Aircastle LTD
Form 10-Q
August 06, 2015

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

FORM 10-Q

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

For the quarterly period ended June 30, 2015

or

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

For the transition period from to

Commission File number 001-32959

AIRCASTLE LIMITED
(Exact name of registrant as specified in its charter)

Bermuda (State or other jurisdiction of incorporation or organization)	98-0444035 (IRS Employer Identification No.)
c/o Aircastle Advisor LLC 300 First Stamford Place, 5th Floor, Stamford, CT (Address of principal executive offices)	06902 (Zip Code)

Registrant's telephone number, including area code (203) 504-1020

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

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

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

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

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

As of July 31, 2015, there were 81,181,495 outstanding shares of the registrant’s common shares, par value $0.01 per share.

Aircastle Limited and Subsidiaries
Form 10-Q
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PART I. — FINANCIAL INFORMATION
Item 1. Financial Statements
Aircastle Limited and Subsidiaries
Consolidated Balance Sheets
(Dollars in thousands, except share data)

	June 30, 2015 (Unaudited)	December 31, 2014
ASSETS		
Cash and cash equivalents	$242,941	$169,656
Accounts receivable	4,996	3,334
Restricted cash and cash equivalents	161,854	98,884
Restricted liquidity facility collateral	65,000	65,000
Flight equipment held for lease, net of accumulated depreciation of $1,361,420 and $1,294,063	5,953,555	5,579,718
Net investment in finance leases	122,855	106,651
Unconsolidated equity method investment	48,712	46,453
Other assets	203,762	157,317
Total assets	$6,803,675	$6,227,013
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Borrowings from secured financings	$1,427,374	$1,396,454
Borrowings from unsecured financings	2,850,000	2,400,000
Accounts payable, accrued expenses and other liabilities	156,045	140,863
Lease rentals received in advance	56,785	53,216
Liquidity facility	65,000	65,000
Security deposits	111,765	117,689
Maintenance payments	351,148	333,456
Total liabilities	5,018,117	4,506,678
Commitments and Contingencies		
SHAREHOLDERS' EQUITY		
Preference shares, $.01 par value, 50,000,000 shares authorized, no shares issued and outstanding	—	—
Common shares, $.01 par value, 250,000,000 shares authorized, 81,181,495 shares issued and outstanding at June 30, 2015; and 80,983,249 shares issued and outstanding at December 31, 2014	812	810
Additional paid-in capital	1,566,268	1,565,180
Retained earnings	242,159	192,805
Accumulated other comprehensive loss	(23,681)	(38,460)
Total shareholders' equity	1,785,558	1,720,335
Total liabilities and shareholders' equity	$6,803,675	$6,227,013

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

Aircastle Limited and Subsidiaries
Consolidated Statements of Income
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenues:				
Lease rental revenue	$184,839	$183,231	$361,985	$357,566
Finance lease revenue	1,877	3,897	3,484	7,884
Amortization of lease premiums, discounts and lease incentives	(4,351)	414	(8,175)	(6,177)
Maintenance revenue	21,349	36,182	39,422	39,224
Total lease revenue	203,714	223,724	396,716	398,497
Other revenue	851	2,422	2,145	4,252
Total revenues	204,565	226,146	398,861	402,749
Operating expenses:				
Depreciation	77,368	75,784	152,214	149,711
Interest, net	61,551	60,494	123,682	124,757
Selling, general and administrative (including non-cash share based payment expense of $1,387 and $1,228 for the three months ended and $2,557 and $2,218 for the six months ended June 30, 2015 and 2014, respectively)	14,699	14,057	28,631	28,001
Impairment of Aircraft	23,955	28,306	23,955	46,569
Maintenance and other costs	3,663	2,646	6,606	4,509
Total expenses	181,236	181,287	335,088	353,547
Other income (expense):				
Gain on sale of flight equipment	21,102	884	27,355	1,994
Loss on extinguishment of debt	—	(36,570)	—	(36,570)
Other	277	—	271	757
Total other income (expense)	21,379	(35,686)	27,626	(33,819)
Income from continuing operations before income taxes	44,708	9,173	91,399	15,383
Income tax provision	4,465	6,558	9,328	7,441
Earnings of unconsolidated equity method investment, net of tax	1,565	521	3,006	971
Net income	$41,808	$3,136	$85,077	$8,913
Earnings per common share — Basic:				
Net income per share	$0.51	$0.04	$1.05	$0.11
Earnings per common share — Diluted:				
Net income per share	$0.51	$0.04	$1.05	$0.11
Dividends declared per share	$0.22	$0.20	$0.44	$0.40

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

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Aircastle Limited and Subsidiaries
Consolidated Statements of Comprehensive Income
(Dollars in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income	$41,808	$3,136	$85,077	$8,913
Other comprehensive income, net of tax:				
Net change in fair value of derivatives, net of tax expense of $26 and $0 for the three months ended and tax expense of $23 and $804 for the six months ended June 30, 2015 and 2014, respectively	564	12	436	382
Net derivative loss reclassified into earnings	6,110	8,854	14,343	18,181
Other comprehensive income	6,674	8,866	14,779	18,563
Total comprehensive income	$48,482	$12,002	$99,856	$27,476

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

Aircastle Limited and Subsidiaries
Consolidated Statements of Cash Flows
(Dollars in thousands)
(Unaudited)

	Six Months Ended June 30,	
	2015	2014
Cash flows from operating activities:		
Net income	$85,077	$8,913
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	152,214	149,711
Amortization of deferred financing costs	7,465	6,987
Amortization of net lease discounts and lease incentives	8,175	6,177
Deferred income taxes	(1,363)	3,999
Non-cash share based payment expense	2,557	2,218
Cash flow hedges reclassified into earnings	14,343	18,181
Security deposits and maintenance payments included in earnings	(22,382)	(40,006)
Gain on sale of flight equipment	(27,355)	(1,994)
Loss on extinguishment of debt	—	36,570
Impairment of aircraft	23,955	46,569
Other	108	(91)
Changes in certain assets and liabilities:		
Accounts receivable	(1,697)	(3,619)
Other assets	(2,155)	(1,914)
Accounts payable, accrued expenses and other liabilities	7,018	(20,438)
Lease rentals received in advance	3,646	2,742
Net cash provided by operating activities	249,606	214,005
Cash flows from investing activities:		
Acquisition and improvement of flight equipment and lease incentives	(797,136)	(834,467)
Proceeds from sale of flight equipment	231,842	246,037
Restricted cash and cash equivalents related to sale of flight equipment	(76,433)	(7,600)
Aircraft purchase deposits and progress payments	(3,461)	(3,785)
Net investment in finance leases	(24,000)	(14,258)
Collections on finance leases	4,795	6,219
Other	(256)	87
Net cash used in investing activities	(664,649)	(607,767)
Cash flows from financing activities:		
Issuance of shares net of repurchases	(1,960)	(2,091)
Proceeds from notes and term debt financings	800,000	803,200
Securitization and term debt financing repayments	(319,994)	(827,512)
Debt extinguishment costs	—	(32,835)
Deferred financing costs	(11,658)	(15,834)
Restricted liquidity facility collateral	—	42,000
Liquidity facility	—	(42,000)
Restricted cash and cash equivalents related to financing activities	13,463	29,015
Security deposits and maintenance payments received	71,536	83,144
Security deposits and maintenance payments returned	(27,336)	(44,577)
Payments for terminated cash flow hedges	—	(33,427)
Dividends paid	(35,723)	(32,402)
Net cash provided by (used in) financing activities	488,328	(73,319)

