

PACIFIC DRILLING S.A.
Form 20-F/A
December 23, 2013

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

FORM 20-F/A
(Amendment No. 1)

.. REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended December 31, 2012

OR

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

OR

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

Commission file number 001-35345

PACIFIC DRILLING S.A.

(Exact name of Registrant as specified in its charter)

Not Applicable

(Translation of Registrant's name into English)

Luxembourg

(Jurisdiction of incorporation or organization)

8-10, Avenue de la Gare

L-1610 Luxembourg

(Address of principal executive offices)

Kinga E. Doris

Vice President, General Counsel and Secretary

3050 Post Oak Blvd., Suite 1500

Houston, Texas 77056

Phone (832) 255-0519

Fax (832) 201-9883

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
Common shares, \$0.01 par value per share	New York Stock Exchange
Securities registered or to be registered pursuant to Section 12(g) of the Act. None.	

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act. None.

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2012, there were 216,902,000 shares outstanding.

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

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes No

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

Indicate by check mark 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued
by the International Accounting Standards Board

Other

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow. Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

EXPLANATORY NOTE

Pacific Drilling S.A. (the Company) is filing this Amendment No. 1 (Amendment No. 1) to its annual report on Form 20-F for the fiscal year ended December 31, 2012, as filed with the U.S. Securities and Exchange Commission (the SEC) on February 28, 2013 (the 2012 Form 20-F), to include (i) the consolidated balance sheets of Transocean Pacific Drilling Inc. (TPDI) as of March 31, 2011 and December 31, 2010 and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for the three months ended March 31, 2011 and for the year ended December 31, 2010, and the audit report of Ernst & Young LLP with respect thereto, (ii) current consents of KPMG LLP and Ernst & Young LLP and (iii) updated certifications of the principal executive officer and principal financial officer. The previously filed audited consolidated financial statements of the Company and the footnotes thereto, as well as KPMG LLP's audit report with respect thereto, are included in Item 18 of this Amendment No. 1; however, no changes were made to such financial statements, footnotes or report as previously filed.

Other than as expressly set forth above, this Amendment No. 1 does not, and does not purport to, amend, update or restate the information in any part of the 2012 Form 20-F or reflect any events that have occurred after the 2012 Form 20-F was filed on February 28, 2013. The filing of this Amendment No. 1, and the inclusion of the updated certifications, should not be understood to mean that any other statements contained in the 2012 Form 20-F are true and complete as of any date subsequent to February 28, 2013. This Amendment No. 1 should be read in conjunction with the 2012 Form 20-F and our other filings with the SEC.

ITEM 18. FINANCIAL STATEMENTS*Historical Consolidated Financial Statements*

Pacific Drilling S.A. was formed as a Luxembourg corporation under the form of a *société anonyme* to act as an indirect holding company for our Predecessor. In connection with the Restructuring, our Predecessor was contributed to a wholly-owned subsidiary of the Company by the Quantum Pacific Group. The Company did not engage in any business or other activities prior to the Restructuring except in connection with its formation and the Restructuring. The Restructuring was limited to entities that were all under the control of the Quantum Pacific Group and its affiliates, and, as such, the Restructuring was accounted for as a transaction between entities under common control. As a result, the consolidated financial statements of Pacific Drilling S.A. are presented using the historical values of the Predecessor's financial statements on a combined basis prior to the Restructuring. However, the issued share capital of Pacific Drilling S.A. is retrospectively reflected for all periods to reflect the 150,000,000 common shares held by the Quantum Pacific Group at the completion of the Restructuring. The financial information relating to the Company and its subsidiaries have been prepared in accordance with GAAP and are in U.S. dollars.

Historical Parent-Only Financial Statements

Pacific Drilling S.A. is the parent-company of subsidiaries owning the *Pacific Bora*, the *Pacific Scirocco*, the *Pacific Mistral* and the *Pacific Santa Ana*, which act as Borrowers under the Project Facilities Agreement. Surplus cash held by these subsidiaries is restricted by the Project Facilities Agreement from transfer by intercompany loans and/or dividend payments to us. Rule 5-04 of Regulation S-X requires separate parent-only financial statements to be presented in Schedule I, Condensed financial information of registrant, when the restricted net assets of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year. Since the restricted net assets of the Borrowers exceeds 25 percent of Pacific Drilling S.A.'s consolidated net assets, this annual report also includes parent-only financial statements for Pacific Drilling S.A. pursuant to the requirements of Rule 5-04 of Regulation S-X. The financial statements of Pacific Drilling S.A. as of December 31, 2012 and 2011 and for the year ended December 31, 2012 and for the period from March 11, 2011 (inception) to December 31, 2011, including the applicable notes thereto, have been prepared in accordance with U.S. GAAP and are presented in U.S. dollars.

TPDI Financial Statements

The Company determined that Transocean was the primary beneficiary of TPDI for accounting purposes, and, as a result, accounted for TPDI as an equity method investment in our consolidated financial statements. The audited financial statements of TPDI as of March 31, 2011 and December 31, 2010 and for the three months ended March 31, 2011 and the year ended December 31, 2010, including the applicable notes thereto, have been prepared in accordance with U.S. GAAP and are presented in U.S. dollars.

The following financial statements listed below are filed as part of this annual report on Form 20-F:

Pacific Drilling S.A.*Consolidated Financial Statements*

<u>Report of Independent Registered Public Accounting Firm</u>	F-1
<u>Consolidated Statements of Operations</u>	F-3
<u>Consolidated Statements of Comprehensive Income (Loss)</u>	F-4
<u>Consolidated Balance Sheets</u>	F-5
<u>Consolidated Statements of Shareholders' Equity</u>	F-6
<u>Consolidated Statements of Cash Flows</u>	F-7

<u>Notes to Consolidated Financial Statements</u>	F-8
<i>Schedule I Condensed Financial Information of Pacific Drilling S.A. (Parent Only):</i>	
<u>Statement of Operations</u>	F-29
<u>Statement of Comprehensive Income (Loss)</u>	F-30
<u>Balance Sheet</u>	F-31
<u>Statement of Cash Flows</u>	F-32
<i>Transocean Pacific Drilling Inc.</i>	
<i>Consolidated Financial Statements March 31, 2011 and December 31, 2010:</i>	
<u>Report of Independent Registered Public Accounting Firm</u>	F-33
<u>Consolidated Statement of Operations</u>	F-34
<u>Consolidated Statement of Comprehensive Income (Loss)</u>	F-35
<u>Consolidated Balance Sheet</u>	F-36
<u>Consolidated Statement of Shareholders Equity</u>	F-37
<u>Consolidated Statement of Cash Flows</u>	F-38
<u>Notes to Consolidated Financial Statements</u>	F-39

ITEM 19.EXHIBITS

Exhibit Number	Description
1.1	Articles of Association of Pacific Drilling S.A. (incorporated by reference to Exhibit 3.1 to our Registration Statement on Form F-1, File No. 333-177774).
1.2	Form of Amended and Restated Articles of Association of Pacific Drilling S.A. (incorporated by reference to Exhibit 3.2 to our Registration Statement on Form F-1, File No. 333-177774).
2(a)(1)	Registration Rights Agreement between Pacific Drilling S.A. and Quantum Pacific (Gibraltar) Limited, dated November 16, 2011 (incorporated by reference to Exhibit 2(a)(1) to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
2(b)(1)	Bond Agreement, dated February 23, 2012, between Pacific Drilling S.A. and Norsk Tillitsmann ASA (incorporated by reference to Exhibit 2(b)(1) to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
2(b)(2)	Indenture, dated as of November 28, 2012, among Pacific Drilling V Limited, Pacific Drilling S.A. and each subsidiary guarantor from time to time party thereto, as guarantors, and Deutsche Bank Trust Company Americas, as Trustee and Collateral Agent (incorporated by reference to Exhibit 99.1 to our Report on Form 6-K, filed December 5, 2012, File No. 001-35345).
2(b)(3)	Form of Note (incorporated by reference to Exhibit 99.2 to our Report on Form 6-K, filed December 5, 2012, File No. 001-35345).
4.1	Amendment and Restatement Agreement in Respect of the Project Facilities Agreement and the Intercreditor Agreement, dated March 30, 2011, among Pacific Bora Ltd., Pacific Mistral Ltd., Pacific Scirocco Ltd. and Pacific Santa Ana Ltd., as Borrowers, Pacific Drilling Limited, as Guarantor, and the arrangers, lenders and agents named therein (incorporated by reference to Exhibit 10.1 to our Registration Statement on Form F-1, File No. 333-177774).
4.2	Second Amendment and Restatement Agreement in Respect of the Project Facilities Agreement and the Intercreditor Agreement, dated March 30, 2012, among Pacific Bora Ltd., Pacific Mistral Ltd., Pacific Scirocco Ltd., as the Borrowers, Pacific Santa Ana Ltd., as the Resigning Borrower, Pacific Drilling Limited, as Guarantor, Pacific Santa Ana S.à.r.l., as the Acceding Borrower and the arrangers, lenders and agents named therein (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.3	Third Amendment and Restatement Agreement in Respect of the Project Facilities Agreement and the Intercreditor Agreement, dated April 19, 2012, among Pacific Bora Ltd., Pacific Mistral Ltd., Pacific Scirocco Ltd., and Pacific Santa Ana S.à.r.l., as the Borrowers, Pacific Drilling Limited, as Guarantor, Pacific Bora Ltd., Pacific Scirocco Ltd., Pacific Drilling Limited, Pacific International Drilling West Africa Limited, Pacific Drilling (Gibraltar) Limited, and Pacific Drilling S.A., as the TI Bond Facility Obligor and the arrangers, lenders and agents named therein (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).

Exhibit Number	Description
4.4	Letter of Credit Facility and Guaranty Agreement for Standby Letter of Credit, dated as of April 19, 2012, among Pacific Scirocco Ltd., Pacific Drilling (Gibraltar) Limited, Pacific Drilling Limited and Pacific Drilling S.A. and the arrangers, lenders and agents named therein (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.5	Letter of Credit Facility and Guaranty Agreement for Standby Letter of Credit, dated as of April 19, 2012, among Pacific Bora Ltd., Pacific Drilling (Gibraltar) Limited, Pacific Drilling Limited and Pacific Drilling S.A. and the arrangers, lenders and agents named therein (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.6	Termination Agreement, dated as of April 19, 2012, among Pacific Drilling (Gibraltar) Limited, Pacific Drilling S.A and Citibank N.A. (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.7	Termination Agreement, dated as of April 19, 2012, among Pacific Drilling (Gibraltar) Limited, Quantum Pacific International Limited and Citibank N.A (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.8	Termination Agreement, dated as of April 24, 2012, among Pacific Drilling (Gibraltar) Limited and Standard Chartered Bank (incorporated by reference to the Report on Form 6-K, filed May 31, 2012, File No. 001-35345).
4.9	Agreement for Standby Letter of Credit, dated as of July 7, 2011, between Pacific Drilling (Gibraltar) Limited and Citibank, N.A. (incorporated by reference to Exhibit 10.2 to our Registration Statement on Form F-1, File No. 333-177774).
4.10	Guaranty, dated as of July 7, 2011, by Quantum Pacific International Limited, as guarantor, in favor of Citigroup Inc. and each subsidiary or affiliate thereof (incorporated by reference to Exhibit 10.3 to our Registration Statement on Form F-1, File No. 333-177774).
4.11	Pledge Agreement, dated as of June 27, 2011, between Pacific Drilling (Gibraltar) Limited, as pledgor, and Citibank, N.A. (incorporated by reference to Exhibit 10.4 to our Registration Statement on Form F-1, File No. 333-177774).
4.12	Pacific Drilling S.A. 2011 Omnibus Stock Incentive Plan (incorporated by reference to Exhibit 10.5 to our Registration Statement on Form F-1, File No. 333-177774).
4.13	Agreement for Standby Letter of Credit, dated as of November 29, 2011, between Pacific Drilling (Gibraltar) Limited and Citibank, N.A (incorporated by reference to Exhibit 4.6 to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
4.14	Guaranty, dated as of November 29, 2011, by Pacific Drilling S.A., as guarantor, in favor of Citigroup Inc. and each subsidiary or affiliate thereof (incorporated by reference to Exhibit 4.7 to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
4.15	Pledge Agreement, dated as of November 29, 2011, between Pacific Drilling (Gibraltar) Limited, as pledgor, and Citibank, N.A., as amended by that letter agreement dated as of December 9, 2011 (incorporated by reference to Exhibit 4.8 to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
4.16	Letter of Credit Reimbursement Agreement, dated as of December 6, 2011, between Pacific International West Africa Limited and Standard Chartered Bank (incorporated by reference to Exhibit 4.9 to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).

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- 4.17 Assignment of Cash Collateral Account, dated as of December 6, 2011, between Pacific Drilling (Gibraltar) Limited and Standard Chartered Bank (incorporated by reference to Exhibit 4.10 to our Annual Report on Form 20-F filed March 27, 2012, File No. 001-35345).
- 4.18 Second Amendment Agreement in Respect of the Project Facilities Agreement, dated December 28, 2012, among Pacific Bora Ltd., Pacific Mistral Ltd., Pacific Scirocco Ltd., and Pacific Santa Ana S.à.r.l., as the Borrowers, Pacific Drilling Limited, as Guarantor, Pacific International Drilling West Africa Limited, Pacific Drilling (Gibraltar) Limited and the arrangers, lenders and agents named therein.
- 4.19 Senior Secured Credit Facility Agreement, dated as of February 19, 2013, among Pacific Sharav S.à.r.l. and Pacific Drilling VII Limited, as Borrowers, Pacific Drilling S.A., as Guarantor, and the arrangers, lenders and agents named therein (incorporated by reference to Exhibit 99.1 to the Report on Form 6-K, filed February 25, 2013, File No. 001-35345).
- 8.1 Subsidiaries of Pacific Drilling S.A.

Exhibit Number	Description
12.1*	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer.
12.2*	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer.
13.1*	Certificate of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
13.2*	Certificate of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
15.1*	Consent of Independent Registered Public Accounting Firm.
15.2*	Consent of Independent Registered Public Accounting Firm.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith.

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

PACIFIC DRILLING S.A.

By: /s/ CHRISTIAN J. BECKETT
Name: **Christian J. Beckett**
Title: **Chief Executive Officer**

Date: December 20, 2013

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Pacific Drilling S.A.:

We have audited the accompanying consolidated balance sheets of Pacific Drilling S.A. and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for each of the years in the three year period ended December 31, 2012. In connection with our audits of the consolidated financial statements, we also have audited Schedule I Condensed Financial Information of Pacific Drilling S.A. (Parent Only) (Schedule I). These consolidated financial statements and Schedule I are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and Schedule I based on our audits. We did not audit the financial statements of Transocean Pacific Drilling Inc. (TPDI - a 50% owned unconsolidated investee company). The Company's investment in TPDI at December 31, 2011 was \$0, and its equity in earnings of TPDI was \$18,955,000 and \$56,307,000 for the years ended December 31, 2011 and 2010, respectively. The financial statements of TPDI were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for TPDI, is based solely on the report of other auditors.

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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pacific Drilling S.A. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related Schedule I, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2013 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Houston, Texas

February 28, 2013

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Pacific Drilling S.A.:

We have audited Pacific Drilling S.A. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Controls over Financial Reporting in Item 15b of Form 20-F. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pacific Drilling S.A. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated February 28, 2013 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Houston, Texas

February 28, 2013

F-2

PACIFIC DRILLING S.A. AND SUBSIDIARIES

Consolidated Statements of Operations

(in thousands, except share and per share information)

	Years Ended December 31,		
	2012	2011	2010
Revenues			
Contract drilling	\$ 638,050	\$ 65,431	\$
Costs and expenses			
Contract drilling	(331,495)	(32,142)	
General and administrative expenses	(45,386)	(52,614)	(19,715)
Depreciation expense	(127,698)	(11,619)	(395)
	(504,579)	(96,375)	(20,110)
Loss of hire insurance recovery	23,671	18,500	
Operating income (loss)	157,142	(12,444)	(20,110)
Other income (expense)			
Equity in earnings of Joint Venture		18,955	56,307
Interest income from Joint Venture		495	1,973
Interest expense	(104,685)	(10,384)	(858)
Other income	3,245	3,675	(62)
Income before income taxes	55,702	297	37,250
Income tax (expense) benefit	(21,713)	(3,200)	49
Net income (loss)	\$ 33,989	\$ (2,903)	\$ 37,299
Earnings (loss) per common share, basic (Note 18)	\$ 0.16	\$ (0.01)	\$ 0.25
Weighted average number of common shares, basic (Note 18)	216,901,000	195,447,944	150,000,000
Earnings (loss) per common share, diluted (Note 18)	\$ 0.16	\$ (0.01)	\$ 0.25
Weighted average number of common shares, diluted (Note 18)	216,903,159	195,447,944	150,000,000

See accompanying notes to consolidated financial statements.

PACIFIC DRILLING S.A. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

(in thousands)

	Years Ended December 31,		
	2012	2011	2010
Net income (loss)	\$ 33,989	\$ (2,903)	\$ 37,299
Other comprehensive income (loss):			
Unrecognized gain (loss) on Joint Venture derivative instruments		720	(28,990)
Reclassification adjustment for loss on Joint Venture derivative instruments realized in net income		2,996	11,540
		3,716	(17,450)
Unrecognized loss on derivative instruments	(22,551)	(62,086)	
Reclassification adjustment for loss on derivative instruments realized in net income	24,419	1,802	
	1,868	(60,284)	
Total other comprehensive income (loss)	1,868	(56,568)	(17,450)
Total comprehensive income (loss)	\$ 35,857	\$ (59,471)	\$ 19,849

See accompanying notes to consolidated financial statements.

