DCP Midstream Partners, LP
Form 10-Q
November 14, 2006

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

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2006**

**OR**

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

**For the transition period from to**

**Commission File Number: 001-32678**

**DCP MIDSTREAM PARTNERS, LP**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **03-0567133** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **370 17th Street, Suite 2775 Denver, Colorado** | **80202** |
| (Address of principal executive offices) | (Zip Code) |

Registrant s telephone number, including area code**: 303-633-2900**

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

Indicate by check mark whether the registrant 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 o Accelerated filer o Non-accelerated filer þ

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

As of November 7, 2006, there were outstanding 10,357,143 common limited partner units, 7,142,857 subordinated units and 200,312 class C units.

**DCP MIDSTREAM PARTNERS, LP**
**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2006**
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## CAUTIONARY STATEMENT ABOUT FORWARD-LOOKING STATEMENTS

Our reports, filings and other public announcements may from time to time contain statements that do not directly or exclusively relate to historical facts. Such statements are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. You can typically identify forward-looking statements by the use of forward-looking words, such as may, could, project, believe, anticipate, expect, estimate, potential, pl other similar words.

All statements that are not statements of historical facts, including statements regarding our future financial position, business strategy, budgets, projected costs and plans and objectives of management for future operations, are forward-looking statements.

These forward-looking statements reflect our intentions, plans, expectations, assumptions and beliefs about future events and are subject to risks, uncertainties and other factors, many of which are outside our control. Important factors that could cause actual results to differ materially from the expectations expressed or implied in the forward-looking statements include known and unknown risks. Known risks and uncertainties include, but are not limited to, the risks set forth in Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2005 as well as the following risks and uncertainties:

- our ability to access the debt and equity markets, which will depend on general market conditions and the credit ratings for our debt obligations;
- our use of derivative financial instruments to hedge commodity and interest rate risks;
- the level of creditworthiness of counterparties to our transactions;
- the amount of collateral required to be posted from time to time in our transactions;
- changes in laws and regulations, particularly with regard to taxes, safety and protection of the environment or the increased regulation of the gathering and processing industry;
- the timing and extent of changes in commodity prices, interest rates and demand for our services;
- weather and other natural phenomena;
- industry changes, including the impact of consolidations, alternative energy sources, technological advances and changes in competition;
- our ability to obtain required approvals for construction or modernization of gathering and processing facilities and propane terminals, and the timing of production from such facilities, which are dependent on the issuance by federal, state and municipal governments, or agencies thereof, of building, environmental and other permits, the availability of specialized contractors and work force and prices of and demand for products;
- our ability to grow through acquisitions, contributions from our parent or internal growth projects;
- the extent of our success in connecting natural gas supplies to gathering and processing systems;
- the extent of our success in distributing wholesale propane supplies through our owned and leased facilities; and
- general economic, market and business conditions.

In light of these risks, uncertainties and assumptions, the events described in the forward-looking statements might not occur or might occur to a different extent or at a different time than we have described. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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## PART I. FINANCIAL INFORMATION

**Item 1**. ***Financial Statements***

### DCP MIDSTREAM PARTNERS, LP
### CONDENSED CONSOLIDATED BALANCE SHEETS
### (Unaudited)

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| | ($ in millions) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 15.1 | $ 42.2 |
| Short-term investments | 4.2 | |
| Accounts receivable: | | |
| Trade, net of allowance for doubtful accounts of $0.1 million at both periods | 15.5 | 24.4 |
| Affiliates | 21.3 | 56.5 |
| Other | 0.3 | 1.1 |
| Inventories | | 0.1 |
| Unrealized gains on non-trading derivative and hedging instruments | 3.5 | 0.1 |
| Other | 1.6 | 0.1 |
| Total current assets | 61.5 | 124.5 |
| Restricted investments | 100.0 | 100.4 |
| Property, plant and equipment, net | 173.6 | 168.9 |
| Intangible asset, net | 2.1 | 2.1 |
| Equity method investment | 5.4 | 5.3 |
| Unrealized gains on non-trading derivative and hedging instruments | 6.8 | 5.4 |
| Other non-current assets | 0.5 | 0.7 |
| Total assets | $ 349.9 | $ 407.3 |
| **LIABILITIES AND PARTNERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable: | | |
| Trade | $ 23.2 | $ 42.5 |
| Affiliates | 3.0 | 42.0 |
| Other | 0.9 | 2.5 |
| Unrealized losses on non-trading derivative and hedging instruments | 0.9 | 2.4 |
| Accrued interest payable | 0.4 | 0.8 |
| Other | 8.3 | 3.2 |
| Total current liabilities | 36.7 | 93.4 |
| Long-term debt | 190.0 | 210.1 |
| Unrealized losses on non-trading derivative and hedging instruments | 3.2 | 2.5 |
| Other long-term liabilities | 1.0 | 0.4 |

| | | |
|---|---|---|
| Total liabilities | 230.9 | 306.4 |
| Commitments and contingent liabilities | | |
| Partners equity: | | |
| Common unitholders (10,357,143 units issued and outstanding at both periods) | 221.0 | 215.8 |
| Subordinated unitholders (7,142,857 convertible units issued and outstanding at both periods) | (103.2) | (109.7) |
| General partner interest (2% interest with 357,143 equivalent units outstanding at both periods) | (5.1) | (5.6) |
| Accumulated other comprehensive income | 6.3 | 0.4 |
| Total partners equity | 119.0 | 100.9 |
| Total liabilities and partners equity | $ 349.9 | $ 407.3 |

See accompanying notes to condensed consolidated financial statements.

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**DCP MIDSTREAM PARTNERS, LP**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (in millions, except per unit amounts) | | | |
| Operating revenues: | | | | |
| Sales of natural gas, NGLs and condensate | $ 50.3 | $ 208.0 | $ 136.6 | $ 441.1 |
| Sales of natural gas, NGLs and condensate to affiliates | 44.7 | 19.4 | 160.0 | 53.1 |
| Transportation and processing services | 3.8 | 2.9 | 11.2 | 8.4 |
| Transportation and processing services to affiliates | 3.2 | 3.0 | 9.2 | 8.3 |
| Total operating revenues | 102.0 | 233.3 | 317.0 | 510.9 |
| Operating costs and expenses: | | | | |
| Purchases of natural gas and NGLs | 68.5 | 173.6 | 224.7 | 410.6 |
| Purchases of natural gas and NGLs from affiliates | 11.6 | 43.7 | 33.2 | 53.8 |
| Operating and maintenance expense | 3.6 | 5.0 | 10.9 | 11.5 |
| Depreciation and amortization expense | 3.0 | 2.9 | 8.9 | 8.8 |
| General and administrative expense | 3.1 | | 8.0 | |
| General and administrative expense affiliates | 1.3 | 4.6 | 4.1 | 8.2 |
| Total operating costs and expenses | 91.1 | 229.8 | 289.8 | 492.9 |
| Operating income | 10.9 | 3.5 | 27.2 | 18.0 |
| Earnings from equity method investment | | 0.1 | 0.1 | 0.4 |
| Interest income | 1.7 | | 4.7 | |
| Interest expense | 2.9 | | 8.1 | |
| Net income | 9.7 | 3.6 | 23.9 | 18.4 |
| Less: | | | | |
| Net income attributable to DCP Midstream Partners Predecessor | | (3.6) | | (18.4) |
| General partner interest in net income | (0.2) | | (0.5) | |
| Net income allocable to limited partners | $ 9.5 | $ | $ 23.4 | $ |
| Net income per limited partner unit basic and diluted | $ 0.51 | $ | $ 1.32 | $ |
| Weighted average limited partners units outstanding basic and diluted | 17.5 | | 17.5 | |

See accompanying notes to condensed consolidated financial statements.