Net increase (decrease) in cash and cash equivalents	73,285	(467,081)
Cash and cash equivalents at beginning of period	169,656	654,613
Cash and cash equivalents at end of period	$242,941	$187,532
Supplemental disclosures of cash flow information:		
Cash paid for interest	$89,639	$112,386
Cash paid for income taxes	$3,918	$3,630
Supplemental disclosures of non-cash investing activities:		
Purchase deposits, advance lease rentals, security deposits and maintenance payments assumed in asset acquisitions	$7,841	$18,522
Term debt financings assumed in asset acquisitions	$—	$39,061
Advance lease rentals, security deposits, and maintenance payments settled in sale of flight equipment	$40,199	$17,533

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

Aircastle Limited and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
(Dollars in thousands, except per share amounts)
June 30, 2015

Note 1. Summary of Significant Accounting Policies
Organization and Basis of Presentation
Aircastle Limited ("Aircastle," the "Company," "we," "us" or "our") is a Bermuda exempted company that was incorporated o
October 29, 2004 under the provisions of Section 14 of the Companies Act of 1981 of Bermuda. Aircastle's business is investing in aviation assets, including acquiring, leasing, managing and selling high utility commercial jet aircraft. Aircastle is a holding company that conducts its business through subsidiaries. Aircastle directly or indirectly owns all of the outstanding common shares of its subsidiaries. The consolidated financial statements presented are prepared in accordance with U.S. generally accepted accounting principles ("US GAAP"). We operate in one segment.
The accompanying consolidated financial statements are unaudited and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting and, in our opinion, reflect all adjustments, including normal recurring items, which are necessary to present fairly the results for interim periods. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the entire year. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with US GAAP have been omitted in accordance with the rules and regulations of the SEC; however, we believe that the disclosures are adequate to make information presented not misleading. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.
The Company's management has reviewed and evaluated all events or transactions for potential recognition and/or disclosure since the balance sheet date of June 30, 2015 through the date on which the consolidated financial statements included in this Form 10-Q were issued.
Principles of Consolidation
The consolidated financial statements include the accounts of Aircastle and all of its subsidiaries. Aircastle consolidates seven Variable Interest Entities ("VIEs") of which Aircastle is the primary beneficiary. All intercompany transactions and balances have been eliminated in consolidation.
We consolidate VIEs in which we have determined that we are the primary beneficiary. We use judgment when deciding (a) whether an entity is subject to consolidation as a VIE, (b) who the variable interest holders are, (c) the potential expected losses and residual returns of the variable interest holders, and (d) which variable interest holder is the primary beneficiary. When determining which enterprise is the primary beneficiary, we consider (1) the entity's purpose and design, (2) which variable interest holder has the power to direct the activities that most significantly impact the entity's economic performance, and (3) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE. When certain events occur, we reconsider whether we are the primary beneficiary of VIEs. We do not reconsider whether we are a primary beneficiary solely because of operating losses incurred by an entity.
Use of Estimates
The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. While Aircastle believes that the estimates and related assumptions used in the preparation of the consolidated financial statements are appropriate, actual results could differ from those estimates.
Proposed Accounting Pronouncements
In May 2013, the Financial Accounting Standards Board ("FASB") issued re-exposure draft, "Leases" (the "Lease Re-ED"), which would replace the existing guidance in the Accounting Standards Codification ("ASC") 840 ("ASC 840"), Leases. In March 2014, the FASB decided that the accounting for leases by lessors would basically remain unchanged from the concepts existing in current ASC 840 accounting. In addition, the FASB decided that a lessor should be precluded

from recognizing selling profit and revenue at lease commencement for any sales-type or direct finance lease that does not transfer control of the underlying asset to the lessee. This requirement aligns the notion of what constitutes a sale in the lessor accounting guidance with that in the forthcoming revenue recognition standard, which evaluates whether a sale has occurred

Aircastle Limited and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
(Dollars in thousands, except per share amounts)
June 30, 2015

from the customer's perspective. We anticipate that the final standard may have an effective date no earlier than 2018. We believe that when and if the proposed guidance becomes effective, it will not have a material impact on the Company's consolidated financial statements.

On May 28, 2014, the FASB and the International Accounting Standards Board (the "IASB") (collectively, the Boards), jointly issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). Lease contracts within the scope of ASC 840, Leases, are specifically excluded from ASU No. 2014-09. The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which a company expects to be entitled in exchange for those goods or services. The standard is effective for public entities beginning after December 15, 2017. The standard allows for either "full retrospective" adoption, meaning the standard is applied to all of the periods presented, or "modified retrospective" adoption, meaning the standard is applied only to the most current period presented in the financial statements. We are evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures. The Company is currently evaluating the impacts of adoption and the implementation approach to be used.

On August 27, 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40). The standard requires management of public companies to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and, if so, disclose that fact. Management should evaluate whether there are conditions or events, considered in the aggregate, that raises substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued, when applicable). The standard is effective for annual periods ending after December 15, 2016 and interim periods thereafter, and early adoption is permitted. We are currently evaluating the effect of the ASU on our consolidated financial statements and related disclosures.

On April 7, 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30) Simplifying the Presentation of Debt Issuance Costs, which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the associated debt liability. The guidance in the new standard is limited to the presentation of debt issuance costs and does not affect the recognition and measurement of debt issuance costs. The standard is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The new guidance will be applied on a retrospective basis. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements

Note 2. Fair Value Measurements

Fair value measurements and disclosures require the use of valuation techniques to measure fair value that maximize the use of observable inputs and minimize use of unobservable inputs. These inputs are prioritized as follows:

- Level 1: Observable inputs such as quoted prices in active markets for identical assets or liabilities.
- Level 2: Inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities or market corroborated inputs.
- Level 3: Unobservable inputs for which there is little or no market data and which require us to develop our own assumptions about how market participants price the asset or liability.

The valuation techniques that may be used to measure fair value are as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- The income approach uses valuation techniques to convert future amounts to a single present amount based on current market expectation about those future amounts.
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The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost).