PACIFIC DRILLING S.A. AND SUBSIDIARIES

Consolidated Balance Sheets

(in thousands, except par value and share amounts)

	December 31, 2012	December 31, 2011
Assets:		
Cash and cash equivalents	\$ 605,921	\$ 107,278
Restricted cash	47,444	168,681
Accounts receivable	152,299	62,578
Materials and supplies	49,626	42,986
Deferred financing costs	17,707	15,124
Current portion of deferred mobilization costs	37,519	54,523
Prepaid expenses and other current assets	13,930	10,376
Total current assets	924,446	461,546
Property and equipment, net	3,760,421	3,436,010
Restricted cash	124,740	208,287
Deferred financing costs	32,157	32,386
Other assets	52,164	46,060
Total assets	\$ 4,893,928	\$ 4,184,289
Liabilities and shareholders equity:		
Accounts payable	\$ 30,230	\$ 26,845
Accrued expenses	39,345	39,095
Current portion of long-term debt	218,750	218,750
Accrued interest payable	29,594	12,099
Derivative liabilities, current	17,995	20,466
Current portion of deferred revenue	66,142	28,829
Total current liabilities	402,056	346,084
Long-term debt, net of current maturities	2,034,958	1,456,250
Deferred revenue	97,014	73,110
Other long-term liabilities	44,652	34,772
Total long-term liabilities	2,176,624	1,564,132
Commitments and contingencies		
Shareholders equity:		
Common shares, \$0.01 par value, 5,000,000,000 shares authorized, 224,100,000 shares issued and 216,902,000 and 216,900,000 shares outstanding as of December 31, 2012 and 2011, respectively	2,169	2,169
Additional paid-in capital	2,349,544	2,344,226

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Accumulated other comprehensive loss	(58,416)	(60,284)
Retained earnings (accumulated deficit)	21,951	(12,038)
Total shareholders' equity	2,315,248	2,274,073
Total liabilities and shareholders' equity	\$ 4,893,928	\$ 4,184,289

See accompanying notes to consolidated financial statements.

F-5

PACIFIC DRILLING S.A. AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity

(in thousands, except share amounts)

	Common shares		Treasury	Additional	Accumulated other	Retained earnings	Total
	Shares	Amount	Shares	paid-in	comprehensive	(accumulated	equity
				capital	loss	deficit)	
Balance at December 31, 2009	805,000	\$ 1		\$ 150,000	\$ 3,992	\$ 53,756	\$ 207,749
Contribution from shareholder				655,000			655,000
Issuance of shares upon conversion of related-party loan	1,115,761	1		892,608			892,609
Other comprehensive loss					(17,450)		(17,450)
Net income						37,299	37,299
Balance at December 31, 2010	1,920,761	2		1,697,608	(13,458)	91,055	1,775,207
Restructuring share issuance, net	148,079,239	1,498		(1,498)			
Issuance of common shares, net	66,900,000	669		625,147			625,816
Issuance of common shares to treasury			7,200,000				
Contribution from shareholder				142,759			142,759
Other comprehensive income from Joint Venture					3,716		3,716
Net income prior to Joint Venture interest assignment						9,135	9,135
Joint Venture interests assigned to shareholder				(124,920)	9,742	(100,190)	(215,368)
Share-based compensation liability modification				2,290			2,290
Share-based compensation				2,840			2,840

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Other comprehensive loss					(60,284)		(60,284)
Net loss subsequent to Joint Venture interest assignment						(12,038)	(12,038)
Balance at December 31, 2011	216,900,000	2,169	7,200,000	2,344,226	(60,284)	(12,038)	2,274,073
Shares issued under share-based compensation plans	2,000		(2,000)				
Share-based compensation				5,318			5,318
Other comprehensive loss					1,868		1,868
Net income						33,989	33,989
Balance at December 31, 2012	216,902,000	\$ 2,169	7,198,000	\$ 2,349,544	\$ (58,416)	\$ 21,951	\$ 2,315,248

See accompanying notes to consolidated financial statements.

PACIFIC DRILLING S.A. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(in thousands)

	Years Ended December 31,		
	2012	2011	2010
Cash flow from operating activities:			
Net income (loss)	\$ 33,989	\$ (2,903)	\$ 37,299
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Interest income from Joint Venture		(495)	(1,973)
Depreciation expense	127,698	11,619	395
Equity in earnings of Joint Venture		(18,955)	(56,307)
Amortization of deferred revenue	(95,750)	(8,566)	
Amortization of deferred mobilization costs	70,660	4,288	
Amortization of deferred financing costs	13,926	1,067	
Deferred income taxes	(3,766)	(3,169)	(371)
Share-based compensation expense	5,318	4,471	65
Changes in operating assets and liabilities:			
Accounts receivable	(89,721)	(45,051)	(17,527)
Materials and supplies	(6,640)	(35,031)	(7,955)
Prepaid expenses and other assets	(61,548)	(108,593)	(2,972)
Accounts payable and accrued expenses	33,865	39,437	6,252
Deferred revenue	156,967	97,550	12,955
Net cash provided by (used in) operating activities	184,998	(64,331)	(30,139)
Cash flow from investing activities:			
Capital expenditures	(449,951)	(1,539,630)	(883,853)
Decrease (increase) in restricted cash	204,784	(315,286)	(60,967)
Net cash used in investing activities	(245,167)	(1,854,916)	(944,820)
Cash flow from financing activities:			
Proceeds from issuance of common shares, net		625,816	
Proceeds from long-term debt	797,415	1,275,000	450,000
Payments on long-term debt	(218,750)	(50,000)	
Deferred financing costs	(19,853)	(6,803)	(57,995)
Proceeds from related-party loan		142,205	685,280
Payments on related-party loan			(69,444)
Net cash provided by financing activities	558,812	1,986,218	1,007,841
Increase in cash and cash equivalents	498,643	66,971	32,882
Cash and cash equivalents, beginning of period	107,278	40,307	7,425

Cash and cash equivalents, end of period	\$ 605,921	\$ 107,278	\$ 40,307
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See accompanying notes to consolidated financial statements.

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PACIFIC DRILLING S.A. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1 Nature of Business

Pacific Drilling S.A. and its subsidiaries (Pacific Drilling, the Company, we, us or our) is an international offshore drilling company committed to becoming the preferred provider of ultra-deepwater drilling services to the oil and natural gas industry through the use of high-specification rigs. Our primary business is to contract our ultra-deepwater rigs, related equipment and work crews, primarily on a dayrate basis, to drill wells for our customers. As of December 31, 2012, the Company operates four drillships under customer contract and has three drillships under construction at Samsung Heavy Industries (SHI), two of which are under customer contract.

Pacific Drilling S.A. was formed on March 11, 2011, as a Luxembourg corporation under the form of a *société anonyme* to act as an indirect holding company for its predecessor, Pacific Drilling Limited (our Predecessor), a company organized under the laws of Liberia, and its subsidiaries in connection with a corporate reorganization completed on March 30, 2011, referred to as the Restructuring. In connection with the Restructuring, our Predecessor was contributed to a wholly-owned subsidiary of the Company by a subsidiary of Quantum Pacific International Limited, a British Virgin Islands company and parent company of an investment holdings group (the Quantum Pacific Group). The Company did not engage in any business or other activities prior to the Restructuring except in connection with its formation and the Restructuring.

In 2007, our Predecessor entered into various agreements with Transocean Ltd. (Transocean) and its subsidiaries, which culminated in the formation of a joint venture company, Transocean Pacific Drilling Inc. (TPDI or the Joint Venture), which was owned 50% by our Predecessor and 50% by a subsidiary of Transocean. On March 30, 2011, in connection with the Restructuring, our Predecessor assigned its equity interest in TPDI to another subsidiary of the Quantum Pacific Group, which is referred to as the TPDI Transfer, to enable the Company to focus on the operation and marketing of the Company's wholly-owned fleet. As a result, neither the Company nor any of its subsidiaries owned any interest in TPDI following March 30, 2011.

Note 2 Significant Accounting Policies

Principles of Consolidation The consolidated financial statements include the accounts of Pacific Drilling S.A. and consolidated subsidiaries that we control by ownership of a majority voting interest. We apply the equity method of accounting for investments in entities when we have the ability to exercise significant influence over an entity that does not meet the variable entity criteria or meets the variable interest entity criteria, but for which we are not deemed to be the primary beneficiary. We eliminate all intercompany transactions and balances in consolidation.

The Restructuring was a business combination limited to entities that were all under the control of the Quantum Pacific Group and its affiliates, and, as such, the Restructuring was accounted for as a transaction between entities under common control. Accordingly, the consolidated financial statements of Pacific Drilling S.A. as of and for the years ended December 31, 2011 and 2010 are presented using the historical values of the Predecessor's financial statements on a combined basis prior to the Restructuring. The financial statements for the years ended December 31, 2011 and 2010 present the results of the Company and its subsidiaries as if Pacific Drilling S.A. was formed and the Restructuring was completed on January 1, 2010.

We currently are party to a Nigerian joint venture, Pacific International Drilling West Africa Limited (PIDWAL), which is fully controlled and 90% owned by us with 10% owned by Derotech Offshore Services Limited (Derotech), a privately-held Nigerian registered limited liability company. Derotech will not accrue the economic benefits of its interest in PIDWAL unless and until it satisfies certain outstanding obligations to us and a certain pledge is cancelled

by us. Accordingly, we consolidate all PIDWAL interests and no portion of PIDWAL's operating results is allocated to the noncontrolling interests. In addition to the joint venture agreement, we currently have marketing and logistic services agreements with Derotech and an affiliated company of Derotech. During the years ended December 31, 2012, 2011 and 2010, we incurred fees of \$7.0 million, \$3.1 million and \$0.2 million under the marketing and logistic services agreements, respectively.

Accounting Estimates The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States (GAAP) requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosures of contingent assets and liabilities at the balance sheet date and the amounts of revenues and expenses recognized during the reporting period. On an ongoing basis, we evaluate our estimates and assumptions, including those related to allowance for doubtful accounts, financial instruments, depreciation of property and equipment, impairment of long-lived assets, income taxes, share-based compensation and contingencies. We base our estimates and assumptions on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from such estimates.

Revenues and Operating Expenses Contract drilling revenues are recognized as earned, based on contractual dayrates. In connection with drilling contracts, we may receive revenues for preparation and mobilization of equipment and personnel or for capital improvements to rigs. Revenues earned and incremental costs incurred directly related to contract preparation and mobilization along with reimbursements received for capital expenditures are deferred and recognized over the primary term of the drilling contract. The actual cost incurred for reimbursed capital expenditures are depreciated over the estimated useful life of the asset. Amortization of deferred revenue and deferred mobilization costs are recorded on a straight-line basis over the primary drilling contract term, which is consistent with the general pace of activity, level of services being provided and dayrates being earned over the life of the contract. Upon completion of drilling contracts, any demobilization fees received and related expenses are reported in income.

Cash and Cash Equivalents Cash equivalents are highly liquid investments with original maturities of three months or less that are readily convertible to known amounts of cash.

Accounts Receivable We record trade accounts receivable at the amount we invoice our customers.

Allowance for Doubtful Accounts We provide an allowance for doubtful accounts, as necessary, based on a review of outstanding receivables, historical collection information and existing economic conditions. We do not generally require collateral or other security for receivables. We have no allowance for doubtful accounts as of December 31, 2012 and 2011.

Promissory Notes to Joint Venture Contributions in the form of promissory notes to the Joint Venture were recorded at cost. The accrued interest on promissory notes from our Joint Venture was recorded at the amount due. Interest income from the Joint Venture was earned on the promissory notes based on the stated loan rates as discussed in Note 4.

Materials and Supplies Materials and supplies held for consumption are carried at the lower of average cost or market. We recorded no allowance for obsolescence on materials and supplies as of December 31, 2012 and 2011.

Property and Equipment Deepwater drillships are recorded at cost of construction, including any major capital improvements, less accumulated depreciation and impairment. Other property and equipment is recorded at cost and consists of purchased software systems, furniture, fixtures and other equipment. Planned major maintenance, ongoing maintenance, routine repairs and minor replacements are expensed as incurred.

Interest is capitalized based on the costs of new borrowings attributable to qualifying new construction or at the weighted average cost of debt outstanding during the period of construction. We capitalize interest costs for qualifying new construction from the point borrowing costs are incurred for the qualifying new construction and cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete.

Property and equipment are depreciated to its salvage value on a straight-line basis over the estimated useful lives of each class of assets. Our estimated useful lives of property and equipment are as follows:

	Years
Drillships and related equipment	15-35
Other property and equipment	2-7

Long-Lived Assets We review our long-lived assets, including property and equipment, for impairment when events or changes in circumstances indicate that the carrying amounts of our assets held and used may not be recoverable. Potential impairment indicators include rapid declines in commodity prices and related market conditions, actual or

expected declines in rig utilization, increases in idle time, cancellations of contracts or credit concerns of customers. We assess impairment using estimated undiscounted cash flows for the long-lived assets being evaluated by applying assumptions regarding future operations, market conditions, dayrates, utilization and idle time. An impairment loss is recorded in the period if the carrying amount of the asset is not recoverable. During 2012, 2011 and 2010, there were no long-lived asset impairments.

Investment Accounted for Using the Equity Method Our 50% ownership in TPDI was accounted for using the equity method based upon the level of ownership and our ability to exercise significant influence over the operating and financial policies of the investee. The investment was adjusted periodically to recognize our proportionate share of the investee's net income or losses after the date of investment. The Company evaluates its investment accounted for under the equity method for impairment when there was evidence or indicators that a decrease in value may be other than temporary. On March 30, 2011, our Predecessor assigned its equity interest in TPDI to a subsidiary of the Quantum Pacific Group (Note 9).

Deferred Financing Costs Deferred financing costs associated with long-term debt are carried at cost and are amortized to expense using the effective interest rate method over the term of the applicable long-term debt.

Foreign Currency Transactions The consolidated financial statements are stated in U.S. dollars. We have designated the U.S. dollar as the functional currency for our foreign subsidiaries in international locations because we contract with customers, purchase equipment and finance capital using the U.S. dollar. Transactions in other currencies have been translated into U.S. dollars at the rate of exchange on the transaction date. Any gain or loss arising from a change in exchange rates subsequent to the transaction date is included as an exchange gain or loss. Monetary assets and liabilities denominated in currencies other than U.S. dollars are reported at the rates of exchange prevailing at the end of the reporting period. During 2012 and 2011, total foreign exchange gains were \$2.4 million and \$1.4 million, respectively, and recorded in other income within our consolidated statements of operations. During 2010, total foreign exchange gains (losses) were nominal.

Earnings per Share Basic earnings (loss) per common share (EPS) is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period. Basic and diluted EPS are retrospectively adjusted for the effects of stock dividends or stock splits. Diluted EPS reflects the potential dilution from securities that could share in the earnings of the Company. Anti-dilutive securities are excluded from diluted EPS.

Fair Value Measurements We estimate fair value at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market for the asset or liability. Our valuation techniques require inputs that are categorized using a three-level hierarchy as follows: (1) unadjusted quoted prices for identical assets or liabilities in active markets (Level 1), (2) direct or indirect observable inputs, including quoted prices or other market data, for similar assets or liabilities in active markets or identical assets or liabilities in less active markets (Level 2) and (3) unobservable inputs that require significant judgment for which there is little or no market data (Level 3). When multiple input levels are required for a valuation, we categorize the entire fair value measurement according to the lowest level input that is significant to the measurement even though we may have also utilized significant inputs that are more readily observable.

Share-Based Compensation The grant date fair value of share-based awards granted to employees is recognized as an employee compensation expense over the requisite service period on a straight-line basis. To the extent the share-based awards were to be settled in cash upon exercise, the awards were accounted for as a liability. The liability was remeasured at each reporting date and at settlement date. Any changes in the fair value of the liability are recognized as employee compensation expense in the current period. As of December 31, 2012 and 2011, the Company has no awards accounted for as liabilities. The amount of compensation expense recognized is adjusted to reflect the number of awards for which the related vesting conditions are expected to be met. As such, the amount of compensation expense ultimately recognized is based on the number of awards that do meet the vesting conditions at the vesting date.

Derivatives We apply cash flow hedge accounting to interest rate swaps that are designated as hedges of the variability of future cash flows. The derivative financial instruments are recorded in our consolidated balance sheet at fair value as either assets or liabilities. Changes in the fair value of derivatives designated as cash flow hedges, to the extent the hedge is effective, are recognized in accumulated other comprehensive income until the hedged item is recognized in earnings.

Hedge effectiveness is measured on an ongoing basis to ensure the validity of the hedges based on the relative cumulative changes in fair value between the derivative contract and the hedged item over time. Any change in fair value resulting from ineffectiveness is recognized immediately in earnings. Hedge accounting is discontinued prospectively if it is determined that the derivative is no longer effective in offsetting changes in the cash flows of the hedged item.

For interest rate hedges related to interest not incurred to construct fixed assets, other comprehensive income is released to earnings as interest expense is accrued on the underlying debt. For interest rate hedges related to interest

capitalized in the construction of fixed assets, other comprehensive income is released to earnings as the asset is depreciated over its useful life.

Contingencies We record liabilities for estimated loss contingencies when we believe a loss is probable and the amount of the probable loss can be reasonably estimated. Once established, we adjust the estimated contingency loss accrual for changes in facts and circumstances that alter our previous assumptions with respect to the likelihood or amount of loss.

We recognize loss of hire insurance recovery once realized or contingencies related to the realizability of the amount earned are resolved.

Income Taxes Income taxes are provided based upon the tax laws and rates in the countries in which our subsidiaries are registered and where their operations are conducted and income and expenses are earned and incurred, respectively. We recognize deferred tax assets and liabilities for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of our assets and liabilities using the applicable enacted tax rates in effect the year in which the asset is realized or the liability is settled. A valuation allowance for deferred tax assets is established when it is more likely than not that some portion or all of the deferred tax assets will not be realized.

We recognize tax benefits from an uncertain tax position only if it is more likely than not that the position will be sustained upon examination by taxing authorities based on the technical merits of the position. The amount recognized is the largest benefit that we believe has greater than a 50% likelihood of being realized upon settlement. Actual income taxes paid may vary from estimates depending upon changes in income tax laws, actual results of operations and the final audit of tax returns by taxing authorities. We recognize interest and penalties related to uncertain tax positions in income tax expense.

Subsequent Events We have evaluated subsequent events through the date the financial statements were issued. See Note 21.

Recently Issued Accounting Standards

Fair Value Measurements and Disclosures In May 2011, the FASB issued an accounting standards update that changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Some of the amendments included in this update are intended to clarify the application of existing fair value measurement requirements. We adopted the accounting standards update effective January 1, 2012 with no material impact to our financial statements or notes to the consolidated financial statements.

Presentation of Comprehensive Income In June and December 2011, the FASB issued an accounting standards update on the presentation of comprehensive income. This guidance eliminates a previously permitted option to report other comprehensive income and its components in the statement of changes in equity. We adopted the effective portions of the FASB accounting standards update on January 1, 2012 with no material impact on our financial statements or notes to the consolidated financial statements.