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**DCP MIDSTREAM PARTNERS, LP**
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
**(Unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| | ($ in millions) | | | |
| Net income | $ 9.7 | $ 3.6 | $ 23.9 | $ 18.4 |
| Other comprehensive income: | | | | |
| Net unrealized gains on cash flow hedges | 10.1 | 0.4 | 7.3 | 0.4 |
| Reclassification of cash flow hedges into earnings | (0.7) | | (1.4) | |
| Total other comprehensive income | 9.4 | 0.4 | 5.9 | 0.4 |
| Total comprehensive income | $ 19.1 | $ 4.0 | $ 29.8 | $ 18.8 |

See accompanying notes to condensed consolidated financial statements.

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**DCP MIDSTREAM PARTNERS, LP**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| | ($ in millions) | |
| OPERATING ACTIVITIES: | | |
| Net income | $ 23.9 | $ 18.4 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 8.9 | 8.8 |
| Undistributed earnings from equity method investment | (0.1) | (0.4) |
| Other, net | (1.8) | (0.1) |
| Change in operating assets and liabilities which provided (used) cash: | | |
| Accounts receivable | 44.5 | (33.7) |
| Net unrealized losses (gains) on non-trading derivative and hedging instruments | 0.3 | (0.1) |
| Inventories | 0.1 | |
| Accounts payable | (59.7) | 14.1 |
| Accrued interest | (0.4) | |
| Other current assets and liabilities | 0.7 | 0.5 |
| Other non-current assets and liabilities | 0.4 | 0.2 |
| Net cash provided by operating activities | 16.8 | 7.7 |
| INVESTING ACTIVITIES: | | |
| Capital expenditures | (11.0) | (5.3) |
| Proceeds from sales of assets | 0.1 | 0.6 |
| Purchases of available-for-sale securities | (5,377.0) | |
| Proceeds from sales of available-for-sale securities | 5,375.5 | |
| Net cash used in investing activities | (12.4) | (4.7) |
| FINANCING ACTIVITIES: | | |
| Payment on long-term debt | (20.1) | |
| Distributions to partners | (14.7) | |
| Contributions from Duke Energy Field Services, LLC | 3.3 | |
| Net change in advances from Duke Energy Field Services, LLC | | (3.0) |
| Net cash used in financing activities | (31.5) | (3.0) |
| Net change in cash and cash equivalents | (27.1) | |
| Cash and cash equivalents, beginning of period | 42.2 | |
| Cash and cash equivalents, end of period | $ 15.1 | $ |
| Supplementary cash flow information: | | |
| Cash paid for interest (net of amounts capitalized) | $ 8.4 | $ |

See accompanying notes to condensed consolidated financial statements.

**DCP MIDSTREAM PARTNERS, LP**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**(Unaudited)**

**1. Description of Business and Basis of Presentation**

DCP Midstream Partners, LP, with its consolidated subsidiaries, or us, we or our, is engaged in the business of gathering, compressing, treating, processing, transporting and selling natural gas and producing, transporting and selling natural gas liquids, or NGLs.

Our partnership includes our North Louisiana system assets, or Minden, Ada and PELICO; our NGL transportation pipeline, or Seabreeze; and our 45% equity method investment in the Black Lake Pipe Line Company, or Black Lake, that were contributed to us on December 7, 2005 by Duke Energy Field Services, LLC, or DEFS. DEFS is owned 50% by Duke Energy Corporation, or Duke Energy, and 50% by ConocoPhillips. The condensed consolidated financial statements include a 50% equity interest in Black Lake for the period beginning January 1, 2005 through September 30, 2005. Upon closing of our initial public offering on December 7, 2005, DEFS retained a 5% interest in Black Lake. An affiliate of BP PLC owns the remaining interest and is the operator of Black Lake.

We closed our initial public offering of 10,350,000 common units at a price of $21.50 per unit on December 7, 2005. Proceeds from the initial public offering were $206.4 million, net of offering costs. Concurrent with the initial public offering, DEFS contributed the assets described above to us and retained (i) a 2% general partner interest; (ii) 7,142,857 subordinated units; and (iii) 7,143 common units, representing in aggregate an approximate 42% interest in our partnership. Our general partner is DCP Midstream GP, LP, a wholly-owned subsidiary of DEFS. See Note 4 for information related to the distribution rights of the common and subordinated unitholders and the incentive distribution rights held by the general partner.

DEFS directs our business operations through its ownership and control of our general partner. DEFS and its affiliates employees provide administrative support to us and operate our assets.

The condensed consolidated financial statements include our accounts and, prior to December 7, 2005, the assets, liabilities and operations contributed to us by DEFS and its wholly-owned subsidiaries, which we refer to as DCP Midstream Partners Predecessor, upon the closing of our initial public offering, and have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The condensed consolidated financial statements of DCP Midstream Partners Predecessor have been prepared from the separate records maintained by DEFS and may not necessarily be indicative of the conditions that would have existed, or the results of operations, if DCP Midstream Partners Predecessor had been operated as an unaffiliated entity. All significant intercompany balances and transactions have been eliminated in consolidation. Transactions between us and other DEFS operations have been identified in the condensed consolidated financial statements as transactions between affiliates (see Note 6).

The accompanying unaudited condensed consolidated financial statements in this quarterly report on Form 10-Q have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Accordingly these condensed consolidated financial statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to present fairly the financial position and results of operations for the respective interim periods. Certain information and notes normally included in our annual financial statements have been condensed or omitted from these interim financial statements pursuant to such rules and regulations. These condensed consolidated financial statements and other information included in this quarterly report on Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2005.

**2. Summary of Significant Accounting Policies**

***Use of Estimates*** Conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and notes. Although these estimates are based on management s best available knowledge of current and expected future events, actual results could differ from those estimates.

***Short-Term and Restricted Investments*** Short-term investments were $4.2 million at September 30, 2006. There were no short-term investments at December 31, 2005. Restricted investments were $100.0 million and $100.4 million at September 30, 2006 and December 31, 2005, respectively. These investments primarily consist of commercial paper and various other high-grade debt securities. The restricted investments are used as collateral to secure the term loan portion of our credit facility and are to be used only for future capital or acquisition expenditures. Both the restricted and short-term investments are classified as available-for-sale securities under Statement of Financial Accounting Standards, or SFAS, No. 115, *Accounting for Certain*

*Investments in Debt and Equity Securities,* as management does not intend to hold them to maturity nor are they bought or sold with the objective of generating profits on short-term differences in prices. These investments are recorded at fair value with changes in fair value recorded as unrealized holding gains or losses in accumulated other comprehensive income, or AOCI. At both September 30, 2006 and December 31, 2005, no amounts related to these investments were deferred in AOCI. Due to the short-term, highly liquid nature of the securities held by us and as interest rates are re-set on a daily, weekly or monthly basis, the cost, including accrued interest on investments, approximates fair value.

***Accounting for Risk Management and Hedging Activities and Financial Instruments*** Each derivative not qualifying for the normal purchases and normal sales exception under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* or SFAS 133, as amended, is recorded on a gross basis in the condensed consolidated balance sheets at its fair value as unrealized gains or unrealized losses on non-trading derivative and hedging instruments. Derivative assets and liabilities remain classified in our condensed consolidated balance sheets as unrealized gains or unrealized losses on non-trading derivative and hedging instruments at fair value until the contractual settlement period occurs.