Aircastle Limited and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
(Dollars in thousands, except per share amounts)
June 30, 2015

The following tables set forth our financial assets and liabilities as of June 30, 2015 and December 31, 2014 that we measured at fair value on a recurring basis by level within the fair value hierarchy. Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to their fair value measurement.

		Fair Value Measurements at June 30, 2015 Using Fair Value Hierarchy			
	Fair Value as of June 30, 2015	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique
Assets:					
Cash and cash equivalents	$242,941	$242,941	$—	$—	Market
Restricted cash and cash equivalents	161,854	161,854	—	—	Market
Total	$404,795	$404,795	$—	$—	
Liabilities:					
Derivative liabilities	$2,548	$—	$2,548	$—	Income

		Fair Value Measurements at December 31, 2014 Using Fair Value Hierarchy			
	Fair Value as of December 31, 2014	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique
Assets:					
Cash and cash equivalents	$169,656	$169,656	$—	$—	Market
Restricted cash and cash equivalents	98,884	98,884	—	—	Market
Total	$268,540	$268,540	$—	$—	
Liabilities:					
Derivative liabilities	$2,879	$—	$2,879	$—	Income

Our cash and cash equivalents, along with our restricted cash and cash equivalents balances, consist largely of money market securities that are considered to be highly liquid and easily tradable. These securities are valued using inputs observable in active markets for identical securities and are therefore classified as Level 1 within our fair value hierarchy. Our interest rate derivatives included in Level 2 consist of United States dollar-denominated interest rate derivatives, and their fair values are determined by applying standard modeling techniques under the income approach to relevant market interest rates (cash rates, futures rates, swap rates) in effect at the period close to determine appropriate reset and discount rates and incorporates an assessment of the risk of non-performance by the interest rate

derivative counterparty in valuing derivative assets and an evaluation of the Company's credit risk in valuing derivative liabilities.

For the three and six months ended June 30, 2015 and 2014, we had no transfers into or out of Level 3.

We measure the fair value of certain assets and liabilities on a non-recurring basis, when US GAAP requires the application of fair value, including events or changes in circumstances that indicate that the carrying amounts of assets may not be recoverable. Assets subject to these measurements include our investment in an unconsolidated joint venture and aircraft. We account for our investment in an unconsolidated joint venture under the equity method of accounting and record impairment when its fair value is less than its carrying value. We record aircraft at fair value when we determine the carrying value may not be recoverable. Fair value measurements for aircraft in impairment tests are based on an income approach

Aircastle Limited and Subsidiaries
Notes to Unaudited Consolidated Financial Statements
(Dollars in thousands, except per share amounts)
June 30, 2015

which uses Level 3 inputs, which include the Company's assumptions and appraisal data as to future cash proceeds from leasing and selling aircraft.

Aircraft Valuation
During the six months ended June 30, 2015, we impaired two MD-11 freighter aircraft and one 737-800 aircraft and recorded impairment charges totaling $23,955 and recorded maintenance revenue of $18,234.
During the six months ended June 30, 2014, we impaired three 747-400 converted freighter aircraft one Boeing 737-400 aircraft and recorded impairment charges totaling $46,570. For these aircraft, we recorded maintenance revenue of $23,678 and other revenue of $91 and reversed lease incentives of $3,626.

Financial Instruments
Our financial instruments, other than cash, consist principally of cash equivalents, restricted cash and cash equivalents, accounts receivable, accounts payable, amounts borrowed under financings and interest rate derivatives. The fair value of cash, cash equivalents, restricted cash and cash equivalents, accounts receivable and accounts payable approximates the carrying value of these financial instruments because of their short-term nature.
The fair value of our Securitization No. 2, which contains a third party credit enhancement, is estimated using a discounted cash flow analysis, based on our current incremental borrowing rates of borrowing arrangements that do not contain third party credit enhancements. The fair values of our ECA term financings and bank financings are estimated using a discounted cash flow analysis, based on our current incremental borrowing rates for similar types of borrowing arrangements. The fair value of our Senior Notes is estimated using quoted market prices.
The carrying amounts and fair values of our financial instruments at June 30, 2015 and December 31, 2014 are as follows:

	June 30, 2015		Decem
	Carrying Amount of Asset (Liability)	Fair Value of Asset (Liability)	Carryin Amour of Asse (Liabili
Securitization No. 2	$(334,073)	$(328,611)	$(391,6
Credit Facilities	(150,000)	(150,000)	(200,00
ECA term financings	(427,378)	(447,838)	(449,88
Bank financings	(665,923)	(684,772)	(554,88
Senior Notes	(2,700,000)		

2. Significant Accounting policies and Recent Accounting Pronouncements:

A discussion of the Company's significant accounting policies can be found in the Company's Consolidated Financial Statements as of December 31, 2010 and 2009 and for the three years in the period ended December 31, 2010 contained in the Company's registration statement on Form F-4 (File No. 333-176641) filed with the Commission on September 1, 2011, as amended by Amendment No. 1 to Form F-4 filed with the Commission on October 11, 2011. There have been no

material changes to these policies in the nine-month period ended September 30, 2011.

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" (ASU 2011-04). This newly issued accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This ASU is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011, which for the Company means January 1, 2012. The Company does not expect that adoption of this standard will have a material impact on its financial position or results of operations.

OCEAN RIG UDW INC.
Notes to unaudited Interim Condensed Consolidated Financial Statements
September 30, 2011
(Expressed in thousands of United States Dollars – except for share and per share data, unless otherwise stated)

2. Significant Accounting policies and Recent Accounting Pronouncements – (continued):

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (Topic 220)" (ASU 2011-05). This newly issued accounting standard (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income nor do the amendments affect how earnings per share is calculated or presented. This ASU is required to be applied retrospectively and is effective for fiscal years and interim periods within those years beginning after December 15, 2011, which for the Company means January 1, 2012. As this accounting standard only requires enhanced disclosure, the adoption of this standard will not impact the Company's financial position or results of operations.

3. Restatement of Previously Issued Financial Statements:

The Company adjusted its previously reported consolidated financial statements for the nine-month period ended September 30, 2010 to reflect the correction of an error in computing capitalized interest expense for assets under construction. Management concluded that the factors affecting the capitalized interest calculations should also include the amortization of deferred financing fees.

Additionally, the Company considered ASC 815-30, Cash Flow Hedges, and adjusted its previously reported financial statements to reflect the correction of an error to reverse the reclassification into earnings of that portion of interest that should have remained in accumulated other comprehensive loss since it related to cash flow hedges of the variability of interest on borrowings associated with assets under construction. Such accumulated other comprehensive loss should be reclassified into earnings in the same period or periods during which the hedged transactions affect earnings.

