Thiess Degremont J.V. (a joint venture of Thiess Pty Ltd. and Degremont S.A.) and Hydrochem (S) Pte Ltd (a Hyflux company) accounted for approximately 23% and

12% of our net revenue, respectively. For the year ended December 31, 2009, three customers IDE Technologies, Ltd., Acciona Agua, and UTE Mostaganem (a consortium of Inima and Aqualia) accounted for approximately 20%, 11%, and 11% of our net revenue, respectively. For the year ended December 31, 2008, two customers accounted for approximately 16% and 11% of our net revenue Hyflux Limited and Befesa Agua S.A. (including affiliated joint ventures), respectively. No other customers accounted for more than 10% of our total revenue during any of this period.

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Original Equipment Manufacturers. We also sell our products and services to suppliers of pumps and other water-related equipment for assembly and use in small to medium-sized desalination plants located in hotels, power plants, cruise ships, farm operations, island bottlers, and small municipalities. These original equipment manufacturers also purchase our products for quick water or emergency water solutions. In this market, the time from project tender to shipment ranges from one to three months.

Competition

The market for energy recovery devices and pumps in desalination plants is competitive. As the demand for fresh water increases and the market expands, we expect competition to persist and intensify.

We have two main competitors for our energy recovery devices: Flowserve Corporation (Flowserve) based in Irving, Texas and Fluid Equipment Development Company (FEDCO) based in Monroe, Michigan. We compete with these companies on the basis of price, technology, materials, efficiency and life cycle maintenance costs. We believe that our products have a competitive advantage, even though these companies may offer competing products at prices lower than ours, because we believe that our products are the most cost-effective energy recovery devices for reverse osmosis desalination over time.

In the market for large desalination projects, our PX devices and large turbochargers compete primarily with Flowserve s DWEER product. We believe that our PX devices have a competitive advantage over the DWEER because they are made with highly durable and corrosion-proof ceramic parts, have a simple design with one moving part, have a small physical footprint, provide system redundancy and scaling capability, and offer lower life cycle maintenance costs. We believe our large turbocharger products have a competitive advantage over the DWEER product, particularly in countries where energy costs are low and upfront capital costs are a key factor in purchase decisions, because our turbocharger products have lower upfront capital costs, a simple design with one moving part, a small physical footprint and a long operating life which leads to low total life cycle costs.

In the market for small to medium-sized desalination plants, our products compete with Flowserve s Pelton turbines and FEDCO turbochargers. We believe that our PX devices have a competitive advantage over these products because our devices provide up to 98% energy transfer efficiency, have lower life cycle maintenance costs, and are made of highly durable and corrosion-proof ceramic parts. We believe that our turbochargers compete favorably with Pelton turbines on the basis of efficiency and price, and that our turbochargers have design advantages over competing turbochargers that enhance efficiency and serviceability.

In the market for high pressure pumps, our products compete with pumps manufactured by Clyde Union Ltd. based in Glasgow, Scotland; FEDCO, Flowserve, Duchting Pumpen Maschinenfabrik GmbH & Co KG based in Witten, Germany; KSB Aktiengesellschaft based in Frankenthal, Germany; Torishima Pump Mfg. Co., Ltd. based in Osaka, Japan and Sulzer Pumps, Ltd. based in Winterthur, Switzerland and other companies. We believe that our pump products have a competitive advantage over these competitive products because our pumps are developed specifically for reverse osmosis desalination, are highly efficient and feature product lubricated bearings.

Sales and Marketing

We market and sell our products directly to customers through our sales organization and, in some countries, through authorized, independent sales agents. In 2010, we integrated our PEI and ERI sales operations. Our current sales organization now has two groups, the Mega-Projects Group, which is responsible for sales of our PX devices and large turbochargers for desalination projects exceeding 50,000 cubic meters per day; and our OEM Group, which is responsible for sales of PX devices, turbochargers and pumps for plants designed to produce less than 50,000 cubic meters per day.

A significant portion of our revenue is from outside of the United States. Sales in the United States represented 7.3%, 6.4%, and 6.7% of our net revenue for the fiscal years 2010, 2009, and 2008, respectively. Additional geographical information regarding our net revenues is included in Note 11 to the Consolidated Financial Statements in this Form 10-K.

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Since many of the large engineering, procurement, and construction firms that specialize in large projects are located in the Mediterranean region, we have a sales and technical center in Madrid, Spain. Our office in Dubai, United Arab Emirates serves the Middle East where many desalination plants and key engineering, procurement and construction firms are located. We also have a sales office in Shanghai, China to address this emerging market for our energy recovery products. We have U.S. sales offices in California and Michigan.

Manufacturing

We have manufacturing facilities in San Leandro, California where our PX devices are made, assembled and tested, and in New Boston, Michigan where our turbochargers and pumps are manufactured and tested. We purchase unfinished ceramic components for our PX products from several suppliers and in 2010, we started to produce some ceramic components in our new ceramics factory in our San Leandro facility. For our PX devices, we depend on two suppliers for our vessel housing and a single supplier for stainless steel castings. For our turbochargers and pumps, we rely on a limited number of foundries for castings. We finish machining and assemble in-house all ceramic components of our PX devices and many components of our turbochargers and pumps to protect the proprietary nature of our methods of manufacturing and product designs and to maintain quality standards.

For a discussion of risks attendant to our manufacturing activities, see Risk Factors We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed, and Risk Factors We depend on a limited number of vendors for our supply of ceramics, which is a key component of our PX products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed, in Item 1A, which is incorporated herein by reference. For a discussion of risks attendant to our planned in-house manufacture of some ceramic components of our PX devices, see Risk Factors Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing, in Item 1A, which is incorporated herein by reference.

Research and Development

Design, quality and innovation are key facets of our corporate culture. Our development efforts are focused on enhancing our existing energy recovery devices and pumps for the desalination market and advancing our know-how in the material science and manufacturing of ceramics. In 2010, our engineering work also led to the development of several potential new product lines for applications inside and outside of seawater desalination. Research and development expense totaled $3.9 million for 2010, $3.0 million for 2009, and $2.4 million for 2008. We expect research and development costs to increase in the future as we continue to advance our existing technology and to develop new energy recovery and efficiency-enhancing solutions for markets outside seawater desalination.

For a discussion of risks attendant to our research and development activities, see Risk Factors The success of our business depends in part on our ability to enhance and scale our existing products, develop new products for desalination, and diversify into new markets by developing or acquiring new technology, in Item 1A, which is incorporated herein by reference.

Intellectual Property

We seek patent protection for new technology, inventions and improvements that are likely to be incorporated into our products. We rely on trade secret law and contractual safeguards to protect the proprietary tooling, processing techniques and other know-how used in the production of our products.

We have ten U.S. patents and sixteen patents outside the U.S. that are counterparts of several of the U.S. patents. The U.S. patents expire between 2011 and 2027, and the corresponding international patents expire at various dates through 2021. We have also applied for five additional U.S. patents and there are thirty-six pending foreign applications corresponding to the U.S. patents and patent applications and two pending international applications.

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We have registered the following trademarks with the United States Patent and Trademark office: ERI, PX, PX Pressure Exchanger, Pressure Exchanger, the ERI logo and Making Desalination Affordable. We have also applied for and received registrations in international trademark offices.

For a discussion of risks attendant to intellectual property rights, see Risk Factors If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights, in Item 1A, which is incorporated herein by reference.

Employees

As of December 31, 2010, we had 129 employees: 46 in manufacturing; 40 in corporate services and management; 25 in sales and marketing; and 18 in engineering/ research and development. Fifteen (15) of these employees were located outside of the United States. We also from time to time engage a relatively small number of independent contractors. We have not experienced any work stoppages. Our employees are not unionized.

Item 1A. *Risk Factors*

Almost all of our revenue is derived from sales of energy recovery devices and pumps used in reverse osmosis desalination; a decline in demand for desalination or the reverse osmosis method of desalination will reduce demand for our products and will cause our sales and revenue to decline.

Products for the desalination market have historically accounted for a high percentage of our revenue. We expect that the revenue from these products will continue to account for most of our revenue in the foreseeable future. Any factors adversely affecting the demand for desalination, including changes in weather patterns, increased precipitation in areas of high human population density, new technology for producing fresh water, increased water conservation or reuse, political changes and unrest, changes in the global economy, or changes in industry or governmental regulations, would reduce the demand for our energy recovery products and services and would cause a significant decline in our revenue. Similarly, any factors adversely affecting the demand for energy recovery products in reverse osmosis desalination, including, new energy technology or reduced energy costs, new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology would reduce the demand for our energy recovery devices and would cause a significant decline in our revenue. Some of the factors that may affect sales of our energy recovery devices and pumps may be out of our control.

We depend on the construction of new desalination plants for revenue, and as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending, availability of project financing, and other factors affecting the water desalination industry.

We derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels, resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines for political, economic or other factors, especially in these regions. Other factors that could affect the number and capacity of desalination plants built or the timing of their completion include: the availability of required engineering and design resources, a weak global economy, shortage in the supply of credit and other forms of financing, changes in government regulations, permitting requirements or priorities, or reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales and revenue, which could lead to increased inventory and use of working capital.

Our revenue and growth model depend upon the continued viability and growth of the seawater reverse osmosis desalination industry using current technology.

If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for, and viability of, our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary.

Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the membrane recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor.

Any of these changes would adversely impact our revenue and growth. Water shortages and demand for desalination can also be adversely affected by water conservation and water reuse initiatives.

New planned seawater reverse osmosis projects can be cancelled and/or delayed, and cancellations and/or delays may negatively impact our revenue.

Planned seawater reverse osmosis desalination projects can be cancelled or postponed due to delays in, or failure to obtain, approval, financing or permitting for plant construction because of political factors, including political unrest in key desalination markets, such as the Middle East, or adverse and increasingly uncertain financial conditions or other factors. Even though we may have a signed contract to provide a certain number of energy recovery devices by a certain date, shipments may be suspended or delayed at the request of customers. Such shipping delays negatively impact our results of operations and revenue. As a result of these factors, we have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis.

We rely on a limited number of engineering, procurement and construction firms for a large portion of our revenue. If these customers delay or cancel their commitments, do not purchase our products in connection with future projects, or are unable to attract and retain sufficient qualified engineers to support their growth, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.

There are a limited number of large engineering, procurement and construction firms in the desalination industry and these customers account for a substantial portion of our net revenue. One or more of these customers represents 10% or more of our total revenue each year and the customers in this category vary from year to year. See Note 12 Concentrations to the Consolidated Financial Statements regarding the impact of customer concentrations on our Consolidated Financial Statements. Since we do not have long-term contracts with these large customers but sell to them on a purchase order or project basis, these orders may be postponed or delayed on short or no notice. If any of these customers reduces or delays its purchases, cancels a project, decides not to specify our products for future projects, fails to attract and retain qualified engineers and other staff, fails to pay amounts due us, experiences financial difficulties or reduced demand for its services, we may not be able to replace that lost business and our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth.

We face competition from a number of companies that offer competing energy recovery and pump solutions. If any of these companies produce superior technology or offer more cost-effective products, our competitive position in the market could be harmed and our profits may decline.

The market for energy recovery devices and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price and warranty terms, to persist and intensify as the desalination market grows, and new competitors may enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do, longer operating histories or greater name recognition. They may also be able to devote greater resources to the development, promotion, sale and support of their products and respond more quickly to new technology. These companies may also have more extensive customer bases, broader customer relationships across product lines, or long-standing or exclusive relationships with our current or potential customers. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions or competing products at lower prices or with other more favorable terms and conditions. As a result, our ability to penetrate the market or sustain our market share may be adversely impacted, which would affect our business, operating results and financial condition. In addition, if another one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

Global economic conditions and the current crisis in the financial markets could have an adverse effect on our business and results of operations.

Current economic conditions may continue to negatively impact our business and make forecasting future operating results more difficult and uncertain. A weak global economy may cause our customers to delay product orders or shipments, or delay or cancel planned or new desalination projects, including retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability or shipment of our products. In addition, most of our cash and cash equivalents are currently invested in money market funds backed by United States Treasury securities. Given the current weak global economy and the instability of financial institutions, we cannot be assured that we will not experience losses on our deposits, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition or results of operations could be materially and adversely affected.

Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or our guidance.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. Since a single order for our energy recovery devices may represent significant revenue, we have experienced significant fluctuations in revenue from quarter to quarter and year to year and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- fluctuations in demand, sales cycles and pricing levels for our products and services;
- the cyclical nature of equipment purchasing for planned reverse osmosis desalination plants, which typically results in increased product shipments in the fourth quarter;
- changes in customers budgets for desalination plants and the timing of their purchasing decisions;
- adverse changes in the local or global financing conditions facing our customers;

delays or postponements in the construction of desalination plants;

our ability to develop, introduce and timely ship new products and product enhancements that meet customer demand and contractual and technical requirements, including scheduled delivery dates, performance tests and product certifications;

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the ability of our customers to obtain other key plant components such as high pressure pumps or membranes;

our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;

our ability to maintain efficient factory throughput in our new facility and minimize overhead given significant variability in orders from quarter to quarter and year to year;

unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;

our ability to control costs, including our operating expenses;

our ability to purchase key components, including ceramics, from third party suppliers;

our ability to compete against other companies that offer energy recovery solutions;

our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and

general economic conditions in our domestic and international markets, including conditions that affect the valuation of the U.S. dollar against other currencies.

If we are unable to collect unbilled receivables, our operating results will be adversely affected.

Our contracts with large engineering, procurement and construction firms generally contain holdback provisions that delay final installment payments up to 24 months after the product has been shipped and revenue has been recognized. Typically, between 10 and 20%, and in some instances up to 30% of the revenue we receive pursuant to our customer contracts is subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. Such holdbacks can result in relatively high current and non-current unbilled receivables. If we are unable to invoice and collect these performance holdbacks or if our customers fail to make these payments when due under the sales contracts, our results of operations will be adversely affected.

If we lose key personnel upon whom we are dependent, we may not be able to execute our strategies. Our ability to increase our revenue will depend on hiring highly skilled professionals with industry-specific experience, particularly given the unique and complex nature of our devices.

Given the specialized nature of our business, we must hire highly skilled professionals for certain positions with industry-specific experience. Given the relative recent growth in the reverse osmosis desalination industry, the number of qualified candidates for certain positions is limited. Our ability to grow depends on recruiting and retaining skilled employees with relevant experience, competing with larger, often better known companies and offering competitive total compensation packages. Our failure to retain existing or attract future talented and experienced key personnel could harm our business.

The success of our business depends in part on our ability to enhance and scale our existing products, develop new products for desalination, diversify into new markets by developing or acquiring new technology and to generate and fulfill sales orders for new products.

Our future success depends in part on our ability to enhance and scale existing products and to develop new products for desalination and applications outside desalination. While new or enhanced products and services have the potential to meet specified needs of new or existing markets, their pricing may not meet customer expectations and they may not compete favorably with products and services of current or potential competitors. New products may be delayed or cancelled if they do not meet specifications, performance requirements or quality standards, or perform as expected in a production environment. Product designs also may not scale as expected. We may have difficulty finding new markets for our existing technology or developing or acquiring new products for new markets. Customers may not accept or be slow to adopt new products and services and potential new markets may be too costly to penetrate. In addition, we may not be able to offer our products and services at prices that meet customer expectations without increasing our costs and eroding our margins. We may also have difficulty executing plans to break into new markets, expanding our operations to successfully manufacture new products or scaling our operations to accommodate increased business. If we are unable to develop competitive new products, open new cost-effective markets, and scale our business to support increased sales and new markets, our business and results of operations will be adversely affected.

Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing.

We outsource the production of our ceramic components to a limited number of ceramic vendors. In 2010, to diversify our supply of ceramics and retain more control over our intellectual property, we developed our own ceramics plant at our headquarters in San Leandro, California to manufacture some of our ceramics components. If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to which we outsource, then our cost of manufacturing may be adversely affected. If we are unable ramp-up the internal production of our ceramics parts or manufacture these parts in-house cost-effectively and/or one of our ceramics suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages and our business and financial results, including our cost of goods sold and margins may be adversely affected. During the ramp-up phase of bringing our ceramics facility on line, we expect our cost of goods sold to be negatively affected until we optimize production throughput.

The durable nature of the PX device may reduce or delay potential aftermarket revenue opportunities.

Our PX devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance and long life in seawater reverse osmosis desalination applications. Because most of our PX devices have been installed for a limited number of years, it is difficult to accurately predict their performance or endurance over a longer period of time. In the event that our products are more durable than expected, our opportunity for aftermarket revenue may be deferred.

Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our energy recovery products. This education process can be time consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international engineering, procurement and construction firm customers, which are involved with larger desalination plants, ranges from nine to 16 months and has, in some cases, extended up to 24 months. In addition, these customers generally must make a significant commitment of resources to test and evaluate our technologies. As a result, our sales process involving these customers is often subject to delays associated with lengthy approval processes that typically accompany the design, testing and adoption of new, technologically complex products. This long sales cycle makes quarter-by-quarter revenue predictions difficult and results in our investing significant resources well in advance of orders for our products.

Since a significant portion of our annual sales typically occurs during the fourth quarter, any delays could affect our fourth quarter and annual revenue and operating results.

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects engineering, procurement and construction firm customer buying patterns. A downturn in the market and delays in, or cancellation of, expected sales during the fourth quarter would reduce our quarterly and annual revenue from what we anticipated. Such a reduction might cause our quarterly and annual revenue or quarterly and annual operating results to fall below the expectations of investors and securities analysts or below any guidance we may provide to the market, causing the price of our common stock to decline.

We depend on a limited number of vendors for our supply of ceramics, which is a key component of our PX products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of vendors to produce ceramics components for our PX products. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products and we are unable to make up that shortfall through in-house production, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition.

We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of suppliers to produce vessel housings and stainless steel castings for our PX devices and castings for our PEI turbochargers and pumps. Our reliance on a limited number of manufacturers for these parts involves a number of risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have long term supply agreements with these suppliers and instead secure manufacturing availability on a purchase order basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of these suppliers and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced and may in the future experience quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change their commitments with us or fail to meet quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We may qualify additional suppliers in the future which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our complete dependence on our current supplier.

We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provisions or result in a significant or a large number of warranty or other claims in any given year.

We provide a warranty for our PX and PEI brand products for a period of one to two years and provide up to a 6 year warranty for the ceramic components of our PX brand products. As our ceramics technology evolves, we may increase the ceramics warranty beyond 6 years. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market, or will replicate the harsh, corrosive and varied conditions of the desalination plants and other plants in which they are installed. In addition, certain components of our turbochargers and pumps are custom-made and may not scale or perform as required in production environments. Accordingly, there is a risk that we may have significant warranty claims or breach supply agreements due to product defects. We may incur additional operating expenses if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition and results of operations. While the number of warranty claims has not been significant to date, we have only offered up to a six year warranty on the ceramic components of our PX products in new sales agreements executed after August 7, 2007, and we have only offered PEI products since December 2009 when we acquired Pump Engineering, LLC. Accordingly, we cannot quantify the error rate of our products and the ceramic components of our PX products with statistical accuracy and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our operating expenses may increase if a significant or large number of warranty or other claims are filed in any specific year, particularly towards the end of any given warranty period.

If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold a limited number of United States patents and patents outside the U.S. that are counterparts to several of the U.S. patents and when their terms expire, we could become more vulnerable to increased competition. We do not hold issued patents in many of the countries where competing products are used though we do have pending applications in countries where we have substantial sales activity. Accordingly, the protection of our intellectual property in some of those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of our technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

Claims by others that we infringe their proprietary rights could harm our business.

Third parties could claim that our technology infringes their proprietary rights. In addition, we or our customers may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers. Because we generally indemnify our customers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf in one or more jurisdictions, regardless of the merits of these claims. If any of these claims succeeds, we may be forced to pay damages on behalf of our customers.

Our business entails significant costs that are fixed or difficult to reduce in the short-term while demand for our products is variable and subject to downturns, which may adversely affect our operating results.

Our business requires investments in facilities, equipment, R&D and training that are either fixed or difficult to reduce or scale in the short term. At the same time, the market for our products is variable and has experienced downturns due to factors such as economic recessions, increased precipitation, uncertain global financial markets, and political changes, many of which are outside our control. During periods of reduced product demand, we may experience periods of excess manufacturing capacity, resulting in high overhead , which may cause gross margin,

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cash flow and profitability to vary in the short and long term. Similarly, while we believe that our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future, the continued success of our business depends on our ability to expand our manufacturing, research and development and testing facilities to meet market needs. If we are unable to respond timely to an increase in demand, our revenue, gross margin, cash flow and profitability may be adversely affected.

If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.

We have historically relied on outside financing to fund our operations, capital expenditures and expansion. In our initial public offering in July 2008, we issued approximately 10,000,000 shares of common stock at $8.50 per share before underwriting discount and issuing expenses. We may require additional capital from equity or debt financing in the future to fund our operations, or respond to competitive pressures or strategic opportunities. We may not be able to secure such additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

If foreign and local government entities no longer guarantee and subsidize, or are willing to engage in, the construction and maintenance of desalination plants and projects, the demand for our products would decline and adversely affect our business.

Our products are used in seawater reverse osmosis desalination plants which are often constructed and maintained with local, regional or national government guarantees and subsidies, including tax-free bonds. The rate of construction of desalination plants depends on each governing entity s willingness and ability to obtain and allocate funds for such projects, which capabilities may be affected by the current weak global financial system and credit market and the weak global economy. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once high crude oil and natural gas prices. Since prices for crude oil and natural gas vary, governments in those countries may not have the necessary funding for such projects and may cancel the projects or divert funds allocated for them to other projects. Political unrest, coups or changes in government administrations may also result in policy or priority changes that may also cause governments to cancel, delay or re-contract planned or ongoing projects. Government embargoes may also prohibit sales into certain countries. As a result, the demand for our products could decline and negatively affect our revenue base, our overall profitability and pace of our expected growth. For example, in late 2009, the Algerian government increased the percentage of required government ownership in desalination plants, which led to the cancellation of the government s contract with a large U.K. engineering, procurement and construction firm and the cancellation or delay in sales of our products.