In February 2013, the FASB issued an accounting standards update on the reporting of amounts reclassified out of accumulated other comprehensive income. This guidance requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. The accounting standards update is effective for interim and annual periods beginning January 1, 2013. We are evaluating the impacts that our adoption of this update will have on our financial statements or notes to the consolidated financial statements.

Balance Sheet Offsetting In December 2011, the FASB issued an accounting standards update that expands the disclosure requirements for the offsetting of assets and liabilities related to certain financial instruments and derivative instruments. The update requires disclosures of gross and net information for financial instruments and derivative instruments that are eligible for net presentation due to a right of offset, an enforceable master netting arrangement or similar agreement. The accounting standards update is effective for interim and annual periods beginning January 1, 2013. We do not expect that our adoption of this update will have a material effect on our financial statements or notes to the consolidated financial statements.

Note 3 Property and Equipment

Property and equipment consists of the following as of:

	December 31,	
	2012	2011
	(In thousands)	
Drillships and related equipment	\$ 3,892,623	\$ 3,435,665
Other property and equipment	7,025	12,441
Property and equipment, cost	3,899,648	3,448,106
Accumulated depreciation	(139,227)	(12,096)
Property and equipment, net	\$ 3,760,421	\$ 3,436,010

On March 15, 2011, we entered into two contracts with SHI for the construction of our fifth and sixth new advanced-capability, ultra-deepwater drillships, the *Pacific Khamsin* and the *Pacific Sharav*, which are expected to be delivered to us at the shipyard in the second quarter and fourth quarter of 2013, respectively. On March 16, 2012, we entered into an additional contract with SHI for the construction of the *Pacific Meltem*, our seventh advanced-capability, ultra-deepwater drillship, which is expected to be delivered to us at the shipyard in the second quarter of 2014. The construction contract for the *Pacific Meltem* also includes an option for an eighth newbuild drillship on the same terms and conditions as those for the *Pacific Meltem*. The option was originally valid until June 15, 2012 and was subsequently extended through January 18, 2013 at no cost. In January 2013, we exercised our option and entered into an additional contract with SHI for the construction of our eighth drillship, which is expected to be delivered in the first quarter of 2015 (see Note 21).

The SHI contracts for the *Pacific Khamsin*, the *Pacific Sharav* and the *Pacific Meltem* provide for an aggregate purchase price of approximately \$1.5 billion for the acquisition of these three vessels, payable in installments during the construction process, of which we have made payments of \$374.3 million through December 31, 2012. We anticipate making payments of approximately \$797.3 million in 2013 and approximately \$329.8 million in 2014.

During the years ended December 31, 2012, 2011 and 2010, we capitalized interest costs of \$33.2 million, \$71.0 million and \$99.0 million, respectively, on assets under construction.

Note 4 Investment In and Notes Receivable from Joint Venture

A legal entity is a variable interest entity (VIE) if the entity's equity investment at risk does not provide its holders, as a group, with the power through voting or similar rights to direct the activities that most significantly impact the entity's economic performance. We are required to consolidate VIEs if we have the power to direct the activities of a VIE that most significantly impact the entity's economic performance and the obligation to absorb losses of the entity or the right to receive benefits from the VIE that could potentially be significant to the VIE. If these conditions are met, we have a controlling financial interest and are the primary beneficiary of the VIE.

Once an entity is identified as a VIE, we perform a qualitative assessment to determine whether we are the primary beneficiary. A qualitative assessment begins with an understanding of nature of the risks in the entity as well as the nature of the entity's activities, including terms of the contracts entered into by the entity, ownership interests issued by the entity, how they were marketed and the parties involved in the design of the entity. We then identify all of the variable interests held by parties involved with the VIE including, among other things, equity investments, debt financing, any financial and performance guarantees and significant contracted service providers. Once we identify the variable interests, we determine those activities that are most significant to the economic performance of the entity and which variable interest holder has the power to direct those activities.

Our Predecessor owned a 50% interest in TPDI that was recorded in our consolidated financial statements through the date of assignment to a subsidiary of the Quantum Pacific Group on March 30, 2011. The TPDI Joint Venture was formed with Transocean Offshore International Ventures Limited (TOIVL) to construct, own, and operate or charter two deepwater drillships, named the *Dhirubai Deepwater KG1* (*KG1*) and *Dhirubai Deepwater KG2* (*KG2*). Until the formation of the Joint Venture in 2007, both drillships under construction were owned by Pacific Drilling. *KG1* started operating in July 2009 and *KG2* started operating in March 2010.

The Joint Venture Shareholder Agreement defined the rights and restrictions with respect to the governance and management of TPDI. Among other things, the Joint Venture Shareholder Agreement provided that TOIVL may provide certain incidental general and administrative functions on behalf of TPDI, including procurement and payables, treasury and cash management, personnel and payroll and accounting. At inception, the Joint Venture Shareholders also entered into construction management agreements that provided TOIVL would design, construct, equip and test the TPDI deepwater drillships.

The Joint Venture Shareholders entered into a marketing agreement with TOIVL that granted TOIVL an exclusive right to market the TPDI deepwater drillships for use in any territory or region. The Joint Venture Shareholders also entered into an operating agreement with TOIVL that appointed TOIVL to act as the operator of the TPDI deepwater drillships, including day-to-day management and supervision and operating, maintenance, administrative and related services.

The Joint Venture Shareholder Agreement required Joint Venture Shareholders each provide capital or loans to the Company, to the extent expenditures were not funded by third-party indebtedness, in proportion to their respective ownership percentages to fund (1) all expenditures required to be made under various management service agreements, (2) any performance guarantees, surety bonds, or letters of credit, (3) an adequate level of working capital

for the Company and (4) additional requirements agreed to by the Joint Venture Shareholders.

The Joint Venture Shareholders entered into an agreement under which Pacific Drilling, beginning on October 18, 2010, had the right to exchange its interest in the Joint Venture for shares of Transocean Ltd. or cash at a purchase price based on an appraisal of the fair value of the *KG1* and *KG2*, subject to various customary adjustments.

We determined that the Joint Venture met the criteria of a VIE as TPDI's equity investment at risk was not sufficient for the entity to finance its activities without additional subordinated financial support. We also determined that Transocean was the primary beneficiary for accounting purposes since Transocean a) had the power to direct the marketing and operating activities, which were the activities that most significantly impact TPDI's economic performance and b) had the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. As a result, we accounted for TPDI as an equity method investment in our consolidated financial statements.

At inception, the Joint Venture shareholders entered into promissory note agreements with TPDI to fund the formation of the Joint Venture. The promissory notes accrued interest at LIBOR plus 2% per annum with semi-annual interest payments. The Joint Venture, upon providing written notice, was permitted to defer payment of interest (including any prior deferred interest) to the following interest payment date. During 2011 and 2010, the Joint Venture elected to defer interest payments due under the promissory notes.

The loans were scheduled to mature ten years after the date of the respective notes. The Joint Venture, upon providing written notice, was permitted to defer the maturity date for a period of up to ten years. The Joint Venture was not required to make any payments of principal or interest prior to the maturity date. The Joint Venture capitalized interest expense on the Shareholder promissory notes as a cost of property and equipment through the date the deepwater drillships were placed in service.

During 2009, the Joint Venture entered into interest rate swaps, which are designated as cash flow hedges of the future interest payments on variable rate borrowings under its bank credit facilities to reduce the variability of cash interest payments. During the years ended December 31, 2011 and 2010, Pacific Drilling reclassified \$3.0 million and \$11.5 million, respectively, of losses previously recognized as accumulated other comprehensive income to equity in earnings of Joint Venture. The Joint Venture recognizes gains and losses associated with the ineffective portion of the cash flow hedges in interest expense in the period in which they are realized. During the years ended December 31, 2011 and 2010, the Joint Venture recorded ineffectiveness gains (losses) of \$0.6 million and \$(0.3) million, respectively, to interest expense.

In April 2010, Transocean and Pacific Drilling entered into a letter of credit fee agreement whereby Transocean agreed to provide a letter of credit as needed for purposes of TPDI's compliance with the terms under TPDI's bank credit facility. In return, Pacific Drilling agreed to pay Transocean our 50% share of a 4.2% per annum fee on the required letter of credit amount. During the years ended December 31, 2011 and 2010, Pacific Drilling incurred \$0.3 million and \$0.9 million, respectively, of fees related to this agreement that is recorded as interest expense in our consolidated statement of operations.

On March 30, 2011, the Company assigned its interests in TPDI's equity, notes receivable from Joint Venture and accrued interest on promissory notes from Joint Venture to a subsidiary of the Quantum Pacific Group. The TPDI interests have been assigned on March 31, 2011, which date was used for convenience after our conclusion that there were no material intervening transactions between March 30, 2011 and March 31, 2011. The assignment was recorded and presented as a dividend in-kind within our consolidated financial statements.

A summarized consolidated balance sheet of TPDI is as follows:

	March 31, 2011
	(In thousands)
Balance sheet:	
Current assets	\$ 193,479
Property and equipment, net	1,421,215
Other assets	8,957
Total assets	\$ 1,623,651
Current liabilities	\$ 275,022
Long-term liabilities	1,216,010

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Shareholders equity	132,619
Total liabilities and shareholders equity	\$ 1,623,651

Summarized TPDI consolidated results of operations are as follows:

	For the three months ended March 31, 2011	Year ended December 31, 2010
	(In thousands)	
Income statement:		
Operating revenues	\$ 90,414	\$ 304,092
Operating expenses	35,492	129,214
Operating income	54,922	174,878
Interest expense, net	(13,958)	(52,762)
Other expense	(99)	(138)
Income before income taxes	40,865	121,978
Income tax expense	4,166	13,715
Net income	\$ 36,699	\$ 108,263

Note 5 Debt

A summary of debt is as follows:

	December 31, 2012	December 31, 2011
	(In thousands)	
Due within one year:		
Bora Term Loan	\$ 50,000	\$ 50,000
Mistral Term Loan	62,500	62,500
Scirocco Term Loan	43,750	43,750
Santa Ana Term Loan	62,500	62,500
Total current debt	218,750	218,750
Long-term debt:		
Bora Term Loan	\$ 300,000	\$ 350,000
Mistral Term Loan	325,000	387,500
Scirocco Term Loan	287,500	331,250
Santa Ana Term Loan	325,000	387,500
8.25% Senior Unsecured Bonds	300,000	
7.25% Senior Secured Notes	497,458	
Total long-term debt	2,034,958	1,456,250
Total debt	\$ 2,253,708	\$ 1,675,000

Project Facilities Agreement

On September 9, 2010, Pacific Bora Ltd., Pacific Mistral Ltd., Pacific Scirocco Ltd., and Pacific Santa Ana Ltd. (collectively, the Borrowers), and Pacific Drilling Limited (the Guarantor) (collectively, the Borrowing Group) entered into a project facilities agreement with a group of lenders to finance the construction, operation and other costs associated with the *Pacific Bora*, the *Pacific Mistral*, the *Pacific Scirocco* and the *Pacific Santa Ana*, (as amended on November 16, 2010, as amended and restated on March 30, 2011 and as further amended and restated on March 30, 2012, the Original Project Facilities Agreement). On April 19, 2012, in connection with the Temporary Import Bond Facilities described below, the Borrowing Group amended and restated the Original Project Facilities Agreement by entering into the Third Amended and Restated Project Facilities Agreement (the Project Facilities Agreement or PFA). On December 28, 2012, the Borrowing Group entered into the Second Amendment Agreement in respect of the Project Facilities Agreement, which changed the frequency of amortization payments from every six months to every three months.

The Project Facilities Agreement includes a term loan with respect to the *Pacific Bora*, a term loan with respect to the *Pacific Mistral*, a term loan with respect to the *Pacific Scirocco* and a term loan with respect to the *Pacific Santa Ana* (each, a Term Loan and, collectively, the Term Loans or the Term Loan Facility). Each Term Loan consists of three tranches: one provided by a syndicate of ten commercial banks (the Commercial Tranche), one provided by the Ministry of Trade and Industry of the Norwegian government (and guaranteed by the Norwegian Guarantee Institute for Export Credits) (the GIEK Tranche) and one provided by The Export-Import Bank of Korea (the KEXIM Tranche).

In November 2010, we borrowed \$450 million under the Bora Term Loan. During 2011, we borrowed \$450 million, \$375 million and \$450 million under the Mistral Term Loan, the Scirocco Term Loan and the Santa Ana Term Loan, respectively. Under the Scirocco Term Loan, \$75 million of the aggregated amount available was cancelled, resulting in our collective final borrowings equaling \$1.725 billion under the Project Facilities Agreement.

Borrowings under the Term Loans bear interest at the London Interbank Offered Rate (LIBOR) plus an applicable margin. Prior to the effective date of the first drilling contract in respect of a Borrower's drillship, the applicable margin under the relevant Term Loan is 4% per annum. Subsequent to the effective date of the first drilling contract in respect of such Borrower's drillship and until 12 months after delivery of all four drillships, the applicable margin is 3.5% per annum. Subsequent to 12 months after the delivery of all four drillships, the applicable margin is based on the Borrowing Group's historical debt service coverage ratio. If the ratio is not greater than 125%, the applicable margin is 3.5% per annum. If the ratio is greater than 125%, the applicable margin is 3% per annum. Interest is payable every three months.

During the years ended December 31, 2012, 2011 and 2010, we incurred \$64.4 million, \$57.2 million and \$12.6 million of interest expense on the Term Loans of which \$8.7 million, \$51.5 million and \$12.6 million was recorded to property and equipment as capitalized interest, respectively.

The Commercial Tranche under the Term Loan Facility matures on October 31, 2015, and the GIEK Tranche and the KEXIM Tranche each mature on October 31, 2019. Each Term Loan requires a residual debt payment of \$200 million at maturity of the Commercial Tranche. The GIEK Tranche and the KEXIM Tranche each contain put options exercisable if the Commercial Tranche is not refinanced on terms acceptable to GIEK and/or KEXIM, respectively. If the GIEK Tranche put option or the KEXIM Tranche put option is exercised, each Borrower must prepay, in full, the portion of all outstanding loans that relate to the GIEK Tranche and/or the KEXIM Tranche, as applicable, on the maturity date of the Commercial Tranche, without any premium, penalty or fees of any kind.

Borrowings under the Commercial Tranche may be prepaid in whole or in part with a 1% penalty on the amount prepaid if such prepayment takes place within one year after the delivery of the fourth drillship, and no penalty thereafter. Borrowings under the GIEK Tranche and the KEXIM Tranche may be prepaid in whole or in part with a 0.5% penalty.

With respect to the term loans relating to the *Pacific Bora*, the *Pacific Mistral*, the *Pacific Scirocco* and the *Pacific Santa Ana*, we are required to make amortization payments of \$12.5 million, \$15.6 million, \$10.9 million and \$15.6 million, respectively, every three months, commencing in January 2013, with the residual debt payment of \$200 million each due in October 2015.

The indebtedness under the Project Facilities Agreement is guaranteed by the Guarantor. The obligations of the Borrowers under the Term Loan Facility are joint and several. The Project Facilities Agreement is secured by several collateral components, which are usual and customary for such financings. The security provided to the lenders is cross-collateralized across all Term Loans and comprises assignments of refund guarantees, shipbuilding contracts and insurances, a first preferred mortgage over each Borrower's drillship and other types of collateral.

The Project Facilities Agreement requires compliance with certain affirmative and negative covenants that are customary for such financings. These include, but are not limited to, restrictions on (i) the ability of each of the Borrowers to pay dividends to its shareholder or sell assets and (ii) the ability of the Borrowing Group to incur additional indebtedness or liens, make investments or transact with affiliates (except for certain specified exceptions). The Borrowers are restricted in their ability to transfer their net assets to the Guarantor, whether in the form of dividends, loans or advances. As of December 31, 2012 and December 31, 2011, the Borrowing Group held \$1.7 billion and \$1.5 billion of restricted net assets, respectively.

The Guarantor (through the Borrowing Group) is also required to (i) enter into and maintain drilling contracts for each drillship (except as permitted pursuant to an executed waiver letter), (ii) maintain cash account balances reserved for debt service payments, (iii) maintain Guarantor liquidity and (iv) maintain contributed equity above certain levels and to meet a required level of collateral maintenance whereby the aggregate appraised collateral value must not be less than a certain percentage of the total outstanding balances and commitments under the Project Facilities Agreement.

The Project Facilities Agreement also requires compliance by the Guarantor with the following financial covenants: (i) a projected (looking forward over the following twelve months) debt service coverage ratio of at least 1.1x through June 30, 2012 and 1.2x thereafter; (ii) a historical (looking back over the preceding twelve months) debt service coverage ratio of at least 1.1x through December 31, 2013 and 1.2x thereafter; (iii) a maximum leverage ratio of 65% and (iv) a minimum liquidity of \$50 million (held in a restricted and pledged account with the Security Trustee) after the delivery of all four drillships.

Each Borrower is also required under the Project Facilities Agreement to hedge 75% of outstanding and available balances against floating interest rate exposure.

The Project Facilities Agreement contains events of default that are usual and customary for a financing of this type, size and purpose. Upon the occurrence of an event of default, borrowings under the Project Facilities Agreement are

subject to acceleration.

2015 Senior Unsecured Bonds

In February 2012, we completed a private placement of 8.25% senior unsecured U.S. dollar denominated bonds due 2015 (the 2015 Senior Unsecured Bonds) in aggregate principal amount of \$300 million to eligible purchasers. The bonds bear interest at 8.25% per annum, payable semiannually on February 23 and August 23, and mature on February 23, 2015.

The 2015 Senior Unsecured Bonds are general unsecured, senior obligations that rank: (i) senior in right of payment to all of the Company's subordinated indebtedness, if any; (ii) pari passu in right of payment with any of the Company's existing and future unsecured indebtedness that is not by its terms subordinated to the 2015 Senior Unsecured Bonds; (iii) effectively junior to the Company's existing and future senior debt facilities (including the Project Facilities Agreement, the Temporary Import Bond Facilities (as defined below), any future customary senior secured debt facilities provided by banks and/or financial institutions and any future first priority senior secured bond financing obtained to finance our fleet, including any refinancing, amendments or replacements of the debt facilities).