All derivative activity reflected in the condensed consolidated financial statements for periods prior to December 7, 2005 was transacted by DEFS and its subsidiaries prior to our initial public offering and was transferred and/or allocated to us. All derivative activity reflected in the condensed consolidated financial statements from December 7, 2005 has been and will be transacted by us, although DEFS personnel execute various transactions on our behalf (see Note 6). Management designated each energy commodity derivative as non-trading. Certain non-trading derivatives are further designated as either a hedge of a forecasted transaction or future cash flow (cash flow hedge), a hedge of a recognized asset, liability or firm commitment (fair value hedge), or normal purchases or normal sales, while certain non-trading derivatives, which are related to asset-based activity, are designated as non-trading derivative activity. For the periods presented, we did not have any non-trading derivative activity. We did have cash flow and fair value hedge activity and normal purchases and normal sales activity included in these condensed consolidated financial statements. For each derivative, the accounting method and presentation of gains and losses or revenue and expense in the condensed consolidated statements of operations are as follows:

| **Classification of Contract** | **Accounting Method** | **Presentation of Gains & Losses or Revenue & Expense** |
|---|---|---|
| Non-trading derivative activity | Mark-to-market (a) | Net basis in gains and losses from non-trading derivative activity |
| Cash flow hedge | Hedge method (b) | Gross basis in the same statement of operations category as the related hedged item |
| Fair value hedge | Hedge method (b) | Gross basis in the same statement of operations category as the related hedged item |
| Normal purchases or normal sales | Accrual method (c) | Gross basis upon settlement in the corresponding statement of operations category based on purchase or sale |

(a) Mark-to-market An accounting method whereby the change in the fair value of the asset or liability is recognized in the results of operations in gains and losses from non-trading derivative activity during the current period.

(b) Hedge method An accounting method whereby the effective portion of the change in the fair value of the asset or liability is recorded as a balance sheet adjustment and there is no recognition in the results of operations for the effective portion until the service is provided or the associated delivery period occurs.

(c) Accrual method An accounting method whereby there is no recognition in the results of operations for changes in fair value of a contract until the service is provided or the associated delivery period occurs.

*Cash Flow and Fair Value Hedges* For derivatives designated as a cash flow hedge or a fair value hedge, management prepares formal documentation of the hedge in accordance with SFAS 133. In addition, management formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedge contract is highly effective in offsetting changes in cash flows or fair values of hedged items. All components of each derivative gain or loss are included in the assessment of hedge effectiveness, unless otherwise noted.

The fair value of a derivative designated as a cash flow hedge is recorded in the condensed consolidated balance sheets as unrealized gains or unrealized losses on non-trading derivative and hedging instruments. The effective portion of the change in fair value of a derivative designated as a cash flow hedge is recorded in partners equity as AOCI and the ineffective portion is recorded in the condensed consolidated statements of operations as sales of natural gas, NGLs and condensate. During the period in which the hedged transaction occurs, amounts in AOCI associated with the hedged transaction are reclassified to the condensed consolidated statements of operations in the same accounts as the item being hedged. Hedge accounting is discontinued prospectively when it is determined that the derivative no longer qualifies as an effective hedge, or when it is no longer probable that the hedged transaction will occur. When hedge accounting is discontinued because the derivative no longer qualifies as an effective hedge, the derivative is subject to the mark-to-market accounting method prospectively. The derivative continues to be carried on the condensed consolidated balance sheet at its fair value; however, subsequent changes in its fair value are recognized in current period earnings. Gains and losses related to discontinued hedges that were previously accumulated in AOCI will remain in AOCI until the hedged transaction occurs, unless it is probable that the hedged transaction will not occur, in which case, the gains and losses that were previously deferred in AOCI will be immediately recognized in current period earnings.

The fair value of a derivative designated as a fair value hedge is recorded in the condensed consolidated balance sheets as unrealized gains or unrealized losses on non-trading derivative and hedging instruments. We recognize the gain or loss on the derivative instrument, as well as the offsetting loss or gain on the hedged item in earnings in the current period. All derivatives designated and accounted for as fair value hedges are classified in the same category as the item being hedged in the results of operations.

*Valuation* When available, quoted market prices or prices obtained through external sources are used to verify a contract s fair value. For contracts with a delivery location or duration for which quoted market prices are not available, fair value is determined based on pricing models developed primarily from historical and expected correlations with quoted market prices.

Changes in market prices and management estimates directly affect the estimated fair value of these contracts. Accordingly, it is reasonably possible that such estimates may change in the near term.

***Property, Plant and Equipment*** Property, plant and equipment are recorded at historical cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The costs of maintenance and repairs, which are not significant improvements, are expensed when incurred. Expenditures to extend the useful lives of the assets are capitalized.

We have adopted SFAS No. 143, *Accounting for Asset Retirement Obligations,* or SFAS 143, and Financial Accounting Standards Board, or FASB, Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations,* or FIN 47, which address financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The standard and interpretation apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal use of the asset. SFAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred, if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset. This additional carrying amount is then depreciated over the life of the asset. The liability increases due to the passage of time based on the time value of money until the obligation is settled. FIN 47 requires the recognition of a liability for a conditional asset retirement obligation as soon as the fair value of the liability can be reasonably estimated. A conditional asset retirement obligation is defined as an unconditional legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity.

***Impairment of Long-Lived Assets*** Management periodically evaluates whether the carrying value of long-lived assets has been impaired when circumstances indicate the carrying value of those assets may not be recoverable. This evaluation is based on undiscounted cash flow projections. The carrying amount is not recoverable if it exceeds the undiscounted sum of cash flows expected to result from the use and eventual disposition of the asset. Management considers various factors when determining if these assets should be evaluated for impairment, including but not limited to:

significant adverse change in legal factors or in the business climate;

a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset;

an accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset;

significant adverse changes in the extent or manner in which an asset is used or in its physical condition;

a significant change in the market value of an asset; or

a current expectation that, more likely than not, an asset will be sold or otherwise disposed of before the end of its estimated useful life.

If the carrying value is not recoverable, an impairment loss is measured as the excess of the asset s carrying value over its fair value. Management assesses the fair value of long-lived assets using commonly accepted techniques, and may use more than one method, including, but not limited to, recent third party comparable sales, internally developed discounted cash flow analysis and analysis from outside advisors. Significant changes in market conditions resulting from events such as the condition of an asset or a change in management s intent to utilize the asset would generally require management to reassess the cash flows related to the long-lived assets.

***Impairment of Equity Method Investment*** We evaluate our equity method investment for impairment when events or changes in circumstances indicate, in management s judgment, that the carrying value of such investment may have experienced an other-than-temporary decline in value. When evidence of loss in value has occurred, management compares the estimated fair value of the investment to the carrying value of the investment to determine whether an impairment has occurred. Management assesses the fair value of its equity method investment using commonly accepted techniques, and may use more than one method, including, but not limited to, recent third party comparable sales, internally developed discounted cash flow analysis and analysis from outside advisors. If the estimated fair value is less than the carrying value and management considers the decline in value to be other than temporary, the excess of the carrying value over the estimated fair value is recognized in the financial statements as an impairment.

***Revenue Recognition*** Our primary types of sales and service activities reported as operating revenues include:

sales of natural gas, NGLs and condensate;

natural gas gathering, processing and transportation, from which we generate revenues primarily through the compression, gathering, treating, processing and transportation of natural gas; and

NGL transportation from which we generate revenues from transportation fees.

Revenues associated with sales of natural gas, NGLs and condensate are recognized when title passes to the customer, which is when the risk of ownership passes to the purchaser and physical delivery occurs. Revenues associated with transportation and processing fees are recognized as the services are provided.

For gathering and processing services, we receive either fees or commodities from natural gas producers depending on the type of contract. Commodities received are in turn sold and recognized as revenue in accordance with the criteria outlined above. Under the percentage-of-proceeds contract type, we are paid for our services by keeping a percentage of the NGLs produced and a percentage of the residue gas resulting from processing the natural gas. Under the percentage-of-index contract type, we purchase wellhead natural gas and sell processed natural gas and NGLs to third parties.