Our products are highly technical and may contain undetected flaws or defects which could harm our business and our reputation and adversely affect our financial condition.

The manufacture of our products is highly technical and some designs and components of our turbochargers and pumps are custom-made. Our products may contain latent defects or flaws. We test our products prior to commercial release and during such testing have discovered and may in the future discover flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more flaws that were not detected prior to commercial release to our customers. Some flaws in our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld or for reasons of good long-term customer relations, we may not be willing to enforce. Defending a lawsuit, regardless of its merit, is costly and may divert management s attention and adversely affect the market s perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

Our international sales and operations subject us to additional risks that may adversely affect our operating results.

Historically, we have derived a significant portion of our revenue from customers whose seawater reverse osmosis desalination facilities that use our energy recovery products are outside the United States. Many of these projects are located in emerging growth countries with relatively young or unstable market economies or changing political environments. These countries may be affected significantly by the current weak global economy and unstable credit markets. We also rely on sales and technical support personnel stationed in Spain, Asia and the Middle East and we expect to continue to add personnel in other countries. Governmental changes, political unrest or reforms, or other disruptions or changes in the business, regulatory or political environments of the countries in which we sell our products or have staff could have a material adverse effect on our business, financial condition and results of operations.

Sales of our products have to date been denominated principally in U.S. dollars. If the U.S. dollar strengthens against most other currencies, it will effectively increase the price of our products in the currency of the countries in which our customers are located. This may result in our customers seeking lower-priced suppliers, which could adversely impact our margins and operating results. A larger portion of our international revenue may be denominated in foreign currencies in the future, which would subject us to increased risks associated with fluctuations in foreign exchange rates.

Our international contracts and operations subject us to a variety of additional risks, including:

- political and economic uncertainties, which the current global economic crisis may exacerbate;
- uncertainties related to the application of local contract and other laws, including reduced protection for intellectual property rights;
- trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;
- difficulties in enforcing contracts, beginning operations as scheduled and collecting accounts receivable, especially in emerging markets;
- increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act;
- difficulty in attracting, hiring and retaining qualified personnel; and
- increasing instability in the capital markets and banking systems worldwide, especially in developing countries, that may limit project financing availability for the construction of desalination plants.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results and financial condition.

If we fail to manage future growth effectively, our business would be harmed.

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting and operational systems and procedures. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

Our failure to achieve or maintain adequate internal control over financial reporting in accordance with SEC rules or prevent or detect material misstatements in our annual or interim consolidated financial statements in the future could materially harm our business and cause our stock price to decline.

As a public company, SEC rules require that we maintain internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles, or GAAP, in the United States. Accordingly, we are required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm is required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies which we may not be able to remediate in a timely manner. Our acquisition of Pump Engineering, LLC and possible future acquisitions may increase this risk by expanding the scope and nature of operations over which we must develop and maintain internal control over financial reporting. If there are material weaknesses or deficiencies in our internal control, we will not be able to conclude that we have maintained effective internal control over financial reporting or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result, our ability to report our financial results on a timely and accurate basis may be adversely affected and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results and you could lose all or a significant portion of your investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements to conform to GAAP. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the interpretation of our current practices may adversely affect our reported financial results or the way we conduct our business.

Our past acquisition and future acquisitions could disrupt our business, impact our margins, cause dilution to our stockholders or harm our financial condition and operating results.

In December 2009, we acquired privately-held competitor Pump Engineering, LLC and, in the future, we may invest in other companies, technologies or assets. We may not realize the expected benefits from our past or future acquisitions. We may not be able to find other suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial markets, investors or the media. Acquisitions could also result in shareholder dilution or significant acquisition-related charges for restructuring, share-based compensation and the amortization of purchased technology and intangible assets. Expenses resulting from impairment of acquired goodwill, intangible assets and purchased technology could also increase over time if the fair value of those assets decreases. A future change in our market conditions, a downturn in our business, or a long-term

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decline in the quoted market price of our stock may result in a reduction of the fair value of acquisition-related assets. Any such impairment of goodwill or intangible assets could harm our operating results and financial condition. In addition, when we make an acquisition, we may have to assume some or all of that entity s liabilities which may include liabilities that are not fully known at the time of the acquisition. Future acquisitions may reduce our cash available for operations and other uses. If we continue to make acquisitions, we may require additional cash or use shares of our common stock as payment, which would cause dilution for our existing stockholders.

Any acquisitions that we make, including our 2009 acquisition of Pump Engineering, LLC, entail a number of risks that could harm our ability to achieve their anticipated benefits. We could have difficulties integrating and retaining key management and other personnel, aligning product plans and sales strategies, coordinating research and development efforts, supporting customer relationships, aligning operations and integrating accounting, order processing, purchasing and other support services. Since acquired companies have different accounting and other operational practices, we may have difficulty harmonizing order processing, accounting, billing, resource management, information technology and other systems company-wide. We may also have to invest more than anticipated in product or process improvements. Especially with acquisitions of privately held or non-US companies, we may face challenges developing and maintaining internal controls consistent with the requirements of the Sarbanes-Oxley Act and US public accounting standards. Acquisitions may also disrupt our ongoing operations, divert management from day-to-day responsibilities and disrupt other strategic, research and development, marketing or sales efforts. Geographic and time zone differences and disparate corporate cultures may increase the difficulties and risks of an acquisition. If integration of our acquired businesses or assets is not successful or disrupts our ongoing operations, acquisitions may increase our expenses, harm our competitive position, adversely impact our operating results and financial condition and fail to achieve anticipated revenue, cost, competitive or other objectives.

Insiders and principal stockholders will likely have significant influence over matters requiring stockholder approval.

Our directors, executive officers and other principal stockholders beneficially own, in the aggregate, a substantial amount of our outstanding common stock. Although they do not have majority control of the outstanding stock, these stockholders will likely have significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets.

Anti-takeover provisions in our charter documents and under Delaware law could discourage delay or prevent a change in control of our company and may affect the trading price of our common stock.

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;

- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;

- specify that special meetings of our stockholders can be called only by our board of directors, the chairman of the board, the chief executive officer or the president;

establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;

establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;

provide that our directors may be removed only for cause;

provide that vacancies on our board of directors may be filled only by a majority vote of directors then in office, even though less than a quorum;

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specify that no stockholder is permitted to cumulate votes at any election of directors; and

require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

We lease approximately 170,000 square feet of space in San Leandro, California for product manufacturing, research and development and executive headquarters under a lease that expires in July 2019. Additionally, we own a commercial building in New Boston, Michigan, which provides 48,000 square feet of space for administration, research and development, and manufacturing for our subsidiary, Pump Engineering, Inc. We believe these facilities will be adequate for our purposes for the foreseeable future.

Item 3. *Legal Proceedings*

We are not party to any material litigation, and we are not aware of any pending or threatened litigation against us that we believe would adversely affect our business, operating results, financial condition or cash flows. In the future, we may be subject to legal proceedings in the ordinary course of our business.

Item 4. *[Reserved]*

PART II

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

Market Information

Since July 2, 2008, our common stock has been quoted on the Nasdaq Global Market under the symbol ERII .

The following table sets forth the high and low sales prices of our common stock for the periods indicated.

	High	Low
2009		
First Quarter	$ 8.67	$ 4.50
Second Quarter	$ 8.79	$ 5.60
Third Quarter	$ 7.40	$ 4.89
Fourth Quarter	$ 7.28	$ 5.40
2010		

First Quarter	$ 7.25	$ 5.75
Second Quarter	$ 6.40	$ 3.15
Third Quarter	$ 4.23	$ 3.08
Fourth Quarter	$ 3.99	$ 3.30

Dividend Policy

We have never declared or paid any cash dividends on our capital stock and we do not currently intend to pay any cash dividends on our capital stock for the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Any future determination to pay dividends on our capital stock will be, subject to applicable law, at the discretion of our board of directors and will depend

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upon, among other factors, our results of operations, financial condition, capital requirements and contractual restrictions in loan agreements or other agreements.

Stockholders

As of March 8, 2011, there were approximately 83 stockholders of record of our common stock as reported by our transfer agent, one of which is Cede & Co., a nominee for Depository Trust Company (DTC). All of the shares of common stock held by brokerage firms, banks and other financial institutions as nominees for beneficial owners are deposited into participant accounts at DTC, and are therefore considered to be held of record by Cede & Co. as one stockholder.

Stock Performance Graph

The following graph shows the cumulative total shareholder return of an investment of $100 on July 2, 2008 in (i) our common stock and (ii) common stock of a selected group of peer issuers (Peer Group) and (iii) on June 30, 2008 in the Nasdaq Composite Index. Cumulative total return assumes the reinvestment of dividends, although dividends have never been declared on our stock, and is based on the returns of the component companies weighted according to their capitalizations as of the end of each quarterly period. The Nasdaq Composite Index tracks the aggregate price performance of equity securities traded on the Nasdaq. The Peer Group tracks the weighted average price performance of equity securities of seven companies in our industry, including Consolidated Water Company Limited, Flowserve Corporation, Hyflux Ltd, Kurita Water Industries Limited, Pentair Inc., Tetra Tech, Inc. and The Gorman-Rupp Company. The returns of each component issuer of the Peer Group is weighted according to the respective issuer s stock market capitalization at the beginning of each period for which a return is indicated. Our stock price performance shown in the graph below is not indicative of future stock price performance.

The following graph and its related information is not soliciting material, is not deemed filed with the SEC, and is not to be incorporated by reference into any filing of the Company under the 1933 Act or 1934 Act, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing.

COMPARISON OF 30 MONTH CUMULATIVE TOTAL RETURN*
Among Energy Recovery Inc., The NASDAQ Composite Index
And A Peer Group

* $100 invested on 7/2/08 in stock or 6/30/08 in index, including reinvestment of dividends. Fiscal year ending December 31.

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	6/30/08 or 7/2/08(1)	12/31/08	12/31/09	12/31/10
Energy Recovery, Inc.	**100.00**	**77.11**	**69.99**	**37.23**
NASDAQ Composite	**100.00**	**68.38**	**99.29**	**116.72**
Peer Group	**100.00**	**62.14**	**89.14**	**100.52**

(1) The index measurement date is 6/30/08; stock measurement dates are 7/2/08

Use of Proceeds

On July 1, 2008, our registration statement (No. 333-150007) on Form S-1 was declared effective for our initial public offering, pursuant to which we registered the offering and sale of an aggregate 16,100,000 shares of common stock at price of $8.50 per share. Of the aggregate offering price of $136.9 million, $86.5 million related to 10,178,566 shares sold by us and $50.4 million related to 5,921,434 shares sold by selling stockholders. The offering closed on July 8, 2008 with respect to the primary shares and on July 11, 2008 with respect to the over-allotment shares. The managing underwriters were Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC.

As a result of the offering, we received net proceeds of approximately $76.7 million, after deducting underwriting discounts and commissions of $6.1 million and additional offering-related expenses of approximately $3.7 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates.

During the period from the offering through December 31, 2010, we used approximately $20.0 million, including amounts held in escrow, for the acquisition of Pump Engineering, LLC.

We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. Pending such uses, we have deposited a substantial amount of the remaining net proceeds in a U.S. Treasury based money market fund. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b).

Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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Item 6. *Selected Financial Data*

The following selected financial data should be read in conjunction with the Management s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in this Report on Form 10-K.

	Years Ended December 31, 2010	2009	2008	2007	2006
Consolidated Statement of Income Data:					
Net revenue	$ 45,853	$ 47,014	$ 52,119	$ 35,414	$ 20,058
Cost of revenue	23,781	17,595	18,933	14,852	8,131
Gross profit	22,072	29,419	33,186	20,562	11,927
Operating expenses:					
General and administrative	17,038	13,756	11,321	4,299	3,372
Sales and marketing	8,205	6,472	6,549	5,230	3,648
Research and development	3,943	3,041	2,415	1,705	1,267
Gain on fair value remeasurement	(2,147)				
Total operating expenses	27,039	23,269	20,285	11,234	8,287
Income (loss) from operations	(4,967)	6,150	12,901	9,328	3,640
Other income (expense):					
Interest expense	(73)	(46)	(79)	(105)	(77)
Interest and other income (expense)	(194)	54	873	517	58
Income (loss) before provision for (benefit from) income taxes	(5,234)	6,158	13,695	9,740	3,621
Provision for (benefit from) income taxes	(1,626)	2,472	5,032	3,947	1,239
Net income (loss)	$ (3,608)	$ 3,686	$ 8,663	$ 5,793	$ 2,382
Earnings (loss) per share-basic	$ (0.07)	$ 0.07	$ 0.19	$ 0.15	$ 0.06
Earnings (loss) per share-diluted	$ (0.07)	$ 0.07	$ 0.18	$ 0.14	$ 0.06
Number of shares used in per share calculations:					
Basic	52,072	50,166	44,848	39,060	38,018
Diluted	52,072	52,644	47,392	41,433	40,244

	As of December 31, 2010	2009	2008	2007(1)	2006(1)
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 55,338	$ 59,115	$ 79,287	$ 240	$ 42
Total assets	133,917	142,969	120,612	28,227	17,937
Long-term liabilities	2,770	4,505	420	620	234

Total liabilities	13,117	22,000	13,613	8,166	9,810
Total stockholders equity	120,800	120,969	106,999	20,061	8,127

(1) Certain prior period balances have been reclassified to conform to the current period presentation.

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

This Annual Report on Form 10-K and certain information incorporated by reference contain forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.

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Forward-looking statements represent our current expectations about future events and are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Forward-looking statements in this report include, without limitation, statements about the following:

- *our plan to enhance our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;*
- *our belief that sales of our PX-300 device will represent a higher percentage of our net revenue in 2011;*
- *our belief that the ceramics components of our PX device will result in low life cycle maintenance costs and that our turbocharger devices have long operating lives;*
- *our objective of finding new applications for our technology and developing new products for use outside of desalination;*
- *our expectation that our 2011 revenue, especially revenue derived from sales of products to large desalination projects, will be impacted by the effects of the global economic downturn and credit crises;*
- *our belief that our products are the most cost effective energy recovery devices over time;*
- *our plan to manufacture a portion of our ceramics components internally and our expectation that in-house production of ceramics will reduce production costs;*
- *our expectation that our expenditures for research and development will increase;*
- *our expectation that we will continue to rely on sales of our energy recovery devices for a substantial portion of our revenue;*
- *our belief that our current facilities will be adequate through 2011;*
- *our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- *our expectation that future sales and marketing expense will increase as revenues increase;*
- *our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months; and*
- *our expectation that, as we expand our international sales, a small portion of our revenue could continue to be denominated in foreign currencies.*

All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under Item 1A: Risk Factors and are based on information available to us as of March 14, 2011. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading Item 1A: Risk Factors, and our results disclosed from time to time in our reports on Forms 10-Q and 8-K and *our Annual Reports to Stockholders.*

The following discussion should be read in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this report.

Overview

We are in the business of designing, developing and manufacturing energy recovery devices for seawater reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our Pressure Exchanger^{tm} energy recovery device in early 1997. In December 2009, we acquired Pump

Engineering, LLC, which manufactures centrifugal energy recovery devices, known as turbochargers, and high pressure pumps.

A significant portion of our net revenue typically has been generated by sales to a limited number of large engineering, procurement and construction firms, which are involved with the design and construction of larger desalination plants. Sales to these firms often involve a long sales cycle, which can range from 6 to 16 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents an opportunity for significant revenue. We also sell our devices to many small to medium size original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant and have shorter sales cycles.

Due to the fact that a single order for our energy recovery devices by a large engineering, procurement and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter and from year to year. In addition, historically our engineering, procurement and construction firm customers tend to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales typically occurs during that quarter. In fiscal year 2010, the fourth quarter revenues did not reflect as high of a percentage of the annual revenues as in past years due to shipment delays caused by customer project delays.

A limited number of our customers account for a substantial portion of our net revenue and accounts receivables. Revenue from customers representing 10% or more of total revenue varies from period to period. For the year ended December 31, 2010, two customers accounted for approximately 35% of our net revenue, for the year ended December 31, 2009, three customers accounted for approximately 42% of our net revenue, and for the year ended December 31, 2008, two customers accounted for approximately 27% of our net revenue. No other customers accounted for more than 10% of the Company s net revenue during any of these periods. See Note 12 *Concentrations* in the Notes to Consolidated Financial Statements for further customer concentration detail.

During the years ended December 31, 2010, 2009 and 2008, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our energy recovery devices. We also derive revenue from the sale of our high pressure and circulation pumps, which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. We also receive incidental revenue from the sale of spare parts and from services, including start-up and commissioning services, that we provide for our customers. We expect our revenue in 2011 to be affected by the delayed effects of the global economic downturn on our industry.

Critical Accounting Policies and Estimates

Our Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the Consolidated Financial Statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, warranty costs, share-based compensation, inventory valuation, allowances for doubtful accounts, income taxes (including our evaluation of the need for any valuation allowance on our deferred tax assets), valuation of goodwill and other intangible assets, and our evaluation and measurement of contingencies, including contingent consideration.

Cash and Cash Equivalents

We consider all highly liquid investments with an original or remaining maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value. Our cash and cash equivalents are maintained in demand deposit accounts with large financial institutions and invested in institutional money market funds. We frequently monitor the creditworthiness of the financial institutions and institutional money market funds in which we invest our surplus funds. We have not experienced any credit losses from our cash investments.

Allowances for Doubtful Accounts

We record a provision for doubtful accounts based on historical experience and a detailed assessment of the collectability of our accounts receivable. In estimating the allowance for doubtful accounts, we consider, among other factors, (1) the aging of the accounts receivable, (2) our historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions.

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. We calculate inventory valuation adjustments for excess and obsolete inventories based on current inventory levels, expected useful life and estimated future demand of the products and spare parts.

Property and Equipment

Property and equipment is recorded at cost and reduced by accumulated depreciation. Depreciation expense is recognized over the estimated useful lives of the assets using the straight-line method. Estimated useful lives are generally three to ten years. We own our manufacturing facility in New Boston, Michigan, which is depreciated over an estimated useful life of 39 years. A small portion of our manufacturing equipment was acquired under capital lease obligations. These assets are amortized over periods consistent with depreciation of owned assets of similar types, generally five to seven years. Certain equipment used in the development and manufacturing of ceramic components is generally depreciated over estimated useful lives of up to ten years. Leasehold improvements represent remodeling and retrofitting costs for leased office and manufacturing space and are depreciated over the shorter of either the estimated useful lives or the term of the lease using the straight-line method. Software purchased for internal use consists primarily of amounts paid for perpetual licenses to third party software providers and are depreciated over the estimated useful lives, generally three to five years. Estimated useful lives are periodically reviewed and, when appropriate, changes are made prospectively. When certain events or changes in operating conditions occur, asset lives may be adjusted and an impairment assessment may be performed on the recoverability of the carrying amounts.

Maintenance and repairs are charged directly to expense as incurred, whereas improvements and renewals are generally capitalized in their respective property accounts. When an item is retired or otherwise disposed of, the cost and applicable accumulated depreciation are removed and the resulting gain or loss is recognized in the results of operations.

Goodwill and Other Intangible Assets

The purchase price of an acquired company is allocated between intangible assets and the net tangible assets of the acquired business with the residual purchase price recorded as goodwill. The determination of the value of the intangible assets acquired involves certain judgments and estimates. These judgments can include, but are not limited to, the cash flows that an asset is expected to generate in the future and the appropriate weighted average cost of capital.

Acquired intangible assets with determinable useful lives are amortized on a straight-line or accelerated basis over the estimated periods benefited, ranging from one to 20 years. Acquired intangible assets with contractual terms are generally amortized over their respective legal or contractual lives. Customer relationships and other noncontractual intangible assets with determinable lives are amortized over periods generally ranging from five to 20 years. Patents developed internally are recorded at cost and amortized on a straight-line basis over their expected useful life of 16 to 20 years. When certain events or changes in operating conditions occur, an impairment assessment is performed and lives of intangible assets with determinable lives may be adjusted. Goodwill is not amortized, but is evaluated annually for impairment or when indicators of a potential impairment are present. The annual evaluation for impairment of goodwill is based on valuation models that incorporate assumptions and internal projections of expected future cash flows and operating plans. As of December 31, 2010 and 2009, acquired intangibles, including goodwill, relate to the acquisition of Pump Engineering, LLC during the fourth quarter of 2009. See Note 4. *Goodwill and Intangible Assets* to the Consolidated Financial Statements included in this report for further discussion of intangible assets.

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, restricted cash, accounts receivable and accrued expenses, accounts payable, and debt. The carrying amounts for these financial instruments reported in the consolidated balance sheets approximate their fair values.

Fair Value Measurements

We follow the authoritative guidance for fair value measurements and disclosures, which among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

The framework for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

Our cash and restricted cash balances are measured at fair value on a recurring basis using market prices on active markets for identical securities (Level 1). The carrying amounts of accounts receivable, accounts payable and other accrued expenses approximate fair value because of the short maturity of those instruments. The carrying amount of the contingent consideration arising from our acquisition of Pump Engineering, LLC is measured at fair value on a recurring basis using unobservable inputs in which little or no market activity exists (Level 3). We estimate fair value of the contingent consideration based on an assessment of the weighted probability of payment under various scenarios.

Revenue Recognition

We recognize revenue when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is reasonably assured. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. The portion of the sales agreement related to the field services and training for commissioning of a desalination plant is deferred using the residual value method. Under this method, revenue allocated to undelivered elements is based on vendor objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements, assuming that the delivered elements have stand-alone value. Vendor objective evidence of fair value for such undelivered elements is based upon the price we charge for such product or service when it is sold separately. We may modify our pricing in the future, which could result in changes to our vendor objective evidence of fair value for such undelivered elements. The services element of our contracts represents an incidental portion of the total contract price.