The Company may acquire 2015 Senior Unsecured Bonds in the open market, or otherwise, at any time without restriction. Within 60 days after notification of a specified change in control event, each bondholder has the right to exercise an early repayment option at a price equal to 101% of par, plus accrued interest.

During the year ended December 31, 2012, we incurred \$21.1 million in interest expense on the 2015 Senior Unsecured Bonds of which \$17.0 million was recorded to property and equipment as capitalized interest, respectively. We did not incur interest expense on the 2015 Senior Unsecured Bonds during the years ended December 31, 2011 and 2010.

The 2015 Senior Unsecured Bonds contain provisions that limit, with certain exceptions, the ability of the Company and our subsidiaries to (i) merge or demerge, (ii) dispose of assets, (iii) incur financial indebtedness and (iv) pay dividends exceeding 50% of consolidated net income for the preceding fiscal year. The 2015 Senior Unsecured Bonds also require compliance with financial covenants including (i) a minimum equity ratio of 35%, (ii) a minimum liquidity of \$25 million and (iii) a leverage restriction limiting the outstanding secured and unsecured borrowings on a consolidated basis (excluding Temporary Import Bond Facilities) to an average of \$475 million per drillship. The 2015 Senior Unsecured Bonds contain events of default that are usual and customary for a financing of this type, size and purpose. Upon the occurrence of an event of default, borrowings under the 2015 Senior Unsecured Bonds are subject to acceleration.

2017 Senior Secured Notes

In November 2012, Pacific Drilling V Limited (the Issuer), an indirect, wholly-owned subsidiary of Pacific Drilling S.A. (the Parent), completed a private placement of \$500 million (the 2017 Senior Secured Notes) in aggregate principal amount of 7.25% senior secured U.S. dollar denominated notes due 2017 to eligible purchasers. The 2017 Senior Secured Notes are fully and unconditionally guaranteed by Pacific Drilling S.A. on a senior unsecured basis. The 2017 Senior Secured Notes constitute a new series of debt securities under an indenture dated as of November 28, 2012 (the Indenture), among the Issuer, the Parent and each subsidiary guarantor from time to time party thereto, as guarantors, and Deutsche Bank Trust Company Americas, as Trustee (in such capacity, the Trustee) and Collateral Agent (in such capacity, the Collateral Agent).

The 2017 Senior Secured Notes were sold at 99.483% of par. The Notes bear interest at 7.25% per annum, payable semiannually on June 1 and December 1, commencing on June 1, 2013, and mature on December 1, 2017.

As of December 31, 2012, the Issuer has no subsidiaries. Any future subsidiary of the Issuer that holds or will hold the *Pacific Khamsin* or certain related assets, or is or becomes party to a drilling contract in respect of the *Pacific Khamsin*, will guarantee the notes on a senior secured basis. None of Pacific Drilling S.A.'s other subsidiaries will be guarantors of the 2017 Senior Secured Notes. The 2017 Senior Secured Notes and the note guarantees will be the Issuer's and each guarantor subsidiary's senior obligation, respectively, and will rank equal in right of payment to all existing and future senior indebtedness of the Issuer and such guarantor, respectively, and will rank senior in right of payment to all existing and future subordinated indebtedness of the Issuer and such guarantor, respectively.

Prior to the delivery of the *Pacific Khamsin*, the 2017 Senior Secured Notes will be secured by a first-priority security interest (subject to certain exceptions) in substantially all of the assets of the Issuer, including the Issuer's rights under the construction contract and the refund guarantee for the *Pacific Khamsin*, and by a pledge of the capital stock of the Issuer. Upon delivery of the *Pacific Khamsin*, the 2017 Senior Secured Notes will also be secured by a first-priority security interest (subject to exceptions) in the *Pacific Khamsin*, and substantially all of the other assets of the Issuer, including an assignment of earnings and insurance proceeds related to the *Pacific Khamsin*.

On or after December 1, 2015, the Issuer has the option to redeem the 2017 Senior Secured Notes, in whole or in part, at one time or from time to time, at the redemption prices plus accrued and unpaid interests and additional amounts, if any, as specified in the Indenture. Prior to December 1, 2015, the Issuer may redeem all or any portion of the Notes at a redemption price equal to 100% of the principal amount of the outstanding notes plus accrued and unpaid interest and additional amounts, if any, to the redemption date, plus a make-whole premium. In addition, prior to December 1, 2015, the Issuer may, at its option, on one or more occasions redeem up to 35% of the aggregate original principal

amount of the Notes (including any additional Notes) with the net cash proceeds from certain equity offerings of the Parent at a redemption price of 107.250% of the principal amount of the outstanding notes plus accrued and unpaid interest and additional amounts, if any, to the redemption date. The Issuer may also, prior to December 1, 2015, redeem up to 10% of the original aggregate principal amount of the Notes in any 12 month period at a redemption price equal to 103% of the aggregate principal amount thereof plus accrued and unpaid interest and additional amounts, if any, to the redemption date.

During the year ended December 31, 2012, we incurred and capitalized interest expense of \$3.4 million on the 2017 Senior Secured Notes. We did not incur interest expense on the 2017 Senior Secured Notes during the years ended December 31, 2011 and 2010.

The 2017 Senior Secured Notes contain provisions that limit, with certain exceptions, the ability of Pacific Drilling S.A., the Issuer and Pacific Drilling S.A.'s other restricted subsidiaries to (i) pay dividends, purchase or redeem Pacific Drilling S.A.'s capital stock or subordinated indebtedness of the Issuer or any guarantor or make other restricted payments, (ii) incur or guarantee additional indebtedness or issue preferred stock, (iii) create or incur liens and (iv) create unrestricted subsidiaries, (v) enter into transactions with affiliates, (vi) enter into new lines of business, (vii) transfer or sell the *Pacific Khamsin* and other related assets and (viii) merge or demerge. As of December 31, 2012 and 2011, the Issuer held \$0 of restricted net assets, respectively.

Temporary Import Bond Facilities

As part of the standard Nigerian importation requirements for equipment, we are required to either import the vessel into Nigeria on a permanent basis and pay import duties or apply for a Temporary Importation (TI) permit and put up a bond for the value of the import duties instead. On July 13, 2011, we entered into a temporary Standby Letter of Credit (SBLC) facility with Citibank, N.A. to support a TI bond for the *Pacific Bora* as required in Nigeria (the Bora TI Bond). On December 6, 2011, we entered into separate temporary SBLC facilities with each of Citibank, N.A. and Standard Charter Bank to support a TI bond for the *Pacific Scirocco* as required in Nigeria (collectively, the Scirocco TI Bond and, together with the Bora TI Bond, the TI Bonds).

Under the SBLC facility for the *Pacific Bora*, Citibank, N.A., as issuing bank, issued a letter of credit for the benefit of Citibank Nigeria denominated in the Nigerian currency, Naira, in the amount of approximately \$99.8 million. This letter of credit provided credit support for the Bora TI Bond that was issued by Citibank Nigeria in favor of the Government of Nigeria Customs Service for the *Pacific Bora*.

Under the temporary SBLC facilities for the *Pacific Scirocco*, Citibank, N.A. and Standard Charter Bank, as issuing banks, each issued a letter of credit for the benefit of Citibank Nigeria and Standard Charter Bank Nigeria, respectively, denominated in Naira in the collective amount of approximately \$109.5 million. These letters of credit provided credit support for the Scirocco TI Bond that was issued by Citibank Nigeria and Standard Charter Bank Nigeria, respectively, in favor of the Government of Nigeria Customs Service for the *Pacific Scirocco*.

On April 19, 2012, the temporary SBLC facilities for the *Pacific Bora* and the *Pacific Scirocco* were each replaced by a Letter of Credit Facility and Guaranty Agreement. Under the Letter of Credit Facility and Guaranty Agreement for the Bora TI Bond (the Bora TI Facility), Citibank, N.A., as administrative agent, issuing bank and arranger, has issued a letter of credit for the benefit of Citibank Nigeria in the amount of 14,884,342,426 Naira or approximately \$94.5 million as of April 19, 2012. This letter of credit provides credit support for the Bora TI Bond that was issued by Citibank Nigeria in favor of the Government of Nigeria Customs Service for the *Pacific Bora*.

Under the Letter of Credit Facility and Guaranty Agreement for the Scirocco TI Bond (the Scirocco TI Facility, and, together with the Bora TI Facility, the TI Facilities), Citibank, N.A., as administrative agent, issuing bank and arranger, has issued letters of credit for the benefit of Citibank Nigeria and Standard Charter Bank Nigeria in the collective amount of 17,280,837,923 Naira or approximately \$109.7 million as of April 19, 2012. These letters of credit provide credit support for the TI bonds that were issued by Citibank Nigeria and Standard Charter Bank Nigeria, respectively, in favor of the Government of Nigeria Customs Service for the *Pacific Scirocco*.

Each letter of credit issued pursuant to the Bora TI Facility and Scirocco TI Facility will expire after a one-year period and will be renewable for up to two additional one-year terms based on the initial contract term of each vessel. In connection with the placement of the Bora TI Facility and the Scirocco TI Facility, our restricted cash deposit obligations were lowered from \$50 million and \$99 million under the former SBLC facilities to \$10.7 million and \$12.3 million, respectively, resulting in a release of approximately \$126 million of cash collateral. The restricted cash balance required is subject to fluctuations in the U.S. dollar to Naira currency exchange rates.

The TI Facilities require the Company to pay fees, in addition to customary fronting fees, calculated based on outstanding balances of the TI Bonds and each outstanding letter of credit. Fees on the TI Facilities are primarily based on 2.5% of the U.S. dollar equivalent of outstanding balances of the Bora TI Facility and the Scirocco TI Facility. During the years ended December 31, 2012 and 2011, we incurred \$5.5 million and \$0.7 million, respectively, in interest expense on the TI Facilities.

F-17

Maturities of Long-Term Debt

For purposes of preparing our scheduled maturities of debt, borrowings under the GIEK Tranche and the KEXIM Tranche are presented assuming an exercise of the option by GIEK and KEXIM to accelerate the maturity date to October 31, 2015. Maturities of long-term debt for each of the five years ending after December 31, 2012 are as follows:

	(In thousands)
Twelve months ended December 31,	
2013	\$ 218,750
2014	218,750
2015	1,318,750
2016	
2017	500,000

Note 6 Restricted Cash

Restricted cash consists primarily of bank accounts held with financial institutions as security for the Project Facilities Agreement and the Temporary Import Bond Facilities.

Note 7 Income Taxes

Pacific Drilling S.A., a holding company and Luxembourg resident, is subject to Luxembourg corporate income tax and municipal business tax at a combined rate of 28.8 percent. Qualifying dividend income and capital gains on the sale of qualifying investments in subsidiaries are exempt from Luxembourg corporate income tax and municipal business tax. Consequently, Pacific Drilling S.A. expects dividends from its subsidiaries and capital gains from sales of investments in its subsidiaries to be exempt from Luxembourg corporate income tax and municipal business tax.

Income taxes have been provided based on the laws and rates in effect in the countries in which our operations are conducted or in which our subsidiaries are considered residents for income tax purposes. Our income tax expense or benefit arises from our mix of pretax earnings or losses, respectively, in the international tax jurisdictions in which we operate. Because the countries in which we operate have different statutory tax rates and tax regimes with respect to one another, there is no expected relationship between the provision for income taxes and our income or loss before income taxes.

Income / (loss) before income taxes consisted of the following:

	Years ended December 31,		
	2012	2011	2010
	(In thousands)		
Luxembourg	\$ (24,451)	\$ (1,281)	\$
United States	(444)	(2,753)	498
Other Jurisdictions	80,597	4,331	36,752
Total	\$ 55,702	\$ 297	\$ 37,250

The components of income tax (provision) / benefit consisted of the following:

	Years ended December 31,		
	2012	2011	
	(In thousands)		
Current income tax expense:			
Luxembourg	\$ (535)	\$	\$
United States	(4,404)	(164)	(301)
Other Foreign	(20,540)	(6,205)	(21)
Total current	\$ (25,479)	\$ (6,369)	\$ (322)
Deferred tax benefit:			
Luxembourg	\$ 32	\$	\$
United States	4,646	782	344
Other Foreign	(912)	2,387	27
Total deferred	\$ 3,766	\$ 3,169	\$ 371
Income tax (expense) benefit	\$ (21,713)	\$ (3,200)	\$ 49

A reconciliation between the Luxembourg statutory rate of 28.8 percent and Liberian statutory rate of zero percent and our effective tax rate is as follows:

	Years ended December 31,		
	2012	2011	2010
Statutory rate	28.8%	28.8%	
Effect of tax rates different than the Luxembourg statutory tax rate	6.8%	108.5%	(0.1)%
Change in valuation allowance	3.4%	934.1%	
Adjustments related to prior years		6.0%	
Effective tax rate	39.0%	1,077.4%	(0.1)%

The components of deferred tax assets and liabilities consist of the following:

	December 31,	
	2012	2011
	(In thousands)	
Deferred tax assets:		
Net operating loss carryforwards	\$ 4,671	\$ 2,547
Accrued payroll expenses	4,644	2,175
Deferred revenue	5,592	2,410
Other	23	18
Deferred tax assets	14,930	7,150
Less: valuation allowance	(4,476)	(2,547)
Total deferred tax assets	\$ 10,454	\$ 4,603
Deferred tax liabilities:		
Depreciation and amortization	\$ (1,125)	\$ (1,063)
Deferred expenses	(2,024)	
Total deferred tax liabilities	\$ (3,149)	\$ (1,063)
Net deferred tax assets	\$ 7,305	\$ 3,540

As of December 31, 2012 and 2011, the Company had gross deferred tax assets of \$4.7 million and \$2.5 million related to loss carry forwards in various worldwide tax jurisdictions. The majority of the loss carry forwards have no expiration.

A valuation allowance for deferred tax assets is established when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of December 31, 2012 and 2011, the valuation allowance for deferred tax assets was \$4.5 million and \$2.5 million, respectively. The increase in our valuation allowance primarily resulted from losses incurred in Nigeria and Brazil during the year ended December 31, 2012, for which we believe it is more likely than not that a tax benefit will not be realized.

We consider the earnings of certain of our subsidiaries to be indefinitely reinvested. As such, we have not provided for taxes on these unremitted earnings. Should we make a distribution from the unremitted earnings of these subsidiaries, we would be subject to taxes payable to various jurisdictions. At December 31, 2012, the amount of indefinitely reinvested earnings was approximately \$29 million. If all of these indefinitely reinvested earnings were distributed, we would be subject to estimated taxes of approximately \$0.4 million.

We recognize tax benefits from an uncertain tax position only if it is more likely than not that the position will be sustained upon examination by taxing authorities based on the technical merits of the position. As of December 31, 2012 and 2011, we have not accrued any liabilities with respect to uncertain tax positions. We will recognize interest and penalties related to uncertain tax positions in income tax expense.

Pacific Drilling is subject to taxation in various U.S., foreign, and state jurisdictions in which it conducts business. Tax years as early as 2009 remain subject to examination. As of December 31, 2012, Pacific Drilling's only ongoing tax audit is in Nigeria and relates to the 2011 tax year. The audit recently commenced and no issues have been raised to date. There are no other known pending tax audits.

Note 8 Related-Party Loan

The related-party loan was provided by Winter Finance Limited (Winter Finance), a subsidiary of the Quantum Pacific Group. In November 2010, the Company made a \$69.4 million related-party loan payment in conjunction and compliance with the first utilization under the Bora Term Loan and \$655 million of the related-party loan was converted into equity. On December 31, 2010, all outstanding related party loan principal and accrued interest, in the amount of \$892.6 million, was converted into equity in Pacific Drilling Limited. During the year ended December 31, 2011, Pacific Drilling borrowed \$142.2 million. On March 23, 2011, all outstanding related party loan principal and accrued interest, in the amount of \$142.8 million, was converted into equity of Pacific Drilling Limited. Following the conversion, the Intercompany Loan Agreement was terminated.

Borrowings under the intercompany revolving loan agreement accrued interest at the rate of six percent per annum. During the years ended December 31, 2011 and 2010, Pacific Drilling incurred and capitalized interest expense of \$0.6 million and \$60.1 million, respectively, on the related-party loan as a cost of property and equipment.

Note 9 Shareholder s Equity

As of December 31, 2009, the common stock of Pacific Drilling Limited consisted of 805,000 shares of authorized and issued common stock with \$0.001 par value.

On November 29, 2010, \$655 million of the related-party loan from Winter Finance was assigned to Quantum. The related-party loan was then converted to equity in Pacific Drilling, in the form of additional paid in capital by means of it being contributed, by Quantum, as an additional capital contribution for the common stock held by it as sole shareholder of the Company.

On December 10, 2010, the Board of Pacific Drilling Limited authorized and approved an amendment and restatement of its Articles of Incorporation, to increase the authorized number of shares of common stock, no par value per share, to 2,000,000 shares of common stock.

On December 31, 2010, Quantum was assigned all outstanding principal and accrued interest of the related-party loan from Winter Finance, which was then converted to equity, in the amount of \$892.6 million, in Pacific Drilling in exchange for the issuance of 1,115,761 shares of common stock.

On March 11, 2011, Pacific Drilling S.A. was incorporated under the form of a *société anonyme* governed by the laws of the Grand Duchy of Luxembourg with a share capital of \$50,000 represented by 50,000 common shares, no par value.

On March 23, 2011, Quantum Pacific Group was assigned all outstanding principal and accrued interest of the related-party loan in the amount of \$142.8 million, which was then converted to equity in the Company by means of it being contributed as additional consideration for the existing shares held by it as sole shareholder of the Company.

On March 30, 2011, the Company assigned its interests in TPDI s equity, promissory notes to Joint Venture and accrued interest on promissory notes from Joint Venture to a subsidiary of the Quantum Pacific Group. The assignment was recorded and presented as a dividend in-kind within our consolidated financial statements.

Additionally, on March 30, 2011, the Board of Pacific Drilling S.A. resolved to split the 50,000 incorporation common shares into 5,000,000 common shares, no par value. The Board also resolved for Quantum Pacific (Gibraltar) Limited to become the indirect sole shareholder of all issued Pacific Drilling Limited common shares in exchange for the issuance of 145,000,000 common shares of Pacific Drilling S.A. Further, on March 30, 2011, the shareholder held a general meeting to approve amending the Company s Articles to authorize the Board of Directors, for a period of five

years, to issue up to \$50,000,000 of share capital (inclusive of current share capital of the Company).