The following tables reflect the impacts on the financial statement line items of the accounting adjustments:

Consolidated Statement of Operations	For the Nine-Months Period Ended September 30, 2010 (as previously reported)	(as restated)
Interest and finance costs	$(21,978)	$(6,066)
Total other expenses, net	(64,560)	(48,648)
Income before income taxes	80,254	96,166
Net income	65,458	81,370
Earnings per common share, basic and diluted	$0.50	$0.62

OCEAN RIG UDW INC.
Notes to unaudited Interim Condensed Consolidated Financial Statements
September 30, 2011
(Expressed in thousands of United States Dollars – except for share and per share data, unless otherwise stated)

3. Restatement of Previously Issued Financial Statements – (continued):

The impact of the foregoing errors is shown below:

Consolidated Cash Flow	For the Nine-Month Period Ended September 30, 2010	
	(as previously reported)	(as restated)
Net Cash provided by Operating Activities	$159,674	$154,201
Advances for rigs under construction	(557,822)	(556,558)
Net Cash Used in Investing Activities	$(650,985)	$(645,512)

OCEAN RIG UDW INC.
Notes to unaudited Interim Condensed Consolidated Financial Statements
September 30, 2011
(Expressed in thousands of United States Dollars – except for share and per share data, unless otherwise stated)

4. Shareholders' equity

There is one class of common shares, and each common share is entitled to one vote for each common share held.

Prior to December 8, 2010, the Company's authorized capital stock consisted of 500 common shares, par value $20.00 per shares. During December 2010, the Company (i) following approval by the Company's board of directors and shareholders, amended and restated its articles of incorporation pursuant to which its authorized capital stock consisted of 250,000,000 common shares, par value $0.01 per share; and (ii) declared and paid a stock dividend of 103,125,000 shares of its common stock to its sole shareholder, DryShips. On December 21, 2010 the Company completed through a private placement the sale of an aggregate of 28,571,428 common shares at $17.50 per share. The proceeds from the private placement net of directly attributable costs of $11,699 were $488,301. The stock dividend has been accounted for as a stock split. As a result, the Company reclassified approximately $1,021 from Additional Paid In Capital to common stock, which represents the par value per share of the shares issued. All previously reported share and per share amounts have been restated to reflect the stock dividend.

On May 3, 2011, following the approval by the Company's board of directors and shareholders, the Company amended and restated its amended and restated articles of incorporation to, among other things, increase its authorized share capital to 1,000,000,000 common shares and 500,000,000 shares of preferred stock, each with a par value of $0.01 per share.

As of September 30, 2011, the Company's total number of common shares outstanding consisted of 131,696,928 issued and outstanding common shares. All of Ocean Rig's shares of common stock are in registered form.

5. Transactions with Related Parties:

Drillship Management Agreements with Cardiff: Effective December 21, 2010, the Company terminated its management agreements with Cardiff pursuant to which Cardiff provided supervisory services in connection with the construction of the drillships Ocean Rig Corcovado and Ocean Rig Olympia. The Company paid Cardiff a management fee of $40 per month per drillship for Ocean Rig Corcovado and Ocean Rig Olympia. The management agreements also provided for: (i) a chartering commission of 1.25% on revenue earned; (ii) a commission of 1% on the shipyard payments or purchase price paid for drillships; (iii) a commission of 1% on loan financing or refinancing; and (iv) a commission of

2% on insurance premiums. For the nine-month periods ended September 30, 2010 and 2011, the Company paid $3,304 and $5,774 respectively, as fees related to the Management Agreement. All incurred costs from management service agreements are directly attributable to the construction of the drillships and are capitalized as a component of "Rigs under construction". These agreements were replaced with the Global Services Agreement discussed below.

Global Services Agreement: On December 1, 2010, DryShips Inc. ("DryShips" or "Parent Company") entered into a Global Services Agreement with Cardiff, effective December 21, 2010, pursuant to which DryShips has engaged Cardiff to act as consultant on matters of chartering and sale and purchase transactions for the offshore drilling units operated by the Company. Under the Global Services Agreement, Cardiff, or its subcontractor, (i) provides consulting services related to identifying, sourcing, negotiating and arranging new employment for offshore assets of the Company and its subsidiaries, including the Company's drilling units; and (ii) identifies, sources, negotiates and arranges the sale or purchase of the offshore assets of the Company and its subsidiaries, including the Company's drilling units. In consideration of such services, DryShips pays Cardiff a fee of 1.0% in connection with employment arrangements and 0.75% in connection with sale and purchase activities. For the nine-month period ended September 30, 2011 the Company incurred a cost of $6,543 related to the Global Services Agreement of which $1,650 is related to employment arrangements and $4,894 to sale and purchase activities. The Company does not pay for services provided in accordance with this agreement since equal equity contributions are made by DryShips. Costs from the Global Services Agreement are expensed in the consolidated statement of operations or capitalized as a component of "Rigs under construction," being directly attributable cost to the construction, as applicable, and as a shareholders contribution to capital

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5. Transactions with Related Parties – (continued):

Vivid Finance Limited: Under the consultancy agreement effective September 1, 2010 between Dryships and Vivid Finance Limited ("Vivid"), a related party entity incorporated in Cyprus, Vivid provides the Company with financing-related services such as (i) negotiating and arranging new loan and credit facilities, interest rate swap agreements, foreign currency contracts and forward exchange contracts, (ii) renegotiating existing loan facilities and other debt instruments and (iii) the raising of equity or debt in the capital markets. In exchange for its services, Vivid is entitled to a fee equal to 0.20% on the total transaction amount. The consultancy agreement has a term of five years and may be terminated (i) at the end of its term unless extended by mutual agreement of the parties, (ii) at any time by the mutual agreement of the parties, and (iii) by the parent Company after providing written notice to Vivid at least 30 days prior to the actual termination date.

In the period from January 1, 2011 to September 30, 2011, total charges from Vivid were $5,230 which were charged to the statement of operations and as a shareholders contribution to Additional paid-in capital.

Legal services
Mr. Savvas D. Georghiades, a member of the Company's board of directors, provides legal services to the Company through his law firm, Savvas D. Georghiades, Law Office. For the nine-month period ended to September 30, 2010 and 2011, the Company paid a fee of Euro 33,149 ($44,790 based on the Euro/U.S. Dollar exchange rate at September 30, 2011) and Euro 47,390 ($64,032 based on the Euro/U.S. Dollar exchange rate at September 30, 2011), respectively, for the legal services provided by Mr. Georghiades.

Related party transactions on the balance sheet
Prior to the private placement described in Note 4, DryShips made a number of payments towards yard installments, loan installments, loan interest and interest rate swap payments on behalf of Ocean Rig. The amount receivable from DryShips included in the accompanying consolidated balance sheets as of December 31, 2010 and September 30, 2011 amounted to $0 and $92, respectively.

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6. Advances for Rigs under Construction:

The amounts shown in the accompanying consolidated balance sheets include milestone payments relating to the shipbuilding contracts with the shipyards, supervision costs and any material related expenses incurred including capitalized interest during the construction periods, all of which are capitalized in accordance with the accounting policy discussed in Note 2 of the Consolidated Financial Statements for the year ended December 31, 2010.