Under our revenue recognition policy, evidence of an arrangement has been met when it has an executed purchase order or a stand-alone contract. Typically, smaller projects utilize purchase orders that conform to standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, our customers typically require their suppliers, including ERI, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalination plant, which may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for our PX device generally pertains to the ability of our product to meet its published performance specifications and warranty provisions, which our products have demonstrated on a consistent basis. This factor, combined with historical performance metrics measured over the past 10 years, provides our management with a reasonable basis to conclude that its PX device will perform satisfactorily upon commissioning of the plant. To ensure this successful product performance, we provide service, consisting principally of supervision of customer personnel, and training to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of our personnel. We defer the value of the service and training component of the contract and recognizes such revenue as services are rendered. Based on these factors, our management has concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

We perform an evaluation of credit worthiness on an individual contract basis to assess whether collectability is reasonably assured. As part of this evaluation, our management considers many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and management s prior history or industry specific knowledge about the customer and its supplier relationships.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

an advance payment due upon execution of the contract, typically 10% to 20% of the total contract amount;

a payment upon delivery of the product due on average between 90 and 150 days from product delivery, and in some cases up to 180 days, typically in the range of 50% to 70% of the total contract amount; and

a retention payment due subsequent to product delivery as described further below, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount.

Under the terms of the retention payment component, we are generally required to issue to the customer a product performance guarantee that takes the form of an irrevocable standby letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is either collateralized by restricted cash on deposit with a financial institution or funds available through a credit facility. The letter of credit remains in place for the performance period as specified in the contract, which is generally 12 to 36 months and, in some cases, up to 65 months from issuance. The performance period generally runs concurrent with our standard product warranty period. Once the letter of credit has been put in place, we invoice the customer for this final retention payment under the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention payment is classified on the balance sheet as an unbilled receivable, of which a portion may be classified as long term to the extent that the billable period extends beyond one year. Once the letter of credit is issued, we invoice the customer and reclassify the retention amount from unbilled receivable to accounts receivable where it remains until payment.

We do not provide our customers with a right of product return. However, we will accept returns of products that are deemed to be damaged or defective when delivered that are covered by the terms and conditions of the product warranty. Product returns have not been significant. Reserves are established for possible product returns related to the advance replacement of products pending the determination of a warranty claim.

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

Warranty Costs

We sell products with a limited warranty for a period ranging from one to six years. We accrue for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. Periodically, we evaluate and adjust the warranty costs to the extent actual warranty costs vary from the original estimates.

Share-Based Compensation

We measure and recognize share-based compensation expense based on the fair value measurement for all share-based payment awards made to our employees and directors, including restricted stock units, restricted shares and employee stock options, over the requisite service period generally the vesting period of the awards for awards expected to vest. The fair value of restricted stock units and restricted stock is based on our stock price on the date of grant. The fair value of stock options is calculated on the date of grant using the Black-Scholes option-pricing model, which requires a number of complex assumptions, including expected life, expected volatility, risk-free interest rate, and dividend yield. The estimation of awards that will ultimately vest requires judgment and, to the extent actual results or updated estimates differ from our current estimates, such amounts are recorded as a cumulative adjustment in the period in which the estimates are revised. See Note 9 *Share-Based Compensation* to the Consolidated Financial Statements included in this report for further discussion of share-based compensation.

Foreign Currency

Our reporting currency is the U.S. dollar, while the functional currencies of our foreign subsidiaries are their respective local currencies. The asset and liability accounts of our foreign subsidiaries are translated from their local currencies at the rates in effect at the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the period. Gains and losses resulting from the translation of our subsidiary balance sheets are recorded as a component of accumulated other comprehensive income. Realized gains and losses from foreign currency transactions are recorded in other income and expense in the Consolidated Statements of Operations.

Income Taxes

Current tax assets and liabilities are based upon an estimate of taxes refundable or payable for each of the jurisdictions in which the company is subject to tax. In the ordinary course of business there is inherent uncertainty in quantifying income tax positions. We assess income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting dates. For those tax positions where it is more likely than not that a tax benefit will be sustained, we record the largest amount of tax benefit with a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a tax benefit will be sustained, no tax benefit is recognized in the financial statements. When applicable, associated interest and penalties are recognized as a component of income tax expense. Accrued interest and penalties are included within the related tax asset or liability on the Consolidated Balance Sheets.

Deferred income taxes are provided for temporary differences arising from differences in basis of assets and liabilities for tax and financial reporting purposes. Deferred income taxes are recorded on temporary differences using enacted tax rates in effect for the year in which the temporary differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Significant judgment is required in determining whether and to what extent any valuation allowance is needed on our deferred tax assets. At December 31, 2010 and 2009, we have not provided any valuation allowance against our deferred tax assets, based on our evaluation of the weight of available evidence including available taxable income in prior carry back years and our five year history of profitability (2005 through 2009). During 2010, we incurred an operating and net loss and we expect such losses to continue into 2011 as our industry seeks to recover from the global downturn. To the extent that we continue to incur operating and net losses in future periods and recovery of our industry is delayed beyond our expectations, the resulting continuing losses over time will increase the likelihood that our judgments regarding the realizability of our deferred tax assets will change and that we will at some point determine that it is more likely than not that some portion or possibly all of our deferred tax assets are not realizable, which will require us to record a valuation allowance which in turn will adversely affect our future results of operations.

Our operations are subject to income and transaction taxes in the U.S. and in foreign jurisdictions. Significant estimates and judgments are required in determining our worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

Results of Operations

2010 Compared to 2009

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For the Year Ended December 31,					
	2010		2009		Change Favorable (Unfavorable)	
Results of Operations: (1)						
Net revenue	$ 45,853	100%	$ 47,014	100%	$ (1,161)	(2)%
Cost of revenue	23,781	52%	17,595	37%	(6,186)	(35)%
Gross profit	22,072	48%	29,419	63%	(7,347)	(25)%
Operating expenses:						
General and administrative	17,038	37%	13,756	29%	(3,282)	(24)%
Sales and marketing	8,205	18%	6,472	14%	(1,733)	(27)%
Research and development	3,943	9%	3,041	6%	(902)	(30)%
Gain on fair value remeasurement	(2,147)	(5)%		0%	2,147	100%

Total Operating Expenses	27,039	59%	23,269	49%	(3,770)	(16)%
Income (loss) from operations	(4,967)	(11)%	6,150	13%	(11,117)	(181)%
Other income (expense):						
Interest expense & finance charges	(73)	*	(46)	*	(27)	(59)%
Interest and other income (expense)	(194)	*	54	*	(248)	(459)%
Net income (loss) before provision for income tax	(5,234)	(11)%	6,158	13%	(11,392)	(185)%
Provision for (benefit from) income tax expense	(1,626)	(4)%	2,472	5%	4,098	166%
Net Income (Loss)	$ (3,608)	(8)%	$ 3,686	8%	$ (7,294)	(198)%

* Less than 1%.

(1) Percentages may not add up to 100% due to rounding.

Net Revenue

Our net revenue decreased by $1.2 million, or 2%, to $45.9 million for the year ended December 31, 2010 from $47.0 million for the year ended December 31, 2009. Revenues from the sales of PX devices and related products and services decreased by approximately $17.3 million while revenues from the sales of turbochargers and pumps increased by approximately $16.1 million. The decrease in revenue from sales of PX devices was primarily due to the timing of larger orders, a global decline in the construction of new projects, and competition. Additionally, there was a slight decrease in the average sales price of PX units during fiscal year 2010. The increase in revenue from sales of turbochargers and pumps was primarily due to a full year of shipments by our subsidiary, Pump Engineering, Inc., which was acquired late in the fourth quarter of 2009, and the timing of larger orders. Revenues from the sales of our turbochargers and related products had a very small impact on our 2009 revenue base, totaling only $0.2 million for the 2009 fiscal year.

For the year ended December 31, 2010, the sales of PX devices and related products and services accounted for approximately 61% of our revenue and sales of turbochargers and pumps accounted for approximately 39%. For the year ended December 31, 2009, the sales of PX devices and related products and services accounted for approximately 96% of our revenue and sales of turbochargers and pumps accounted for approximately 4%. Turbochargers and related high pressure pumps, manufactured by our subsidiary, Pump Engineering, Inc., had a negligible impact on our product offerings in 2009 as the subsidiary was acquired late in the fourth quarter of 2009.

The following geographic information includes net revenue to our domestic and international customers based on the customers requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location. The amounts below are in thousands, except percentage data.

	Years Ended December 31,	
	2010	**2009**
Domestic net revenue	$ 3,334	$ 3,022
International net revenue	42,519	43,992
Total net revenue	$ 45,853	$ 47,014
Revenue by country:		
Australia	31%	19%
Algeria	12	24
Israel	2	21
Others	55	36
Total	100%	100%

The impact of the current global economic climate on future demand for our products is uncertain. The weakening global economy may cause our customers to delay or cancel plans for future orders of our products.

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Gross Profit

The following table reflects the impact of product sales activities to our overall gross margin for the periods indicated (in thousands, except percentages):

	Years Ended December 31,					
	2010			2009		
	PX and Related Products and Services	Turbochargers and Pumps	Total	PX and Related Products and Services	Turbochargers and Pumps(1)	Total
Net revenue	$ 27,850	$ 18,003	$ 45,853	$ 45,091	$ 1,923	$ 47,014
Cost of revenue	11,262	12,519	23,781	16,041	1,554	17,595
Gross profit	$ 16,588	$ 5,484	$ 22,072	$ 29,050	$ 369	$ 29,419
Gross margin %	60%	30%	48%	64%	19%	63%

(1) Turbochargers and related high pressure pumps had a negligible impact on overall gross profit as a percentage of revenue in fiscal year 2009 as the acquisition of Pump Engineering, LLC occurred late in the fourth quarter of 2009.

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials. For the year ended December 31, 2010, gross profit as a percentage of net revenue was 48%, as compared to 63% for the year ended December 31, 2009.

The decrease in gross profit as a percentage of net revenue was primarily due to a shift of product sales to lower margin turbochargers and high-pressure pumps, a result of our acquisition of Pump Engineering, LLC in late 2009, and an increase in overhead costs related to our PX devices, largely attributed to the underutilization of our newly expanded manufacturing facility. Additionally, the amortization of an inventory valuation step-up of $0.9 million, stemming from our acquisition of Pump Engineering, LLC, and a slight decline in the average selling prices of our PX devices also served to negatively impact gross margin in fiscal year 2010.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our own ceramics factory and our assembly operations that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. In addition, our recent production facility expansion will continue to have a negative impact to our margins if our production volume does not increase in the foreseeable future.

General and Administrative Expense

General and administrative expense increased by $3.3 million, or 24%, to $17.0 million for the year ended December 31, 2010 from $13.8 million for the year ended December 31, 2009. The increase of general and administrative expense was attributable primarily to the amortization of acquired intangible assets and an increase in general and administrative headcount related to the acquisition of Pump Engineering, LLC in December 2009 and an increase in occupancy costs related to our new corporate headquarters. General and administrative expense as a percentage of our net revenue increased to 37% for the year ended December 31, 2010 from 29% for the year ended December 31, 2009 as general and administrative costs increased period over period while net revenue decreased.

Of the $3.3 million net increase in general and administrative expense, increases of $2.4 million related to amortization of intangible assets, $1.2 million related to occupancy costs, $0.5 million related to compensation and employee-related benefits, and $0.2 million related to local taxes and other administrative costs. These increases in costs were offset in part by decreases of $0.6 million related to professional and other services, $0.3 million related to changes in bad debt and other reserves, and $0.1 million related to Value Added Taxes (VAT). Share-based compensation expense included in general and administrative expense was $1.8 million for the year ended December 31, 2010 and $1.5 million for the year ended December 31, 2009.

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General and administrative average headcount increased to 40 for the year ended December 31, 2010 from 36 for the prior year largely as a result of the acquisition of Pump Engineering, LLC in December 2009. Increased compensation and employee benefit costs related to this increase in headcount were largely offset by the effects of cost cutting measures implemented at our corporate headquarters in 2010.

Sales and Marketing Expense

Sales and marketing expense increased by $1.7 million, or 27%, for the year ended December 31, 2010 compared to the year ended December 31, 2009. This increase was primarily related to an increase in sales and marketing headcount as a result of the Pump Engineering acquisition in December 2009. Sales and marketing average headcount increased to 26 for the year ended December 31, 2010 from 22 for the year ended December 31, 2009. As a percentage of our net revenue, sales and marketing expense increased to 18% for the year ended December 31, 2010 from 14% for the year ended December 31, 2009, primarily due to lower net revenue for the current period.

The $1.7 million net increase in sales and marketing expense for the year ended December 31, 2010 was primarily related to increases in compensation, employee-related benefits, and commissions to outside sales representatives as a result of the acquisition of Pump Engineering, LLC in December 2009. Sales and marketing headcount increased due to the acquisition. Additionally, Pump Engineering has historically relied on outside sales agents rather than inside sales representatives to generate sales, resulting in higher commission rates. Share-based compensation expense included in sales and marketing expense was $599,000 for the year ended December 31, 2010 and $488,000 for the year ended December 31, 2009.

Research and Development Expense

Research and development expense increased by $0.9 million, or 30%, to $3.9 million for the year ended December 31, 2010 from $3.0 million for the year ended December 31, 2009. Research and development expense as a percentage of our net revenue increased to 9% for the year ended December 31, 2010 compared to 6% for the year ended December 31, 2009, as research and development expense increased for those periods while net revenue decreased.

Of the $0.9 million increase in research and development expense for the year ended December 31, 2010, $0.4 million related to increased compensation and employee-related benefits as a result of our acquisition of Pump Engineering, LLC in December 2009, $0.2 million related to increased occupancy costs and consulting and professional fees, and $0.3 million related to an increase in research and development direct project costs.

Average headcount in our research and development department increased to 17 for the year ended December 31, 2010 from 11 for the year ended December 31, 2009, primarily due to the acquisition of Pump Engineering, LLC in December 2009. Share-based compensation expense included in research and development expense was $214,000 for year ended December 31, 2010 and $246,000 for the year ended December 31, 2009.

We anticipate that our research and development expenditures will increase substantially in the future as we expand and diversify our product offerings.

Gain on Fair Value Remeasurement

We acquired Pump Engineering, LLC in December 2009. Under the business combinations guidance of U.S. GAAP, we initially recognized a liability of $5.5 million as an estimate of the acquisition date fair value of contingent and other consideration, consisting of $3.5 million of contingent consideration subject to pay-out to the sellers upon the acquired company s achievement of certain milestones and $2.0 of other consideration securing the sellers indemnification obligations. The fair value measurement of the $3.5 million of contingent consideration was based on the weighted probability of achievement, as of the acquisition date, that the milestones would be achieved. In the fourth quarter of 2010, some of the milestones were not met. Accordingly, we remeasured the contingent consideration at $1.4 million to reflect its estimated fair value at December 31, 2010 and recognized a gain of $2.1 million in our Consolidated Statement of Operations. See

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Note 3 *Business Combinations* to the Consolidated Financial Statements included in this report for further discussion of the gain on fair value remeasurement.

Non-operating Income (Expense), Net

Non-operating income (expense), net, changed unfavorably by $275,000 to $(267,000) of other net expense for the year ended December 31, 2010 from $8,000 of other net income for the year ended December 31, 2009. The unfavorable variance was primarily due to a loss of $0.1 million on the sale of equipment in 2010, a decrease of $0.1 million in interest income and a decrease of $0.1 million increase in net foreign currency losses year over year.

2009 Compared to 2008

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For the Year Ended December 31,					
	2009		**2008**		**Change Favorable (Unfavorable)**	
Results of Operations: (1)						
Net revenue	$ 47,014	100%	$ 52,119	100%	$ (5,105)	(10)%
Cost of revenue	17,595	37%	18,933	36%	1,338	7%
Gross profit	29,419	63%	33,186	64%	(3,767)	(11)%
Operating expenses:						
General and administrative	13,756	29%	11,321	22%	(2,435)	(22)%
Sales and marketing	6,472	14%	6,549	13%	77	1%
Research and development	3,041	6%	2,415	5%	(626)	(26)%
Total Operating Expenses	23,269	49%	20,285	39%	(2,984)	(15)%
Income from operations	6,150	13%	12,901	25%	(6,751)	(52)%
Other income (expense):						
Interest expense & finance charges	(46)	*	(79)	*	33	42%
Interest and other income	54	*	873	2%	(819)	(94)%
Net income before provision for income tax	6,158	13%	13,695	26%	(7,537)	(55)%
Provision for income tax expense	2,472	5%	5,032	10%	2,560	51%
Net Income	$ 3,686	8%	$ 8,663	17%	$ (4,977)	(57)%

(millions, except per-share data)	Years Ended December 31,		
	2009	2008	2007

Net sales	$ 3,235	$ 4,608	$ 5,202
Cost of products sold	3,090	4,416	4,601
Gross profit	145	192	601
Selling and administrative expenses	304	380	408
Litigation settlement income	(97)	-	-
Restructuring and long-lived asset impairment charges	80	98	26
Goodwill and other intangible asset impairment charges	43	226	-
Operating profit (loss)	(185)	(512)	167
Interest expense	165	86	105
Interest income	(4)	(7)	(22)
Other income, net	(9)	(10)	(4)
Earnings (loss) before income taxes	(337)	(581)	88
Income taxes (benefit)	450	(118)	11
Net earnings (loss)	$ (787)	$ (463)	$ 77
Basic earnings (loss) per common share	$ (7.93)	$ (4.67)	$ 0.80
Diluted earnings (loss) per common share	$ (7.93)	$ (4.67)	$ 0.79

The notes to consolidated financial statements are an integral part of these statements.

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USG CORPORATION
CONSOLIDATED BALANCE SHEETS

(millions, except share data)	As of December 31,	
	2009	2008
Assets		
Current Assets:		
Cash and cash equivalents	$ 690	$ 471
Restricted cash	2	1
Receivables (net of reserves: 2009 - $16; 2008 - $15)	357	467
Inventories	289	404
Income taxes receivable	20	15
Deferred income taxes	2	68
Other current assets	71	68
Total current assets	1,431	1,494
Property, plant and equipment, net	2,427	2,562
Deferred income taxes	-	374
Goodwill	-	12
Other assets	239	277
Total assets	$ 4,097	$4,719
Liabilities and Stockholders Equity		

Current Liabilities:		
Accounts payable	$ 205	$ 220
Accrued expenses	273	338
Short-term debt	-	190
Current portion of long-term debt	7	4
Income taxes payable	7	4
Total current liabilities	492	756
Long-term debt	1,955	1,642
Deferred income taxes	17	7
Other liabilities	703	764
Commitments and contingencies		
Stockholders Equity:		
Preferred stock (000) - $1 par value, $1.80 convertible preferred stock (initial series);		
authorized 36,000 shares; outstanding - none	-	-
Common stock (000) - $0.10 par value; authorized 200,000 shares;		
issued: 2009 - 103,972 shares; 2008 - 103,972 shares	10	10
Treasury stock at cost (000) -2009 - 4,672 shares; 2008 - 4,793 shares	(194)	(199)
Capital received in excess of par value	2,640	2,625
Accumulated other comprehensive (loss) income	(80)	(227)
Retained earnings (deficit)	(1,446)	(659)
Total stockholders equity	930	1,550

Total liabilities and stockholders equity	$ 4,097	$4,719

The notes to consolidated financial statements are an integral part of these statements.

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USG CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(millions)	Years Ended December 31,		
	2009	2008	2007
Operating Activities			
Net earnings (loss)	$(787)	$ (463)	$ 77
Adjustments to Reconcile Net Earnings (Loss) to Net Cash:			
Goodwill and other intangible asset impairment charges	43	226	-
Depreciation, depletion and amortization	203	182	176
Share-based compensation expense	21	24	20
Deferred income taxes	453	(111)	5
(Gain) loss on asset dispositions	(10)	1	-
Convertible debt embedded derivative	(10)	(11)	-
(Increase) Decrease in Working Capital (net of acquisitions):			
Receivables	108	(37)	91
Income taxes receivable	(4)	22	1,063
Inventories	113	27	5
Payables	(8)	(78)	(60)
Accrued expenses	(23)	49	(59)
Decrease (increase) in other assets	25	(23)	(29)
Increase in other liabilities	2	25	33
Reorganization distribution - other	-	-	(40)
Other, net	13	2	25

Net cash provided by (used for) operating activities	139	(165)	1,307
Investing Activities			
Capital expenditures	(44)	(238)	(460)
Investment in joint venture	(7)	(12)	-
(Deposit) return of restricted cash	(1)	(1)	6
Net proceeds from asset dispositions	16	-	3
Acquisitions of businesses, net of cash acquired	-	(1)	(279)
Net cash used for investing activities	(36)	(252)	(730)
Financing Activities			
Issuance of debt	319	1,950	499
Repayment of debt	(195)	(1,331)	(1,765)
Payment of debt issuance fees	(15)	(10)	(4)
Excess tax benefits from share-based compensation	-	(1)	(5)
Proceeds from equity offering, net of fees	-	-	422
Net cash provided by (used for) financing activities	109	608	(853)
Effect of exchange rate changes on cash	7	(17)	8
Net increase (decrease) in cash and cash equivalents	219	174	(268)
Cash and cash equivalents at beginning of period	471	297	565
Cash and cash equivalents at end of period	$ 690	$ 471	$ 297

Supplemental Cash Flow Disclosures:			
Interest paid	$ 139	$ 83	$ 90
Income taxes (refunded), net	(1)	(21)	(1,046)
Payables adjustment for capital expenditures	(4)	(32)	39

The notes to consolidated financial statements are an integral part of these statements.