On April 5, 2011, Pacific Drilling completed a private placement of 60,000,000 common shares for net proceeds of approximately \$575.5 million, \$0.01 par value.

In November 2011, the Company completed an initial public offering of 6,000,000 common shares. In December 2011, the underwriters purchased an additional 900,000 common shares pursuant to the full exercise of an over-allotment option. The initial public offering resulted in net proceeds of approximately \$50.3 million.

In December 2011, the Company also issued 7,200,000 common shares to one of our wholly-owned subsidiaries, which represents 3.3% of our outstanding common shares. These common shares are held in treasury for purposes of administering our Pacific Drilling S.A. 2011 Omnibus Stock Incentive Plan.

As of December 31, 2012, the Company's share capital consisted of 5,000,000,000 common shares authorized, 224,100,000 common shares issued and 216,902,000 common shares outstanding of which approximately 69.2% is held by Quantum Pacific (Gibraltar) Limited.

Note 10 Share-Based Compensation

During the years ended December 31, 2012, 2011 and 2010, compensation expense recognized related to share-based arrangement grants totaled \$5.3 million, \$4.5 million and \$0.1 million, respectively, and is recorded in general and administrative expenses in our consolidated statements of operations.

2009 Stock Plan

On April 24, 2009, the Board of our Predecessor approved the creation of the Pacific Drilling Limited 2009 Omnibus Stock Incentive Plan (the 2009 Stock Plan), which provided for issuance of common stock options, as well as share appreciation rights, restricted shares, restricted share units, and other equity based or equity related awards to directors, officers, employees and consultants of Pacific Drilling. The Board also authorized the issuance of 6,684 common stock options to certain executives and employees at a per share exercise price of \$1,000, which the Board determined at issuance to be the fair market value of a share of our Predecessor's common stock. The options issued in 2009 had a contractual term of 10 years and were scheduled to vest 50%, 25% and 25% on March 31, 2011, 2012 and 2013, respectively.

On December 21, 2010, the Board authorized the issuance of 12,577 common stock options to certain executives and employees at a per share exercise price of \$800, which the Board determined at issuance to be the fair market value of a share of our Predecessor's common stock. The options issued in 2010 had a contractual term of 10 years and were scheduled to vest 25% annually on March 31, 2011, 2012, 2013 and 2014.

Pursuant to the terms of the options granted, our Predecessor could elect to settle the stock options upon exercise in cash instead of issuing shares of our common stock. The Company anticipated settling any of the 2010 and 2009 stock options in cash. As such, the stock options were accounted for as liability awards at fair value.

2011 Stock Plan

Stock Options

On March 31, 2011, as part of the Restructuring, the Company cancelled the 2009 Stock Plan. Further, the Board approved the creation of the Pacific Drilling S.A. 2011 Omnibus Stock Incentive Plan (the 2011 Stock Plan), which provides for issuance of common stock options, as well as share appreciation rights, restricted shares, restricted share units and other equity based or equity related awards to directors, officers, employees and consultants. The Board also resolved that 7.2 million common shares of Pacific Drilling S.A. be reserved and authorized for issuance pursuant to the terms of the 2011 Stock Plan.

In conjunction with the Restructuring and cancellation of stock option grants under the 2009 Stock Plan, the Company issued 1,471,601 common stock options in Pacific Drilling S.A. as a replacement of the 2010 and 2009 stock options. The replacement awards were recorded as a modification of an existing award. As exercises of replacement awards will be settled in common shares, the \$2.3 million liability for stock options issued under the 2009 Stock Plan on the date of modification was extinguished and the balance reclassified to additional paid-in capital. Additionally, on March 31, 2011, the Company granted 1,329,710 common stock options to certain executives and employees pursuant to the 2011 Stock Plan.

The 2009 replacement option grants vest 50%, 25% and 25% on March 31, 2011, 2012, and 2013, respectively. The 2010 replacement option grants and the 2011 option grants vest 25% annually over four years commencing on March 31, 2011 and March 31, 2012, respectively. The 2009 replacement option grants, 2010 replacement option grants and the 2011 option grants were issued at an exercise price of \$10.00 and have a 10 year contractual term.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model utilizing the assumptions noted in the table below. Expected volatility is based on implied volatilities from the expected volatility of a representative group of our publicly listed industry peer group as the historical volatility of the Company does not provide a reasonable basis for estimating volatility. The expected terms of the options is calculated using the simplified method as the historical option exercise experience of the Company does not provide a reasonable basis for estimating expected term. The risk free interest rates are determined using the implied yield currently available for zero-coupon U.S. government issues with a remaining term equal to the expected life of the options.

The fair value of the 2011, 2010 and 2009 stock option grants as of March 31, 2011, the date of modification and grant, was calculated using the following assumptions:

	2011	2010	2009
	stock options	stock options	stock options
Expected volatility	52%	53%	53%
Expected term (in years)	6.25	6.00	5.75
Expected dividends			
Risk-free interest rate	2.65%	2.57%	2.49%

On March 31, 2012, the Company granted 1,294,840 common stock options to certain members of our Board of Directors, executives and employees pursuant to the 2011 Stock Plan. The 2012 option grants vest 25% annually over four years. The 2012 option grants were issued at an exercise price of \$10.12 and have a 10 year contractual term.

The fair value of the 2012 stock option grants as of March 31, 2012, the date of grant, was calculated using the following assumptions:

	2012 stock options
Expected volatility	48.5%
Expected term (in years)	6.25
Expected dividends	
Risk-free interest rate	1.40%

A summary of option activity under the 2011 Stock Plan as of and for the year ended December 31, 2012 is as follows:

	Number of shares under option	Weighted-average exercise price (per share)	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding January 1, 2012	2,788,596	\$ 10.00		
Granted	1,294,840	10.12		
Exercised				
Cancelled				
Forfeited or expired	(107,798)	10.00		
Outstanding December 31, 2012	3,975,638	\$ 10.04	8.1	
Exercisable December 31, 2012	1,121,429	\$ 10.00	7.3	

The weighted-average grant-date fair value of options granted during the years ended December 31, 2012 and 2011 was \$4.85 and \$5.24. There were no options exercised during the years ended December 31, 2012, 2011 and 2010. As of December 31, 2012, total compensation costs related to nonvested option awards not yet recognized is \$10.6 million and is expected to be recognized over 2.5 years.

Restricted Stock Units

On November 2, 2011, we granted awards of 12,000 restricted stock units with a grant date fair value of \$8.54 under the 2011 Plan to certain members of our Board of Directors. On March 31, 2012, the Company also granted 297,180 restricted stock units to certain members of our Board of Directors, executives and employees pursuant to the 2011 Stock Plan. These restricted stock units will be settled in shares of our stock and will generally vest over a period of four years.

A summary of restricted stock units activity under the 2011 Stock Plan as of and for the year ended December 31, 2012 is as follows:

	Number of restricted stock units	Weighted-average grant-date fair value (per share)
Nonvested January 1, 2012	12,000	\$ 8.54
Granted	297,180	10.12
Vested	(2,000)	8.54
Forfeited	(17,492)	10.12
Nonvested December 31, 2012	289,688	\$ 10.07

As of December 31, 2012, total compensation costs related to nonvested restricted stock units not yet recognized is \$2.4 million and is expected to be recognized over a weighted average period of 3.2 years.

Note 11 Derivatives

We are currently exposed to market risk from changes in interest rates. From time to time, we may enter into a variety of derivative financial instruments in connection with the management of our exposure to fluctuations in interest rates and to meet our debt covenant requirements. We do not enter into derivative transactions for speculative purposes; however, for accounting purposes, certain transactions may not meet the criteria for hedge accounting.

During 2011, we entered into four interest rate swaps to reduce the variability of future cash flows in the interest payments for the variable-rate debt under the Project Facilities Agreement. We designated the interest rate swaps as cash flow hedges for accounting purposes. The interest rate swaps pay a fixed rate of interest and receive LIBOR. The fixed interest rate swap rates are 1.83%, 1.87%, 1.6% and 2.39% for the Bora Term Loan, Scirocco Term Loan, Mistral Term Loan and Santa Ana Term Loan, respectively. As of December 31, 2012, the notional amounts of the Bora, Scirocco, Mistral and Santa Ana interest rate swaps were \$350.0 million, \$316.7 million, \$331.3 million and \$387.5 million, respectively. The notional amounts of the interest rate swaps amortize quarterly and will expire on October 31, 2015.

On December 28, 2012, management de-designated a portion of the Bora, Scirocco, Mistral and Santa Ana interest rate swaps from hedge accounting due to the change in payment frequency of principal payments resulting from the Second Amendment Agreement to the Project Facilities Agreement. Subsequent to de-designation, we account for the de-designated portion of the interest rate swaps on a mark-to-market basis, with both realized and unrealized gains and losses on the de-designated portion recorded currently in earnings in interest expense in the Consolidated Statements of Operations. As a result of the de-designation, \$2.8 million of accumulated other comprehensive income associated with the de-designated portion of the interest rate swap was reclassified into interest expense.

The table below provides data about the fair values of derivatives that are designated as hedge instruments as of December 31, 2012 and 2011:

Derivatives designated as hedging instruments		Derivative liabilities Balance sheet location	December 31,	
			2012	2011
(In thousands)				
Short-term	Interest rate swaps	Derivative liabilities, current	\$ 17,017	\$ 20,466
Long-term	Interest rate swaps	Other long-term liabilities	\$ 27,437	\$ 30,769
Total			\$ 44,454	\$ 51,235

As of December 31, 2012, the estimated amount of net losses associated with derivative instruments that would be reclassified to earnings during the next twelve months is \$18.5 million.

The table below provides data about the fair values of derivatives that are not designated as hedge instruments as of December 31, 2012 and 2011:

Derivatives not designated as hedging instruments		Derivative liabilities Balance sheet location	December 31,	
			2012	2011
(In thousands)				
Short-term	Interest rate swaps	Derivative liabilities, current	\$ 978	\$
Long-term	Interest rate swaps	Other long-term liabilities	\$ 1,574	\$
Total			\$ 2,552	\$

The following table summarizes the cash flow hedge gains and losses for the years ended December 31, 2012, 2011 and 2010:

Derivatives in cash flow hedging relationships	Amount of income (loss) recognized in equity for the year ended December 31,			Amount of loss reclassified from accumulated OCI into income for the year ended December 31,			Amount recognized in income (ineffective portion and amount excluded from effectiveness testing) for the year ended December 31,		
	2012	2011	2010	2012	2011	2010	2012	2011	2010
Interest rate swaps	\$ 1,868	\$ (60,284)	\$	\$ 24,419	\$ 1,802	\$	\$	\$	\$

(In thousands)

For the de-designated portion of the interest rate swaps not in a cash flow hedge relationship, gains and losses recorded from December 28, 2012 to December 31, 2012 were immaterial.

Note 12 Fair Value Measurements

We have estimated fair value by using appropriate valuation methodologies and information available to management as of December 31, 2012 and 2011. Considerable judgment is required in developing these estimates, and accordingly, estimated values may differ from actual results.

The estimated fair value of accounts receivable, accounts payable and accrued expenses approximates their carrying value due to their short-term nature. Additionally, the estimated fair value of current and noncurrent restricted cash approximates its carrying value as it consists of cash and cash equivalent balances. The estimated fair value of our Project Facilities Agreement debt approximates carrying value because the variable rates approximate current market rates. As of December 31, 2012, we estimated the

fair value of our 2015 Senior Unsecured Bonds and our 2017 Senior Secured Notes to be approximately \$308.9 million and \$512.5 million compared to their carrying value of \$300.0 million and \$497.5 million. We estimate the fair values of our variable-rate and fixed-rate debts using significant other observable inputs, which represent Level 2 fair value measurements.

The following table presents the carrying value and estimated fair value of our financial instruments recognized at fair value on a recurring basis:

	December 31, 2012			
	Carrying value	Fair value measurements using		
		Level 1	Level 2	
		Level 3		
		(in thousands)		
Liabilities:				
Interest rate swaps	\$ 47,006		47,006	

	December 31, 2011			
	Carrying value	Fair value measurements using		
		Level 1	Level 2	
		Level 3		
		(in thousands)		
Liabilities:				
Interest rate swaps	\$ 51,235		51,235	

We use an income approach to value assets and liabilities for outstanding interest rate swaps. These contracts are valued using a discounted cash flow model that calculates the present value of future cash flows under the terms of the contracts using market information as of the reporting date, such as prevailing interest rates. The determination of the fair values above incorporates various factors, including the impact of the counterparty's non-performance risk with respect to the Company's financial assets and the Company's non-performance risk with respect to the Company's financial liabilities. The Company has not elected to offset the fair value amounts recognized for multiple derivative instruments executed with the same counterparty, but report them gross on its consolidated balance sheets.

Refer to Note 11 for further discussion of the Company's use of derivative instruments and their fair values.

Note 13 Commitments and Contingencies

Operating Leases The Company leases office space in countries it operates. The future minimum lease payments under the non-cancelable operating leases with lease terms in excess of one year are as follows:

	(In thousands)
Years ending December 31,	
2013	\$ 1,041
2014	1,057
2015	751
2016	738
2017	757
Thereafter	2,375

Total future minimum lease payments	\$	6,719
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During the years ended December 31, 2012, 2011 and 2010, rent expense was \$1.7 million, \$1.1 million and \$0.6 million, respectively.

Commitments As of December 31, 2012 and 2011, Pacific Drilling had no material commitments other than commitments related to deepwater drillship construction purchase commitments discussed in Note 3.

Contingencies The Company may be the subject of certain claims and lawsuits occurring in the normal course of business. No pending or known threatened claims, actions or proceedings against us are expected to have a material adverse effect on our consolidated financial position, results of operations and cash flows.

On November 9, 2010, Pacific Drilling entered into a drilling contract for the *Pacific Bora* with a subsidiary of Chevron Corporation (Chevron). Under the contract terms, Chevron will reimburse Pacific Drilling for up to \$30 million in capital upgrades. At the end of the contract, Pacific Drilling is obligated to refund a portion of these costs. The amount of refund is dependent upon the timing of the expiration of the drilling contract. If the contract ends on the initial primary term of three years, Pacific Drilling will refund Chevron 50% of the capital upgrades cost. For each year the contract is extended beyond the initial primary term, the amount

refunded is reduced by 10%. As of December 31, 2012 and 2011, Pacific Drilling has recorded a liability of \$15.6 million and \$4.0 million, respectively, for costs of upgrades incurred and billed to Chevron. If the contract is extended, Pacific Drilling will record the resulting gain contingency to reimbursable revenues in future periods.

We maintain loss of hire insurance that becomes effective 45 days after an accident or major equipment failure covered by hull and machinery insurance, resulting in a downtime event and extends for 180 days. In the third quarter 2011, the *Pacific Scirocco* underwent repairs and upgrades to ensure engine reliability, which was a covered event under our loss of hire policy that resulted in the \$23.7 million and \$18.5 million of loss of hire insurance recovery recognized for the years ended December 31, 2012 and 2011.

Note 14 Retirement Plan

Pacific Drilling sponsors a defined contribution retirement plan covering substantially all U.S. employees (the U.S. Savings Plan) and an international savings plan (the International Savings Plan). Under the U.S. Savings Plan, the Company matches 100% of employee contributions (limited to \$17,000 or, for employees age 50 or over, \$22,500) up to 6% of eligible compensation per participant. Under the International Savings Plan, we contribute 6% of base income (limited to \$15,000 per participant). During the years ended December 31, 2012, 2011 and 2010, our total employer contributions to both plans amounted to \$3.7 million, \$2.8 million and \$0.5 million, respectively.

Note 15 Concentrations of Credit and Market Risk

Financial instruments that potentially subject Pacific Drilling to credit risk are primarily cash equivalents and restricted cash. At times, cash equivalents may be in excess of FDIC insurance limits. Pacific Drilling has a concentration of customers in the offshore drilling industry, which exposes us to a concentration of credit risk within a single industry. This industry concentration has the potential to impact our overall exposure to market and credit risks as our customers could be affected by similar changes in economic, industry or other conditions. However, we believe that the credit risk posed by this industry concentration is largely offset by the creditworthiness of our customer base. During the years ended December 31, 2012, 2011 and 2010, the percentage revenues earned from our customers was as follows:

	Years ended December 31,		
	2012	2011	2010
Chevron	45.0%	100.0%	
Total	32.9%		
Petrobras	22.1%		

Note 16 Related-Party Transactions

Prior to the Restructuring, we received funding in the form of a related-party loan as presented in our consolidated financial statements and described in Note 8 and Note 9. On December 31, 2010, the Quantum Pacific Group was assigned all outstanding principal and accrued interest of the loan from Winter Finance, which was then converted into 1,115,761 shares of Pacific Drilling. During the year ended December 31, 2011, we borrowed \$142.2 million under the related-party loan. On March 23, 2011, all outstanding related party loan principal and accrued interest, in the amount of \$142.8 million, was converted into equity of Pacific Drilling Limited.

Prior to the TPDI Transfer, the Company entered into promissory note agreements with TPDI and Transocean to fund TPDI as presented in our consolidated financial statements and described in Note 4. The promissory notes accrued interest at LIBOR plus 2% per annum. As of December 31, 2012 and 2011, promissory notes to the Joint Venture and the accrued interest receivable on these promissory notes were \$0. During the years ended December 31, 2012, 2011

and 2010, the Company recorded related-party interest income from the Joint Venture of \$0, \$0.5 million and \$2.0 million on the promissory notes, respectively.

On March 30, 2011, we transferred our equity interest in TPDI, including promissory notes, to a subsidiary of the Quantum Pacific Group. We did not receive any consideration for the transfer. In connection with the TPDI Transfer, we entered into a management agreement pursuant to which we provided day-to-day oversight and management services with respect to the Quantum Pacific Group's equity interest in TPDI for a fee of \$4,000 per drillship per day, or \$8,000 per day. On May 31, 2012, as a result of Quantum Pacific's divestiture of their equity position in TPDI, this management agreement was terminated. During the years ended December 31, 2012, 2011 and 2010 management fee income of \$1.2 million, \$2.2 million and \$0, respectively, was recorded in other income within our consolidated statements of operations.