We recognize revenues for non-trading derivative activity net in the condensed consolidated statements of operations as (losses) gains from non-trading derivative activity, in accordance with EITF Issue No. 02-03, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.* These activities include mark-to-market gains and losses on energy derivative contracts and the financial or physical settlement of energy derivative contracts.

We generally report revenues gross in the condensed consolidated statements of operations, in accordance with Emerging Issues Task Force, or EITF, Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent.* Except for fee- based agreements, we act as the principal in these transactions, take title to the product, and incur the risks and rewards of ownership.

***Equity-Based Compensation*** Under our long term incentive plan, or the Plan, equity-based instruments may be granted to our key employees. DCP Midstream GP, LLC adopted the Plan for employees, consultants and directors of DCP Midstream GP, LLC and its affiliates who perform services for us. The Plan provides for the grant of unvested units, phantom units, unit options

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and substitute awards and the grant of distribution equivalent rights. Subject to adjustment for certain events, an aggregate of 850,000 common units may be delivered pursuant to awards under the Plan. Awards that are canceled, forfeited or are withheld to satisfy DCP Midstream GP, LLC s tax withholding obligations are available for delivery pursuant to other awards. The Plan is administered by the compensation committee of DCP Midstream GP, LLC s board of directors. We first granted awards under the Plan during 2006.

Effective January 1, 2006, we adopted the provisions of SFAS No. 123 (Revised 2004), *Share-Based Payment,* or SFAS 123R, which establishes accounting for stock-based awards exchanged for employee and non-employee services. Accordingly, equity classified stock-based compensation cost is measured at grant date, based on the estimated fair value of the award, and is recognized as expense over the vesting period. Liability classified stock-based compensation cost is remeasured at each reporting date and is recognized over the requisite service period. Compensation expense for awards with graded vesting provisions is recognized on a straight-line basis over the requisite service period of each separately vesting portion of the award. Awards granted to non-employees are accounted for under the provisions of EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.*

Since no equity-based awards were outstanding or granted during the three and nine months ended September 30, 2005, pro forma disclosures are not necessary relating to what earnings available for limited partners, basic earnings per limited partner unit and diluted earnings per limited partner unit would have been if we had applied the fair value recognition provisions of SFAS 123R to all equity-based compensation awards.

***Net Income per Limited Partner Unit*** Basic and diluted net income per limited partner unit is calculated by dividing limited partners interest in net income, less any applicable pro forma general partner incentive distributions under EITF Issue No. 03-6, *Participating Securities and the Two-Class Method Under FASB Statement No. 128,* or EITF 03-6, by the weighted average number of outstanding limited partner units during the period (see Note 5).

***Reclassifications*** Certain prior period amounts have been reclassified in the condensed consolidated financial statements to conform to the current period presentation.

**3. Recent Accounting Pronouncements**

***SFAS No. 157, Fair Value Measurements,* or SFAS 157** In September 2006, the FASB issued SFAS 157, which provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS 157, fair value measurements are disclosed by level within that hierarchy. SFAS 157 will apply whenever another standard requires (or permits) assets or liabilities to be measured at fair value. SFAS 157 does not expand the use of fair value to any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not currently expect SFAS 157 to have a material impact on our consolidated results of operations, cash flows or financial position.

***SFAS No. 154, Accounting Changes and Error Corrections*, or SFAS 154** In June 2005, the FASB issued SFAS 154, a replacement of APB Opinion No. 20, *Accounting Changes,* or APB 20, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements.* Among other changes, SFAS 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) carried forward without change the guidance within APB 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. The adoption of SFAS 154 on January 1, 2006 did not have an impact on our consolidated results of operations, cash flows or financial position.

***FIN No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement 109,* or FIN 48** In July 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The provisions of FIN 48 are effective for the first fiscal year beginning after December

15, 2006. The adoption of FIN 48 is not expected to have a material impact on our consolidated results of operations, cash flows or financial position.

***EITF Issue No. 04-13,  Accounting for Purchases and Sales of Inventory with the Same Counterparty*, or EITF 04-13** In September 2005, the FASB ratified the EITF s consensus on Issue 04-13, which requires an entity to treat sales and purchases of inventory between the entity and the same counterparty as one transaction for purposes of applying APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* when such transactions are entered into in contemplation of each other. When such transactions are legally contingent on each other, they are considered to have been entered into in contemplation of each other. The EITF also agreed on other factors that should be considered in determining whether transactions have been entered into in contemplation of each other. EITF 04-13 is to be applied to new arrangements that we enter into in reporting periods beginning after March 15, 2006. The adoption of EITF 04-13 did not have a material impact on our consolidated results of operations, cash flows or financial position.

***Staff Accounting Bulletin No. 108,  Co:nowrap;">***

(14,143

)

(52,654

)

(27,693

)

(149,157

)

Other Income (Expense):

Interest income (expense) - net

(11,847

)

363

(50,531

)

1,133

Gain (loss) on foreign currency-net

(2,397

)

4,460

143

10,838

Other income (expense) - net

473

1,062

(104

)

1,813

Total other income (expense)

(13,771

)

5,885

(50,492

)

13,784

Loss before Provision for Income Taxes and Noncontrolling Interests

(27,914

)

(46,769

)

(78,185

)

(135,373

)

Provision for Income Taxes

1,464

12,278

9,741

45,493

Net Loss

(29,378

)

(59,047

)

(87,926

)

(180,866

)

Less: net income attributable to noncontrolling interest

4,306

5,023

6,541

12,074

Net Loss Attributable to McDermott International, Inc.

$

(33,684

)

$

(64,070

)

$

(94,467

)

$

(192,940

)

Loss per Common Share:

Basic:

Net loss attributable to McDermott International, Inc.

(0.14

)

(0.27

)

(0.40

)

(0.82

)

Diluted:

Loss from operations, less noncontrolling interests

(0.14

)

(0.27

)

(0.40

)

(0.82

)

Shares used in the computation of earnings per share:

Basic:

237,429,394

236,257,920

237,262,044

236,132,847

Diluted:

237,429,394

236,257,920

237,262,044

236,132,847

See accompanying notes to condensed consolidated financial statements.

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McDERMOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (unaudited) (in thousands) | | | |
| Net Loss | $(29,378) | $(59,047) | $(87,926) | $(180,866) |
| Other comprehensive income (loss), net of tax: | | | | |
| Amortization of benefit plan costs | 3,432 | 3,438 | 10,298 | 10,308 |
| Unrealized gain on investments | (7) | 158 | - | 599 |
| Translation adjustments | (1,455) | (1,245) | (2,714) | (765) |
| Gain (loss) on derivatives | (32,930) | 25,090 | (17,664) | (44,988) |
| Other comprehensive income (loss), net of tax [(1)] | (30,960) | 27,441 | (10,080) | (34,846) |
| Total Comprehensive Loss | $(60,338) | $(31,606) | $(98,006) | $(215,712) |
| Less: Comprehensive Income Attributable to Non-controlling Interests | 4,290 | 5,026 | 6,494 | 12,050 |
| Comprehensive Loss Attributable to McDermott International, Inc. | $(64,628) | $(36,632) | $(104,500) | $(227,762) |

(1) The tax impacts on amounts presented in other comprehensive income are not significant.
See accompanying notes to condensed consolidated financial statements.