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USG CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(millions, except share data)	Common Shares Issued (000)	Treasury Shares (000)	Common Stock	Treasury Stock	Capital Received in Excess of Par Value	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2006	94,908	(5,043)	$ 9	$ (208)	$ 2,176	$ (275)	$ (136)	$ 1,566
Net earnings						77		77
Foreign currency translation, net of tax benefit of $1							53	53
Change in fair value of derivatives, net of tax of $15							21	21
Change in pension and postretirement benefit plans, net of tax of $48							72	72
Unrealized loss on marketable securities, net of tax benefit of $0.1							(1)	(1)
Total comprehensive income								222
Adoption of new accounting pronouncements, net of tax of $2						2		2

Equity offering	9,064		1		421			422
Share-based compensation					20			20
Stock issuances		122		4	(4)			-
Other					(6)			(6)
Balance at December 31, 2007	103,972	(4,921)	$ 10	$(204)	$ 2,607	$ (196)	$ 9	$2,226
Net loss						(463)		(463)
Foreign currency translation, net of tax benefit of $1							(100)	(100)
Change in fair value of derivatives, net of tax benefit of $20							(30)	(30)
Change in pension and postretirement benefit plans, net of tax benefit of $49							(107)	(107)
Unrealized loss on marketable securities, net of tax of $0.1							1	1
Total comprehensive income (loss)								(699)
Share-based compensation					24			24
Stock issuances		128		5	(5)			-
Other					(1)			(1)
Balance at December 31, 2008	103,972	(4,793)	$ 10	$(199)	$ 2,625	$ (659)	$ (227)	$1,550
Net loss						(787)		(787)

Foreign currency translation, net of tax of $0.4							52	52
Change in fair value of derivatives, net of tax benefit of $0.1							36	36
Change in pension and postretirement benefit plans, net of tax benefit of $4							59	59
Total comprehensive income (loss)								(640)
Share-based compensation					21			21
Stock issuances		121		5	(5)			-
Other					(1)			(1)
Balance at December 31, 2009	103,972	(4,672)	$ 10	$(194)	$ 2,640	$(1,446)	$ (80)	$ 930

The notes to consolidated financial statements are an integral part of these statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In the following Notes to Consolidated Financial Statements, USG, we, our and us refer to USG Corporation, a Delaware corporation, and its subsidiaries included in the consolidated financial statements, except as otherwise indicated or as the context otherwise requires.

1. Significant Accounting Policies

NATURE OF OPERATIONS

USG, through its subsidiaries, is a leading manufacturer and distributor of building materials. We produce a wide range of products for use in new residential, new nonresidential, and residential and nonresidential repair and remodel construction as well as products used in certain industrial processes. Our operations are organized into three reportable segments: North American Gypsum, which manufactures SHEETROCK® brand gypsum wallboard and related products in the United States, Canada and Mexico; Building Products Distribution, which distributes gypsum wallboard, drywall metal, ceilings products, joint compound and other building products throughout the United States; and Worldwide Ceilings, which manufactures ceiling tile in the United States and ceiling grid in the United States, Canada, Europe and the Asia-Pacific region. Our products also are distributed through building materials dealers, home improvement centers and other retailers, specialty wallboard distributors, and contractors.

CONSOLIDATION

Our consolidated financial statements include the accounts of USG Corporation and its majority-owned subsidiaries. Entities in which we have more than a 20% but not more than 50% ownership interest are accounted for on the equity basis of accounting and are not material to consolidated operations. All intercompany balances and transactions are eliminated in consolidation.

USE OF ESTIMATES

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from these estimates.

REVENUE RECOGNITION

With the exception of our Building Products Distribution segment, we recognize revenue upon the shipment of products to customers, which is when title and risk of loss are transferred to customers. With the exception of Building Products Distribution, our products are generally shipped free on board, commonly called FOB, shipping point. For Building Products Distribution, revenue is recognized and title and risk of loss are transferred when customers receive products, either through delivery by company trucks or customer pickup. We record provisions for discounts to customers based on the terms of sale in the same period in which the related sales are recorded. We record estimated reductions to revenue for customer programs and incentive offerings, including promotions and other volume-based incentives.

SHIPPING AND HANDLING COSTS

Shipping and handling costs are included in cost of products sold.

ADVERTISING

Advertising expenses consist of media advertising and related production costs and sponsorships. We charge advertising expenses to earnings as incurred. These expenses amounted to $13 million in 2009, $23 million in 2008 and $30 million in 2007.

RESEARCH AND DEVELOPMENT

We charge research and development expenditures to earnings as incurred. These expenditures amounted to $13 million in 2009, $19 million in 2008 and $23 million in 2007.

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INCOME TAXES

We record income taxes (benefit) under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized based on the future tax consequences to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and attributable to net operating loss, or NOL, and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which the temporary differences are expected to be recovered or paid. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the change is enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized, which can occur when a cumulative loss period is reached.

INVENTORY VALUATION

All of our inventories are stated at the lower of cost or market. Virtually all of our inventories are valued under the average cost method with the remainder valued under the first-in, first-out cost method. Inventories include material, labor and applicable factory overhead costs. Depreciation associated with manufacturing assets is excluded from inventory cost, but is included in cost of products sold.

EARNINGS PER SHARE

Basic earnings per share are based on the weighted average number of common shares outstanding. Diluted earnings per share are based on the weighted average number of common shares outstanding, the dilutive effect, if any, of restricted stock units, or RSUs, and performance shares, the potential exercise of outstanding stock options and the potential conversion of our 10% convertible senior notes.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include highly liquid investments (primarily money market mutual funds) with maturities of three months or less at the time of purchase.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is recorded at cost. We determine provisions for depreciation of property, plant and equipment on a straight-line basis over the expected average useful lives of composite asset groups. We determine estimated useful lives to be 50 years for buildings and improvements, a range of 10 to 25 years for machinery and equipment, and five years for computer software and systems development costs. Leasehold improvements are capitalized and amortized over the shorter of the remaining lease term or remaining economic useful life. We capitalize interest during the active construction period of major capital projects. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful lives of the assets. Capitalized interest was $3 million in 2009, $19 million in 2008 and $15 million in 2007. Facility start-up costs that cannot be capitalized are expensed as incurred and are recorded in cost of products sold. We compute depletion on a basis calculated to spread the cost of gypsum and other applicable resources over the estimated quantities of material recoverable. We review property, plant and equipment for impairment when indicators of a potential impairment are present by comparing the carrying value of the assets with their estimated future undiscounted cash flows. If we determine an impairment exists, the asset is written down to estimated fair value. As of December 31, 2009, $23 million of net property, plant and equipment included in other current assets on the consolidated balance sheet was classified as assets held for sale. Assets in this category are primarily related to our United States Gypsum Company, or U.S. Gypsum, reporting unit. These assets are anticipated to be sold in 2010.

GOODWILL AND OTHER INTANGIBLE ASSETS

We perform impairment tests for goodwill and other intangible assets with indefinite useful lives as of October 31 of each year, or more frequently if events or circumstances indicate they might be impaired. The impairment test consists of a comparison of the fair value of the asset with its carrying amount. See Note 3 for information related to impairment testing and impairment charges.

SHARE-BASED COMPENSATION

We award share-based compensation to employees in the form of stock options, restricted stock units and performance shares. All grants under share-based payment programs are accounted for at fair value at the date of grant. The expense for these equity-based incentives is based on their fair value at date of grant. We recognize expense on all share-based awards expected to vest over the service period, which is the shorter of the period until the employees retirement eligibility dates or the service period of the award.

DERIVATIVE INSTRUMENTS

We use derivative instruments to manage selected commodity price and foreign currency exposures. We do not use derivative instruments for speculative trading purposes, and we typically do not hedge beyond five years. All derivative instruments must be recorded on the balance sheet at fair value. For derivatives designated as fair value hedges, the changes in the fair values of both the derivative instrument and the hedged item are recognized in earnings in the current period. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is recorded to accumulated other comprehensive income (loss), or AOCI, and is reclassified to earnings when the transaction underlying the derivative instrument has an impact on earnings. The ineffective portion of changes in the fair value of the derivative is reported in cost of products sold. We periodically re-assess the probability of the forecasted transaction underlying the derivative instrument occurring. For derivatives designated as net investment hedges, we record changes in value to AOCI. For derivatives not classified as cash flow or net investment hedges, all changes in fair value are recorded to earnings.

Commodity Derivative Instruments: Currently, we are using swap and option contracts to hedge a significant portion of our anticipated purchases of natural gas to be used in our manufacturing operations. Generally, we hedge the cost of a majority of our anticipated purchases of natural gas over the next 12 months. However, we review our positions regularly and make adjustments as market conditions warrant. The majority of contracts currently in place are designated as cash flow hedges, and the remainder are not designated as hedging instruments.

Foreign Exchange Derivative Instruments: We have operations in a number of countries and use forward contracts and cross-currency swaps from time to time to hedge selected risk of changes in cash flows resulting from forecasted intercompany and third-party sales or purchases, as well as intercompany loans, denominated in non-U.S. currencies, or to hedge selected risk of changes in our net investment in foreign subsidiaries. These contracts are designated as either cash flow hedges or hedges of net investment or are not designated as hedging instruments.

FOREIGN CURRENCY TRANSLATION

We translate foreign-currency-denominated assets and liabilities into U.S. dollars at the exchange rates existing as of the respective balance sheet dates. We translate income and expense items at the average exchange rates during the respective periods. We record translation adjustments resulting from fluctuations in exchange rates to AOCI on our consolidated balance sheets. We record transaction gains and losses to earnings. The total transaction loss was $2 million in 2009, $8 million in 2008 and less than $1 million in 2007.

FAIR VALUE MEASUREMENTS

Certain assets and liabilities are required to be recorded at fair value. The estimated fair values of those assets and liabilities have been determined using market information and valuation methodologies. Changes in assumptions or estimation methods could affect the fair value estimates. However, we do not believe any such changes would have a material impact on our financial condition, results of operations or cash flows. There are three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices for identical assets and liabilities in active markets;

Level 2 Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

SUBSEQUENT EVENTS

We have evaluated subsequent events through the filing of these financial statements.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2008, the Financial Accounting Standards Board, or FASB, issued an update to Accounting Standards Codification, or ASC, 715 Compensation Retirement Benefits. This update requires additional disclosures about assets held in an employer s defined benefit pension or other postretirement plan. This update replaces the requirement to disclose the percentage of the fair value of total plan assets for each major category of plan assets, such as equity securities, debt securities, real estate and all other assets, with the fair value of each major asset category as of each annual reporting date for which a financial statement is presented. It also requires disclosure of the level within the fair value hierarchy in which each major category of plan assets falls. This update is applicable to employers that are subject to the disclosure requirements and is effective for fiscal years ending after December 15, 2009. We are complying with the disclosure provisions of this update. See Note 7.

In June 2009, the FASB issued an update to ASC 810 Consolidation. This update addresses (1) the effects on certain provisions of previous accounting guidance related to the consolidation of variable interest entities as a result of the elimination of the qualifying special-purpose entity concept in ASC 860 Transfers and Servicing and (2) constituent concerns about the application of certain key provisions of ASC 810, including those in which the accounting and disclosures under the standard do not always provide timely and useful information about an enterprise s involvement in a variable interest entity. This update is effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. We have adopted this update effective January 1, 2010 and do not anticipate any impact on our financial statements.

2. Restructuring and Long-Lived Asset Impairment Charges

In response to adverse market conditions, we implemented restructuring activities in 2009, 2008 and 2007 that resulted in the charges described below.

2009

In 2009, we recorded restructuring and long-lived asset impairment charges totaling $80 million primarily associated with salaried workforce reductions, the closure of 37 distribution centers and the temporary idling or permanent closure of production facilities. On a segment basis, $39 million of the total amount related to Building Products Distribution, $25 million to North American Gypsum, $5 million to Worldwide Ceilings and $11 million to Corporate.

Severance charges totaled $16 million. This amount included $10 million for severance primarily related to salaried workforce reductions and $6 million for severance related to the closure of distribution centers, the temporary idling of a paper mill in Clark, N.J., and the permanent closure of a sealants and finishes production facility in La Mirada, Calif. The number of salaried employees terminated and open salaried positions eliminated was approximately 360. The number of hourly employees terminated and open hourly positions eliminated was approximately 460.

Lease obligation charges totaled $32 million. This amount included $26 million for lease obligations primarily related to the closure of distribution centers and $6 million for future lease obligations related to space that we no longer occupy in our corporate headquarters.

Asset impairment charges totaled $24 million. This amount included (1) $7 million for write-downs of the values of machinery and equipment at the temporarily idled structural cement panel production facility in Delavan,

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Wis., and gypsum wallboard production facility in Detroit, Mich., (2) $3 million for write-downs of the values of machinery and equipment at the permanently closed gypsum wallboard and cement board production facilities in Santa Fe Springs, Calif., and sealants and finishes production facility in La Mirada, Calif., (3) $9 million primarily for the write-off of receivables and inventories and $2 million for the write-off of equipment related to the closure of distribution centers and (4) $3 million for the write-off of leasehold improvements related to leased space that we no longer occupy in our corporate headquarters.

An additional $8 million was recorded for costs related to production facilities that were temporarily idled or permanently closed prior to 2009 and other exit costs.

2008

In 2008, we recorded restructuring and long-lived asset impairment charges totaling $98 million. On a segment basis, $48 million of the total amount related to North American Gypsum, $34 million to Building Products Distribution, $5 million to Worldwide Ceilings and $11 million to Corporate. These charges included (1) $39 million for severance related to salaried workforce reductions and $11 million for severance related to the idling or closure of production facilities and distribution centers, (2) $24 million for lease obligations related to the closure of production facilities and distribution centers and excess leased office space, (3) $18 million for the write-down of the value of machinery and equipment at production facilities that were permanently closed and of leasehold improvements and the write-off of receivables and inventory at the closed distribution centers, and (4) $6 million for the clean-up of closed or idled production facilities, other exit activities and additional expenses incurred in 2008 for production facilities that were closed in 2007. The number of employees terminated and open positions eliminated during 2008 as a result of our salaried workforce reductions was approximately 1,400. The number of hourly employees terminated and open hourly positions eliminated during 2008 as a result of the closing or idling of production facilities was approximately 1,000.

2007

In 2007, we recorded restructuring and long-lived asset impairment charges totaling $26 million. On a segment basis, $18 million of the total amount related to North American Gypsum, $2 million to Worldwide Ceilings, $1 million to Building Products Distribution, and $5 million to Corporate. These charges included $18 million for severance related to salaried workforce reductions, $2 million for severance and other exit costs related to the temporary idling or permanent closure of certain production facilities and $6 million for long-lived asset impairments. The number of employees terminated and open positions eliminated during 2007 as a result of our salaried workforce reductions was approximately 500. The other severance primarily reflected severance for approximately 130 employees at the closed or idled production facilities and the other exit costs primarily reflected lease obligation costs.

RESTRUCTURING RESERVE

A restructuring reserve of $40 million was included in accrued expenses and long-term liabilities on the consolidated balance sheet as of December 31, 2009. We expect future payments to be approximately $21 million in 2010, $8 million in 2011 and $11 million after 2011. All restructuring-related payments in 2009 were funded with cash from operations. We expect that the future payments also will be funded with cash from operations. The restructuring reserve is summarized as follows:

	Balance	2009 Activity			Balance
	as of		Cash	Asset	as of
(millions)	12/31/08	Charges	Payments	Impairment	12/31/09
Severance	$ 27	$ 16	$ (39)	$ -	$ 4
Lease obligations	23	32	(15)	(6)	34

Asset impairments	-	24	-	(24)	-
Other exit costs	-	8	(6)	-	2
Total	$ 50	$ 80	$ (60)	$ (30)	$ 40

3. Goodwill and Other Intangible Assets

We have both indefinite and definite lived other intangible assets. We perform impairment tests on goodwill and other intangible assets with indefinite useful lives as of October 31 of each fiscal year, or when events occur or circumstances change that would, more likely than not, reduce the fair value of a reporting unit or an intangible asset with an indefinite useful life to below its carrying value.

The measurement of impairment of goodwill consists of two steps. In the first step, we compare the fair value of each reporting unit with goodwill to its carrying value. We determine the fair value of each of our reporting units with goodwill using a combination of the income approach and the market approach. The income approach uses a discounted cash flow methodology to determine fair value. This methodology recognizes value based on the expected receipt of future economic benefits. Key assumptions in the income approach include a free cash flow projection, an estimated discount rate, a long-term growth rate and a terminal value. These assumptions are based on our historical experience, current market trends and future expectations. The market approach uses the guideline public company methodology to determine fair value. This methodology recognizes value by applying valuation multiples of similar companies trailing 12-month revenue and earnings before interest, taxes, depreciation and amortization, or EBITDA, adjusted for various performance metrics. Our assessment also considers indicators of potential impairment that have occurred in our business, including declining U.S. residential housing starts, declining gross margins, curtailment of gypsum wallboard operations and closing of distribution centers. Based on this evaluation, if we determine that the fair value of a reporting unit is less than its carrying value, we perform a second step to determine the implied fair value of goodwill in that reporting unit and compare it to its carrying value. The activities in the second step include hypothetically valuing all of the tangible and intangible assets of the impaired reporting unit as if the reporting unit had been acquired in a business combination.

Other intangible assets determined to have indefinite useful lives, primarily comprised of trade names, are not amortized. We perform impairment tests for intangible assets with indefinite useful lives annually, or more frequently if events or circumstances indicate they might be impaired. The impairment test consists of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. An income approach is used for valuing trade names. Assumptions used in the income approach include projected revenues and assumed royalty, long-term growth and discount rates.

In 2009, we recorded goodwill and other intangible asset impairment charges of $43 million. Because of continuing weak economic conditions, macroeconomic factors impacting industry business conditions, recent segment operating performance and our decision in September 2009 to close additional distribution centers, we performed interim impairment tests on L&W Supply Corporation and its subsidiaries, or L&W Supply, the reporting unit that comprises our Building Products Distribution segment, as of September 30, 2009. This testing indicated that the fair value of the L&W Supply reporting unit was less than its carrying value and, as a result, impairment existed. Consequently, in the third quarter of 2009, we recorded impairment charges totaling $41 million, of which $29 million related to L&W Supply s intangible assets associated with trade names and $12 million was its remaining goodwill balance. No impairment existed for L&W Supply s intangible assets associated with customer relationships. During our annual impairment review in the fourth quarter of 2009, we determined that a full impairment existed for the trade names of the Latin America reporting unit within our Worldwide Ceilings segment. This impairment resulted in an additional impairment charge of $2 million. We determined that no additional impairment existed for L&W Supply s intangible assets based on the annual review.

In 2008, we recorded goodwill and other intangible asset impairment charges of $226 million as a result of our annual impairment testing in the fourth quarter of that year. The conditions that contributed to that impairment included our sustained low stock price and reduced market capitalization relative to the book value of our equity, which was adversely affected by generally weak economic conditions, macroeconomic factors impacting industry business conditions, recent and forecasted segment operating performance, the increased competitive environment, and continued tightening of the credit markets, along with other factors, such as a significant decline in housing starts. The total charge recorded in the fourth quarter of 2008 consisted of $201 million of goodwill related to L&W Supply, $12 million of goodwill related to the Latin America reporting unit within our Worldwide Ceilings segment, $1 million of goodwill related to the USG Mexico, S.A. de C.V., or USG Mexico, reporting unit within our North American Gypsum segment and $12 million of intangible assets associated with L&W Supply s trade names. A portion of the charges related to goodwill was deductible for tax purposes, resulting in a tax benefit of $49 million, or approximately 22% of the pretax charges amount. An additional $1 million write-off of trade names was recorded to cost of products sold earlier in 2008.

GOODWILL

Changes in the carrying amount of goodwill by reportable segment as of December 31 are summarized as follows:

	2009		2008		
(millions)	Building Products Distribution	North American Gypsum	Building Products Distribution	Worldwide Ceilings	Total
Balance as of January 1:					
Goodwill	$ 213	$ 1	$ 213	$ 12	$ 226
Accumulated impairment charges	(201)	-	-	-	-
	$ 12	$ 1	$ 213	$ 12	$ 226
Impairment charges	(12)	(1)	(201)	(12)	(214)
Balance as of December 31:					
Goodwill	$ 213	$ 1	$ 213	$ 12	$ 226
Accumulated impairment charges	(213)	(1)	(201)	(12)	(214)
	$ -	$ -	$ 12	$ -	$ 12

INTANGIBLE ASSETS

Other intangible assets, which are included in long-term other assets on the consolidated balance sheets, as of December 31 are summarized as follows:

	2009				2008			
	Gross				Gross			
	Carrying	Impairment	Accumulated		Carrying	Impairment	Accumulated	
(millions)	Amount	Charges	Amortization	Net	Amount	Charges	Amortization	Net
Intangible Assets with Definite Lives:								
Customer relationships	$ 70	$ -	$ (20)	$ 50	$ 70	$ -	$ (13)	$ 57
Other	9	-	(4)	5	9	-	(3)	6
Total	79	-	(24)	55	79	-	(16)	63
Intangible Assets with Indefinite Lives:								
Trade names	53	(31)	-	22	66	(13)	-	53
Other	9	-	-	9	9	-	-	9
Total	62	(31)	-	31	75	(13)	-	62
Total Other Intangible Assets	$ 141	$ (31)	$ (24)	$ 86	$ 154	$ (13)	$ (16)	$ 125

Intangible assets with definite lives are amortized. The weighted average amortization periods are 10 years for customer relationships and 12 years for other intangible assets with definite lives. Total amortization expense was $8 million in 2009, $8 million in 2008 and $7 million in 2007. Estimated annual amortization expense for other intangible assets is $8 million for each of the years 2010 and 2011 and $7 million for each of the years 2012 through 2014. Intangible assets with indefinite lives are not amortized.