The amounts in the accompanying consolidated balance sheets are analyzed as follows:

	December 31, 2010	September 30, 2011
Balance at beginning of year/period	$1,178,392	$1,888,490
Advances for drillships under construction and related costs	710,098	2,229,272
Drillships delivered	-	(3,372,156)
Balance at end of year/period	$1,888,490	$745,606

On January 3, March 30, July 28 and September 30, 2011, the Company took delivery of its newbuilding drillships the Ocean Rig Corcovado, the Ocean Rig Olympia, the Ocean Rig Poseidon and the Ocean Rig Mykonos.

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6. Advances for Rigs under Construction – (continued):

On April 18, 2011 April, 27, 2011 and June 23, 2011, pursuant to the drillship master agreement, the Company exercised three of its four newbuilding drillship options under its contract with Samsung Heavy Industries Co., Ltd. ("Samsung"), dated November 22, 2010 and entered into shipbuilding contracts for three seventh generation ultra-deepwater drillships, namely NB#1, NB#2 and NB#3, for a total average yard cost (including extras) of $620,000, per drillship. The Company paid $622,413 to the shipyard in connection with the exercise of these options. Delivery of these hulls is scheduled for July 2013, September 2013 and November 2013, respectively.

On May 16, 2011, the Company entered into an addendum to its option contract with Samsung, pursuant to which the Company was granted the option for the construction of up to two additional ultra-deepwater drillships, which would be "sister-ships" to the Ocean Rig Corcovado, the Ocean Rig Olympia, the Ocean Rig Poseidon and the Ocean Rig Mykonos and the seventh generation ultra-deepwater drillships described above, with certain upgrades to vessel design and specifications. Pursuant to the addendum, the two additional newbuilding drillship options and the remaining option under the original contract may be exercised at any time on or prior to January 31, 2012.

During the nine-month period ended September 30, 2010 and 2011, the Company paid an amount of $233,746 and $771,021 to the yard for the construction of the Ocean Rig Poseidon and the Ocean Rig Mykonos.

7. Drilling Rigs, machinery and equipment:

The amounts in the accompanying consolidated balance sheets are analyzed as follows:

	Cost	Accumulated Depreciation	Net Book Value
Balance, December 31, 2010	$1,440,118	(190,785)	$1,249,333
Additions/transfer from rigs under construction	3,388,110	-	3,388,110
Disposals	(169)	70	(99)
Depreciation	-	(106,460)	(106,460)
Balance, September 30, 2011	$4,828,059	(297,175)	$4,530,884

As of September 30, 2011, all of the Company's drilling rigs and drillships have been pledged as collateral to secure the bank loans (Note 9).

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8. Other non current assets:

The amounts included in the accompanying consolidated balance sheets are as follows:

	December 31, 2010	September 30, 2011
Security deposits for derivatives	$ 78,600	$ 36,200
Delivery payment for drillship	294,569	-
Option for construction of drillships	99,024	24,756
Prepaid investment	-	12,323
Balance at end of year/period	$ 472,193	$ 73,279

As of December 31, 2010, security deposits (margin calls) of $39,500 and $39,100 for the Ocean Rig Poseidon and the Ocean Rig Mykonos, respectively, were paid and recorded as "Other non current assets" in the accompanying consolidated balance sheet as of December 31, 2010. As of September 30, 2011, security deposits (margin calls) of $1,800 and $34,400 for the Ocean Rig Poseidon and the Ocean Rig Mykonos, respectively, were recorded as "Other non current assets" in the accompanying interim condensed consolidated balance sheet. These deposits are required by the counterparty due to the market loss in the swap agreements as of December 31, 2010 and September 30, 2011.

On December 28, 2010 the final yard installment of $294,569 for the Ocean Rig Corcovado was paid to a suspense account and was recorded as 'Other non current assets' in the accompanying consolidated balance sheet as of December 31, 2010. On January 3, 2011 and in connection with the delivery of Ocean Rig Corcovado the balance in the suspense account was released to the yard.

On November 22, 2010, Dryships, entered into a contract with Samsung for the construction of up to four additional ultra-deepwater drillships, which would be "sister-ships" to the Ocean Rig Corcovado, Ocean Rig Olympia, Ocean Rig Poseidon and the Ocean Rig Mykonos with certain upgrades to vessels design and specifications. The total construction cost plus extras is estimated to be $620,000 per drillship. The option agreement required Dryships to pay a non-refundable slot reservation fee of $24,756 per drillship, which fee will be applied towards the drillship contract price if the options are exercised. The option agreement was novated by DryShips to the Company on December 30, 2010 at a cost of $99,024 paid by the Company. During the nine-month period ended September 30, 2011, the Company paid an additional amount of $30,000 to exercise three of the above options. On May 16, 2011, the Company entered into an addendum to the option agreement for the option to construct of up to two

additional ultra-deepwater drillships with the same contract terms, conditions and specifications as the four optional drillships under the original agreement and to extend the date to exercise the option for the construction of the fourth optional drillship under the original agreement from November 22, 2011 to January 31, 2012.

The Company has exercised three of the six options under the option agreement and, as a result, has entered into shipbuilding contracts for three seventh generation ultra-deepwater drill ships with deliveries scheduled in July 2013, September 2013 and November 2013, respectively. The Company may exercise the three remaining newbuilding drillship options at any time on or prior to January 31, 2012, with vessel deliveries ranging from the third quarter of 2014 and onwards, depending on when the options are exercised.

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9. Long-term Debt:

The amount of long-term debt shown in the accompanying consolidated balance sheets is analyzed as follows:

	December 31, 2010	September 30, 2011
Loan Facilities	$1,285,357	$2,312,795
Senior Notes	-	500,000
Less: Deferred financing costs	(27,810)	(45,841)
Total debt	1,257,547	2,766,954
Less: Current portion	(560,561)	(219,167)
Long-term portion	$696,986	$2,547,787

The principal payments to be made during each of the twelve-month periods subsequent to September 30, 2011 for the loan payments as classified in the balance sheet are as follows:

September 30, 2012	$219,167
September 30, 2013	646,667
September 30, 2014	176,667
September 30, 2015	176,667
September 30, 2016 and thereafter	1,593,627
Total principal payments	2,812,795
Less: Financing fees	(45,841)
Total debt	$2,766,954