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McDERMOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2014 (Unaudited) | December 31, 2013 |
|---|---|---|
| | (In thousands, except share and per share amounts) | |
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | $643,951 | $118,702 |
| Restricted cash and cash equivalents | 239,315 | 23,652 |
| Accounts receivable – trade, net | 271,019 | 381,858 |
| Accounts receivable – other | 75,741 | 89,273 |
| Contracts in progress | 336,920 | 425,986 |
| Deferred income taxes | 7,004 | 7,091 |
| Assets held for sale | 14,253 | 1,396 |
| Other current assets | 58,603 | 32,242 |
| Total Current Assets | 1,646,806 | 1,080,200 |
| Property, Plant and Equipment | 2,390,385 | 2,367,686 |
| Less accumulated depreciation | (807,990 ) | (889,009 ) |
| Net Property, Plant and Equipment | 1,582,395 | 1,478,677 |
| Accounts Receivable – Long-Term Retainages | 132,248 | 65,365 |
| Investments in Unconsolidated Affiliates | 43,713 | 50,536 |
| Deferred Income Taxes | 18,008 | 16,766 |
| Assets Held for Sale | - | 12,243 |
| Investments | 2,613 | 13,511 |
| Other Assets | 101,533 | 90,073 |
| Total Assets | $3,527,316 | $2,807,371 |
| | | |
| Liabilities and Equity | | |
| Current Liabilities: | | |
| Notes payable and current maturities of long-term debt | $27,002 | $39,543 |
| Accounts payable | 292,129 | 398,739 |
| Accrued liabilities | 328,005 | 365,224 |
| Advance billings on contracts | 200,258 | 278,929 |
| Deferred income taxes | 17,738 | 17,892 |
| Income taxes payable | 16,626 | 20,657 |
| Total Current Liabilities | 881,758 | 1,120,984 |
| Long-Term Debt | 873,289 | 49,019 |
| Self-Insurance | 23,740 | 20,531 |
| Pension Liability | 14,762 | 15,681 |

| | | |
|---|---|---|
| Non-current Income Taxes | 52,187 | 56,042 |
| Other Liabilities | 92,887 | 104,770 |
| Commitments and Contingencies (Note 10) | | |
| Stockholders' Equity: | | |
| Common stock, par value $1.00 per share, authorized 400,000,000 shares; issued 244,966,109 and 244,271,365 shares at September 30, 2014 and December 31, 2013, respectively | 244,966 | 244,271 |
| Capital in excess of par value (including prepaid common stock purchase contracts) | 1,663,850 | 1,414,457 |
| Accumulated Deficit | (165,624 ) | (71,157 ) |
| Treasury stock, at cost; 7,322,694 and 7,130,294 shares at at September 30, 2014 and December 31, 2013, respectively | (96,654 ) | (97,926 ) |
| Accumulated other comprehensive loss | (150,164 ) | (140,131 ) |
| Stockholders' Equity - McDermott International, Inc. | 1,496,374 | 1,349,514 |
| Noncontrolling interest | 92,319 | 90,830 |
| Total Equity | 1,588,693 | 1,440,344 |
| Total Liabilities and Equity | 3,527,316 | 2,807,371 |

See accompanying notes to condensed consolidated financial statements.

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McDERMOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| | (Unaudited) | |
| | (In thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net Loss | $(87,926) | $(180,866) |
| Non-cash items included in net loss: | | |
| Depreciation and amortization | 68,655 | 60,114 |
| Drydock amortization | 15,567 | 14,179 |
| Stock-based compensation charges | 14,387 | 15,492 |
| Net periodic pension benefit cost | 9,245 | (955) |
| Equity in loss of unconsolidated affiliates | 5,647 | 12,967 |
| Gain on foreign currency-net | (143) | (10,838) |
| Restructuring activity | (2,235) | 12,940 |
| Gain on asset disposals | (57,026) | (15,492) |
| Benefit for deferred taxes | (4,175) | (3,761) |
| Other non-cash items | 6,406 | 280 |
| Changes in assets and liabilities, net of effects from acquisitions and dispositions: | | |
| Accounts receivable | 44,368 | 50,206 |
| Net contracts in progress and advance billings on contracts | 10,353 | 44,601 |
| Accounts payable | (99,588) | (27,953) |
| Accrued and other current liabilities | (16,200) | 3,038 |
| Pension liability and accrued postretirement and employee benefits | 1,180 | (29,196) |
| Derivative instruments and hedging activities | 1,671 | (46,270) |
| Other assets and liabilities | (22,484) | (66,596) |
| TOTAL CASH USED IN OPERATING ACTIVITIES | (112,298) | (168,110) |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment | (216,526) | (225,397) |
| Increase in restricted cash and cash equivalents | (215,663) | (372) |
| Purchases of available-for-sale securities | (1,997) | (9,886) |
| Sales and maturities of available-for-sale securities | 12,903 | 39,210 |
| Proceeds from the sale and disposal of assets | 70,252 | 37,189 |
| Other investing activities | (5,076) | (8,503) |
| TOTAL CASH USED IN INVESTING ACTIVITIES | (356,107) | (167,759) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from 8.00% senior Notes | 500,000 | - |
| Proceeds from Term Loan | 300,000 | - |
| Proceeds from prepaid common stock purchase contracts issuance | 240,044 | - |
| Proceeds from amortizing notes issuance | 47,456 | - |
| Issuance of common stock | 170 | - |

| | | |
|---|---|---|
| Payments - long term debt | (39,542 ) | - |
| Borrowings - short term debt | 250,000 | 80,000 |
| Payments - short term debt | (250,000) | (88,567 ) |
| Debt issuance costs | (46,914 ) | - |
| Distributions to noncontrolling interests | (5,002 ) | (12,493 ) |
| Other financing activities | (1,707 ) | (1,033 ) |
| TOTAL CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES | 994,505 | (22,093 ) |
| | | |
| EFFECTS OF EXCHANGE RATE CHANGES ON CASH | (851 ) | 185 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 525,249 | (357,777) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 118,702 | 640,147 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $643,951 | $282,370 |
| | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for: | | |
| Income taxes (net of refunds) | $21,273 | $90,462 |
| Interest expense (net of amount capitalized) | $9,136 | $- |

See accompanying notes to condensed consolidated financial statements.

McDERMOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF EQUITY

| | Common Stock | | Capital in Excess of Par | Accumulated | Accumulated Other Comprehensive | Treasury | Stockholders' | Noncontrolling | Total |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Par Value | Value | Deficit | Loss | Stock | Equity | Interest | Equity |
| | (Unaudited) (In thousands, except for share amounts) | | | | | | | | |
| Balance December 31, 2012 | 243,442,156 | $243,442 | $1,391,271 | $445,756 | $(94,413) | $(98,725) | $1,887,331 | $64,774 | $1,952,105 |
| Net loss | - | - | - | (192,940) | - | - | (192,940) | 12,074 | (180,866) |
| Other comprehensive loss, net of tax | - | - | - | - | (34,822) | - | (34,822) | (24) | (34,846) |
| Exercise of stock options | 54,454 | 55 | 93 | - | - | - | 148 | - | 148 |
| Share vesting | 444,398 | 444 | (444) | - | - | | - | - | - |
| Purchase of treasury shares | - | - | - | - | - | (1,088) | (1,088) | - | (1,088) |
| Stock-based compensation charges | - | - | 14,369 | - | - | 1,123 | 15,492 | - | 15,492 |
| Distributions to noncontrolling interests | - | - | - | - | - | - | - | (12,493) | (12,493) |
| Balance at September 30, 2013 | 243,941,008 | $243,941 | $1,405,289 | $252,816 | $(129,235) | $(98,690) | $1,674,121 | $64,331 | $1,738,452 |
| | | | | | | | | | |
| Balance December 31, 2013 | 244,271,365 | $244,271 | $1,414,457 | $(71,157) | $(140,131) | $(97,926) | $1,349,514 | $90,830 | $1,440,344 |
| Net loss | - | - | - | (94,467) | - | - | (94,467) | 6,541 | (87,926) |
| Other comprehensive loss, net of tax | - | - | - | - | (10,033) | - | (10,033) | (47) | (10,080) |
| Exercise of stock options | 169,322 | 170 | 193 | - | - | - | 363 | - | 363 |
| Share vesting | 525,422 | 525 | (525) | - | - | | - | - | - |
| Purchase of treasury shares | - | - | - | - | - | (1,460) | (1,460) | - | (1,460) |
| Stock-based compensation | - | - | 9,681 | - | - | 2,732 | 12,413 | - | 12,413 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| charges | | | | | | | | | |
| Issuance of tangible equity units | - | - | 240,044 | - | - | - | 240,044 | - | 240,044 |
| Distributions to noncontrolling interests | - | - | - | - | - | - | - | (5,005) | (5,005) |
| Balance at September 30, 2014 | 244,966,109 | $244,966 | $1,663,850 | $(165,624) | $(150,164) | $(96,654) | $1,496,374 | $92,319 | $1,588,693 |

See accompanying notes to condensed consolidated financial statements.