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4. Debt

Total debt as of December 31 consisted of the following:

(millions)	2009	2008
6.3% senior notes	$ 500	$ 500
7.75% senior notes, net of discount	499	499
9.75% senior notes, net of discount	295	-
10% convertible senior notes, net of discount	380	379
Ship mortgage facility	49	29
Industrial revenue bonds	239	239
Revolving credit facility	-	190
Total	$1,962	$1,836

CREDIT FACILITY

Our amended and restated credit facility, which is guaranteed by, and secured by trade receivables and inventory of, our significant domestic subsidiaries, allows for revolving loans and letters of credit (up to $250 million) in an aggregate principal amount not to exceed the lesser of (i) $500 million or (ii) a borrowing base determined by reference to the trade receivables and inventory of USG and its significant domestic subsidiaries. This facility is available to fund working capital needs and for other general corporate purposes. Borrowings under the credit facility bear interest at a floating rate based on an alternate base rate or, at our option, at adjusted LIBOR plus 3.00%. We are also required to pay annual facility fees of 0.75% on the entire facility, whether drawn or undrawn, and fees on outstanding letters of credit. We have the ability to repay amounts outstanding under the credit agreement at any time without prepayment premium or penalty. The credit facility matures on August 2, 2012.

The credit agreement contains a single financial covenant that would require us to maintain a minimum fixed charge coverage ratio of 1.1 to 1.0 if and for so long as the excess of the borrowing base over the outstanding borrowings under the credit agreement is less than $75 million. Because we do not currently satisfy the required fixed charge coverage ratio, we must maintain borrowing availability of at least $75 million under the credit facility. The credit agreement contains other covenants and events of default that are customary for similar agreements and may limit our ability to take various actions. Our significant domestic subsidiaries have guaranteed our obligations under the credit agreement.

Taking into account the most recent borrowing base calculation delivered under the credit facility, which reflects trade receivables and inventory as of December 31, 2009, outstanding letters of credit and the $75 million availability requirement for the fixed charge coverage ratio not to apply, borrowings available under the credit facility were approximately $90 million. As of December 31, 2009, there were no borrowings under the facility and outstanding letters of credit totaled $84 million. Had there been any borrowings as of that date, the applicable interest rate would have been 3.25%. As of December 31, 2008, $190 million of borrowings were outstanding under the credit facility and classified as short-term debt on our consolidated balance sheet. We repaid those borrowings in January 2009, and we recorded a pretax charge of $7 million to write off deferred financing fees, in connection with the amendment and restatement of the credit agreement.

SENIOR NOTES

During the third quarter of 2009, we completed an offering of $300 million in aggregate principal amount of 9.75% senior notes due 2014 that are recorded on the consolidated balance sheet at $295 million, which is net of debt discount of $5 million. Our obligations under the notes are guaranteed on a senior unsecured basis by certain of our domestic subsidiaries.

We have $500 million of 7.75% senior notes due 2018 that are recorded on the consolidated balance sheets at $499 million, which is net of debt discount of $1 million. The interest rate payable on these notes is subject to adjustment from time to time by up to 2% in the aggregate if the debt ratings assigned to the notes decrease or thereafter increase. At our current credit ratings, the interest rate on these notes is 9.50%. We also have $500 million of 6.3% senior notes due 2016.

The 9.75% senior notes, 7.75% senior notes and 6.3% senior notes are senior unsecured obligations and rank equally with all of our other existing and future unsecured senior indebtedness. The indentures governing the notes contain events of default, covenants and restrictions that are customary for similar transactions, including a limitation on our ability and the ability of certain of our subsidiaries to create or incur secured indebtedness. The 9.75% senior notes also contain a provision requiring us to offer to purchase those notes at a premium of 101% of their principal amount (plus accrued and unpaid interest) in the event of a change in control. The 7.75% senior notes and the 6.3% senior notes contain a provision requiring us to offer to purchase those notes at a premium of 101% of their principal amount (plus accrued and unpaid interest) in the event of a change in control and a related downgrade of the rating on the notes to below investment grade by both Moody s Investors Service and Standard & Poor s Financial Services LLC. All three series of notes also contain a provision that allows us to redeem the notes in whole at any time, or in part from time to time, at our option, at a redemption price equal to the greater of (1) 100% of the principal amount of the notes being redeemed and (2) the sum of the present value of the remaining scheduled payments of principal and interest on the notes being redeemed discounted to the redemption date on a semi-annual basis at the applicable U.S. Treasury rate plus a spread (as outlined in the respective indentures), plus, in each case, any accrued and unpaid interest on the principal amount being redeemed to the redemption date.

CONVERTIBLE SENIOR NOTES

We have $400 million aggregate principal amount of 10% convertible senior notes due 2018 outstanding that are recorded on the consolidated balance sheets at $380 million, which is net of debt discount of $20 million as a result of the embedded derivative discussed in Note 5. The notes bear cash interest at the rate of 10% per year until maturity, redemption or conversion. The notes are initially convertible into 87.7193 shares of our common stock per $1,000 principal amount of notes which is equivalent to an initial conversion price of $11.40 per share, or a total of 35.1 million shares. The notes contain anti-dilution provisions that are customary for convertible notes issued in transactions similar to that in which the notes were issued. The notes mature on December 1, 2018 and are not callable until December 1, 2013, after which we may elect to redeem all or part of the notes at stated redemption prices, plus accrued and unpaid interest.

The notes are senior unsecured obligations and rank equally with all of our other existing and future unsecured senior indebtedness. The indenture governing the notes contains events of default, covenants and restrictions that are customary for similar transactions, including a limitation on our ability and the ability of certain of our subsidiaries to create or incur secured indebtedness. The notes also contain a provision requiring us to offer to purchase the notes at a premium of 105% of their principal amount (plus accrued and unpaid interest) in the event of a change in control or the termination of trading of our common stock on a national securities exchange.

SHIP MORTGAGE FACILITY

Our subsidiary, Gypsum Transportation Limited, or GTL, has a secured loan facility agreement with DVB Bank SE, as lender, agent and security trustee. As of December 31, 2009, both advances provided for under the secured loan facility had been drawn, and the total outstanding loan balance under the secured loan facility was $49 million. Of the total amount outstanding, $7 million was classified as current portion of long-term debt on our consolidated balance sheet as of December 31, 2009.

Advances under the secured loan facility bear interest at a floating rate based on LIBOR plus a margin of 1.65%. The interest rate on borrowings under this facility was 2.23% as of December 31, 2009. Each advance is repayable in quarterly installments in amounts determined in accordance with the secured loan facility agreement, with the balance of each advance repayable eight years after the date it was advanced, or October 31, 2016 and May 22, 2017. The secured loan facility agreement contains affirmative and negative covenants affecting GTL and certain customary events of default. GTL has granted DVB Bank SE a security interest in the Gypsum Centennial and Gypsum Integrity ships and related insurance, contract, account and other rights as security for borrowings under the secured loan facility. USG Corporation has guaranteed the obligations of GTL under the secured loan facility and has agreed to maintain liquidity of at least $175 million.

CGC CREDIT FACILITY

Our Canadian subsidiary, CGC Inc., or CGC, has a Can. $30 million credit agreement with The Toronto-Dominion Bank. The credit agreement allows for revolving loans and letters of credit (up to Can. $3 million in aggregate) in an aggregate principal amount not to exceed Can. $30 million. The credit agreement is available for the general corporate purposes of CGC, excluding hostile acquisitions. The credit agreement is secured by a general security interest in substantially all of CGC s assets other than intellectual property.

Revolving loans under the agreement may be made in Canadian dollars or U.S. dollars. Revolving loans made in Canadian dollars bear interest at a floating rate based on the prime rate plus 1.50% or the Bankers Acceptance Discount Rate plus 3.00%, at the option of CGC. Revolving loans made in U.S. dollars bear interest at a floating rate based upon a base rate plus 1.50% or the LIBOR rate plus 3.00%, at the option of CGC. CGC may prepay the revolving loans at its discretion without premium or penalty and may be required to repay revolving loans under certain circumstances. The credit agreement matures on June 1, 2012, unless terminated earlier in accordance with its terms. The credit agreement contains customary representations and warranties, affirmative and negative covenants that may limit CGC s ability to take certain actions and events of default. Borrowings under the credit agreement are subject to acceleration upon the occurrence of an event of default.

As of December 31, 2009, there were no borrowings or letters of credit outstanding under this credit agreement. Had there been any borrowings as of that date, the applicable interest rate would have been 3.44%. The U.S. dollar equivalent of borrowings available under this agreement as of December 31, 2009 was $28 million.

INDUSTRIAL REVENUE BONDS

Our $239 million of industrial revenue bonds have fixed interest rates ranging from 5.5% to 6.4%. The weighted average rate of interest on our industrial revenue bonds is 5.875%. The average maturity of these bonds is 21 years.

OTHER INFORMATION

The fair value of our debt was $2.211 billion as of December 31, 2009 and $1.407 billion as of December 31, 2008. The fair value was based on quoted market prices of our debt or, where quoted market prices were not available, on quoted market prices of instruments with similar terms and maturities or internal valuation models. As of December 31, 2009, we were in compliance with the covenants contained in our credit facilities. The amounts of total debt outstanding as of December 31, 2009 maturing during the next five years and beyond were: $7 million in each of the years 2010 through 2012, $4 million in 2013, $304 million in 2014 and $1.659 billion after 2014.

5. Derivative Instruments

COMMODITY DERIVATIVE INSTRUMENTS

As of December 31, 2009, we had swap and option contracts to hedge $105 million notional amounts of natural gas. All of these contracts mature by December 31, 2012. As of December 31, 2009, the fair value of these contracts was a $21 million unrealized loss, of which $25 million remained in AOCI. For contracts designated as cash flow hedges, no ineffectiveness was recorded in 2009. Gains and losses on the contracts designated as cash flow hedges are reclassified into earnings when the underlying forecasted transactions affect earnings. Changes in fair value on contracts not designated as hedges are recorded to earnings. In the third quarter of 2009, we determined that the forecasted purchases of natural gas to which a portion of our hedge contracts related to were probable of not occurring. As a result, the associated hedge contracts were de-designated as cash flow hedges, and we reclassified $4 million of losses from AOCI to earnings.

FOREIGN EXCHANGE DERIVATIVE INSTRUMENTS

We have foreign exchange forward contracts in place to hedge changes in the value of intercompany loans to certain foreign subsidiaries due to changes in foreign exchange rates. The notional amount of these hedges is $33 million, and all contracts mature by December 31, 2010. We do not apply hedge accounting for these hedges and all changes in their fair value are recorded to earnings. As of December 31, 2009, the fair value of these hedges was immaterial.

We have foreign exchange forward contracts to hedge purchases of our products denominated in non-functional currencies. The notional amount of these hedges is $23 million, and they mature by September 27, 2010. These forward contracts are designated as cash flow hedges and no ineffectiveness was recorded in 2009. Gains and losses on the contracts are reclassified into earnings when the underlying transactions affect earnings. The fair value of these hedges that remained in AOCI was immaterial as of December 31, 2009.

EMBEDDED DERIVATIVE INSTRUMENTS

The 10% convertible senior notes that we issued in 2008 bear interest at the rate of 10% per year. If, however, our stockholders had not approved the issuance of shares of our common stock upon conversion of the notes, the interest rate on the notes would have increased to 20% per annum. We evaluated this interest rate increase feature and determined that it was an embedded derivative that was required to be bifurcated and valued separately as of the date of issuance of the notes. The fair value of this embedded derivative was determined to be $21 million on the issuance date of the notes. This amount was recorded as a current liability and as a reduction to the initial carrying amount of the notes that will be amortized to interest expense over the life of the notes using the effective interest rate method. As of December 31, 2008, the fair value of this embedded derivative was $10 million, and the $11 million change in value was recorded as income in other income, net in 2008. Following approval of the conversion feature of the notes by our stockholders in February 2009, the value of the derivative became zero and the remaining $10 million liability was reversed to income in other income, net on the consolidated statement of operations.

COUNTERPARTY RISK

We are exposed to credit losses in the event of nonperformance by the counterparties to our derivative instruments. All of our counterparties have investment grade credit ratings; accordingly, we anticipate that they will be able to fully satisfy their obligations under the contracts. Additionally, the derivatives are governed by master netting agreements negotiated between us and the counterparties that reduce our counterparty credit exposure. The agreements outline the conditions (such as credit ratings and net derivative fair values) upon which we, or the counterparties, are required to post collateral. As of December 31, 2009, our derivatives were in a net liability position of $21 million, and we provided $19 million of collateral to our counterparties related to our derivatives. We have not adopted an accounting policy to offset fair value amounts related to derivative contracts under our master netting arrangements. Amounts paid as cash collateral are included in receivables on our consolidated balance sheets.

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FINANCIAL STATEMENT INFORMATION

The following are the pretax effects of derivative instruments on the consolidated statement of operations for the year ended December 31, 2009 (dollars in millions):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in Other Comprehensive Income on Derivatives (Effective Portion)	Location of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion)
Commodity contracts	$ (27)	Cost of products sold	$ (64)
Foreign exchange contracts	(2)	Cost of products sold	(1)
Total	$ (29)		$ (65)

Derivatives Not Designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain or (Loss) Recognized in Income on Derivatives
Interest rate contracts	Interest expense	$ (1)
Interest rate contracts	Other income, net	1
Commodity contracts	Cost of products sold	(4)
Foreign exchange contracts	Other income, net	1
Total		$ (3)

As of December 31, 2009, we had no derivatives designated as net investment or fair value hedges.

The following are the fair values of derivative instruments on the consolidated balance sheet as of December 31, 2009 (dollars in millions):

Derivatives	Assets		Liabilities	
Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Commodity contracts	Other current assets	$ 2	Accrued expenses	$ 13
Commodity contracts	Other assets	2	Other liabilities	13
	Total	$ 4	Total	$ 26

Derivatives Not	Assets		Liabilities	
Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Commodity contracts	Other current assets	$ 1	Accrued expenses	$ -
Total Derivatives		$ 5		$ 26

6. Fair Value Measurements

The fair values of our derivatives were determined using the fair value hierarchy of inputs described in Note 1. We primarily use readily observable market data in conjunction with internally developed valuation models when valuing our derivative portfolio and, consequently, we designate most of our derivatives as Level 2. As of December 31, 2009, our assets and liabilities measured at fair value on a recurring basis were as follows:

(millions)	As of December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Derivative assets	$ 5	$ -	$ 5	$ -
Derivative liabilities	(26)	-	(26)	-

Certain assets and liabilities are measured at fair value on a nonrecurring basis rather than on an ongoing basis, but are subject to fair value adjustments in certain circumstances such as when there is evidence of impairment or when a new liability is being established that requires fair value measurement. As of December 31, 2009, certain trade names were measured at fair value using measurements classified as Level 3. These trade names were measured at fair value on a nonrecurring basis as a result of an impairment test using the techniques and assumptions discussed in Note 3. We recorded noncash impairment charges of $31 million to write-down trade names to their fair value of $22 million. In addition, as disclosed in Note 2, we recorded impairment charges of $3 million to write-off the remaining value of machinery and equipment for certain plants that were permanently closed, also using fair value measurements classified as Level 3.

As of December 31, 2008, the fair value of the embedded derivative liability related to our 10% convertible senior notes was $10 million. Following our stockholders approval of the conversion feature of the notes in February 2009, the value of the derivative became zero and the remaining $10 million liability was reversed to income in other income, net on the consolidated statement of operations.

7. Employee Retirement Plans

We maintain defined benefit pension plans for most of our employees. Most of these plans require employee contributions in order to accrue benefits. Benefits payable under the plans are based on employees years of service and compensation during specified years of employment.

We also maintain plans that provide postretirement benefits (retiree health care and life insurance) for eligible employees. Employees hired before January 1, 2002 generally become eligible for the postretirement benefit plans when they meet minimum retirement age and service requirements. The cost of providing most postretirement benefits is shared with retirees.

During 2009, we modified our postretirement medical plan in response to continuing retiree health care cost increases. Effective January 1, 2011, the increase in the annual amount we will pay for retiree health care coverage for eligible existing retirees and for eligible active employees who may qualify for retiree health care coverage in the future will be limited to no more than 3% per year. This change resulted in a remeasurement of our accumulated postretirement benefit obligation, or APBO, on May 31, 2009, which reduced the obligation by $95 million. The assumptions used in the remeasurement of our APBO were unchanged from our December 31, 2008 valuation, except that the discount rate changed from 6.85% to 7.35% as of May 31, 2009.

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The components of net pension and postretirement benefit costs are summarized in the following table:

(millions)	2009	2008	2007
Pension Benefits:			
Service cost of benefits earned	$ 27	$ 34	$ 40
Interest cost on projected benefit obligation	68	69	67
Expected return on plan assets	(69)	(77)	(73)
Net amortization	5	8	12
Net pension cost	$ 31	$ 34	$ 46
Postretirement Benefits:			
Service cost of benefits earned	$ 7	$ 14	$ 15
Interest cost on projected benefit obligation	19	26	24
Net amortization	(14)	(8)	(3)
Net postretirement cost	$ 12	$ 32	$ 36

We use a December 31 measurement date for our plans. The accumulated benefit obligation, or ABO, for the defined benefit pension plans was $944 million as of December 31, 2009 and $881 million as of December 31, 2008. For defined benefit pension plans with plan assets having a fair value in excess of the ABO, the aggregate fair value of those plans assets was $162 million and the aggregate ABO was $134 million. For defined benefit plans with an ABO in excess of the fair value of plan assets, the aggregate ABO of those plans was $810 million and the aggregate fair value was $719 million.

The following table summarizes projected pension and accumulated postretirement benefit obligations, plan assets and funded status as of December 31:

	Pension		Postretirement	
(millions)	2009	2008	2009	2008
Change in Benefit Obligation:				
Benefit obligation as of January 1	$ 975	$ 1,125	$ 351	$ 411
Service cost	27	34	7	14
Interest cost	68	69	19	26

Participant contributions	10	12	6	5
Benefits paid	(98)	(99)	(22)	(19)
Medicare Part D subsidy receipts	-	-	1	2
Plan amendment	(8)	3	(84)	(29)
Actuarial loss (gain)	78	(132)	21	(53)
Foreign currency translation	23	(37)	5	(6)
Benefit obligation as of December 31	$ 1,075	$ 975	$ 304	$ 351
Change in Plan Assets:				
Fair value as of January 1	$ 750	$ 1,152	$ -	$ -
Actual return on plan assets	146	(299)	-	-
Employer contributions	49	22	16	14
Participant contributions	10	12	6	5
Benefits paid	(98)	(99)	(22)	(19)
Foreign currency translation	24	(38)	-	-
Fair value as of December 31	$ 881	$ 750	$ -	$ -
Funded status	$ (194)	$ (225)	$ (304)	$ (351)

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	Pension		Postretirement	
(millions)	2009	2008	2009	2008
Components on the Consolidated Balance Sheets:				
Noncurrent assets	$ 5	$ 10	$ -	$ -
Current liabilities	-	(2)	(17)	(16)
Noncurrent liabilities	(199)	(233)	(287)	(335)
Net liability as of December 31	$ (194)	$ (225)	$ (304)	$ (351)
Pretax Components in AOCI:				
Net actuarial loss	$ 329	$ 326	$ 29	$ 7
Prior service cost (credit)	3	13	(143)	(73)
Total as of December 31	$ 332	$ 339	$ (114)	$ (66)

For the defined benefit pension plans, we estimate that during the 2010 fiscal year we will amortize from AOCI into net pension cost a net actuarial loss of $14 million and prior service cost of $2 million. For the postretirement benefit plans, we estimate that during the 2010 fiscal year we will amortize from AOCI into net postretirement cost a prior service credit of $17 million.

ASSUMPTIONS

The following tables reflect the assumptions used in the accounting for our plans:

	Pension		Postretirement	
	2009	2008	2009	2008
Weighted average assumptions used to determine benefit obligations as of December 31:				
Discount rate	5.95%	6.85%	5.85%	6.85%
Compensation increase rate	3.50%	3.50%	-	-

Weighted average assumptions used to determine net cost for years ended December 31:				
Discount rate	6.85%	6.55%	6.85%	6.65%
Expected return on plan assets	7.00%	7.00%	-	-
Compensation increase rate	3.50%	4.00%	-	-

For the measurement of APBO at December 31, 2009, for our principal U.S. postretirement health care plan, the assumed health care cost trend rates start with an 8.1% increase in 2010 and a gradual decline in increases to 5.25% for 2015 and beyond. However, the annual increase to our contributions was limited to 3% effective January 1, 2011. For this measurement at December 31, 2008, the assumed health care cost trend rates started with a 7.95% increase in 2009 and a gradual decline in increase to 5.25% for 2013 and beyond.

Assumed health care cost trend rates can have a significant effect on the amounts reported for retiree health care costs. The impact will be mitigated by the 3% limit on our contributions for the principal U.S. plan effective January 1, 2011. A one percentage point change in the assumed health care cost trend rates would have the following effects:

(millions)	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on total service and interest cost	$ -	$ -
Effect on postretirement benefit obligation	(4)	3

RETIREMENT PLAN ASSETS

Investment Policies and Strategies: We have established investment policies and strategies for the defined benefit pension plans assets with a long-term objective of maintaining the plans assets at a level equal to or greater than that of their liabilities (as measured by a funded ratio of 100% or more of the ABO) and maximizing returns on the plans assets consistent with our moderate tolerance for risk. Contributions are made to the plans periodically as

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needed to meet funding targets or requirements. Factors influencing our determination to accept a moderate degree of risk include the timing of plan participants retirements and the resulting disbursement of retirement benefits, the liquidity requirements of the plans and our financial condition.

Our overall long-term objective is to achieve a 7.0% rate of return on plan assets with a moderate level of risk as indicated by the volatility of investment returns. This rate of return target was established using a building block approach. In this approach, ranges of long-term expected returns for the various asset classes in which the plans invest are estimated. The estimated ranges are primarily based on observations of historical asset returns and their historical volatility. In determining the expected returns, we also consider consensus forecasts of certain market and economic factors that influence returns, such as inflation, gross domestic product trends and dividend yields. Any adjustment made to historical returns is minor. We then calculate an overall range of likely expected rates of return by applying the expected asset returns to the plans target asset allocation. The most likely rate of return is then determined and is adjusted to account for investment management fees.