Senior Notes
On April 27, 2011, the Company issued $500,000 aggregate principal amount of its 9.5% senior unsecured notes due 2016 (the "Senior Notes") offered in a private placement resulting in net proceeds of approximately $487,400. The Senior Notes are unsecured obligations and rank senior in right of payment to any of the Company's future subordinated indebtedness and equally in right of payment to all of the Company's existing and future unsecured senior indebtedness. The notes are not be guaranteed by any of the Company's subsidiaries. The Company may redeem some or all of the notes as follows: (i) at any time and from time to time from April 27, 2014 to April 26, 2015, at a redemption price equal to 104.5% of the aggregate principal amount, plus accrued and unpaid interest to the date of redemption; or (ii) at any time and

from time to time from April 27, 2015 at a redemption price equal to 102.5% of the aggregate principal amount, plus accrued and unpaid interest to the date of redemption. Upon a change of control, which occurs if 50% or more of the Company's shares are acquired by any person or group other than DryShips or its affiliates, the noteholders will have an option to require the Company to purchase all outstanding notes at a redemption price of 100% of the principal amount thereof plus accrued and unpaid interest to the date of purchase. Subject to a number of limitations and exceptions, the bond agreement governing the notes contains covenants limiting, among other things, the Company's ability to: (i) create liens; or

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9. Long-term Debt – (continued):

(ii) merge, or consolidate or transfer, sell or lease all or substantially all of the Company's assets. Furthermore, the bond agreement contains financial covenants requiring the Company, among other things, to ensure that the Company maintain: (i) a minimum consolidated equity ratio of 35%; (ii) minimum free cash of $50,000; (iii) a minimum current ratio of 1-to-1; and (iv) an interest coverage ratio of 2.5x calculated on a 12 month rolling basis. As of September 30, 2011, the Company was in compliance with the bond agreement financial covenants.

The total interest expense related to the Senior Notes in the Company's unaudited interim condensed consolidated statement of operations for the nine-month periods ended September 30, 2011 was $20,452. The contractual semi-annual coupon interest rate is 9.5% per year.

Term loans

Please refer to Note 10 to the Company's Consolidated Financial Statements for the year ended December 31, 2010 contained in the Company's registration statement on Form F-4 (File No. 333-176641) filed with the Commission on September 1, 2011, as amended by Amendment No. 1 to Form F-4 filed with the Commission on October 11, 2011, for a discussion of the Company's various credit facilities and the material loan covenants contained therein as of December 31, 2010.

On December 21, 2010, Drillship Hydra Owners Inc. entered into a $325,000 short-term loan facility (the "$325,000 Bridge Loan") with a syndicate of lenders for the purpose of (i) meeting the ongoing working capital needs of Drillships Hydra Owners Inc.; (ii) financing the partial repayment of existing debt in relation to the purchase of the Ocean Rig Corcovado; and (iii) financing the payment of the final installment associated with the purchase of said drillship. This loan facility was repayable in full in June 2011 and bore interest at a rate of LIBOR plus a margin. The Company drew down the full amount of this loan on January 5, 2011 and repaid the full amount of this loan on April 20, 2011 with borrowings under the $800,000 senior secured term loan agreement discussed below.

On April 18, 2011, the Company entered into an $800,000 syndicated secured term loan facility to partially finance the construction costs of the Ocean Rig Corcovado and the Ocean Rig Olympia. This facility has a five year term and is repayable in 20 quarterly installments starting July 2011, plus a balloon payment payable with the last installment. The facility bears interest at LIBOR plus a

margin. The facility is guaranteed by DryShips and Ocean Rig and imposes certain financial covenants on both entities. On April 20, 2011, the Company drew down the full amount of this facility and prepaid the outstanding balance of its existing $325,000 Bridge Loan Facility.

On April 27, 2011, the Company entered into an amended agreement with all lenders under its two $562,500 loan agreements to restructure the terms of the agreements. The principal terms of the restructuring are as follows: (i) the maximum amount permitted to be drawn is reduced from $562,500 to $495,000 under each facility; (ii) in addition to the guarantee already provided by DryShips, the Company provided an unlimited recourse guarantee that will include certain financial covenants that will apply quarterly to Ocean Rig, (iii) the Company is permitted to draw under the facility with respect to the Ocean Rig Poseidon based upon the employment of the drillship under its drilling contract with Petrobras Tanzania, and on April 27, 2011, the cash collateral deposited for this vessel was released; and (iv) the Company will be permitted to draw under the facility with respect to the Ocean Rig Mykonos provided it has obtained suitable employment for such drillship no later than August 2011.

On August 10, 2011, the Company amended the terms of its $495,000 credit facility for the construction of the Ocean Rig Mykonos to allow for full draw downs to finance the remaining installment payments for the Ocean Rig Mykonos based on the Petrobras Brazil contract for the Ocean Rig Mykonos and, on August 10, 2011, the cash collateral deposited for the drillship was released. The amendment also requires that the Ocean Rig Mykonos be re-employed under a contract acceptable to the lenders meeting certain minimum terms and dayrates at least six months, in lieu of 12 months, prior to the expiration of the Petrobras Brazil contract. All other material terms of the credit facility were unchanged.

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9. Long-term Debt – (continued):

The credit facilities are reduced in quarterly and semi-annual installments or bullets starting May and October 2012 repeatedly. Interest is payable at a rate based on LIBOR plus a margin.

As of December 31, 2010 and September 30, 2011 the Company had an aggregate available unsecured line of credit amounting to $938,726 and $538, respectively.

Total interest and debt issuance amortization cost incurred on long-term debt for the nine-month periods ended September 30, 2010 and 2011, amounted to $27,456 and $76,861, respectively, of which $27,265 and $48,442 respectively, were capitalized as part of the cost of the "Rigs under construction". Total interest incurred on long-term debt, net of capitalized interest, is included in "Interest and finance costs" in the accompanying unaudited interim condensed consolidated statement of operations (Note 11).

The weighted-average interest rates on the above outstanding loans, senior notes and credit facilities for the applicable periods were 4.50% for the year ended December 31, 2010 and 4.0% for the nine-month period ended September 30, 2011.

The outstanding loans above, except for the senior notes, are secured by a first priority mortgage over the drillships/drill rigs or assignment of shipbuilding contracts, corporate guarantee, and a first assignment of all freights, earnings, insurances and requisition compensation. The loans contain covenants including restrictions, without the bank's prior consent, as to changes in management and ownership of the vessels, additional indebtedness and mortgaging of vessels, change in the general nature of the Company's business, and maintaining an established place of business in the United States or the United Kingdom. The loans also contain certain financial covenants relating to the Company's financial position and the consolidated financial position of DryShips, operating performance and liquidity. A default situation in DryShips could have a substantial effect on the Company. Should DryShips fail to pay loan installments as they fall due, this would result in a cross-default on the Company's facilities. As of September 30, 2011, there was no default situation with respect to the loans of the Company and DryShips was in compliance, had waivers or had the ability to remedy breaches of financial covenants, including loan-to-value ratios relating to its credit facilities. Based on the loan agreements, DryShips is required to meet certain loan-to-value ratios. However, according to the loan agreements, loan-to-value ratio shortfalls can be remedied by providing additional collateral or repaying the portion of the loan equal to the shortfall to

bring DryShips into compliance with the required loan-to-value ratios upon notification by the lenders. As of September 30, 2011, DryShips was not in compliance with the loan-to-value ratios contained in certain of its loan agreements under which a total of $461.7 million was outstanding as of September 30, 2011. As a result, DryShips plans, if requested, to provide additional collateral to its lenders in the form of cash or other assets in the total amount of $74.6 million in order to comply with these ratios.