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McDERMOTT INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1—BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

McDermott International, Inc. (“MII”), a corporation incorporated under the laws of the Republic of Panama in 1959, is a leading engineering, procurement, construction and installation (“EPCI”) company focused on designing and executing complex offshore oil and gas projects worldwide. Providing fully integrated EPCI services, we deliver fixed and floating production facilities, pipeline installations and subsea systems from concept to commissioning. Operating in approximately 20 countries across the Americas, Middle East, Asia Pacific, the North Sea and Africa, our integrated resources include approximately 14,000 employees and a diversified fleet of marine vessels, fabrication facilities and engineering offices. We support our activities with comprehensive project management and procurement services, while utilizing our fully integrated capabilities in both shallow water and deepwater construction. Our customers include national, major integrated and other oil and gas companies, and we operate in most major offshore oil and gas producing regions throughout the world. We execute our contracts through a variety of methods, principally fixed-price, but also including cost reimbursable, cost-plus, day-rate and unit-rate basis or some combination of those methods. In these notes to our unaudited condensed consolidated financial statements, unless the context otherwise indicates, “we,” “us” and “our” mean MII and its consolidated subsidiaries.

Basis of Presentation

We have presented our unaudited condensed consolidated financial statements in U.S. Dollars, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) applicable to interim reporting. Financial information and disclosures normally included in our financial statements prepared annually in accordance with accounting principles generally accepted in the United States (“GAAP”) have been condensed or omitted. Readers of these financial statements should, therefore, refer to the consolidated financial statements and the accompanying notes in our annual report on Form 10-K for the year ended December 31, 2013.

We have included all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation. These condensed consolidated financial statements include the accounts of McDermott International, Inc., its consolidated subsidiaries and controlled entities. We use the equity method to account for investments in entities that we do not control, but over which we have significant influence. We generally refer to these entities as “unconsolidated affiliates” or “joint ventures.” We have eliminated all intercompany transactions and accounts.

Certain 2013 amounts in the condensed consolidated balance sheets and statement of cash flows, reflecting the non cash impacts on gain of foreign exchange, have been reclassified to conform to the 2014 presentation.

Business Segments

In March 2014, we changed our organizational structure to orient around our offshore and subsea business activities through four primary geographic regions. The four geographic regions, which we consider to be our operating segments, consist of Asia Pacific, Americas (previously Atlantic), Middle East and North Sea and Africa. The Caspian is no longer considered an operating segment and will continue to be aggregated in the Middle East reporting segment. The North Sea and Africa operating segment is also aggregated into the Middle East reporting segment due to the proximity of regions and similarities in the nature of services provided, economic characteristics and oversight responsibilities. Accordingly, we continue to report financial results under reporting segments consisting of Asia Pacific, Americas and the Middle East. We also report certain corporate and other non-operating activities under the heading "Corporate and other," which primarily reflects corporate personnel and activities, incentive compensation programs and other costs that are generally fully allocated to our operating segments. The only corporate costs not allocated to our operating segments are the restructuring costs associated with our corporate reorganization. See Note 9 for summarized financial information on our segments.

Revenue Recognition

We determine the appropriate accounting method for each of our long-term contracts before work on the project begins. We generally recognize contract revenues and related costs on a percentage-of-completion method for individual contracts or combinations of contracts based on work performed, man hours, or a cost-to-cost method, as applicable to the activity involved. We include the amount of accumulated contract costs and estimated earnings that exceed billings to customers in contracts in progress. We include billings to customers that exceed accumulated contract costs and estimated earnings in advance billings on contracts. Most long-term contracts contain provisions for progress payments. We expect to invoice customers for and collect all unbilled revenues. Certain costs are generally excluded from the cost-to-cost method of measuring progress, such as significant procurement costs for materials and third-party subcontractors. Total estimated project costs, and resulting income, are affected by changes in the expected cost of materials and labor, productivity, vessel costs, scheduling and other factors. Additionally, external factors such as weather, customer requirements and other factors outside of our control may affect the progress and estimated cost of a project's completion and, therefore, the timing and amount of revenue and income recognition.

In addition, change orders, which are a normal and recurring part of our business, can increase (sometimes substantially) the future scope and cost of a job. Therefore, change order awards (although frequently beneficial in the long term) can have the short-term effect of reducing the job percentage of completion and thus the revenues and profits recognized to date. We regularly review contract price and cost estimates as the work progresses and reflect adjustments in profit, proportionate to the job percentage of completion in the period when those estimates are revised. Revenue from unapproved change orders is generally recognized to the extent of the lesser of amounts we expect to recover or costs incurred. Additionally, to the extent that claims included in backlog, including those that arise from change orders which are under dispute or which have been previously rejected by the customer, are not resolved in our favor, there could be reductions in or reversals of previously reported revenues and profits, and charges against current earnings, which could be material. Unapproved change orders that are disputed by the customer are treated as claims.

As of September 30, 2014, total unapproved change orders included in our estimates at completion aggregated approximately $352.3 million, of which approximately $168.9 million was included in backlog. As of September 30, 2013, total unapproved change orders included in our estimates at completion aggregated approximately $468.0 million, of which approximately $138.0 million was included in backlog.

Claims Revenue

Claims revenue may relate to various factors, including the procurement of materials, equipment performance failures, change order disputes or schedule disruptions and other delays, including those associated with weather or sea conditions. Claims revenue, when recorded, is only recorded to the extent of the lesser of the amounts we expect to recover or the associated costs incurred in our consolidated financial statements. We include certain unapproved claims in the applicable contract values when we have a legal basis to do so, consider collection to be probable and believe we can reliably estimate the ultimate value. Amounts attributable to unapproved change orders are not included in claims unless and until they are disputed by the customer. We continue to actively engage in negotiations with our customers on our outstanding claims. However, these claims may be resolved at amounts that differ from our current estimates, which could result in increases or decreases in future estimated contract profits or losses. Claims are generally negotiated over the course of the respective projects and many of our projects are long-term in nature. None of the pending claims as of September 30, 2014 were the subject of any litigation proceedings.

The amount of revenues and costs included in our estimates at completion (i.e., contract values) associated with such claims was $6.5 million and $186.3 million as of September 30, 2014 and September 30, 2013, respectively. All of these claim amounts at September 30, 2014 were related to our Middle East segment. Approximately 41%, 8% and 51% of these claim amounts as of September 30, 2013 were related to our Asia Pacific, Americas and Middle East segments, respectively. For the three- and nine-month periods ended September 30, 2014, no revenues or costs pertaining to claims were included in our condensed consolidated financial statements. For the three- and nine-month periods ended September 30, 2013, $17.6 million and $56.9 million of revenues and costs pertaining to claims were included in our condensed consolidated financial statements, respectively.