Our investment strategy is to invest in a diversified mix of asset classes in accordance with an asset allocation that we believe is likely to achieve our long-term target return while prudently considering risk. This strategy recognizes that many investment professionals believe that certain asset classes, such as equities, may be expected to produce the greatest return in excess of inflation over time, but may also generate the greatest level of volatility. Conversely, many investment professionals believe that an asset class such as fixed income securities may be likely to be less volatile, but may also produce lower returns over time. In order to manage risk, the plans pension and investment committees periodically rebalance their asset allocations and monitor the investment performance of the individual investment managers compared to their benchmark returns and investment guidelines on an ongoing basis, in part through the use of quarterly investment portfolio reviews and compliance reporting by investment managers. The pension and investment committees also evaluate risk by periodically conducting asset/liability studies to assess the correlation of the plans assets and liabilities and the degree of risk in the target asset allocations. The plans limit the use of leverage to select investment strategies where leverage is typically employed, such as private equity and real estate. Certain investment managers utilize derivatives, such as swaps, bond futures, and options, as part of their investment strategies. This is done primarily to gain a desired market exposure or manage factors such as interest rate risk or duration of a bond portfolio.

The target asset allocation for the plans and acceptable ranges around the targets as of December 31, 2009 were as follows:

	Investment Policy	
	Target	Range
Asset Categories:		
Equity securities	60%	55% - 65%
Fixed income securities	20%	15% - 30%
Limited partnerships	15%	7% - 17%
Real estate funds	5%	0% - 10%
Cash equivalents	0%	0% - 10%

Total	100%

Equity securities are primarily investments in the common stock of U.S. companies, but also include investments in the stock of non-U.S. companies. Those investments are in companies with a range of market capitalizations. Fixed income securities include U.S. Treasury securities, sovereign debt securities such as U.K. Gilts, corporate bonds of companies from diversified industries and mortgage-backed securities. Limited partnerships include investments in funds that follow several different strategies, including investing in distressed debt, energy development and infrastructure. These investments use strategies with returns normally expected to have a reduced correlation to the return of equities as compared to other asset classes and often provide a current income component that is a meaningful portion of the investment s total return. Real estate funds are primarily

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investments in large core, private real estate funds that directly own a diverse portfolio of properties located in the United States.

Fair Values of Plan Assets: The fair values of our defined benefit plans consolidated assets by asset category as of December 31 were as follows:

(millions)	2009	2008
Asset Categories:		
Equity securities	$ 572	$ 421
Fixed income securities	191	206
Limited partnerships	91	80
Real estate funds	19	34
Cash equivalents	8	9
Total	$ 881	$ 750

The fair values of our defined benefit plans consolidated assets were determined using the fair value hierarchy of inputs described in Note 1. The fair values by category of inputs as of December 31, 2009 were as follows:

(millions)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Asset Categories:				
Equity securities (a)	$ 572	$ -	$ -	$ 572
Fixed income securities (b)	190	1	-	191
Limited partnerships (c)	-	42	49	91
Real estate funds (d)	-	-	19	19
Cash equivalents	8	-	-	8
Total	$ 770	$ 43	$ 68	$ 881

(a) The majority of these funds are invested with investment managers that invest in common stocks of large capitalization U.S. companies. Approximately 84% of these investments are actively managed.

(b) Includes investments in individual fixed income securities and in institutional funds that invest in fixed income securities.

(c) Limited partnerships include investments in funds that follow several different strategies, including investing in distressed debt, energy development and infrastructure. These investments use strategies with returns normally expected to have a low correlation to the return of equities and often provide a current income component that is a meaningful portion of the investment s total return.

(d) Includes investments in three different private equity real estate funds that invest primarily in a variety of property types in geographically diverse markets across the U.S.

A reconciliation of the change in the fair value measurement of the defined benefit plans consolidated assets using significant unobservable inputs (Level 3) between December 31, 2008 and December 31, 2009 is as follows:

(millions)	Real Estate	Limited Partnerships	Total
Balance as of December 31, 2008	$ 34	$ 50	$ 84
Realized gains (losses) (a)	1	1	2
Unrealized gains (losses)	(15)	(5)	(20)
Purchases, sales and settlements	(1)	3	2
Balance as of December 31, 2009	$ 19	$ 49	$ 68

(a) All realized gains (losses) relate to assets held at the end of the year.

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CASH FLOWS

For 2010, our defined benefit pension plans have no minimum funding requirements under the Employee Retirement Income Security Act of 1974, or ERISA. We are evaluating our level of funding for pension plans and currently estimate that we will contribute approximately $45 million to our pension plans in 2010. Total benefit payments we expect to make to participants, which include payments funded from USG s assets as well as payments from our pension plans and the Medicare subsidy we expect to receive, are as follows (in millions):

Years ended December 31	Pension Benefits	Postretirement Benefits	Medicare Subsidy Receipts
2010	$ 51	$ 17	$ 2
2011	51	18	2
2012	53	19	2
2013	65	19	2
2014	65	20	2
2015-2019	442	111	12

8. Share-Based Compensation

We grant share-based compensation to eligible participants under our Long-Term Incentive Plan, or LTIP. The LTIP was approved by our Board of Directors and stockholders in 2006. A total of 8.2 million shares of common stock were authorized for grants under the LTIP, of which 2.6 million shares were reserved for future grants as of December 31, 2009. The LTIP authorizes the Board, or the Board s Compensation and Organization Committee, to provide equity-based compensation in the form of stock options, stock appreciation rights, or SARs, restricted stock, RSUs, performance shares and units, and other cash and share-based awards for the purpose of providing our officers and other employees incentives and rewards for performance. We may issue common shares upon option exercises and upon the vesting of other awards under the LTIP from our authorized but unissued shares or from treasury shares.

Our expense for share-based arrangements was $21 million in 2009, $24 million in 2008 and $20 million in 2007. The income tax benefit recognized for share-based arrangements in the consolidated statements of earnings was zero in 2009, $9 million in 2008 and $7 million in 2007. We recognize expense on all share-based awards over the service period, which is the shorter of the period until the employees retirement eligibility dates or the service period of the award for awards expected to vest. Accordingly, expense is generally reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

STOCK OPTIONS

We granted stock options in 2009, 2008 and 2007 at the closing price of USG common stock on the date of grant. The stock options generally become exercisable in four equal annual installments beginning one year from the date of grant, although they may become exercisable earlier in the event of death, disability, retirement or a change in control. The stock options generally expire 10 years from the date of grant, or earlier in the event of death, disability or retirement.

We estimated the fair value of each stock option granted on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. We based expected volatility on a 50% weighting of peer volatilities and 50% weighting of implied volatilities. We did not consider historical volatility of our common stock price to be an appropriate measure of future volatility because of the impact of our Chapter 11 proceedings on our historical stock price. The risk-free rate was based on zero coupon U.S. government issues at the time of grant. The expected term was developed using the simplified method, as permitted by the Securities and Exchange Commission s Staff Accounting Bulletin No. 110, because there is not sufficient historical stock option exercise experience available.

Assumptions:	2009	2008	2007
Expected volatility	62.58%	37.59%	35.45%
Risk-free rate	2.63%	3.20%	4.55%
Expected term (in years)	6.25	6.25	6.25
Expected dividends	-	-	-

A summary of stock options outstanding as of December 31, 2009 and of stock option activity during the fiscal year then ended is presented below:

	Number of Options (000)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (millions)
Outstanding at January 1, 2009	2,469	$ 41.81	7.68	$ -
Granted	1,349	6.86		
Exercised	-	-		
Canceled	(106)	38.54		
Forfeited	(110)	33.25		
Outstanding at December 31, 2009	3,602	$ 29.08	7.75	$ 10
Exercisable at December 31, 2009	1,188	$ 42.19	6.60	$ -
Vested or expected to vest at December 31, 2009	3,572	$ 29.15	7.86	$ 9

The weighted average grant date fair value was $4.12 for options granted during the year ended December 31, 2009, $14.78 for options granted during the year ended December 31, 2008 and $21.73 for options granted during the year ended December 31, 2007.

Intrinsic value for stock options is defined as the difference between the current market value of our common stock and the exercise price of the stock options. The total intrinsic value of stock options exercised was less than $1 million in each of 2008 and 2007. Cash received from the exercise of stock options was less than $1 million in each of 2008 and 2007. There were no stock options exercised in 2009. As a result of the net operating loss we reported for federal tax purposes for 2009, 2008 and 2007, none of the tax benefit with respect to these exercises has been reflected in capital received in excess of par value as of December 31, 2009. Included in our net operating loss carryforwards is $15 million for which a tax benefit of $5 million will be recorded in capital received in excess of par value when the loss carryforward is utilized.

As of December 31, 2009, there was $8 million of total unrecognized compensation cost related to nonvested share-based compensation awards represented by stock options granted under the LTIP. We expect that cost to be recognized over a weighted average period of two years. The total fair value of stock options vested was $11 million during the year ended December 31, 2009, $7 million during the year ended December 31, 2008 and $5 million during the year ended December 31, 2007.

RESTRICTED STOCK UNITS

We granted RSUs during 2009, 2008 and 2007. RSUs generally vest in four equal annual installments beginning one year from the date of grant. RSUs granted as special retention awards generally vest 100% after either four or five years from the date of grant. RSUs may vest earlier in the case of death, disability, retirement or a change in control. Each RSU is settled in a share of our common stock after the vesting period. The fair value of each RSU granted is equal to the closing market price of our common stock on the date of grant.

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RSUs outstanding as of December 31, 2009 and RSU activity during 2009 were as follows:

	Number of Shares (000)	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	492	$ 43.44
Granted	838	6.98
Vested	(173)	42.42
Forfeited	(36)	24.22
Nonvested at December 31, 2009	1,121	$ 16.96

As of December 31, 2009, there was $6 million of total unrecognized compensation cost related to nonvested share-based compensation awards represented by RSUs granted under the LTIP. We expect that cost to be recognized over a weighted average period of 1.78 years. The total fair value of RSUs that vested was $7 million during the year ended December 31, 2009, $7 million during the year ended December 31, 2008 and $6 million during the year ended December 31, 2007.

PERFORMANCE SHARES

We granted performance shares during 2009, 2008 and 2007. The performance shares generally vest after a three-year period based on our total stockholder return relative to the performance of the Dow Jones U.S. Construction and Materials Index, with adjustments to that index in certain circumstances, for the three-year period. The number of performance shares earned will vary from 0% to 200% of the number of performance shares awarded depending on that relative performance. Vesting will be pro-rated based on the number of full months employed during the performance period in the case of death, disability, retirement or a change in control, and pro-rated awards earned will be paid at the end of the three-year period. Each performance share earned will be settled in a share of our common stock.

We estimated the fair value of each performance share granted on the date of grant using a Monte Carlo simulation that uses the assumptions noted in the following table. Expected volatility is based on implied volatility of our traded options and the daily historical volatilities of our peer group. The risk-free rate was based on zero coupon U.S. government issues at the time of grant. The expected term represents the period from the grant date to the end of the three-year performance period.

Assumptions:	2009	2008	2007
Expected volatility	60.84%	35.16%	30.69%
Risk-free rate	1.40%	2.20%	4.55%
Expected term (in years)	2.89	2.92	2.78%
Expected dividends	-	-	-

Nonvested performance shares outstanding as of December 31, 2009 and performance share activity during 2009 were as follows:

	Weighted Number of Shares (000)	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	217	$ 44.70
Granted	350	8.94
Canceled	(77)	45.17
Forfeited	(21)	25.98
Nonvested at December 31, 2009	469	$ 18.74

No performance shares granted in 2007 were earned because the threshold level of total stockholder return relative to the performance of the Dow Jones U.S. Construction and Materials Index for the three-year period ended December 31, 2009 was not attained.

Total unrecognized compensation cost related to nonvested share-based compensation awards represented by performance shares granted under the LTIP was $4 million as of December 31, 2009. We expect that cost to be recognized over a weighted average period of 1.5 years.

NON-EMPLOYEE DIRECTOR DEFERRED STOCK UNITS

Our non-employee directors may elect to receive a portion of their compensation as deferred stock units that increase or decrease in value in direct relation to the market price of our common stock. Deferred stock units earned through December 31, 2007 will be paid in cash upon termination of board service. Deferred stock units earned thereafter will be paid in cash or shares of USG common stock, at the election of the director, upon termination of board service.

The number of deferred stock units held by non-employee directors was approximately 81,347 as of December 31, 2009, 76,877 as of December 31, 2008 and 21,085 as of December 31, 2007. We recorded $1 million to expenses in 2009 related to these units. The amounts recorded to expenses in 2008 and 2007 related to these units were less than $1 million for each year.

Pursuant to our Non-Employee Director Compensation Program, on December 31, 2009, our non-employee directors were entitled to receive an $80,000 annual grant, payable at their election in cash or shares of USG common stock with an equivalent value. Pursuant to this provision, a total of 5,550 shares of common stock were issued to one non-employee director based on the average of the high and low sales prices of a share of USG common stock on December 31, 2009.

9. Supplemental Balance Sheet Information

INVENTORIES

Inventories as of December 31 consisted of the following:

(millions)	2009	2008
Finished goods and work in progress	$ 232	$ 312
Raw materials	57	92
Total	$ 289	$ 404

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment as of December 31 consisted of the following:

(millions)	2009	2008
Land and mineral deposits	$ 114	$ 136
Buildings and improvements	1,141	1,133
Machinery and equipment	2,730	2,661
	3,985	3,930

Reserves for depreciation and depletion	(1,558)	(1,368)
Total	$ 2,427	$ 2,562

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ACCRUED EXPENSES

Accrued expenses as of December 31 consisted of the following:

(millions)	2009	2008
Self-insurance reserves	$ 54	$ 58
Employee compensation	48	49
Interest	45	33
Restructuring	21	50
Derivatives	13	45
Other	92	103
Total	$ 273	$ 338

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

AOCI as of December 31 consisted of the following:

(millions)	2009	2008
Unrecognized loss on pension and postretirement benefit plans, net of tax	$ (110)	$ (169)
Gain (loss) on derivatives, net of tax	1	(35)
Foreign currency translation, net of tax	29	(23)
Total	$ (80)	$ (227)

Reclassifications of net after-tax gains or losses from AOCI to earnings during 2009 consisted of the following:

(millions)	2009
Loss on derivatives, net of tax benefit of $0.4 million	$ (69)
Gain on unrecognized pension and postretirement benefit costs, net of tax benefit of $0.2 million	9
Total	$ 60

We estimate that we will reclassify a net $11 million after-tax loss on derivatives from AOCI to earnings within the next 12 months.

ASSET RETIREMENT OBLIGATIONS

Changes in our liability for asset retirement obligations during 2009 and 2008 consisted of the following:

(millions)	2009	2008
Balance as of January 1	$ 89	$ 85
Accretion expense	6	5
Liabilities incurred	6	3
Retirements	(2)	(1)
Foreign currency translation	2	(3)
Balance as of December 31	$ 101	$ 89

Our asset retirement obligations include reclamation requirements as regulated by government authorities related principally to assets such as our mines, quarries, landfills, ponds and wells. The accounting for asset retirement obligations requires estimates by management about the timing of asset retirements, the cost of retirement obligations, discount and inflation rates used in determining fair values and the methods of remediation associated with our asset retirement obligations. We generally use assumptions and estimates that reflect the most likely remediation method on a site-by-site basis. Asset retirement obligations are included in other liabilities on the consolidated balance sheets.

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10. Income Taxes

Earnings (loss) before income taxes consisted of the following:

(millions)	2009	2008	2007
U.S.	$ (359)	$ (618)	$ 11
Foreign	22	37	77
Total	$ (337)	$ (581)	$ 88

Income tax expense (benefit) consisted of the following:

(millions)	2009	2008	2007
Current:			
Federal	$ 3	$ (4)	$ 8
Foreign	10	4	19
State	1	(2)	(5)
	14	(2)	22
Deferred:			
Federal	357	(195)	2
Foreign	4	4	(11)
State	75	75	(2)
	436	(116)	(11)
Total (a)	$ 450	$ (118)	$ 11

(a) Income taxes (benefit) includes noncash deferred tax asset valuation allowances of $575 million in 2009, $71 million in 2008 and $(10) million in 2007.

Differences between actual provisions for income taxes and provisions for income taxes at the U.S. federal statutory rate (35%) were as follows:

(millions)	2009	2008	2007
Taxes on income at U.S. federal statutory rate	$ (118)	$ (203)	$ 31
Foreign earnings subject to different tax rates	(1)	(4)	(8)
State income tax, net of federal benefit	(1)	(21)	(2)
Change in valuation allowance	575	71	(10)
Goodwill impairment charges	-	34	-
Change in unrecognized tax benefits	(7)	3	10
Tax law changes	-	-	(10)
Other, net	2	2	-
Provision for income taxes (benefit)	$ 450	$ (118)	$ 11
Effective income tax rate	(133.2)%	20.4%	12.2%

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Significant components of deferred tax assets and liabilities as of December 31 were as follows:

(millions)	2009	2008
Deferred Tax Assets:		
Net operating loss and tax credit carryforwards	$ 706	$ 577
Pension and postretirement benefits	238	244
Goodwill and other intangible assets	27	37
Reserves not deductible until paid	47	35
Self insurance	13	11
Capitalized interest	13	12
Derivative instruments	25	23
Share-based compensation	24	19
Deferred tax assets before valuation allowance	1,093	958
Valuation allowance	(772)	(166)
Total deferred tax assets	$ 321	$ 792
Deferred Tax Liabilities:		
Property, plant and equipment	316	307
State taxes	2	29
Inventories	11	19
Other	7	2
Total deferred tax liabilities	336	357
Net deferred tax (liabilities) assets	$ (15)	$ 435

We have established a valuation allowance in the amount of $772 million consisting of $518 million for federal deferred tax assets, $250 million for state deferred tax assets and $4 million for foreign deferred tax assets.

As of December 31, 2009, we had federal NOL carryforwards of approximately $1.161 billion that are available to offset future federal taxable income and will expire in the years 2026-2029. In addition, as of that date, we had federal alternative minimum tax credit carryforwards of approximately $53 million that are available to reduce future regular federal income taxes over an indefinite period. In order to fully realize the U.S. federal net deferred tax assets, taxable income of approximately $1.311 billion would need to be generated during the period before their expiration. In addition, we have federal foreign tax credit carryforwards of $6 million that will expire in 2015.

As of December 31, 2009, we had a gross deferred tax asset related to our state NOLs and tax credit carryforwards of $250 million, of which $11 million expire in years 2010-2011, $14 million expire in 2012-2014, $31 million expire in 2015-2017, $17 million expire in 2018-2020, $49 million expire in 2021-2025, $105 million expire in 2026-2027, $12 million expire in 2028, $10 million expire in 2029 and $1 million does not expire. To the extent that we do not generate sufficient state taxable income within the statutory carryforward periods to utilize the NOL and tax credit carryforwards in these states, they will expire unused.

Accounting rules require a reduction of the carrying amounts of deferred tax assets by a valuation allowance if, based on the available evidence, it is more likely than not that such assets will not be realized. The need to establish valuation allowances for deferred tax assets is assessed periodically. In assessing the requirement for, and amount of, a valuation allowance in accordance with the more-likely-than-not standard, we give appropriate consideration to all positive and negative evidence related to the realization of the deferred tax assets. Under the accounting rules, this assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods, our experience with operating loss and tax credit carryforwards not expiring unused and tax planning alternatives. A history of cumulative losses for a certain threshold period is a significant form of negative evidence used in the assessment, and the accounting rules require that we have a policy regarding the duration of the threshold period. If a cumulative loss threshold is met,

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forecasts of future profitability may not be used as positive evidence related to the realization of the deferred tax assets in the assessment. Consistent with practices in the home building and related industries, we have a policy of four years as our threshold period for cumulative losses.

Based on our assessment, the uncertain and volatile market conditions in which we currently operate and the fact that we are now in a four-year cumulative loss position, we recorded a noncash deferred tax asset valuation allowance of $575 million in the year ended December 31, 2009. In future periods, the valuation allowance can be reversed based on sufficient evidence indicating that it is more likely than not that a portion of our deferred tax assets will be realized. Our net deferred tax liabilities were $15 million as of December 31, 2009, and net deferred tax assets were $435 million as of December 31, 2008.

We also had NOL and tax credit carryforwards in various foreign jurisdictions in the amount of $4 million as of December 31, 2009, against a portion of which we have historically maintained a valuation allowance.

The Internal Revenue Code imposes limitations on a corporation s ability to utilize NOLs if it experiences an ownership change. In general terms, an ownership change may result from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50 percentage points over a three-year period. If we were to experience an ownership change, utilization of our NOLs would be subject to an annual limitation determined by multiplying the market value of our outstanding shares of stock at the time of the ownership change by the applicable long-term tax-exempt rate, which was 4.16% for December 2009. Any unused annual limitation may be carried over to later years within the allowed NOL carryforward period. The amount of the limitation may, under certain circumstances, be increased or decreased by built-in gains or losses held by us at the time of the change that are recognized in the five-year period after the change. Many states have similar limitations. If an ownership change had occurred as of December 31, 2009, our annual U.S. federal NOL utilization would have been limited to approximately $58 million per year.

During the fourth quarter of 2008, the Internal Revenue Service, or IRS, concluded its audit of our federal income tax returns for the years 2005 and 2006. Upon final joint committee approval, which we received in the second quarter of 2009, the IRS audit was considered effectively settled. As a result of the audit, our federal taxable income for those years was increased by $8 million in the aggregate, most of which resulted in a decrease to the amount of our NOL at December 31, 2008.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

(millions)	2009	2008
Balance as of January 1	$ 47	$ 56
Tax positions related to the current period:		
Gross increase	-	4
Gross decrease	-	-
Tax positions related to prior periods:		
Gross increase	2	2
Gross decrease	(10)	(13)
Settlements	(3)	(1)

Lapse of statutes of limitations	(1)	(1)
Balance as of December 31	$ 35	$ 47

We classify interest expense and penalties related to unrecognized tax benefits and interest income on tax overpayments as components of income taxes (benefit). As of December 31, 2009, the total amount of interest expense and penalties recognized on our consolidated balance sheet was $4 million and $1 million, respectively. The total amount of interest and penalties recognized in our consolidated statement of operations for 2009 was $(1) million. The total amount of unrecognized tax benefit that, if recognized, would affect our effective tax rate was $33

76

million.