The joint venture agreements relating to TPDI provided Quantum Pacific Group with a put option that allowed it to exchange its 50% interest in TPDI for shares of Transocean Ltd. or cash at a purchase price based on an appraisal of the fair value of the two vessels owned by TPDI, subject to various customary adjustments. In conjunction with the TPDI Transfer and a related amendment to the Original Project Facilities Agreement, a subsidiary of the Quantum Pacific Group provided the TPDI Put Option Guarantee. In consideration for the TPDI Put Option Guarantee, we agreed to pay the Quantum Pacific Group a fee of 0.25% per annum on the

outstanding borrowings on the Project Facilities Agreement. During the years ended December 31, 2012, 2011 and 2010, guarantee fees of \$1.3 million, \$1.9 million and \$0 were incurred of which \$0.5 million, \$1.5 million and \$0 were recorded to property and equipment as capitalized interest costs, respectively. On April 24, 2012, the Quantum Pacific Group TPDI Put Option Guarantee was terminated and the Quantum Pacific Group was released from its obligations thereunder. In connection with the termination and release of the TPDI Put Option Guarantee, we were released from our obligation to pay the Quantum Pacific Group a fee of 0.25% per annum on the outstanding borrowings on the Project Facilities Agreement and the related agreement was terminated.

In February 2012, the Quantum Pacific Group purchased \$40 million of the 2015 Senior Unsecured Bonds. Following their initial purchase, the Quantum Pacific Group sold the 2015 Senior Unsecured Bonds purchased to unrelated parties. See Note 5 for a description of the 2015 Senior Unsecured Bonds.

Note 17 Segments and Geographic Areas

Pacific Drilling is engaged in offshore contract drilling operations in international locations, with the operation and management of our ultra-deepwater drillships. Our primary business is to contract our drillships, related equipment and work crews primarily on a dayrate basis. We specialize in technically demanding segments of the offshore drilling business with a focus on deepwater drilling services.

Although we operate in many geographic locations, there is a similarity of economic characteristics among all of our locations, including the nature of services provided and the type of customers. Our drillships are part of a single, global market for contract drilling services and can be redeployed globally due to changing demands. We intend to evaluate the performance of our operating segments based on revenues from external customers and operating profit by rig. The consolidation of our operating segments into one reportable segment is attributable to how we manage our business. The accounting policies of our operating segments are the same as those described in the summary of significant accounting policies (Note 2).

As of December 31, 2012, the *Pacific Bora* and the *Pacific Scirocco* were located offshore Nigeria, the *Pacific Mistral* was located offshore Brazil, the *Pacific Santa Ana* was located offshore the United States and the *Pacific Khamsin*, the *Pacific Sharav* and the *Pacific Meltem* were located offshore South Korea, where they are under construction by SHI.

During the years ended December 31, 2012, 2011 and 2010, the percentage revenues earned by geographic area as follows is based on drilling location:

	Years ended December 31,		
	2012	2011	2010
Nigeria	63.6%	100.0%	
Brazil	22.1%		
Gulf of Mexico	14.3%		

Note 18 Earnings per Share

On March 11, 2011, Pacific Drilling S.A. was formed by Quantum as a Luxembourg company with a share capital of 50,000 common shares. On March 30, 2011, the Board of Pacific Drilling S.A. resolved to split the 50,000 incorporation common shares into 5,000,000 common shares. Further, Pacific Drilling S.A. issued 145,000,000 common shares to Quantum Pacific (Gibraltar) Limited, a wholly-owned subsidiary of Quantum, to become the indirect shareholder of all issued Pacific Drilling Limited common shares.

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In computing earnings per common share, the reported share and per share amounts for the years ended December 31, 2011 and 2010 has been retrospectively restated to reflect the Restructuring that occurred on March 30, 2011. The following reflects the income and the share data used in the basic and diluted earnings per share computations:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands, except share and per share information)		
Numerator:			
Net income (loss), basic and diluted	\$ 33,989	\$ (2,903)	\$ 37,299
Denominator:			
Weighted average number of common shares outstanding, basic	216,901,000	195,447,944	150,000,000
Effect of share-based compensation awards	2,159		
Weighted average number of common shares outstanding, diluted	216,903,159	195,447,944	150,000,000
Earnings (loss) per share:			
Basic	\$ 0.16	\$ (0.01)	\$ 0.25
Diluted	\$ 0.16	\$ (0.01)	\$ 0.25

For the years ended December 31, 2012 and 2011, the computation of diluted earnings per common share excludes shares of potentially dilutive common shares related to stock options and restricted stock units since the effect would have been anti-dilutive. For the year ended December 31, 2010, the computation of diluted earnings per common share excludes shares of potentially dilutive common shares related to stock options because the Company anticipated settling those stock options in cash.

Note 19 Supplemental Cash Flow Information

During the years ended December 31, 2012 and 2011, we paid \$70.9 million and \$3.0 million of interest, net of amounts capitalized, respectively. During the year ended December 31, 2010, all amounts paid for interest were capitalized. During the years ended December 31, 2012, 2011 and 2010, we paid income taxes of \$19.3 million, \$0.5 million, and \$0, respectively.

Capital expenditures in our consolidated statements of cash flows include the effect of changes in accrued capital expenditures, which are capital expenditures that were accrued but unpaid at period end. We have included these amounts in accounts payable, accrued expenses and accrued interest in our consolidated balance sheets as of December 31, 2012 and 2011. During the years ended December 31, 2012, 2011 and 2010, capital expenditures includes the decrease in accrued capital expenditures of \$4.0 million and the increase in accrued capital expenditures of \$1.3 million and \$79.4 million in our consolidated statements of cash flows, respectively.

During the years ended December 31, 2012, 2011 and 2010, non-cash amortization of deferred financing costs and accretion of debt discount totaling \$3.6 million, \$13.2 million and \$3.0 million, respectively, were capitalized to property and equipment. Accordingly, these amounts are excluded from capital expenditures in our consolidated statements of cash flows for the years ended December 31, 2012, 2011 and 2010.

Note 20 Liquidity

Our liquidity requirements include funding ongoing working capital needs, repaying our outstanding indebtedness and anticipated capital expenditures, which largely comprise our progress payments for our ultra-deepwater drillship construction projects, and maintaining adequate cash reserves to compensate the effects of fluctuations in operating cash flows.

As of December 31, 2012, we have taken delivery of four of our ultra-deepwater drillships, all of which are operating under long-term drilling contracts. The *Pacific Bora*, the *Pacific Scirocco*, the *Pacific Mistral* and the *Pacific Santa Ana* commenced drilling operations on August 26, 2011, December 31, 2011, February 6, 2012 and May 4, 2012, respectively. Additionally, the *Pacific Sharav* entered into a five-year drilling contract in June 2012 and the *Pacific Khamsin* entered into a two-year drilling contract in November 2012.

Our ability to meet these liquidity requirements will depend in large part on our future operating and financial performance. Primary sources of funds for our short-term liquidity needs will be cash flow generated from operating and financing activities and available cash balances. Our liquidity fluctuates depending on a number of factors, including, among others, our revenue efficiency and the timing of collecting accounts receivable as well as amounts paid for operating costs. We believe that our cash on hand and cash flows generated from operating and financing activities will provide sufficient liquidity over the next twelve months to fund our working capital needs, amortization payments on our long-term debt and anticipated capital expenditures for the Company's ultra-deepwater drillship construction projects.

Note 21 Subsequent Events

In January 2013, we exercised our option and entered into an additional contract with SHI for the construction of our eighth drillship, which is expected to be delivered in the first quarter of 2015.

On February 19, 2013, Pacific Sharav S.à r.l. and Pacific Drilling VII Limited (collectively, the Borrowers), and Pacific Drilling S.A. (the Guarantor) (collectively, the Borrowing Group) entered into a senior secured credit facility agreement with a group of lenders to finance the construction, operation and other costs associated with the *Pacific Sharav* and the *Pacific Meltem* (the Senior Secured Credit Facility Agreement or SSCF).

The SSCF includes a term loan (the SSCF Term Loan) which consists of two tranches: (i) a tranche of \$500.0 million provided by a syndicate of nine commercial banks (the Commercial Tranche) and (ii) a tranche of \$500.0 million provided by Eksportkreditt Norge AS (and guaranteed by the Norwegian Guarantee Institute for Export Credits) (the GIEK Tranche). The SSCF Term Loan will become available upon the satisfaction of customary conditions precedent, as described therein.

Borrowings under the Commercial Tranche bear interest at the London Interbank Offered Rate (LIBOR) plus a margin of 3.5%. Borrowings under the GIEK Tranche bear interest, at the Borrower s option, at (i) LIBOR plus a margin of 1.50% (which margin may be reset 60 months after the first borrowing under the SSCF Term Loan) or (ii) at a Commercial Interest Reference Rate (CIRR) of (a) 3.96% for borrowings relating to the *Pacific Sharav* and (b) 2.37% for borrowings relating to the *Pacific Meltem*. Borrowings under the GIEK Tranche will also be subject to a guarantee fee of 2.00% per annum (the GIEK Premium). Undrawn commitments for the SSCF Term Loan shall bear a fee equal to (i) in the case of the Commercial Tranche, 40% of the margin for such tranche and (ii) in the case of the GIEK Tranche, 40% of the applicable margin for such tranche and 40% of the GIEK Premium.

The Commercial Tranche matures on the earlier of (i) five years following the delivery of the second vessel under the SSCF and (ii) May 31, 2019. The GIEK Tranche matures (for each vessel) twelve years following the delivery of the applicable vessel. The GIEK Tranche contains a put option exercisable if the Commercial Tranche is not refinanced on terms acceptable to GIEK. If the GIEK Tranche put option is exercised, each Borrower must prepay, in full, the portion of all outstanding loans that relate to the GIEK Tranche, on the maturity date of the Commercial Tranche, without any premium, penalty or fees of any kind. Amortization payments under the SSCF Term Loan are calculated on a 12 year repayment schedule and must be made every six months following the delivery of the relevant vessel.

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF PACIFIC DRILLING S.A.**(PARENT ONLY)**

Statement of Operations

(in thousands, except share and per share information)

	For the year ended December 31, 2012	For the period March 11, 2011 (inception) to December 31, 2011
General and administrative expenses	\$ (4,147)	\$ (1,295)
Operating loss	(4,147)	(1,295)
Equity in earnings (losses) of subsidiaries	42,906	(10,757)
Interest expense	(4,510)	
Other income	(260)	14
Net income (loss)	\$ 33,989	\$ (12,038)
Earnings (loss) per common share, basic	\$ 0.16	\$ (0.06)
Weighted average number of common shares, basic	216,901,000	210,321,818
Earnings (loss) per common share, diluted	\$ 0.16	\$ (0.06)
Weighted average number of common shares, diluted	216,903,159	210,321,818

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF PACIFIC DRILLING S.A.**(PARENT ONLY)**

Statement of Comprehensive Income (Loss)

(in thousands)

	For the year ended December 31, 2012	For the period March 11, 2011 (inception) to December 31, 2011
Net income (loss)	\$ 33,989	\$ (12,038)
Other comprehensive income (loss):		
Unrecognized loss on derivative instruments	(22,551)	(62,086)
Reclassification adjustment for loss on derivative instruments realized in net income	24,419	1,802
Total other comprehensive income (loss)	1,868	(60,284)
Total comprehensive income (loss)	\$ 35,857	\$ (72,322)

F-30

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF PACIFIC DRILLING S.A.**(PARENT ONLY)**

Balance Sheet

(in thousands, except share amounts)

	December 31,	
	2012	2011
Assets:		
Cash and cash equivalents	\$ 155	\$ 7,226
Amount due from subsidiaries	997	
Deferred financing costs	2,036	
Prepaid expenses and other current assets	545	61
Total current assets	3,733	7,287
Investment in subsidiary	2,647,215	2,277,787
Deferred financing costs	2,206	
Other assets		76
Total assets	\$ 2,653,154	\$ 2,285,150
Liabilities and shareholders equity:		
Accounts payable and accrued expenses	\$ 706	\$ 568
Amount due to subsidiary	28,469	10,509
Accrued interest payable	8,731	
Total current liabilities	37,906	11,077
Long-term debt, net of current maturities	300,000	
Commitments and contingencies		
Shareholders equity:		
Common shares, \$0.01 par value, 5,000,000,000 shares authorized, 224,100,000 shares issued and 216,902,000 and 216,900,000 shares outstanding as of December 31, 2012 and 2011, respectively	2,169	2,169
Additional paid-in capital	2,349,544	2,344,226
Accumulated other comprehensive loss	(58,416)	(60,284)
Accumulated deficit	21,951	(12,038)
Total shareholders equity	2,315,248	2,274,073
Total liabilities and shareholders equity	\$ 2,653,154	\$ 2,285,150

SCHEDULE I CONDENSED FINANCIAL INFORMATION OF PACIFIC DRILLING S.A.**(PARENT ONLY)**

Statement of Cash Flows

(in thousands)

	For the year ended December 31, 2012	For the period March 11, 2011 (inception) to December 31, 2011
Cash flow from operating activities:	10,031	(11,845)
Cash flow from investing activities:		
Capital contributions to consolidated subsidiaries	(310,994)	(606,745)
Cash flow from financing activities:		
Issuance of common shares		625,816
Proceeds from long-term debt	300,000	
Deferred financing costs	(6,108)	
Net cash provided by financing activities	293,892	625,816
Decrease (increase) in cash and cash equivalents	(7,071)	7,226
Cash and cash equivalents, beginning of period	7,226	
Cash and cash equivalents, end of period	\$ 155	\$ 7,226

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Transocean Pacific Drilling Inc.

We have audited the accompanying consolidated balance sheets of Transocean Pacific Drilling Inc. (the Company) as of March 31, 2011 and December 31, 2010 and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for the three months ended March 31, 2011 and for the year ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Transocean Pacific Drilling Inc. at March 31, 2011 and December 31, 2010, and the consolidated results of its operations and its cash flows for the three months ended March 31, 2011 and for the year ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Houston, Texas

March 5, 2012

TRANSOCEAN PACIFIC DRILLING INC.**Consolidated Statements of Operations****(In thousands)**

	Three months ended March 31, 2011	Year ended December 31, 2010
Operating revenues		
Contract drilling revenues	\$ 90,414	\$ 304,092
Cost and expenses		
Operating and maintenance	22,157	79,405
Operating and maintenance affiliates	3,299	12,213
Depreciation	9,917	35,688
General and administrative	121	226
(Gain) loss on disposal of assets	(2)	1,682
	35,492	129,214
Operating income	54,922	174,878
Other income (expense)		
Interest expense, net	(13,958)	(52,762)
Other	(99)	(138)
	(14,057)	(52,900)
Income before income taxes	40,865	121,978
Income tax expense	4,166	13,715
Net income	\$ 36,699	\$ 108,263

See accompanying notes.

TRANSOCEAN PACIFIC DRILLING INC.**Consolidated Statements of Comprehensive Income (Loss)****(In thousands)**

	Three months ended March 31, 2011	Year ended December 31, 2010
Net income	\$ 36,699	\$ 108,263
Other comprehensive income (loss)		
Unrecognized gain (loss) on derivative instruments	1,439	(57,979)
Reclassification adjustment for loss on derivative instruments realized in net income	5,991	23,079
Other comprehensive income (loss), net of income taxes	7,430	(34,900)
Total comprehensive income	\$ 44,129	\$ 73,363

See accompanying notes.

TRANSOCEAN PACIFIC DRILLING INC.**Consolidated Balance Sheets****(In thousands, except share data)**

	March 31, 2011	December 31, 2010
Assets		
Cash and cash equivalents	\$ 26,227	\$ 70,457
Short-term restricted cash	24,508	23,333
Accounts receivable		
Trade and other	117,093	85,703
Affiliates	1,006	290
Materials and supplies, net	21,948	20,071
Prepayments and other current assets	2,697	4,103
Total current assets	193,479	203,957
Property and equipment	1,475,160	1,474,988
Less accumulated depreciation	53,945	44,027
Property and equipment, net	1,421,215	1,430,961
Other assets	8,957	11,064
Total assets	\$ 1,623,651	\$ 1,645,982
Liabilities and shareholders equity		
Accounts payable		
Trade	\$ 10,069	\$ 10,640
Affiliates	67,182	74,789
Debt due to affiliate within one year	70,000	70,000
Debt due to third parties within one year	70,000	70,000
Interest payable	24,025	22,137
Other current liabilities	33,746	35,403
Total current liabilities	275,022	282,969
Long-term debt to affiliates	750,959	768,459
Long-term debt to third party	455,000	490,195
Deferred income taxes	183	163
Other long-term liabilities	9,868	15,706
Total long-term liabilities	1,216,010	1,274,523
Common stock, \$0.01 par value, 50,000 shares authorized, issued, fully paid and outstanding at March 31, 2011 and December 31, 2010	1	1

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Additional paid-in capital	1,743	1,743
Accumulated other comprehensive loss	(19,485)	(26,915)
Retained earnings	150,360	113,661
Total shareholders equity	132,619	88,490
Total liabilities and shareholders equity	\$ 1,623,651	\$ 1,645,982

See accompanying notes.

TRANSOCEAN PACIFIC DRILLING INC.**Consolidated Statements of Shareholders Equity****(In thousands, except for shares)**

	Common stock		Additional	Accumulated	Retained	Total
	Shares	Amount	paid-in	other	earnings	shareholders
			capital	comprehensive		
				income/(loss)		
Balance at December 31, 2009	50,000	\$ 1	\$ 1,743	\$ 7,985	\$ 5,398	\$ 15,127
Net income					108,263	108,263
Other comprehensive loss				(34,900)		(34,900)
Balance at December 31, 2010	50,000	\$ 1	\$ 1,743	\$ (26,915)	\$ 113,661	\$ 88,490
Net income					36,699	36,699
Other comprehensive income				7,430		7,430
Balance at March 31, 2011	50,000	\$ 1	\$ 1,743	\$ (19,485)	\$ 150,360	\$ 132,619

See accompanying notes.