Our unconsolidated joint ventures did not include any claims revenue or associated cost in their financial results for the three- and nine-month periods ended September 30, 2014. For the three- and nine-month periods ended

September 30, 2013, our unconsolidated joint ventures included nil and $3.7 million, respectively, of claims and associated costs in their financial results.

Deferred Profit Recognition

For contracts as to which we are unable to estimate the final profitability due to their uncommon nature, including first-of-a-kind projects, we recognize equal amounts of revenue and cost until the final results can be estimated more precisely. For these contracts, we only recognize gross margin when reliably estimable and the level of uncertainty has been significantly reduced, which we generally determine to be when the contract is at least 70% complete. We treat long-term construction contracts that contain such a level of risk and uncertainty that estimation of the final outcome is impractical as deferred profit recognition contracts. If, while being accounted for under our deferred profit recognition policy, a current estimate of total contract costs indicates a loss, the projected loss is recognized in full and the project is accounted for under our normal revenue recognition guidelines. At September 30, 2014, no projects were being accounted for under our deferred profit recognition policy.

Completed Contract Method

Under the completed contract method, revenue and gross profit is recognized only when a contract is completed or substantially complete. We generally do not enter into fixed-price contracts without an estimate of cost to complete that we believe to be reasonable. However, it is possible that in the time between contract execution and the start of work on a project, we could lose the ability to forecast cost to complete based on intervening events, including, but not limited to, experience on similar projects, civil unrest, strikes and volatility in our expected costs. In such a situation, we would use the completed contract method of accounting for that project. We did not enter into any contracts that we accounted for under the completed contract method during the quarters ended September 30, 2014 and September 30, 2013.

Loss Recognition

A risk associated with fixed-priced contracts is that revenue from customers may not cover increases in our costs. It is possible that current estimates could materially change for various reasons, including, but not limited to, fluctuations in forecasted labor and vessel productivity, vessel repair requirements, weather downtime, subcontractor or supplier performance, pipeline lay rates or steel and other raw material prices. Increases in costs associated with our fixed-price contracts could have a material adverse impact on our consolidated financial condition, results of operations and cash flows. Alternatively, reductions in overall contract costs at completion could materially improve our consolidated financial condition, results of operations and cash flows.

As of September 30, 2014, we have provided for our estimated costs to complete on all of our ongoing contracts. However, it is possible that current estimates could change due to unforeseen events, which could result in adjustments to overall contract costs. Variations from estimated contract performance could result in material adjustments to operating results for any fiscal quarter or year. For all contracts, if a current estimate of total contract cost indicates a loss, the projected loss is recognized in full when determined.

Of the September 30, 2014 backlog, approximately $385.4 million relates to four active projects that are in loss positions, whereby future revenues are expected to equal costs when recognized. Included in this amount is $169.0 million of backlog associated with an EPCI project in Altamira, which is expected to be completed in the fourth quarter of 2015, and $116.1 million pertaining to a five-year charter of the Agile in Brazil, which began in early 2012, both of which are in our Americas segment. The amount also includes $91.1 million of backlog relating to an EPCI project in Saudi Arabia, which is expected to be completed by early 2016 and $9.2 million relating to another EPCI project in Saudi Arabia scheduled for completion during the fourth quarter of 2014, both of which are being conducted in our Middle East segment. These four projects represent 100% of the backlog amount in a loss position. It is possible that our estimates of gross profit could increase or decrease based on changes in productivity, actual downtime and the resolution of change orders and claims with the customers.

Use of Estimates

We use estimates and assumptions to prepare our financial statements in conformity with GAAP. These estimates and assumptions affect the amounts we report in our financial statements and accompanying notes. Our actual results could differ from these estimates, and variances could materially affect our financial condition and results of operations in future periods. Changes in project estimates generally exclude change orders and changes in scope, but may include, without limitation, unexpected changes in weather conditions, productivity, unanticipated vessel repair requirements, customer, subcontractor and supplier delays and other costs. We generally expect to experience a reasonable amount of unanticipated events, and some of these events can result in significant cost increases above cost amounts we previously estimated. As of September 30, 2014, we have provided for our estimated costs to complete on all of our ongoing contracts. However, it is possible that current estimates could change due to unforeseen events, which could result in adjustments to overall contract costs. Variations from estimated contract performance could result in material adjustments to operating results.

The following is a discussion of our most significant changes in estimates that impacted operating income for the three months and nine months ended September 30, 2014 and 2013.

Three months ended September 30, 2014

Operating income for the three months ended September 30, 2014 was impacted by changes in cost estimates relating to projects in each of our segments.

The Asia Pacific segment was positively impacted by favorable changes in estimates aggregating approximately $20.2 million from three projects. On a recently completed marine installation project in Brunei, reduction in estimated costs to complete from productivity improvements on marine vessels and offshore support activities resulted in a favorable change of approximately $10.8 million. On two previously completed projects, insurance claim collection and final project close-out adjustments resulted in a combined additional recovery of approximately $9.5 million during the three months ended September 30, 2014.

The Middle East segment deteriorated by a net amount of approximately $5.4 million due to change in estimates during the three months ended September 30, 2014. On one EPCI project in Saudi Arabia, estimated costs to complete increased by $7.9 million, primarily as a result of vessel downtime due to weather and standby delays (which may be recoverable from the customer, but were not recognizable at September 30, 2014). On two other EPCI projects in Saudi Arabia, estimated costs to complete increased by an aggregate of $6.7 million, as a result of revisions to project execution plans, primarily due to extended offshore hookup campaigns, increased vessel mobilization activities, and delays in the completion of onshore activities. On another EPCI project in Saudi Arabia, we increased our overall estimated costs to complete by approximately $8.6 million, reflecting the costs of an incremental mobilization and inefficiencies of executing out-of-sequence work due to a revised execution plan, which resulted from delayed access to the project site. These negative changes were offset by an improvement of approximately $17.8 million on a pipelay project in the Caspian, primarily due to increased cost recovery estimates based on positive developments during the three months ended September 30, 2014 from the ongoing project close-out process with the customer. This project was completed earlier in 2014.

The Americas segment improved by a net $1.5 million from changes in estimates on five projects. On a subsea project in the U.S. Gulf of Mexico completed during the period, project close-out savings on marine spread costs and increased cost recovery based on positive developments from the ongoing negotiations with the customer resulted in a reduction of project losses of $12.4 million during the three months ended September 30, 2014. Two projects completed earlier in 2014 improved by an aggregate of approximately $4.8 million based on positive developments from ongoing project close-out negotiations with the customers. These improvements were partially offset by negative changes of approximately $10.9 million on an EPCI project in Altamira, primarily due to increased cost estimates to complete the project as a result of a revised fabrication execution plan, and reduced cost recovery of approximately $4.8 million on a fabrication project in Morgan City completed during 2013, based on an agreement in principle reached with the customer during the three months ended September 30, 2014, which resulted in lower-than-anticipated recoveries.

Nine months ended September 30, 2014

Operating income for the nine months ended September 30, 2014 was impacted by changes in cost estimates relating to projects in each of our segments.

The Asia Pacific segment experienced net favorable changes in estimates aggregating approximately $53.5 million, due to changes in estimates on four projects. Changes in estimates on a subsea project in Malaysia resulted in improvements of approximately $31.5 million during the nine months ended September 30, 2014, primarily related to productivity improvements on our marine vessels and offshore support activities, as well as project close-out savings. On a recently completed marine installation project in Brunei, a reduction in estimated costs to complete from productivity improvements on marine vessels and offshore support activities resulted in a favorable change of approximately $11.8 million. On two previously completed projects, insurance claim collection and final project close-out adjustments resulted in a combined additional recovery of approximately $10.3 million during the nine months ended September 30, 2014.