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10. Financial Instruments and Fair Value Measurements:

As of September 30, 2011, the Company had outstanding seven interest rate swap (IRS), cap and floor agreements, with a notional amount of $0.9 billion. All derivatives are carried at fair value on the consolidated balance sheets at each period end. Balances as of December 31, 2010 and September 30, 2011, are as follows:

	December 31, 2010			September 30, 2011		
	Interest Rate Swaps	Foreign currency forward contracts	Total	Interest Rate Swaps	Foreign currency forward contracts	Total
Current Assets	$-	1,538	$1,538	$-	99	$99
Current liabilities	(12,503)	-	(12,503)	(21,370)	-	(21,370)
Non-current liabilities	(96,901)	-	(96,901)	(77,908)	-	(77,908)
	$(109,404)	1,538	$(107,866)	$(99,278)	99	$(99,179)

Derivatives designated as hedging instruments	Balance Sheet Location	Asset Derivatives December 31, 2010 Fair value	Asset Derivatives September 30, 2011 Fair value	Balance Sheet Location	Liability Derivatives December 31, 2010 Fair value	Liability Derivatives September 30, 2011 Fair value
Interest rate swaps	Financial instruments	$-	$-	Financial instruments non-current liabilities	$(36,523)	$-
Total derivatives designated as hedging instruments		-	-		(36,523)	-
Derivatives not designated as hedging instruments						
		-	-	Financial	(12,503)	(21,370)

Interest rate swaps	Financial Instruments current assets			Instruments current liabilities		
Interest rate swaps	Financial Instruments non-current assets	-	-	Financial instruments-non current liabilities	(60,378)	(77,908)
Foreign currency forward contracts	Financial instruments current assets	1,538	99	Financial instruments current liabilities	-	-
Total derivatives not designated as hedging instruments		1,538	99		(72,881)	(99,278)
Total derivatives		$ 1,538	$ 99	Total derivatives	$ (109,404)	$ (99,278)

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10. Financial Instruments and Fair Value Measurements:

The Effect of Derivative Instruments on the unaudited interim condensed consolidated statements of operations:

Derivatives designated for cash flow hedging relationships	Amount of Gain/(Loss) Recognized in Other Comprehensive Income on Derivatives (Effective Portion) Nine-month period ended September 30, 2010	Nine-month period ended September 30, 2011
Interest rate swaps – unrealized gains/(losses)	$ (13,801)	$ -
Total	$ (13,801)	$ -

No portion of the cash flow hedges shown above was ineffective during 2010. Effective January 1, 2011, the Company removed the designation of the cash flow hedges and discontinued hedge accounting for the associated interest rate swaps.

During the nine-month periods ended September 30, 2010 and 2011, $0 and $7,005, respectively, of existing losses were transferred from Other Comprehensive Income (OCI) to the unaudited interim condensed consolidated statement of operations. The estimated net amount of existing losses at September 30, 2011 that will be reclassified to earnings within the next twelve months is $14,123.

The effects of derivative instruments not designated or qualifying as hedging instruments on the unaudited interim condensed consolidated statement of operations:

Derivatives not designated as hedging instruments	Location of Gain or (Loss) Recognized	Amount of Gain/(Loss) Nine-month period ended September 30, 2010	Nine-month period ended September 30, 2011
Interest rate swaps	Gain/(Loss) on interest rate swaps	$ (52,781)	$ (34,158)

Foreign currency forward contracts	Other, net		857		(1,439)
Total		$	(51,924)	$	(35,597)

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10. Financial Instruments and Fair Value Measurements-(continued):

ASC 815, 'Derivatives and Hedging' requires companies to recognize all derivatives instruments as either assets or liabilities at fair value in the statement of financial position. Effective January 1, 2011, the Company removed the designation of the cash flow hedges and discontinued hedge accounting for the associated interest rate swaps.

For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in the accompanying consolidated statement of operations. Changes in the fair value of derivative instruments that have not been designated as hedging instruments are reported in the accompanying consolidated statement of operations.

The Company enters into interest rate swap transactions to manage interest costs and risk associated with changing interest rates with respect to its variable interest rate loans and credit facilities. The Company enters into foreign currency forward contracts in order to manage risks associated with fluctuations in foreign currencies, respectively.

The carrying amounts of cash and cash equivalents, restricted cash trade accounts receivable and accounts payable reported in the consolidated balance sheets approximate their respective fair values because of the short-term nature of these accounts. The carrying value approximates the fair market value for the floating rate loans. The fair value of the interest rate swaps was determined using a discounted cash flow method based on market-based LIBOR swap yield curves, taking into account current interest rates and the creditworthiness of both the financial instrument counterparty and the Company. The fair value of foreign currency forward contracts was based on the forward exchange rates. Senior Notes have a fixed rate and their estimated fair value represents the tradable value of the notes, determined through Level 2 inputs of the fair value hierarchy (quoted price in the over-the counter-market). The estimated fair value of the Notes at September 30, 2011 is approximately $440,000.

The guidance for fair value measurements applies to all assets and liabilities that are being measured and reported on a fair value basis. This guidance enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability

of the information used to determine fair values. The statement requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

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The following table summarizes the valuation of assets and liabilities measured at fair value on a recurring basis as of the valuation date.

	September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Recurring measurements:				
Interest rate swaps-liability position	$ (99,278)	-	(99,278)	-
Foreign currency forward contracts-asset position	99	99	-	-
Total	$ (99,179)	99	(99,278)	-

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11. Interest and Finance costs:

The amounts in the accompanying unaudited interim condensed consolidated statements of operations are analyzed as follows:

	Nine-month period ended September 30,	
	2010	2011
Interest on long-term debt, including amortization of financing fee	$27,456	$76,861
Amortization of unrealized OCI hedge reserve	-	6,544
Capitalized interest	(27,265)	(48,442)
Long-term debt commitment fees and bank charges	5,875	5,313
Total	$6,066	$40,276

12. Income Tax

Ocean Rig operates through its various subsidiaries in a number of countries throughout the world. Income taxes have been provided based upon the tax laws and rates in the countries in which operations are conducted and income is earned. The countries in which Ocean Rig operates have taxation regimes with varying nominal rates or no system of corporate taxation, as well differing deductions, credits and other tax attributes. Consequently, there is not an expected relationship between the provision for/or benefit from income taxes and income or loss before income taxes.

13. Commitments and Contingencies

13.1 Legal proceedings
Various claims, suits, and complaints, including those involving government regulations and product liability, arise in the ordinary course of the offshore drilling business.