TRANSOCEAN PACIFIC DRILLING INC.**Consolidated Statements of Cash Flows****(In thousands)**

	Three months ended March 31, 2011	Year ended December 31, 2010
Operating activities		
Net income	\$ 36,699	\$ 108,263
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	9,917	35,688
Deferred income tax	20	373
(Gain) loss from disposals of assets, net	(2)	1,682
Other, net	1,498	3,189
Changes in operating assets and liabilities:		
Restricted cash interest	(1,175)	
Account receivable and other current assets	(32,574)	(22,447)
Other assets	11	214
Accounts payable and accrued liabilities	1,523	19,186
Income tax receivable / payable	1,614	(4,881)
Other long-term liabilities	(203)	2,296
Receivable from / payable to affiliates, net	3,407	43,055
Net cash provided by operating activities	20,735	186,618
Investing activities		
Capital expenditures	(12,270)	(64,913)
Net cash used in investing activities	(12,270)	(64,913)
Financing activities		
Proceeds from restricted cash investments	52,695	105,000
Deposits to restricted cash investments	(52,695)	(128,333)
Repayment of short-term affiliate debt	(17,500)	(52,500)
Repayment of short-term third-party debt	(35,195)	(52,500)
Proceeds from long-term affiliate debt		31,478
Proceeds from long-term third-party debt		31,479
Net cash used in financing activities	(52,695)	(65,376)
Net (decrease) increase in cash and cash equivalents	(44,230)	56,329
Cash and cash equivalents at beginning of period	70,457	14,128
Cash and cash equivalents at end of period	\$ 26,227	\$ 70,457

See accompanying notes.

F-38

TRANSOCEAN PACIFIC DRILLING INC.

Notes to Consolidated Financial Statements

Note 1 Nature of Operations

Transocean Pacific Drilling Inc. (and together with its consolidated subsidiaries, the Company, we, us, or our), a British Virgin Islands joint venture company having its registered office at Walkers Chambers, P.O. Box 92, Road Town, Tortola, British Virgin Islands, was incorporated on October 5, 2007 by Pacific Drilling Limited, a Liberian corporation (PDL), whose ultimate parent is Gladebrooke Holdings Limited. On October 18, 2007 (Inception), Transocean Offshore International Ventures Limited (TOIVL) acquired a 50 percent interest in the Company from PDL to form a joint venture for the purpose of, either directly or through its subsidiaries, constructing, owning, operating and chartering two ultra-deepwater drillships (together, the Drilling Rigs) named Dhirubhai Deepwater KG1 (KG1) and Dhirubhai Deepwater KG2 (KG2). In January 2008, TOIVL approved the transfer of its equity in the joint venture to a wholly-owned subsidiary, Transocean Pacific Drilling Holdings Limited (TPDHL), a Cayman Islands company whose ultimate parent is Transocean Ltd. (together with PDL, the Shareholders). Beginning on October 18, 2010, PDL had the right to exchange its interest in the Company for Transocean Ltd. shares or cash at a purchase price based on an appraisal of the fair value of the Drilling Rigs subject to certain adjustments. On March 30, 2011, PDL transferred all of its interest in the Company to Quantum Pacific Management Limited (Quantum), an affiliate of PDL and a Cyprus corporation, whose ultimate parent is Gladebrooke Holdings Limited. See Note 5 Related Party Transactions.

Since its inception, the Company has devoted substantial efforts to designing, engineering and contracting with shipyards and vendors and has entered into various construction management agreements with TOIVL and its affiliates, in connection with the construction of the Drilling Rigs (see Note 5 Related Party Transactions). The KG1 started operating in July 2009 and the KG2 started operating in March 2010.

Funding for the Company, as provided for in the Shareholders Agreement (see Note 5 Related Party Transactions), requires that the Shareholders each provide capital or loans to the Company. To the extent expenditures are not funded by third-party indebtedness, the shareholders are to fund in proportion to their respective ownership (1) all expenditures required to be made under various management services agreements (see Note 5 Related Party Transactions), (2) any performance guarantees, surety bonds or letters of credit, (3) an adequate level of working capital for the Company, and (4) additional requirements as agreed to by the Shareholders. Prior to Inception, capital expenditure commitments were funded by PDL. At Inception, the Shareholders issued promissory notes to the Company for the funding of capital expenditures (see Note 3 Interest-bearing Loans and Borrowings and Note 5 Related Party Transactions). As of March 31, 2011, the amounts required to fund capital expenditures have been provided through a combination of loans made in accordance with the Shareholders Agreement and third-party indebtedness.

Note 2 Summary of Significant Accounting Policies

Accounting estimates The preparation of financial statements in accordance with accounting principles generally accepted in the United States (U.S.) requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses and the disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates and assumptions, including those related to our allowance for doubtful accounts, materials and supplies obsolescence, property and equipment, income taxes, and contingencies. We base our estimates and assumptions on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying amounts of assets and liabilities that are not readily apparent from other sources. Actual results could differ from such estimates.

Fair value measurements We estimate fair value at a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market for the asset or liability. Our valuation techniques require inputs that we categorize using a three-level hierarchy, from highest to lowest level of observable inputs, as follows: (1) unadjusted quoted prices for identical assets or liabilities in active markets (Level 1), (2) direct or indirect observable inputs, including quoted prices or other market data, for similar assets or liabilities in active markets or identical assets or liabilities in less active markets (Level 2) and (3) unobservable inputs that require significant judgment for which there is little or no market data (Level 3). When multiple input levels are required for a valuation, we categorize the entire fair value measurement according to the lowest level of input that is significant to the measurement even though we may have also utilized significant inputs that are more readily observable.

Principles of consolidation We consolidate entities in which we have a majority voting interest and entities that meet the criteria for variable interest entities for which we are deemed to be the primary beneficiary for accounting purposes. We eliminate intercompany transactions and accounts in consolidation. We apply the equity method of accounting for investments in entities when we have the ability to exercise significant influence over an entity that (a) does not meet the variable interest entity criteria or (b) meets the variable interest entity criteria, but for which we are not deemed to be the primary beneficiary. We apply the cost method of accounting for investments in other entities if we do not have the ability to exercise significant influence over the unconsolidated affiliate.

Cash and cash equivalents Cash equivalents are highly liquid debt instruments with original maturities of three months or less that may include time deposits with commercial banks that have high credit ratings, U.S. Treasury and government securities, Eurodollar time deposits, certificates of deposit and commercial paper. We may also invest excess funds in no-load, open-end, management investment trusts (management trusts). The management trusts invest exclusively in high-quality money market instruments.

Restricted cash Restricted cash is a cash item which is restricted as to withdrawal or usage.

Accounts receivable Accounts receivable are stated at the historical carrying amount net of allowance for doubtful accounts.

Allowance for doubtful accounts We establish an allowance for doubtful accounts on a case-by-case basis, considering changes in the financial position of a major customer, when we believe the required payment of specific amounts owed is unlikely to occur. We derive a majority of our revenues from services to international oil companies and government-owned or government-controlled oil companies. We evaluate the credit quality of our customers on an ongoing basis, and we do not generally require collateral or other security to support customer receivables. This allowance was zero at March 31, 2011 and December 31, 2010.

Materials and supplies Materials and supplies are carried at average cost less an allowance for obsolescence. Such allowance was \$121 thousand and \$218 thousand at March 31, 2011 and December 31, 2010, respectively.

Property and equipment Property and equipment, consisting primarily of offshore drilling rigs and related equipment, represented approximately 88 percent of our total assets at March 31, 2011. The carrying amounts of these assets are based on estimates, assumptions and judgments relative to capitalized costs, useful lives and salvage values of our rigs. These estimates, assumptions and judgments reflect both historical experience and expectations regarding future industry conditions and operations. We compute depreciation using the straight-line method after allowing for salvage values. We capitalize expenditures for renewals, replacements and improvements, and we expense maintenance and repair costs as incurred. Upon sale or other disposition of an asset, we recognize a net gain or loss on disposal of the asset, which is measured as the difference between the net carrying amount of the asset and the net proceeds received.

Estimated original useful lives for the Drilling Rigs are 35 years and machinery and equipment from five to 12 years. From time to time, we may review the estimated remaining useful lives of our drilling units, and we may extend the useful life when events and circumstances indicate a drilling unit can operate beyond its remaining useful life.

Long-lived assets We review the carrying amounts of long-lived assets for potential impairment when events occur or circumstances change that indicate that the carrying value of such assets may not be recoverable.

Operating revenues and expenses We recognize operating revenues as they are earned, based on average daily rates over the primary contract term or based on a fixed-price. In connection with drilling contracts, we may receive revenues for preparation and mobilization of equipment and personnel or for capital improvements to rigs. In connection with new drilling contracts, revenues earned and incremental costs incurred directly related to contract preparation and mobilization are deferred and recognized over the primary contract term of the drilling project using the straight-line method. Our policy to amortize the fees related to contract preparation, mobilization and capital upgrades on a straight-line basis over the estimated firm period of drilling is consistent with the general pace of activity, level of services being provided and dayrates being earned over the life of the contract. For contractual daily rate contracts, we account for loss contracts as the losses are incurred. Costs of relocating drilling units without contracts to more promising market areas are expensed as incurred. Upon completion of drilling contracts, any demobilization fees received are reported in income, as are any related expenses. Capital upgrade revenues received are deferred and recognized over the primary contract term of the drilling project. The actual cost incurred for the

capital upgrade is depreciated over the estimated remaining useful life of the asset. We incur periodic survey and drydock costs in connection with obtaining regulatory certification to operate our rigs on an ongoing basis. Costs associated with these certifications are deferred and amortized on a straight-line basis over the period until the next survey.

Capitalized interest We capitalize interest costs for qualifying construction and upgrade projects. We capitalized interest costs on construction work in progress of zero and \$5 million for the three months ended March 31, 2011 and for the year ended December 31, 2010, respectively.

Derivative instruments and hedging activities From time to time, we may enter into a variety of derivative financial instruments in connection with the management of our exposure to variability in foreign exchange rates and interest rates. We record derivatives on our consolidated balance sheet, measured at fair value. For derivatives that do not qualify for hedge accounting, we recognize the gains and losses associated with changes in the fair value in current period earnings. See Note 4 Derivatives and Hedging and Note 7 Financial Instruments and Risk Concentration.

We may enter into cash flow hedges to manage our exposure to variability of the expected future cash flows of recognized assets or liabilities or of unrecognized forecasted transactions. For a derivative that is designated and qualifies as a cash flow hedge, we initially recognize the effective portion of the gains or losses in other comprehensive income (loss) and subsequently recognize the gains and losses in earnings in the period in which the hedged forecasted transaction affects earnings. We recognize the gains and losses associated with the ineffective portion of the hedges in interest expense in the period in which they are realized.

We may enter into fair value hedges to manage our exposure to changes in fair value of recognized assets or liabilities, such as fixed-rate debt, or of unrecognized firm commitments. For a derivative that is designated and qualifies as a fair value hedge, we simultaneously recognize in current period earnings the gains or losses on the derivative along with the offsetting losses or gains on the hedged item attributable to the hedged risk. The resulting ineffective portion, which is measured as the difference between the change in fair value of the derivative and the hedged item, is recognized in current period earnings. See Note 4 Derivatives and Hedging and Note 7 Financial Instruments and Risk Concentration.

Foreign currency The majority of our revenues and expenditures are denominated in U.S. dollars to limit our exposure to foreign currency fluctuations, resulting in the use of the U.S. dollar as the functional currency for all of our operations. Foreign currency exchange gains and losses are primarily included in other income (expense) as incurred. We had net foreign currency exchange losses of \$105 thousand and \$145 thousand for the three months ended March 31, 2011 and for the year ended December 31, 2010, respectively.

Income taxes The Company is a British Virgin Islands (BVI) company and our earnings are not subject to income tax in BVI because the country does not levy tax on corporate income. Currently business is conducted through our subsidiaries with offices based in India. We have provided for income taxes based upon the tax laws and rates in the countries in which operations are conducted and income is earned.

Taxes Collected from Customers and Remitted to Governmental Authorities The Company reports service taxes collected from customers and remitted to governmental authorities on a net basis. Certain operating activities are subject to service taxes of 10.3 percent on revenues earned from our customers. The amount of service tax incurred is excluded from contract drilling revenues and operating and maintenance expenses on our consolidated statements of operations. Unremitted service tax collected from our customers is reported in other current liabilities on our consolidated balance sheets.

Fair value of derivative financial instruments To determine the fair value of derivative financial instruments, the Company discounts projected cash flows as of the measurement date using significant observable market data, including mid-market rates for the forward USD-LIBOR curve consisting of short-term cash rates, Eurodollar futures, treasury yields, and swap spreads. In addition, for fair value adjusted credit risk, the Company applies credit spreads to the discount factors, applying a weighted-average credit spread prevailing on the third party debt if the derivative is a liability. If the derivative is an asset, the credit risk adjustment is based on the credit quality of each respective counterparty. To determine the credit adjustment necessary for its affiliate, TOIVL, the Company applies the credit spreads prevailing on third-party debt agreements with this entity.

Subsequent events We evaluate subsequent events through the date our financial statements are available to be issued. For the three months ended March 31, 2011, we have evaluated subsequent events through March 5, 2012. See Note 10 Subsequent Events.

Recently adopted accounting pronouncements

Fair value measurements and disclosures Effective January 1, 2011, we adopted the remaining provisions of the accounting standards update that clarified existing disclosure requirements and introduced additional disclosure

requirements for fair value measurements. The update required entities to separately disclose information about purchase, sales, issuances, and settlements in the reconciliation of recurring Level 3 measurements on a gross basis. Our adoption did not have a material effect on the disclosures contained in our notes to condensed consolidated financial statements.

Note 3 Interest-bearing Loans and Borrowings

\$1.265 billion Credit Facility In October 2008, the Company entered into a credit agreement for a \$1.265 billion secured credit facility, comprised of a \$1.0 billion senior tranche and a \$190 million junior tranche (the Term Loan Facility) as well as a \$75 million revolving credit facility (the Revolving Credit Facility). The Term Loan Facility and the Revolving Credit Facility (together, the Credit Facilities) financed the construction of the Drilling Rigs which serve as security against outstanding debt. The Term Loan Facility senior and junior tranches are both comprised of two equal tranches for the KG1 and KG2. TOIVL participates as a lender in the senior and junior tranches with a 50 percent commitment totaling \$595 million in the aggregate. The Credit Facilities bore interest at LIBOR plus the margin of 1.60 percent until each drilling rig was accepted. Subsequent to the acceptance of the respective rig, the related tranches of the Term Loan Facility bear interest at a margin of 1.45 percent for the senior tranche and 2.25 percent for the junior tranche. Subsequent to acceptance of the KG2, the Revolving Credit Facility bears interest at a margin of 1.45 percent. The availability of any commitment amounts not borrowed under the Term Loan Facility ceased upon completion of

construction of the Drilling Rigs. The Revolving Credit Facility remains available for the financing of general working capital needs throughout the term of the facility. The maximum amount available under the Revolving Credit Facility reduces to \$35 million at December 2013 and to \$15 million at December 2014, and at each commitment reduction date, the Company is required to repay any outstanding borrowings in excess of the reduced commitment amount. The senior tranche requires quarterly payments beginning in April 2010 and is due in full in March 2015. The junior tranche and the Revolving Credit Facility are due in full in March 2015. We are required to maintain certain cash balances, as defined in the loan agreement, to service the debt. At March 31, 2011 and December 31, 2010, the Company had \$24.5 million and \$23.3 million, respectively, of restricted cash classified as a current asset. The Credit Facilities have covenants that contain minimum liquidity requirements, a minimum debt service ratio and a maximum leverage ratio. The Credit Facilities may be prepaid in whole or in part without premium or penalty. At March 31, 2011, \$1,050 million was outstanding under the Credit Facilities, of which \$525 million was due to TOIVL, at a weighted-average interest rate of 1.90 percent, not including the effects of the cash flow hedges. At December 31, 2010, \$1,103 million was outstanding under the Credit Facilities, of which \$542 million was due to TOIVL, at a weighted-average interest rate of 1.89 percent, not including the effects of the cash flow hedges.

Promissory Notes At Inception the Company entered into unsecured promissory note agreements (the Promissory Notes) with TOIVL and PDL for the purpose of funding the joint venture formation (see Note 5 Related Party Transactions). In October 2008, using borrowings under the Credit Facilities, the Company prepaid \$441 million of outstanding Promissory Notes. In September 2009 and October 2009, additional promissory notes of \$20 million and \$54.5 million, respectively were issued to the Company. As of March 31, 2011 and December 31, 2010, \$296 million in Promissory Notes were outstanding, \$148 million of which was due to each of Quantum and TOIVL. As of March 31, 2011 and December 31, 2010, the Company deferred interest payments totaling \$21.6 million and \$18.6 million, respectively, and is classified as interest payable in our consolidated balance sheet. The weighted-average interest rate was 2.5 percent and 2.6 percent for the three months ended March 31, 2011 and the year ended December 31, 2010, respectively. The components of the Company's debt balances were as follows:

<i>(In thousands)</i>	March 31, 2011	December 31, 2010
Related party debt		
Term loan facility due within one year due to TOIVL	\$ 70,000	\$ 70,000
Total current debt to affiliates	70,000	70,000
Long-term term loan due to TOIVL	454,999	472,499
Long-term promissory note due to TOIVL	147,980	147,980
Total long-term due to TOIVL	602,979	620,479
Long-term promissory note due to Quantum	147,980	147,980
Total long-term debt to affiliates	750,959	768,459
Third party debt		
Term loan facility due within one year	70,000	70,000
Total current debt to third party	70,000	70,000
Long-term debt	455,000	490,195
Total long-term debt to third party	455,000	490,195

Total debt	\$	1,345,959	\$	1,398,654
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F-42

The following table presents the carrying amounts of the Company's debt along with the key terms and balances presented at face value of its debt agreements:

<i>(In thousands)</i>	Effective Interest Rate (%) at March 31, 2011	Final maturity	March 31, 2011 December 31, 2010	
Current				
\$1.265 billion Credit Facility				
\$1 billion senior tranche KG1	LIBOR + 1.45%	March 9, 2015	\$ 35,000	\$ 35,000
\$1 billion senior tranche KG2	LIBOR + 1.45%	March 9, 2015	35,000	35,000
\$1 billion senior tranche KG1 due to TOIVL	LIBOR + 1.45%	March 9, 2015	35,000	35,000
\$1 billion senior tranche KG2 due to TOIVL	LIBOR + 1.45%	March 9, 2015	35,000	35,000
Total current debt \$1.265 billion Credit Facility			\$ 140,000	\$ 140,000
Long-term				
\$1.265 billion Credit Facility				
\$1 billion senior tranche KG1	LIBOR + 1.45%	March 9, 2015	\$ 180,000	\$ 188,750
\$1 billion senior tranche KG2	LIBOR + 1.45%	March 9, 2015	180,000	188,750
\$1 billion senior tranche KG1 due to TOIVL	LIBOR + 1.45%	March 9, 2015	180,000	188,750
\$1 billion senior tranche KG2 due to TOIVL	LIBOR + 1.45%	March 9, 2015	180,000	188,750
\$190 million junior tranche KG1	LIBOR + 2.25%	March 9, 2015	47,500	47,500
\$190 million junior tranche KG2	LIBOR + 2.25%	March 9, 2015	47,500	47,500
\$190 million junior tranche KG1 due to TOIVL	LIBOR + 2.25%	March 9, 2015	47,499	47,500
\$190 million junior tranche KG2 due to TOIVL	LIBOR + 2.25%	March 9, 2015	47,500	47,499
\$75 million revolving credit facility	LIBOR + 1.45%	March 9, 2015		17,695
Total \$1.265 billion Credit Facility			909,999	962,694
Promissory Notes				
Promissory Note due to Quantum	LIBOR + 2.00%	October 18, 2017	18,110	18,110
Promissory Note due to Quantum	LIBOR + 2.00%	January 22, 2018	51,100	51,100
Promissory Note due to Quantum	LIBOR + 2.00%	July 1, 2018	41,520	41,520
Promissory Note due to Quantum	LIBOR + 2.00%	September 4, 2019	10,000	10,000
Promissory Note due to Quantum	LIBOR + 2.00%	October 23, 2019	27,250	27,250
Total Promissory Notes due to Quantum			147,980	147,980
Promissory Note due to TOIVL	LIBOR + 2.00%	October 18, 2017	18,110	18,110
Promissory Note due to TOIVL	LIBOR + 2.00%	January 22, 2018	51,100	51,100

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Promissory Note due to TOIVL	LIBOR + 2.00%	July 1, 2018	41,520	41,520
Promissory Note due to TOIVL	LIBOR + 2.00%	September 4, 2019	10,000	10,000
Promissory Note due to TOIVL	LIBOR + 2.00%	October 23, 2019	27,250	27,250
Total Promissory Notes due to TOIVL			147,980	147,980
Total Promissory Notes			295,960	295,960
Total long-term debt			\$ 1,205,959	\$ 1,258,654
Total debt			\$ 1,345,959	\$ 1,398,654

F-43

Scheduled maturities At March 31, 2011, the scheduled maturities of our debt were as follows (in thousands):

Within one year	\$ 140,000
2012 (Nine months ended December 31, 2012)	105,000
2013	140,000
2014	140,000
2015	524,999
Thereafter	295,960
	\$ 1,345,959

Note 4 Derivatives and Hedging

Cash flow hedges In January 2009, the Company entered into interest rate swaps with an aggregate maximum notional value of \$892.8 million which are designated as a cash flow hedge of the future interest payments on variable rate borrowings under the Credit Facilities to reduce the variability of cash interest payments. Under the interest rate swaps, the Company will receive interest at three-month LIBOR and pay interest at a fixed rate of 2.24 percent over the expected term of the Credit Facilities. TOIVL, acting as a swap counter-party with the Company, provided \$446.4 million of the \$892.8 million in aggregate maximum notional value.

In May 2009, the Company entered into interest rate swaps with an aggregate maximum notional value of \$297.2 million which are designated as a cash flow hedge of the future interest payments on variable rate borrowings under the Credit Facilities to reduce the variability of cash interest payments. Under the interest rate swaps, the Company will receive interest at three-month LIBOR and pay interest at a fixed rate of 2.65 percent over the expected term of the Credit Facilities. TOIVL, acting as a swap counter-party with the Company, provided \$148.8 million of the \$297.5 million in aggregate maximum notional value.

The Company recognizes the gains and losses associated with the ineffective portion of the hedges in interest expense in the period in which they are realized. During construction of the Drilling Rigs, the notional value increases proportionately with the forecasted borrowings under the Credit Facilities to a maximum amount of \$1,190 million, of which \$595 million is attributable to TOIVL. Upon completion of construction of Drilling Rigs, the notional value decreases proportionately with the repayment of borrowings under the Credit Facilities. As of March 31, 2011 and December 31, 2010, the aggregate notional value had decreased to \$1,015 million and \$1,050 million, respectively.

At March 31, 2011, the fair market value of the cash flow hedges was \$19.6 million, of which \$18.3 million was recorded in other current liabilities and \$1.3 million was recorded in other long-term liabilities. Other comprehensive gain of \$7.4 million was recorded in the first three months of 2011. At March 31, 2011, the ineffective portion was recorded as a decrease to interest expense of \$640 thousand. In the first three months of 2011, the Company reclassified \$5.4 million of amounts previously recognized as other comprehensive income to interest expense. As of March 31, 2011, we estimate that we will reclassify interest expense of \$18.4 million from the amount recorded in Accumulated Other Comprehensive Income into earnings during the next 12 months.

At December 31, 2010, the fair market value of the cash flow hedges was \$26.4 million, of which \$19.1 million was recorded in other current liabilities and \$7.3 million was recorded in other long-term liabilities. Other comprehensive loss of \$34.9 million was recorded in 2010. At December 31, 2010, the ineffective portion was recorded as an increase to interest expense of \$254 thousand. In 2010, the Company reclassified \$23 million of amounts previously recognized as other comprehensive income to interest expense.

Note 5 Related Party Transactions

Shareholder Agreement The Shareholders have entered into an agreement (the Shareholders Agreement) under which the rights and restrictions with respect to the governance and management of the Company are defined. Among other things, the Shareholders Agreement states that the Shareholders will provide future funding of capital expenditures and other liquidity needs as required in the form of additional loans or capital contributions. Additionally, TOIVL may, during the course of its ongoing operations, provide certain incidental general and administrative functions on behalf of the Company, including procurement and payables, treasury and cash management, personnel and payroll and accounting at cost to the Company.

Put Option and Registration Rights Agreement The Shareholders and Transocean Ltd. have entered into an agreement under which Quantum, beginning on October 18, 2010, had the unilateral right to exchange its interest in the Company for shares of Transocean Ltd. or cash at a purchase price based on an appraisal of the fair value of the Drilling Rigs, subject to certain adjustments.

Promissory Note Agreements At Inception, the Company entered into unsecured promissory note agreements with TOIVL and PDL for the purpose of funding the formation of the Company. The Promissory Notes bear an interest rate of LIBOR plus 2 percent per annum with semi-annual interest payments commencing April 30, 2008. The Company may, upon written notice to Quantum and TOIVL, elect to defer the payment of accrued interest (including any prior deferred interest) to the next succeeding interest payment date. At April 30, 2008, the Company elected to defer the interest payments due under the Promissory Notes. In

October 2008, in connection with borrowings under the Credit Facilities, the Company paid approximately \$32 million to satisfy interest accrued and deferred through September 30, 2008. Through March 31, 2011, no further interest payments had been made, and all interest due was deferred. The Promissory Notes are scheduled to mature ten years after the date of the respective note and the Company may, upon written notice to Quantum and TOIVL, elect to defer the maturity date for a period up to ten years. The Company is not required to make any payments of principal or interest prior to the maturity date. As of March 31, 2011 and December 31, 2010, \$296 million in Promissory Notes remained outstanding, \$148 million of which was due to each of Quantum and TOIVL.

Construction Management Agreements At Inception, the Shareholders entered into construction management agreements with TOIVL in connection with the construction of the Drilling Rigs. Pursuant to these agreements, TOIVL will design, construct, equip and test the Drilling Rigs in accordance with the terms, conditions and requirements of their respective construction and equipments contracts. The Company has agreed to reimburse TOIVL for all documented costs incurred by TOIVL in performing its duties under these agreements. The terms of this agreement allow TOIVL to delegate certain of its duties and obligations under the agreement (see *Construction Support Agreements*). This agreement was terminated upon customer acceptance of the KG2.

Construction Support Agreements TOIVL has elected to delegate certain duties and obligations under the Construction Management Agreements to an affiliate, Transocean Construction Management Ltd. Korea Branch (TCML). In connection with this delegation, in January 2008 the Company entered into construction support agreements with TCML under which TCML will design, construct, equip and test the Drilling Rigs in accordance with the terms, conditions and requirements of their respective construction and equipments contracts. The Company has agreed to reimburse TCML for all documented costs incurred by TCML in performing its duties under these agreements. This agreement was terminated upon customer acceptance of the KG2. The costs incurred under the Construction Support Agreement were zero and \$286 thousand for the three months ended March 31, 2011 and the year ended December 31, 2010, respectively.

Marketing Agreement The Shareholders entered into a marketing agreement with TOIVL. Under the terms of the marketing agreement, the Company granted TOIVL and its affiliates, on an exclusive basis, all rights to market each of the Drilling Rigs worldwide for use in any territory or region. Commencing upon the date of the completion and delivery of the Drilling Rigs through perpetuity unless otherwise terminated by the party in accordance with the agreement, the Company will pay TOIVL a marketing fee of \$7,000 per day in respect of each Drilling Rig. The marketing fee is subject to adjustment annually based on the consumer pricing index published by the U.S. Department of Labor. Expense related to this agreement recorded in Operating and maintenance affiliates on the statement of operations was \$1 million and \$5 million for the three months ended March 31, 2011 and the year ended December 31, 2010, respectively.

Operating Agreement The Shareholders entered into an operating agreement with TOIVL. Under the terms of the operating agreement, the Company appoints TOIVL and its affiliates to act as the operator of the Drilling Rigs. Commencing upon the date of the completion and delivery of the Drilling Rigs, TOIVL is providing services to include day to day management supervision and operating, maintenance, administrative and related services in respect of each Drilling Rig. The Company has agreed to reimburse TOIVL for all documented costs incurred by TOIVL in performing its duties under this agreement. In addition to the documented costs incurred, TOIVL allocated local overhead costs of \$2 million and \$7 million for the three months ended March 31, 2011 and the year ended December 31, 2010, respectively.

Term Loan Facility As described in Note 3 Interest-bearing Loans and Borrowings, the Company entered into a Term Loan Facility in which TOIVL participates in the senior and junior tranches with a commitment totaling \$595 million in the aggregate.

Guarantees from TOIVL In connection with the Credit Facilities, TOIVL has provided a guarantee in the amount of \$160 million backing the obligations of the Company under the Credit Facilities.

Cash flow hedges As described in Note 4 Derivatives and Hedging, the Company entered into an interest rate swap agreement in which TOIVL acts as a swap counterparty providing a maximum notional value of \$595 million.

Contract labor expenses TOIVL and its affiliates incur certain payroll costs on the Company's behalf. Through the operating agreement TOIVL and its affiliates provide work crews to perform day to day operations. These expenses were \$13 million and \$42 million for the three months ended March 31, 2011 and the year ended December 31, 2010, respectively and are a component of operating and maintenance expense on the statement of operations.

Letter of credit In connection with the minimum liquidity requirements under the Credit Facilities, the Company funded the minimum balance of \$60 million required for the Debt Service Reserve Account (the DSRA). This was funded by a letter of credit issued by an affiliate of TOIVL, Transocean Inc., in April 2010.

Note 6 Fair Value of Financial Instruments

We estimate the fair value of each class of financial instruments, for which estimating fair value is practicable, by applying the following methods and assumptions:

Cash and cash equivalents, Restricted cash, Accounts receivable Affiliates and Accounts receivable Trade and other, Interest receivable from affiliates The carrying amounts approximate fair value because of the short maturity of these instruments.

Short-term and long-term debt due to affiliates The determination of the fair value of short-term debt due to affiliates with carrying amounts of \$70.0 million at March 31, 2011 and December 31, 2010, respectively, and the fair value of long-term debt due to affiliates with carrying amounts of \$751 million and \$768 million at March 31, 2011 and December 31, 2010, respectively, is not practicable due to the related party nature of such debt. See Note 5 Related Party Transactions.

Short-term and long-term debt to third parties The face value of interest-bearing loans and borrowings approximates the fair value of the loans and borrowings since they have effective interest rates that are based on floating rates.

Derivative instruments The carrying amount of our derivative instruments represents the estimated fair value, measured using direct or indirect observable inputs, including quoted prices or other market data for similar assets or liabilities in active markets or identical assets or liabilities in less active markets. At March 31, 2011, the fair market value of the cash flow hedges was \$19.6 million, of which \$18.3 million was recorded in other current liabilities and \$1.3 million was recorded in other long-term liabilities. At December 31, 2010, the fair market value of the cash flow hedges was \$26.4 million, of which \$19.1 million was recorded in other current liabilities and \$7.3 million was recorded in other long-term liabilities.

Note 7 Financial Instruments and Risk Concentration

Foreign exchange risk We operate internationally, resulting in exposure to foreign exchange risk. This risk is primarily associated with compensation costs and with purchases from foreign suppliers denominated in currencies other than the U.S. dollar.

We do not enter into derivative transactions for speculative purposes. At March 31, 2011 and December 31, 2010, we had no outstanding foreign exchange derivative instruments.

Interest rate risk Financial instruments that potentially subject us to concentrations of interest rate risk include our cash equivalents and debt obligations. We are exposed to interest rate risk related to our cash equivalents, as the interest income earned on these investments changes with market interest rates. Floating rate debt, where the interest rate can be adjusted every year or less over the life of the instrument, exposes us to short-term changes in market interest rates.

From time to time, we may use interest rate swap agreements to manage the effect of interest rate changes on future income. These derivatives are used as hedges and are not used for speculative or trading purposes. Interest rate swaps are designated as a hedge of underlying future interest payments. These agreements involve the exchange of amounts based on variable interest rates and amounts based on a fixed interest rate over the life of the agreement without an exchange of the notional amount upon which the payments are based. The interest rate differential to be received or paid on the swaps is recognized over the lives of the swaps as an adjustment to interest expense. Gains and losses on terminations of interest rate swap agreements are deferred and recognized as an adjustment to interest expense over the remaining life of the underlying debt. In the event of the early retirement of a designated debt obligation, any

realized or unrealized gain or loss from the swap would be recognized in income. At March 31, 2011, the Company had approximately \$1,346 million of outstanding variable rate debt at face value, of which \$1,050 million was in an effective hedging relationship. At December 31, 2010, the Company had approximately \$1,399 million of outstanding variable rate debt at face value, of which \$1,085 million was in an effective hedging relationship.

Credit risk Financial instruments that potentially subject us to concentrations of credit risk are primarily cash and cash equivalents, trade receivables, and obligations owed to the Company by its counterparties under the cash flow hedges. It is our practice to place our cash and cash equivalents in time deposits at commercial banks with high credit ratings or mutual funds, which invest exclusively in high quality money market instruments.

In its initial drilling contracts, the Company expected to derive revenue from contract drilling services to Reliance Industries Limited (RIL), a large, independent energy company. The Company has a five-year drilling contract with RIL for each of the Drilling Rigs that commenced upon completion of shipyard construction, sea trials, mobilization to India and customer acceptance of each rig. In November 2009, the Company entered into an agreement (the Assignment Agreement) with RIL and Oil and Natural Gas Company Limited (ONGC), where RIL assigned its interest in the first four years of the drilling contract for the KG1 to ONGC, a national oil company in India. Under the terms of the Assignment Agreement, the Company will derive revenue directly from ONGC during the first four years of the operations phase of the contract, and jointly from RIL and ONGC during the mobilization and demobilization phases of the contract.

For the three months ended March 31, 2011 and the year ended December 31, 2010, RIL and/or ONGC accounted for 100 percent of total operating revenues.

Note 8 Supplementary Cash Flow Information

Additional cash flow information is as follows (in thousands):

	Three months ended March 31, 2011	Year ended December 31, 2010
Certain cash operating activities		
Cash payments for interest	\$ 10,572	\$ 46,060
Cash payments for taxes	2,533	18,194
Non-cash investing activities		
Capital expenditures third party, accrued at end of period	\$ 399	\$ 1,483
Capital expenditures affiliates, accrued at end of period	\$ 11,903	\$ 22,784

Note 9 Income Taxes

Tax provision The components of the Company's provision (benefit) for income taxes are as follows (in thousands):

	Three Months Ended March 31, 2011	Year ended December 31, 2010
Current tax expense	\$ 4,146	\$ 13,342
Deferred tax (benefit) expense	20	373
Income tax expense	\$ 4,166	\$ 13,715
Effective tax rate	10%	11%

The Company is a BVI company and its earnings are not subject to income tax in BVI because the country does not levy tax on corporate income. As a result, the Company has not presented a reconciliation of the differences between the income tax provision computed at the statutory rate and the reported provision for income taxes for these periods.

The Company is subject to changes in tax laws, treaties and regulations in and between the countries in which the Company conducts business, or in which the Company is incorporated or resident. A material change in these tax laws, treaties or regulations could result in a higher or lower effective tax rate on the Company's earnings.

The Company recognizes deferred tax assets and liabilities for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of its assets and liabilities at the applicable tax rates in effect. As of March 31, 2011 and December 31, 2010, the Company's net deferred tax liability balance of \$183 thousand and \$163 thousand, respectively, relates to the net effects of deferred revenue and straight line revenue recognition.

Tax returns The Company's income tax returns are subject to review and examination in the jurisdictions in which the Company conducts business. The Company is not currently undergoing audits or contesting tax assessments.

The following is a reconciliation of our unrecognized tax benefits, excluding interest and penalties (in thousands):

	Three Months Ended March 31, 2011	Year Ended December 31, 2010
Balance, beginning of the period	\$ 1,047	\$
Additions for current year tax position	375	1,047
Balance, end of the period	\$ 1,422	\$ 1,047

We recognize interest and penalties related to our unrecognized tax benefits, recorded as a component of income tax expense. For the year ended December 31, 2010, there was no interest or penalties recorded on our unrecognized tax positions. For the three months ended March 31, 2011, there was no interest or penalties recorded on our unrecognized tax positions. If recognized, the entire amount of our unrecognized tax benefits, as of March 31, 2011, would favorably impact our effective tax rate. We expect our existing liabilities for unrecognized tax benefits to increase approximately \$1 million to \$2 million during the next twelve months.

Note 10 Subsequent Events

On February 29, 2012, Quantum irrevocably exercised its right to exchange its interest in the Company for Transocean Ltd. shares or cash. The purchase price is subject to negotiation and, failing agreement, will be determined based on an appraisal of the fair value of the Drilling Rigs after taking into account outstanding indebtedness. Quantum must elect on or before March 29, 2012 to receive the purchase price in either shares or cash.