Our federal income tax returns for 2006 and prior years have been examined by the IRS. The U.S. federal statute of limitations remains open for the year 2004 and later years. We are also under examination in various U.S. state and foreign jurisdictions. It is possible that these examinations may be resolved within the next 12 months. Due to the potential for resolution of the state and foreign examinations and the expiration of various statutes of limitation, it is reasonably possible that our gross unrecognized tax benefit may change within the next 12 months by a range of $5 million to $10 million. Foreign and U.S. state jurisdictions have statutes of limitations generally ranging from three to five years.

We do not provide for U.S. income taxes on the portion of undistributed earnings of foreign subsidiaries that is intended to be permanently reinvested. The cumulative amount of such undistributed earnings totaled approximately $626 million as of December 31, 2009. These earnings would become taxable in the United States upon the sale or liquidation of these foreign subsidiaries or upon the remittance of dividends. The estimate of the amount of the deferred tax liability on such earnings is $26 million, consisting of foreign withholding taxes.

11. Earnings (Loss) Per Share

The reconciliation of basic earnings (loss) per share to diluted earnings per share is shown in the following table:

(millions, except share data)	Net Earnings (Loss)	Weighted Average Shares (000)	Per-Share Amount
2009:			
Basic loss	$ (787)	99,238	$ (7.93)
Diluted loss	$ (787)	99,238	$ (7.93)
2008:			
Basic loss	$ (463)	99,100	$ (4.67)
Diluted loss	$ (463)	99,100	$ (4.67)
2007:			
Basic earnings	$ 77	97,088	$ 0.80

Dilutive effect of stock options		215	
Diluted earnings	$ 77	97,303	$ 0.79

The diluted losses per share in 2009 and 2008 were computed using the weighted average number of common shares outstanding during the year.

The approximately 35.1 million shares issuable upon conversion of the $400 million of 10% convertible senior notes we issued in 2008 at the initial conversion price of $11.40 per share were not included in the computation of the diluted loss per share for 2009 and 2008 because their inclusion was anti-dilutive. Stock options, RSUs and performance shares with respect to 5.3 million common shares, 3.3 million common shares and 1.6 million common shares were not included in the computation of diluted earnings (loss) per share for 2009, 2008 and 2007, respectively, because they were anti-dilutive.

In March 2007, we completed a public offering of 9.06 million shares of our common stock at a price of $48.60 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, were approximately $422 million. We used the net proceeds of the equity offering for the acquisition of California Wholesale Material Supply, Inc., or CALPLY, and for general corporate purposes.

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12. Segments

REPORTABLE SEGMENTS

(millions)	2009	2008	2007
Net Sales:			
North American Gypsum	$ 1,770	$ 2,358	$ 2,837
Building Products Distribution	1,289	1,993	2,291
Worldwide Ceilings	663	846	813
Eliminations	(487)	(589)	(739)
Total	$ 3,235	$ 4,608	$ 5,202
Operating Profit (Loss):			
North American Gypsum	$ (9)	$ (241)	$ 84
Building Products Distribution	(172)	(243)	91
Worldwide Ceilings	62	68	75
Corporate	(71)	(97)	(110)
Eliminations	5	1	27
Total	$ (185)	$ (512)	$ 167
Depreciation, Depletion and Amortization:			
North American Gypsum	$ 146	$ 141	$ 124
Building Products Distribution	13	13	14
Worldwide Ceilings	19	19	17

Corporate	25	9	21
Total	$ 203	$ 182	$ 176
Capital Expenditures:			
North American Gypsum	$ 36	$ 213	$ 425
Building Products Distribution	5	6	6
Worldwide Ceilings	3	19	15
Corporate	-	-	14
Total	$ 44	$ 238	$ 460
Assets:			
North American Gypsum	$ 2,558	$ 2,677	$ 2,738
Building Products Distribution	371	571	801
Worldwide Ceilings	391	455	466
Corporate	816	1,068	713
Eliminations	(39)	(52)	(64)
Total	$ 4,097	$ 4,719	$ 4,654

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GEOGRAPHIC INFORMATION

(millions)	2009	2008	2007
Net Sales:			
United States	$ 2,725	$ 3,942	$ 4,568
Canada	339	428	426
Other Foreign	335	482	443
Geographic transfers	(164)	(244)	(235)
Total	$ 3,235	$ 4,608	$ 5,202
Long-Lived Assets:			
United States	$ 2,192	$ 2,390	$ 2,402
Canada	174	165	217
Other Foreign	300	283	293
Total	$ 2,666	$ 2,838	$ 2,912

OTHER SEGMENT INFORMATION

Segment operating profit (loss) includes all costs and expenses directly related to the segment involved and an allocation of expenses that benefit more than one segment.

The consolidated operating loss in 2009 included restructuring and long-lived asset impairment charges of $80 million. On a segment basis, $39 million of the total amount related to Building Products Distribution, $25 million to North American Gypsum, $5 million to Worldwide Ceilings and $11 million to Corporate. The consolidated operating loss in 2009 also included goodwill and other intangible asset impairment charges of $43 million. On a segment basis, $41 million of the total amount related to Building Products Distribution and $2 million to Worldwide Ceilings. The consolidated operating loss in 2009 also included litigation settlement income, net of fees, of $97 million from our lawsuit against Lafarge North America Inc. and Lafarge S.A. as discussed in Note 16. The total amount of this settlement related to the North American Gypsum segment.

The consolidated operating loss in 2008 included restructuring and long-lived asset impairment charges of $98 million. On a segment basis, $48 million of the total amount related to North American Gypsum, $34 million to

Building Products Distribution, $5 million to Worldwide Ceilings and $11 million to Corporate. The consolidated operating loss in 2008 also included goodwill and other intangible asset impairment charges of $226 million. On a segment basis, $213 million of the total amount related to Building Products Distribution, $12 million to Worldwide Ceilings and $1 million to North American Gypsum.

The consolidated operating profit in 2007 included restructuring and long-lived asset impairment charges of $26 million. On a segment basis, $18 million of the total amount related to North American Gypsum, $2 million to Worldwide Ceilings, $1 million to Building Products Distribution and $5 million to Corporate.

See Note 2 for additional information regarding restructuring and long-lived asset impairment charges. See Note 3 for additional information regarding goodwill and other intangible asset impairment charges.

Revenues are attributed to geographic areas based on the location of the assets producing the revenues. Transactions between reportable segments and geographic areas are accounted for at transfer prices that are approximately equal to market value. Intercompany transfers between segments (shown above as eliminations) largely reflect intercompany sales from U.S. Gypsum to L&W Supply. Geographic transfers largely reflect intercompany sales from U.S. Gypsum and USG Interiors, Inc. to CGC and USG Mexico.

On a worldwide basis, The Home Depot, Inc. accounted for approximately 14% of our consolidated net sales in 2009, approximately 10% in 2008 and approximately 11% in 2007. All three reportable segments had net sales to The Home Depot, Inc. in each of those years.

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13. Acquisitions

We record acquisitions using the purchase method of accounting and include the results of operations of the businesses acquired in our consolidated results as of the date of acquisition. We allocate the purchase price of acquisitions to the tangible assets, intangible assets and liabilities acquired based on fair values. The excess purchase price over those fair values is recorded as goodwill. The fair value assigned to assets acquired is based on valuations using management s estimates and assumptions. Pro forma combined results of operations for the year ended December 31, 2007 would not be materially different as a result of the acquisitions described below and, therefore, are not presented.

California Wholesale Material Supply, Inc.: On March 30, 2007, L&W Supply purchased the outstanding stock of CALPLY for approximately $268 million. This amount included debt repaid at closing and acquisition-related expenses and was net of CALPLY s cash at closing. CALPLY sells building products and provides services to acoustical contractors, drywall contractors, plaster contractors, roofing companies, manufactured housing companies, countertop fabricators, government institutions and exporters.

Grupo Supremo: On March 28, 2007, USG Mexico purchased the assets of Grupo Supremo, located in the central north region of Mexico, the businesses of which include extracting gypsum rock from several mines and manufacturing plaster products. The total purchase price was approximately $12 million including acquisition-related expenses.

14. Stockholder Rights Plan

On December 21, 2006, our Board of Directors approved the adoption of a new stockholder rights plan. The plan was amended on December 5, 2008. Under the rights plan, if any person or group acquires beneficial ownership of 15% or more of our then-outstanding voting stock, stockholders other than the 15% triggering stockholder will have the right to purchase additional shares of our common stock at half the market price, thereby diluting the triggering stockholder. During a seven-year standstill period that expires in August 2013, Berkshire Hathaway Inc. (and certain of its affiliates) will not trigger the rights so long as Berkshire Hathaway complies with the terms of a shareholder s agreement we entered into with Berkshire Hathaway in connection with its backstop commitment and, following that seven-year standstill period, the term Acquiring Person will not include Berkshire Hathaway (and certain of its affiliates) unless Berkshire Hathaway and its affiliates acquire beneficial ownership of more than 50% of our voting stock on a fully diluted basis. Among other things, the shareholder s agreement limits during the standstill period Berkshire Hathaway s acquisitions of beneficial ownership of our voting stock to 40% of our voting stock on a fully diluted basis, except in limited circumstances, and the manner in which it may seek to effect an acquisition or other extraordinary transaction involving USG.

The rights issued pursuant to the stockholder rights plan will expire on January 2, 2017. However, our Board of Directors has the power to accelerate or extend the expiration date of the rights. In addition, a Board committee composed solely of independent directors will review the rights plan at least once every three years to determine whether to modify the plan in light of all relevant factors. The first of those reviews was conducted in November 2009, and no modification of the plan was adopted. The next review is required by the end of 2012.

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15. Commitments and Contingencies

We lease some of our offices, buildings, machinery and equipment, and autos under noncancelable operating leases. These leases have various terms and renewal options. Lease expense amounted to $94 million in 2009, $107 million in 2008 and $123 million in 2007. Future minimum lease payments required under operating leases with initial or remaining noncancelable terms in excess of one year as of December 31, 2009 were $79 million in 2010, $64 million in 2011, $49 million in 2012, $39 million in 2013 and $26 million in 2014. The aggregate obligation after 2014 was $112 million.

16. Litigation

CHINESE-MANUFACTURED DRYWALL LAWSUITS

L&W Supply Corporation is a defendant, along with many other companies, in lawsuits relating to Chinese-made wallboard installed in homes primarily in the southeastern United States. The wallboard was manufactured in China by a number of manufacturers, including Knauf Plasterboard (Tianjin) Co., and was sold or used by many distributors, contractors, and homebuilders. Knauf Tianjin is an affiliate or indirect subsidiary of Knauf Gips KG, a multinational manufacturer of building materials headquartered in Germany. L&W Supply Corporation sold some Knauf Tianjin wallboard primarily in the Florida region in 2006. Other defendants in these lawsuits include Knauf Tianjin, two other Knauf Chinese wallboard facilities, Knauf Gips KG, other Chinese wallboard manufacturers unrelated to Knauf, homebuilders, contractors, and other distributors. These lawsuits claim that the Chinese-made wallboard is defective and emits high levels of sulfur causing, among other things, a bad smell and corrosion of copper or other metal surfaces. Most of the lawsuits also allege that the Chinese-made wallboard causes health problems such as respiratory problems and allergic reactions. Some of the lawsuits are brought by individual homeowners and some are class actions brought on behalf of a group of homeowners who claim their homes contain defective Chinese-made wallboard. The plaintiffs seek unspecified damages for the costs of removing and replacing the Chinese-made wallboard and other allegedly damaged property as well as damages for personal injury, including medical monitoring in some cases.

As more specifically described below, L&W Supply Corporation has been dismissed from some of the Chinese wallboard lawsuits on the basis that it did not supply the wallboard installed in the plaintiffs homes. Our records contain the addresses of the homes and other construction sites to which L&W Supply delivered wallboard (although, as is typical in the industry, our records do not specifically identify the manufacturer of the wallboard delivered). Therefore, where Chinese-made wallboard is identified in a home, we can determine from our records whether L&W Supply delivered wallboard to that home.

As of the end of the fourth quarter of 2009, L&W Supply Corporation was a defendant in lawsuits filed in federal courts in Florida, Louisiana, and Alabama relating to Chinese-made wallboard. In June 2009, all federal court lawsuits, wherever they were originally filed, were transferred by the Judicial Panel on Multi-District Litigation to the United States District Court for the Eastern District of Louisiana for consolidated pretrial proceedings. The multi-district litigation is titled *In re Chinese-Manufactured Drywall Products Liability Litigation*, MDL No. 2047. In December 2009, more than 2,600 homeowners joined in an omnibus class action complaint filed in the multi-district litigation naming as defendants Knauf Tianjin and approximately 500 other defendants, including other manufacturers of Chinese-made wallboard, homebuilders, distributors (including L&W Supply Corporation), and contractors. Of the approximately 2,600 plaintiffs who recently joined in the omnibus class action complaint filed in the multi-district federal litigation, 36 of those plaintiffs specifically named L&W Supply Corporation as the supplier of wallboard to their home. However, approximately 1,900 of the 2,600 plaintiffs did not identify the distributor that allegedly supplied the drywall installed in their home. We are in the process of reviewing our records to determine the total number of homes involved in the omnibus complaint to which L&W Supply Corporation delivered wallboard. Based on the information available to date, we do not believe that number will be significant. In addition to being a defendant in the omnibus multi-district class action complaint, L&W Supply Corporation was named as a defendant in approximately 140 other federal lawsuits that are now part of the multi-district litigation. We have been dismissed from 79 of those lawsuits on the basis that we did not supply the wallboard used in the plaintiffs homes. We expect to be dismissed from the remainder of these lawsuits for the same reason.

L&W Supply Corporation is also a defendant in state court lawsuits filed in Florida and Louisiana relating to Chinese-made wallboard. As of December 31, 2009, L&W Supply Corporation was a defendant in 119 individual homeowner lawsuits and one homeowner class action filed in Florida state court and five individual homeowner lawsuits filed in Louisiana state court. Based on a review of our records, we do not believe that L&W Supply sold or delivered wallboard (including Knauf Tianjin wallboard) to any of the homes identified in any of the Florida or Louisiana state court homeowner lawsuits. Plaintiffs counsel have informed us that we will be dismissed from the 119 individual Florida homeowner lawsuits. L&W Supply Corporation is also a defendant in a lawsuit filed by Lennar Homes in Florida state court relating to Knauf Tianjin wallboard installed in homes built by Lennar in Florida. Our records indicate that L&W Supply Corporation delivered wallboard to 16 of the more than 400 homes in Florida that are part of the Lennar state court lawsuit.

In addition to the homeowner lawsuits, in January 2010, L&W Supply Corporation was named as a defendant in a lawsuit filed by the Louisiana Attorney General against manufacturers, distributors, and homebuilders relating to Chinese drywall. The Louisiana Attorney General seeks to recover alleged losses to the state as a result of Chinese-made drywall installed in Louisiana homes. L&W Supply did not sell any Knauf Tianjin wallboard in Louisiana. L&W Supply Corporation sold in Louisiana in 2006 a limited amount of Knauf wallboard made at a different Knauf plant in China, but we are not aware of any evidence showing problems with this wallboard.

Although USG Corporation did not manufacture, distribute, or sell any Chinese-made wallboard, all of the Chinese-made wallboard lawsuits filed against L&W Supply Corporation also name USG Corporation as a defendant. The lawsuit recently filed by the Louisiana Attorney General also names U.S. Gypsum and USG Interiors, Inc. as defendants, although neither company manufactured, distributed, or sold any Chinese-made wallboard.

The Chinese-made wallboard cases are in a preliminary stage, and we expect that additional similar suits will be filed. However, we believe that L&W Supply s sales of the allegedly defective Knauf Tianjin wallboard, which were confined to the Florida region, were limited. Based on our records, we believe that the amount of Knauf Tianjin wallboard potentially sold by L&W Supply Corporation would completely furnish approximately 250-300 average-size homes, although the actual number of homes could be somewhat larger because some homes may contain a mixture of different brands of wallboard. To date, L&W Supply Corporation has received lawsuits or claims outside of litigation relating to approximately 115 houses or condominium units to which it has confirmed it delivered Knauf Tianjin wallboard. Of that number, it has resolved the claims relating to approximately 50 of those homes. L&W Supply Corporation sold other Chinese-made wallboard, primarily manufactured by Knauf entities, but we are not aware of any instances in which the non-Tianjin Knauf wallboard sold by L&W Supply Corporation has been determined to cause odor or corrosion problems. If the other Knauf Chinese-made wallboard is determined to cause such problems, claims against L&W Supply Corporation and its potential liability could increase.

We have recorded appropriate reserves in connection with the Chinese-manufactured wallboard lawsuits. Taking into account all factors known to date, including that we did not manufacture the allegedly defective wallboard and sold a limited amount of the Knauf Tianjin wallboard, we do not believe that these lawsuits and other similar lawsuits that might be filed will have a material adverse effect on our results of operations, financial position or cash flows. However, there can be no assurance that the lawsuits will not have such an effect.

ENVIRONMENTAL LITIGATION

We have been notified by state and federal environmental protection agencies of possible involvement as one of numerous potentially responsible parties in a number of Superfund sites in the United States. As a potentially responsible party, we may be responsible to pay for some part of the cleanup of hazardous waste at those sites. In

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most of these sites, our involvement is expected to be minimal. In addition, we are involved in environmental cleanups of other property that we own or owned. We believe that appropriate reserves have been established for our potential liability in connection with these matters. Our reserves take into account all known or estimated undiscounted costs associated with these sites, including site investigations and feasibility costs, site cleanup and remediation, certain legal costs, and fines and penalties, if any. However, we continue to review these accruals as additional information becomes available and revise them as appropriate.

PATENT AND TRADE SECRETS LAWSUIT

U.S. Gypsum was the plaintiff in a lawsuit against Lafarge North America Inc., a manufacturer and seller of gypsum wallboard in the United States, and its parent, Lafarge S.A., a French corporation, or together Lafarge. The lawsuit, filed in 2003 in the federal district court for the Northern District of Illinois, alleged that Lafarge misappropriated our trade secrets and other information through hiring certain U.S. Gypsum employees (a number of whom were also defendants), and that Lafarge infringed one of our patents regarding a method for producing gypsum wallboard. On December 4, 2009, U.S. Gypsum entered into a settlement agreement with Lafarge to resolve the lawsuit. Pursuant to the settlement agreement, Lafarge agreed to pay U.S. Gypsum $105 million, the lawsuit was dismissed, and U.S. Gypsum granted Lafarge a fully paid-up license to use certain technology. Lafarge paid U.S. Gypsum $80 million ($74 million net of fees) in December 2009 and will pay U.S. Gypsum an additional $25 million no later than December 1, 2010.

OTHER LITIGATION

We are named as defendants in other claims and lawsuits arising from our operations, including claims and lawsuits arising from the operation of our vehicles, product warranties, personal injury and commercial disputes. We believe that we have recorded appropriate reserves for these claims and suits, taking into account the probability of liability, whether our exposure can be reasonably estimated and, if so, our estimate of our liability or the range of our liability. We do not expect these or any other litigation matters involving USG to have a material adverse effect upon our results of operations, financial position or cash flows.

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17. Quarterly Financial Data (unaudited)

	Quarter					
(millions, except share data)	First	Second	Third		Fourth	
2009:						
Net sales	$ 864	$ 829	$ 822		$ 720	
Gross profit	48	51	38		8	
Operating loss	(42)	(40)	(92)	(a)	(11)	(b)
Net loss	(42)	(53)	(94)	(a)	(598)	(b)
Loss Per Common Share:						
Basic	(0.42)	(0.53)	(0.96)	(a)	(6.02)	(b)
Diluted	(0.42)	(0.53)	(0.96)	(a)	(6.02)	(b)
2008:						
Net sales	$ 1,165	$ 1,251	$ 1,211		$ 981	
Gross profit	46	76	64		6	
Operating loss	(60)	(39)	(32)		(381)	(c)
Net loss	(41)	(37)	(36)		(349)	(c)
Loss Per Common Share:						
Basic	(0.42)	(0.37)	(0.36)		(3.52)	(c)
Diluted	(0.42)	(0.37)	(0.36)		(3.52)	(c)

(a) Operating loss and net loss for the third quarter of 2009 included goodwill and other intangible asset impairment charges of $41 million, or $0.41 per diluted share.

(b) Operating loss and net loss for the fourth quarter of 2009 included litigation settlement income, net of fees, of $97 million, or $0.98 per diluted share, from our lawsuit against Lafarge. Net loss for the fourth quarter of 2009 also included a tax valuation allowance charge of $548 million, or $5.52 per diluted share.

(c) Operating loss and net loss for the fourth quarter of 2008 included goodwill and other intangible asset impairment charges of $226 million pretax ($177 million after-tax, or $1.78 per diluted share). Net loss for the fourth quarter of 2008 also included a tax valuation allowance charge of $61 million, or $0.62 per diluted share.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of USG Corporation:

We have audited the accompanying consolidated balance sheets of USG Corporation and subsidiaries (the Corporation) as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedule, Schedule II-Valuation and Qualifying Accounts. These consolidated financial statements and financial statement schedule are the responsibility of the Corporation s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of USG Corporation and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation s internal control over financial reporting as of December 31, 2009, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 12, 2010 expressed an unqualified opinion on the Corporation s internal control over financial reporting.