The Company has obtained insurance for the assessed market value of the rigs. However, such insurance coverage may not provide sufficient funds to protect the Company from all liabilities that could result from its operations in all situations. Risks against which the Company may not be fully insured or insurable include environmental liabilities, which may result from a blow-out or similar accident, or liabilities resulting from reservoir damage alleged to have been caused by the negligence of the Company.

The Company's loss of hire insurance coverage does not protect against loss of income from day one, but will be effective after 45 days off-hire. The occurrence of casualty or loss, against which the Company is not fully insured, could have a material adverse effect on the Company's results of operations and financial condition. The insurance covers approximately one year with loss of hire.

As part of the Company's normal course of operations, the Company's customer may disagree on amounts due to the Company under the provision of the contracts which are normally settled through negotiations with the customer. Disputed amounts are normally reflected in revenues at such time as the Company reaches an agreement with the customer on the amounts due. Except for the matter discussed below, the Company is not a party to any material litigation where claims or counterclaims have been filed against the Company, other than routine legal proceedings incidental to the Company's business which should be disclosed, or for which a provision should be established in the accompanying interim condensed consolidated financial statements.

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13. Commitments and Contingencies – (continued):

Ocean Rig's Leiv Eiriksson operated in Angola in the period 2002 to 2007. Ocean Rig's manager in Angola during this period has made a legal claim for reimbursement of import/export duties for two export/importation events in the period 2002 to 2007 retroactively levied by the Angolan government. As Ocean Rig has formally disputed all claims in relation to the potential duties, no provision has been made. The maximum amount is estimated to be $9 million in addition to interest, fees and costs.

13.2 Contractual revenue

Future minimum contractual charter revenue, based on drillships and rigs committed to non-cancelable, long-term contracts as of September 30, 2011, amounts to $903,639 during 2012, $451,576 during 2013, $332,975 during 2014 and, $76,060 during 2015. These amounts do not include any assumed off-hire.

13.3 Purchase obligations
The following table sets forth the Company's contractual obligations and their maturity dates as of September 30, 2011.

Obligations:

	Total	1st year	2nd year	3rd year
Drillship shipbuilding contracts plus owners furnished equipment	$1,230,268	$-	$-	$1,230,268
Total obligations	1,230,268	$-	$-	$1,230,268

13.4 Rental payments
The Company entered into two and three-year office lease agreements with Vestre Svanholmen 6 AS, which commenced on September 1, 2011 and October 1, 2011, respectively. These leases include an option for an additional two and three-year terms, which must be exercised at least six months prior to the end of the term of the contracts, which expires in September 2014 and October 2014, respectively. The Company also entered into a three-year office lease with a third party in Nicosia, Cyprus which commenced on September 1, 2010. As of September 30, 2011, the future obligations amount to $1,371 for the twelve months ending September 30, 2012, $1,371 for twelve months ending September 30, 2013 and $1,332 for twelve months ending September 30, 2014.

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14. Comprehensive income/(loss):

Total Comprehensive Income is analyzed as follows:

	Nine-month period ended September 30,	
	2010	2011
Net Income	$ 81,370	$ 59,567
(Realized losses)/adjustment for amortization on previously designated cash flow hedges associated with capitalized interest	(16,237)	461
(Unrealized losses)/adjustment for amortization on previously designated cash flow hedges	(13,801)	6,544
(Decrease) in defined benefit plan adjustments	(2,749)	(489)
Total Comprehensive Income	$ 48,583	$ 66,083

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15. Subsequent Events:

15.1 On October 5, 2011, DryShips Inc. ("DryShips") completed the partial spin off of the Company by distributing an aggregate of 2,967,291 of the Company's common shares, after giving effect to the treatment of fractional shares, on a pro rata basis to DryShips' shareholders as of the record date of September 21, 2011 (the "Spin Off"). In lieu of fractional shares, DryShips' transfer agent aggregated all fractional shares that would otherwise be distributable to DryShips' shareholders and sold a total of 105 common shares on behalf of those shareholders who would otherwise be entitled to receive a fractional share of the Company's common stock. Following the distribution, each such shareholder received a cash payment in an amount equal to its pro rata share of the total net proceeds of the sale of fractional shares.

15.2 On October 6, 2011, the Company's common shares commenced "regular way" trading on the NASDAQ Global Select Market under the ticker symbol "ORIG." The Company's common shares began "when issued" trading on the NASDAQ Global Select Market on September 19, 2011 in connection with the Spin Off described above.

15.3 On October 12, 2011 the Company announced that it has entered into drilling contracts for three additional wells offshore West Africa, with two independent oil operators based in the UK and the USA respectively, for the semi-submersible rig Eirik Raude. The total revenue backlog, excluding mobilization cost, to complete the three wells program is estimated at $96,000 for a period of approximately 175 days. The new contracts commenced after the Eirik Raude's completion of its previous contract with Tullow Oil on September 13, 2011.

15.4 On October 13, 2011, a putative shareholder class action lawsuit captioned Litwin V. OceanFreight, Inc. et. Al. was filed in the United States District Court for the Southern District of New York against the Company, OceanFreight, Dryships, Pelican and the directors of OceanFreight (the "Defendants"). The plaintiff alleges violations of the Securities and Exchange Commission (the SEC) proxy rules and breach of fiduciary duties by the directors of the OceanFreight, purportedly aided and abetted by the other defendants, in connection with OceanFreight's agreement to merge with Pelican, a wholly-owned subsidiary of DryShips. The complaint sets out various alternatives remedies, including an injunction barring the merger, rescission, and /or actual and punitive damages. The plaintiff made a motion for a temporary restraining order and preliminary injunction to delay the merger, which was denied on November 2, 2011. The lawsuit has not been served on the defendants yet. The Defendants believe that the complaint is without merit and, if served, intend to defend the lawsuit

vigorously.

15.5 On November 2, 2011, the Board of Directors of Oslo Børs resolved to admit the common shares of Ocean Rig UDW to listing on Oslo Børs or, alternatively, Oslo Axess, subject to the Company's compliance with certain customary listing requirements of the Oslo Børs. The Chief Executive Officer of Oslo Børs is authorized to decide whether the Company should be listed on Oslo Børs or Oslo Axess and to fix the date of listing, which is to be no later than December 16, 2011.

15.6 On November 3, 2011, the merger of Pelican, a wholly-owned subsidiary of DryShips, and OceanFreight was completed, following approval by shareholders of OceanFreight at a special meeting of shareholders held on November 3, 2011. Following the completion of the merger, OceanFreight is a wholly-owned subsidiary of DryShips. Under the terms of the merger agreement, OceanFreight shareholders are entitled to receive $11.25 in cash and 0.52326 of a share of the Company's common stock per share of OceanFreight common stock previously owned. The Company's common shares that constitute the stock portion of the merger consideration are currently outstanding shares that were owned by Dryships.