DELOITTE & TOUCHE LLP
Chicago, Illinois
February 12, 2010

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USG CORPORATION
SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

(millions)	Beginning Balance	Additions (a)	Deductions (b)	Ending Balance
Year ended December 31, 2009:				
Doubtful accounts	$ 11	$ 12	$ (9)	$ 14
Cash discounts	4	28	(30)	2
Year ended December 31, 2008:				
Doubtful accounts	12	6	(7)	11
Cash discounts	5	43	(44)	4
Year ended December 31, 2007:				
Doubtful accounts	11	7 (c)	(6)	12
Cash discounts	5	50	(50)	5

(a) Reflects provisions charged to earnings.

(b) Reflects receivables written off as related to doubtful accounts and discounts allowed as related to cash discounts.

(c) Includes doubtful accounts from acquisitions of $3 million.

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Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

Item 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, or the Act), have concluded that, as of the end of the fiscal year covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer s management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(a) MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and our Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2009. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in *Internal Control Integrated Framework*. Based on its assessment, management believes that, as of December 31, 2009, our internal control over financial reporting is effective based on those criteria.

Our independent registered public accounting firm has issued an attestation report on our internal control over financial reporting. This report appears below.

February 12, 2010

(b) REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of USG Corporation:

We have audited the internal control over financial reporting of USG Corporation and subsidiaries (the Corporation) as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Corporation s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Corporation s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A corporation s internal control over financial reporting is a process designed by, or under the supervision of, the corporation s principal executive and principal financial officers, or persons performing similar functions, and effected by the corporation s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A corporation s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the corporation; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the corporation are being made only in accordance with authorizations of management and directors of the corporation; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the corporation s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2009 of the Corporation and our report dated February 12, 2010 expressed an unqualified opinion on those financial statements.

DELOITTE & TOUCHE LLP
Chicago, Illinois
February 12, 2010

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(c) CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) promulgated under the Act) identified in connection with the evaluation required by Rule 13a-15(d) promulgated under the Act that occurred during the fiscal quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9A(T). CONTROLS AND PROCEDURES

Not applicable

Item 9B. OTHER INFORMATION

On February 10, 2010, our Board of Directors approved our 2010 Annual Management Incentive Program. Under the program, 40% of the par incentive award for each of our named executive officers is based on a formula related to adjusted consolidated net earnings and 60% is based on specified operating and financial targets.

On February 10, 2010, the Board of Directors also approved the following operating and financial targets for our named executive officers under the 2010 Annual Management Incentive Program: Building Systems adjusted operating profit, L&W Supply adjusted operating profit, International adjusted operating profit, United States wallboard spread, United States wallboard cost, adjusted EBITDA and average quarterly liquidity. Each named executive officer is assigned one or more of the first four of these targets and two of the last three of these targets.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Executive Officers of the Registrant (as of February 12, 2010):

Name	**Age**	**Present Position and Business Experience During the Last Five Years**
William C. Foote	58	Chairman and Chief Executive Officer since January 2006. Chairman, Chief Executive Officer and President prior thereto.
James S. Metcalf	52	President and Chief Operating Officer since January 2006. Executive Vice President; President, USG Building Systems, prior thereto.
Stanley L. Ferguson	57	Executive Vice President and General Counsel.
Richard H. Fleming	62	Executive Vice President and Chief Financial Officer.
Brian J. Cook	52	Senior Vice President, Human Resources.
D. Rick Lowes	55	Senior Vice President and Controller since May 2007. Vice President and Controller prior thereto.
Dominic A. Dannessa	53	Senior Vice President and Chief Technology Officer since February 2010. Vice President and Chief Technology Officer to February 2010. Vice President, Supply Chain, Information Technology and Corporate Efficiency Initiatives to July 2008. Vice President; Executive Vice President, Manufacturing, USG Building Systems, to January 2008. Senior Vice President, Manufacturing, United States Gypsum Company, prior thereto.

Name	Age	Present Position and Business Experience During the Last Five Years
Brendan J. Deely	44	Senior Vice President since February 2010 and President and Chief Executive Officer, L&W Supply Corporation, since May 2007. Vice President to February 2010; President and Chief Operating Officer, L&W Supply Corporation, to May 2007. Senior Vice President and Chief Operating Officer, L&W Supply Corporation, to June 2005.
Christopher R. Griffin	47	Senior Vice President since February 2010 and President, USG International and President, CGC Inc., since January 2008. Vice President to February 2010. President, CGC Inc., to January 2008.
Fareed A. Khan	44	Senior Vice President since February 2010 and President, USG Building Systems, since January 2008. Vice President to February 2010. Executive Vice President, Sales and Marketing, USG Building Systems, to January 2008. Senior Vice President, Supply Chain and CRM and IT, United States Gypsum Company, to January 2006.
Karen L. Leets	53	Vice President and Treasurer.
Mary A. Martin	54	Vice President and Associate General Counsel since July 2009. Associate General Counsel prior thereto.
Ellis A. Regenbogen	63	Vice President since February 2008 and Corporate Secretary and Associate General Counsel since October 2006. Associate General Counsel and Assistant Secretary to October 2006. Associate General Counsel Securities and Governance, Sears Holdings Corporation, to April 2006. Assistant General Counsel Corporate and Securities, Sears, Roebuck and Co., to April 2005.
Jeffrey P. Rodewald	55	Vice President, Employee Benefits, Safety and Corporate Services since July 2009. Senior Director, Employee Benefits, Safety and Corporate Services to July 2009. Director, Employee Benefits, USG Corporation, and Vice President, Human Resources, USG International, to September 2007. Director, Human Resources, USG Corporation, and Vice President, Human Resources, USG International, to January 2006.
Jennifer F. Scanlon	43	Vice President and Chief Information Officer since February 2008. Director, Information Technology, and Chief Information Officer to February 2008. Director, CRM/SCM Strategy and Implementation, USG Building Systems, to May 2007.

Committee Charters and Code of Business Conduct

Our Corporate Code of Business Conduct (applicable to directors, officers and employees), our Corporate Governance Guidelines and the charters of the committees of our Board of Directors, including the Audit Committee, Governance Committee and Compensation and Organization Committee, are available through the Investor Relations and Corporate Governance links in the Company Information section of our Web site at www.usg.com.

Other information required by this Item 10 is included under the headings Director Nominees and Directors Continuing in Office, Committees of the Board of Directors, Audit Committee and Section 16(a) Beneficial Ownership Reporting Compliance in the definitive Proxy Statement for our annual meeting of stockholders scheduled to be held on May 12, 2010, which information is incorporated herein by reference.

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Item 11. EXECUTIVE COMPENSATION

Information required by this Item 11 is included under the heading Compensation of Executive Officers and Directors in the definitive Proxy Statement for our annual meeting of stockholders scheduled to be held on May 12, 2010, which information is incorporated herein by reference.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth information about our common stock that may be issued upon exercise of options under all of our equity compensation plans as of December 31, 2009, including the Long-Term Incentive and Omnibus Management Incentive Plans, both of which were approved by our stockholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options and rights	Weighted average exercise price of outstanding options and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reported in column one)
Equity compensation plans approved by stockholders	3,586,522	$29.01	2,638,138
Equity compensation plans not approved by stockholders	-	-	-
Total	3,586,522	$29.01	2,638,138

Other information required by this Item 12 is included under the headings Principal Stockholders and Security Ownership of Directors and Executive Officers in the definitive Proxy Statement for our annual meeting of stockholders scheduled to be held on May 12, 2010, which information is incorporated herein by reference.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required by this Item 13 is included under the heading Certain Relationships and Related Transactions in the definitive Proxy Statement for our annual meeting of stockholders scheduled to be held on May 12, 2010, which information is incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information required by this Item 14 is included under the heading Independent Registered Public Accounting Firm Fees and Services in the definitive Proxy Statement for our annual meeting of stockholders scheduled to be held on May 12, 2010, which information is incorporated herein by reference.

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PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1 and 2. See Part II, Item 8, Financial Statements and Supplementary Data, for an index of our consolidated financial statements and supplementary data schedule.

3. Exhibits

Exhibit Number	Exhibit
Plan of Reorganization:	
2.1	First Amended Joint Plan of Reorganization of USG Corporation and its Debtor Subsidiaries (incorporated by reference to Exhibit 2.01 to USG Corporation s Current Report on Form 8-K filed June 21, 2006, or the June 2006 8-K)
2.2	Order Confirming First Amended Joint Plan of Reorganization (incorporated by reference to Exhibit 2.02 to the June 2006 8-K)
Articles of Incorporation and By-Laws:	
3.1	Restated Certificate of Incorporation of USG Corporation (incorporated by reference to Exhibit 3.0 to the June 2006 8-K)
3.2	Certificate of Designation of Junior Participating Preferred Stock, Series D, of USG Corporation (incorporated by reference to Exhibit A of Exhibit 4 to USG Corporation s Current Report on Form 8-K dated March 27, 1998)
3.3	Amended and Restated By-Laws of USG Corporation, dated as of May 13, 2009 (incorporated by reference to Exhibit 3.1 to USG Corporation s Current Report on Form 8-K dated May 19, 2009)
Instruments Defining the Rights of Security Holders, Including Indentures:	
4.1	Form of Common Stock certificate (incorporated by reference to Exhibit 4.1 to USG Corporation s Annual Report on Form 10-K dated February 16, 2007)
4.2	Rights Agreement, dated as of December 21, 2006, between USG Corporation and Computershare Investor Services, LLC, as Rights Agent (incorporated by reference to Exhibit 4.1 to USG Corporation s Registration Statement on Form 8-A dated December 21, 2006)
4.3	Amendment to Rights Agreement, dated as of December 5, 2008, to the Rights Agreement, dated as of December 21, 2006, by and between USG Corporation and Computershare Investor Services, LLC, as Rights Agent (incorporated by reference to Exhibit 4.1 to USG Corporation s Amendment No. 1 to Form 8-A dated December 5, 2008)
4.4	Indenture, dated as of November 1, 2006, by and between USG Corporation and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.01 to USG Corporation s Current Report on Form 8-K dated November 20, 2006, or the November 2006 8-K)
4.5	Supplemental Indenture No. 1, dated as of November 17, 2006, by and between USG Corporation and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.02 to the

November 2006 8-K)

4.6 Form of 7.750% Senior Note due 2018 (incorporated by reference to USG Corporation s Current Report on Form 8-K dated September 26, 2007)

4.7 Indenture, dated as of November 1, 2008, by and between USG Corporation and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.1 to USG Corporation s Current Report on Form 8-K dated November 26, 2008, or the November 2008 8-K)

4.8 Supplemental Indenture No. 1, dated as of November 26, 2008, by and between USG Corporation and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.2 to the November 2008 8-K)

4.9 Agreement of Resignation, Appointment and Acceptance, dated as of February 11, 2009, by and among USG Corporation, HSBC Bank USA, National Association and Wells Fargo Bank, N.A. (incorporated by reference to Exhibit 10.1 to USG Corporation s Quarterly Report on Form 10-Q dated May 4, 2009)

4.10 Supplemental Indenture No. 2, dated as of August 4, 2009, between USG Corporation, each of United States Gypsum Company, L&W Supply Corporation, USG Foreign Investments, Ltd. and USG Interiors, Inc. and HSBC Bank USA, National Association, as trustee (incorporated by reference to Exhibit 4.01 to USG Corporation s Current Report on Form 8-K dated August 4, 2009)

USG Corporation and certain of its consolidated subsidiaries are parties to other long-term debt instruments under which the total amount of securities authorized does not exceed 10% of the total assets of USG Corporation and its subsidiaries on a consolidated basis. Pursuant to paragraph (b)(4)(iii)(A) of Item 601 of Regulation S-K, USG Corporation agrees to furnish a copy of such instruments to the Securities and Exchange Commission upon request.

Material Contracts:

10.1 Amendment and Restatement of USG Corporation Supplemental Retirement Plan, effective as of January 1, 2007 and dated December 10, 2008 (incorporated by reference to Exhibit 10.1 to USG Corporation s Annual Report on Form 10-K dated February 20, 2009, or the 2008 10-K) *

10.2 Form of Employment Agreement (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated October 2, 2008, or the First October 2008 8-K) *

10.3 Form of Change in Control Severance Agreement (Tier 1 Benefits) (incorporated by reference to Exhibit 10.2 to the First October 2008 8-K) *

10.4 Form of Change in Control Severance Agreement (Tier 2 Benefits) (incorporated by reference to Exhibit 10.3 to the First October 2008 8-K) *

10.5 Form of Indemnification Agreement (incorporated by reference to Exhibit 10.14 to USG Corporation s Annual Report on Form 10-K dated February 15, 2008, or the 2007 10-K) *

10.6 USG Corporation Stock Compensation Program for Non-Employee Directors (as Amended and Restated Effective as of January 1, 2005) (incorporated by reference to Exhibit 10.2 to USG Corporation s Current Report on Form 8-K dated November 14, 2005) *

10.7 Amendment No. 1 to the USG Corporation Stock Compensation Program for Non-Employee Directors (as Amended and Restated as of January 1, 2005) (incorporated by reference to Exhibit 10.1 to USG Corporation s Quarterly Report on Form 10-Q dated August 3, 2006, or the second quarter 2006 10-Q) *

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10.8 Amendment No. 2 to the USG Corporation Stock Compensation Program for Non-Employee Directors (as Amended and Restated as of January 1, 2005) (incorporated by reference to Exhibit 10.8 to USG Corporation s Quarterly Report on Form 10-Q dated April 30, 2007) *

10.9 USG Corporation Non-Employee Director Compensation Program (Amended and Restated February 13, 2008) (incorporated by reference to Exhibit 10.18 to the 2007 10-K) *

10.10 USG Corporation Deferred Compensation Program for Non-Employee Directors (as Amended and Restated effective December 31, 2008) (incorporated by reference to Exhibit 10.10 to the 2008 10-K) *

10.11 Second Amended and Restated Credit Agreement, dated as of January 7, 2009 among USG Corporation, the Lenders Party thereto, JPMorgan Chase Bank, N.A., as Administrative Agent, and Goldman Sachs Credit Partners, L.P., as Syndication Agent (incorporated by reference to Exhibit 10.2 to USG Corporation s Current Report on Form 8-K dated January 12, 2009, or the January 2009 8-K)

10.12 Guarantee Agreement, dated as of January 7, 2009 among USG Corporation, the subsidiary guarantors party thereto and JPMorgan Chase Bank, N.A., as administrative agent (incorporated by reference to Exhibit 10.3 to the January 2009 8-K)

10.13 Pledge and Security Agreement, dated as of January 7, 2009 among USG Corporation, the other grantors party thereto and JPMorgan Chase Bank, N.A., as administrative agent (incorporated by reference to Exhibit 10.4 to the January 2009 8-K)

10.14 2009 Annual Management Incentive Program of USG Corporation (Executive Officers Only) (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated March 12, 2009) *

10.15 2010 Annual Management Incentive Program of USG Corporation (Executive Officers Only) * **

10.16 Annual Base Salaries of Named Executive Officers of USG Corporation (incorporated by reference to Exhibit 10.3 to USG Corporation s Quarterly Report on Form 10-Q dated April 29, 2008) *

10.17 USG Corporation Deferred Compensation Plan (incorporated by reference to Exhibit 10.31 to USG Corporation s Annual Report on Form 10-K dated February 16, 2007) *

10.18 First Amendment of USG Corporation Deferred Compensation Plan, effective as of April 1, 2007 and dated December 10, 2008 (incorporated by reference to Exhibit 10.25 to the 2008 10-K) *

10.19 USG Corporation Long-Term Incentive Plan (incorporated by reference to Annex C to the Proxy Statement for the Annual Meeting of Stockholders of USG Corporation held on May 10, 2006, or the 2006 Proxy Statement) *

10.20 Amendment No. 1 to the USG Corporation Long-Term Incentive Plan (incorporated by reference to Exhibit 10.8 to the second quarter 2006 10-Q) *

10.21 Form of USG Corporation Nonqualified Stock Option Agreement (incorporated by reference to Exhibit 10.9 to the second quarter 2006 10-Q) *

10.22 Form of USG Corporation Nonqualified Stock Option Agreement (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated March 28, 2007, or the March 2007 8-K) *

10.23 Form of USG Corporation Restricted Stock Units Agreement (incorporated by reference to Exhibit 10.10 to the second quarter 2006 10-Q) *

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10.24	Form of USG Corporation Restricted Stock Units Agreement (Annual Grant) (incorporated by reference to Exhibit 10.2 to the March 2007 8-K) *
10.25	Form of USG Corporation Restricted Stock Units Agreement (Retention Grant) (incorporated by reference to Exhibit 10.3 to the March 2007 8-K) *
10.26	Form of USG Corporation Performance Shares Agreement (incorporated by reference to Exhibit 10.4 to the March 2007 8-K) *
10.27	Form of USG Corporation Nonqualified Stock Option Agreement (incorporated by reference to Exhibit 10.36 to the 2008 10-K) *
10.28	Form of USG Corporation Restricted Stock Units Agreement (incorporated by reference to Exhibit 10.37 to the 2008 10-K) *
10.29	Form of USG Corporation Performance Shares Agreement (incorporated by reference to Exhibit 10.38 to the 2008 10-K) *
10.30	Form of USG Corporation Nonqualified Stock Option Agreement * **
10.31	Form of USG Corporation Restricted Stock Units Agreement * **
10.32	Form of USG Corporation Performance Shares Agreement * **
10.33	Changes to Equity Awards for Compliance With Section 409A (incorporated by reference to Exhibit 10.39 to the 2008 10-K) *
10.34	USG Corporation Management Incentive Plan (incorporated by reference to Annex B to the 2006 Proxy Statement) *
10.35	Equity Commitment Agreement, dated January 30, 2006, by and between USG Corporation and Berkshire Hathaway Inc. (incorporated by reference to Exhibit 10.2 to USG Corporation s Current Report on Form 8-K dated January 30, 2006, or the January 2006 8-K)
10.36	Shareholder s Agreement, entered into as of January 30, 2006, by and between USG Corporation and Berkshire Hathaway Inc. (incorporated by reference to Exhibit 10.3 to the January 2006 8-K)
10.37	Amended and Restated Registration Rights Agreement, dated as of November 26, 2008, by and between USG Corporation and Berkshire Hathaway Inc. (incorporated by reference to Exhibit 10.1 to the November 2008 8-K)
10.38	Equity Purchase Agreement dated as of February 25, 2007 among L&W Supply Corporation, Joseph George Zucchero, JCSG Holdings Corporation, the Joseph G. Zucchero Family Trust dated September 12, 1998 and the entities listed on Exhibit A-1 thereto (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated February 27, 2007)
10.39	Secured Loan Facility Agreement, dated October 21, 2008, between Gypsum Transportation Limited and DVB Bank SE, as lender, agent and security trustee (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated October 27, 2008, or the Second October 2008 8-K)

10.40	Guarantee and Indemnity Agreement, dated October 21, 2008, between USG Corporation and DVB Bank SE, as agent (incorporated by reference to Exhibit 10.2 to the Second October 2008 8-K)

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10.41	Form of Deed of Covenants between Gypsum Transportation Limited and DVB Bank SE, as mortgagee (incorporated by reference to Exhibit 10.3 to the Second October 2008 8-K)
10.42	Form of Deed of Assignment between Gypsum Transportation Limited and DVB Bank SE, as assignee (incorporated by reference to Exhibit 10.4 to the Second October 2008 8-K)
10.43	Second Supplemental Agreement, dated November 10, 2009, to Secured Loan Facility Agreement dated October 21, 2008 between Gypsum Transportation Limited, USG Corporation and DVB Bank SE, as lender, agent and security trustee **
10.44	Credit Agreement, dated as of June 30, 2009, between CGC Inc. and The Toronto-Dominion Bank (incorporated by reference to Exhibit 10.1 to USG Corporation s Current Report on Form 8-K dated July 6, 2009)
10.45	Securities Purchase Agreement, dated November 21, 2008, between USG Corporation and Berkshire Hathaway Inc. (incorporated by reference to Exhibit 1.1 to the November 2008 8-K)
10.46	Securities Purchase Agreement, dated November 21, 2008, between USG Corporation and Fairfax Financial Holdings Limited (incorporated by reference to Exhibit 1.2 to the November 2008 8-K)
10.47	Registration Rights Agreement, dated as of November 26, 2008, between USG Corporation and Fairfax Financial Holdings Limited (incorporated by reference to Exhibit 10.2 to the November 2008 8-K)
Other:	
21	Subsidiaries **
23	Consent of Independent Registered Public Accounting Firm **
24	Power of Attorney **
31.1	Rule 13a - 14(a) Certifications of USG Corporation s Chief Executive Officer **
31.2	Rule 13a - 14(a) Certifications of USG Corporation s Chief Financial Officer **
32.1	Section 1350 Certifications of USG Corporation s Chief Executive Officer **
32.2	Section 1350 Certifications of USG Corporation s Chief Financial Officer **

* Management contract or compensatory plan or arrangement

** Filed or furnished herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	USG CORPORATION
February 12, 2010	
	By: /s/ Richard H. Fleming Richard H. Fleming Executive Vice President and Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

/s/ William C. Foote	February 12, 2010
WILLIAM C. FOOTE Director, Chairman and Chief Executive Officer (Principal Executive Officer)	
/s/ Richard H. Fleming	February 12, 2010
RICHARD H. FLEMING Executive Vice President and Chief Financial Officer (Principal Financial Officer)	
/s/ D. Rick Lowes	February 12, 2010
D. RICK LOWES Senior Vice President and Controller (Principal Accounting Officer)	

JOSE ARMARIO, ROBERT L. BARNETT,	)	By: /s/ Richard H. Fleming
LAWRENCE M. CRUTCHER, W. DOUGLAS FORD,	)	Richard H. Fleming
WILLIAM H. HERNANDEZ, RICHARD P. LAVIN,	)	Attorney-in-fact
STEVEN F. LEER, MARVIN E. LESSER,	)	February 12, 2010
JAMES S. METCALF, JUDITH A. SPRIESER,	)	
Directors	)	

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EXHIBIT INDEX

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	Financial Holdings Limited (incorporated by reference to Exhibit 1.2 to the November 2008 8-K)
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