The Middle East segment was negatively impacted by net unfavorable changes aggregating approximately $10.7 million, due to changes in four projects. On two EPCI projects in Saudi Arabia, we increased our estimated costs at completion by approximately $42.4 million, primarily as a result of vessel downtime due to weather and standby delays (which may be recoverable from the customer, but which were not recognizable at September 30, 2014) and reduced productivity levels and increased cost estimates to complete the onshore scope of one of the projects. On another EPCI project in Saudi Arabia, we increased our overall estimated costs to complete by approximately $15.2 million, to reflect cost overruns related to (1) the onshore work, which was substantially completed in July 2014, and (2) delays in completing the offshore work, due to delayed access to the project site, resulting in a revised execution plan. The revised execution plan included the costs of an incremental mobilization and reflected inefficiencies of executing out-of-sequence work. These negative changes were partially offset by approximately $46.9 million of increased cost recovery estimates on a pipelay project in the Caspian, based on positive developments during the nine months ended September 30, 2014 from the ongoing project close-out process with the customer. This project was substantially completed in June 2014.

The Americas segment was negatively impacted by net unfavorable changes in estimates aggregating approximately $41.5 million associated with five projects. On an EPCI project in Altamira, we increased our estimated costs to complete by approximately $66.3 million, due to liquidated damages and extended project management costs arising from unexpected project delays and projected fabrication cost increases reflecting reduced productivity and execution plan changes to mitigate further project delays, as well as procurement and marine installation cost increases. This project is in a loss position and is estimated to be completed in the fourth quarter of 2015. On a subsea project in the U. S. Gulf of Mexico, we increased our estimated costs to complete by a net amount of approximately $10.1 million, primarily due to increased costs from equipment downtime issues on the North Ocean 102 (the “NO 102”), our primary vessel working on the project, partially offset by project close-out savings on marine spread costs and increased cost recovery estimates based on positive developments from the ongoing negotiations with the customer. This project, which was in a loss position, was completed during the nine months ended September 30, 2014. On a fabrication project in Morgan City completed during 2013, we reduced our cost recovery estimates by approximately $7.8 million, mainly based on an agreement in principle with the customer during the nine months ended September 30, 2014, which resulted in lower-than-anticipated recoveries. These negative impacts were partially offset by $37.4 million of project close-out improvements on an EPCI project in Brazil, from marine cost reductions upon completion of activities and increased recoveries due to successful developments from ongoing approval process for additional weather-related compensation. We also recognized $5.2 million cost reductions, mainly due to project close-out improvements, on a marine installation project in the U. S. Gulf of Mexico.

Three months ended September 30, 2013

The Asia Pacific segment was primarily impacted by changes in estimates on one subsea project in Malaysia. On that project, we increased our estimated cost at completion by approximately $66 million in the three months ended September 30, 2013, primarily due to an accelerated project execution schedule agreed with the customer and further delays in vessel availability related to downtime for the Lay Vessel North Ocean 105 (the “NO 105”). The change in cost estimate was partially offset by approximately $33 million of improvements resulting from commercial negotiations with our customer in which we agreed to expedite project completion by returning to a single marine campaign project execution plan, including working in adverse weather periods on a best-efforts basis, with reimbursable weather downtime, and the customer agreed to re-establish the project completion date and waive liquidated damages. The $66 million of additional costs were driven by several factors, including continued NO 105 major pipe-lay system commissioning problems and the additional cost impacts of the commercial negotiations noted above, which required a revised execution plan transferring work scope from the NO 105 to the NO 102 and the Emerald Sea, which were added to the fleet of vessels working on the project. This resulted in increased costs from additional vessel mobilizations, increased daily operating costs and decreased productivity from working in adverse weather periods. This project was completed during the three months ended June 30, 2014.

The Middle East segment was impacted by changes in estimates on a pipelay project in the Caspian. We increased our cost recovery estimates by approximately $29.0 million during the three months ended September 30, 2013, based on preliminary verbal agreements and then-recent commercial negotiations with the customer. Based on information available at that time, it was our opinion that the cost recovery was probable and the contractual negotiations would be completed as planned. This project was completed during the three months ended March 31, 2014.

The Americas segment was impacted by changes in estimates on one project in Mexico. On that project, we recognized approximately $9.0 million of project losses in the three months ended September 30, 2013, primarily due to increased fabrication costs associated with increases to the scope of the project and incremental costs associated with labor productivity. The project is currently in a loss position and is expected to be completed in the fourth quarter of 2015.

Nine months ended September 30, 2013

The Asia Pacific segment was primarily impacted by changes in estimates on three projects. On one project (the project in Malaysia described above), in the nine months ended September 30, 2013 we increased our estimated cost at completion by a net of approximately $99 million. An aggregate of $132.0 million of increased cost to complete the project was primarily due to delays resulting from direct and indirect impacts of the equipment modification problems during the final commissioning stage of the major pipelay systems upgrade to the NO 105 and the other cost increase factors described above. Those items were partially offset by a $33 million improvement resulting from the commercial negotiations described above. On two EPCI projects completed during the first half of 2013, we benefited in the aggregate from approximately $14 million of reduced at-completion costs, primarily due to efficiencies associated with marine campaigns.

The Middle East segment was impacted by changes in estimates on an EPCI project in Saudi Arabia and a pipelay project in the Caspian. On the EPCI project in Saudi Arabia, we increased our estimated costs at completion by approximately $38.0 million in the nine months ended September 30, 2013, primarily as a result of revisions to the project's execution plan, increases in our estimated costs to complete due to an extended offshore hookup campaign requiring multiple vessel mobilizations and, to a lesser extent, delays in the completion of onshore activities. While the project recognized losses in the nine months ended September 30, 2013, it remains in an overall profitable position. On the pipelay project in the Caspian, we increased our cost recovery estimates by approximately $47.7 million during the nine months ended September 30, 2013 based on preliminary verbal agreements and then-recent commercial negotiations with the customer.  Based on information available at that time, it was our opinion that the cost recovery was probable and the contractual negotiations would be completed as planned.  This project was completed during the three months ended March 31, 2014.

The Americas segment was impacted by changes in estimates on a fabrication project in Morgan City and an EPCI project in Altamira. On those two projects, we recognized an aggregate of approximately $21.0 million of incremental project losses in the nine months ended September 30, 2013, primarily due to lower-than-expected labor productivity and incremental fabrication costs.  The fabrication project in Morgan City that experienced lower labor productivity was completed during the fourth quarter of 2013, while

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the EPCI project in Altamira that recognized additional fabrication costs is expected to be completed in the fourth quarter of 2015. That project is in a loss position.

Loss Contingencies

We record liabilities for loss contingencies when it is probable that a liability has been incurred and the amount of loss is reasonably estimable. We provide disclosure when there is a reasonable possibility that the ultimate loss will exceed the recorded provision or if such loss is not reasonably estimable. We are currently involved in litigation and other proceedings, as discussed in Note 10. We have accrued our estimates of the probable losses associated with these matters, and associated legal costs are generally recognized in selling, general and administrative expenses as incurred. However, our losses are typically resolved over long periods of time and are often difficult to estimate due to various factors, including the possibility of multiple actions by third parties. Therefore, it is possible future earnings could be affected by changes in our estimates related to these matters.

Cash and Cash Equivalents

Our cash and cash equivalents are highly liquid investments with maturities of three months or less when we purchase them. We record cash and cash equivalents as restricted when we are unable to freely use such cash and cash equivalents for our general operating purposes. A majority of our restricted cash and cash equivalents represents collateralizing letters of credit as further discussed in Note 3.

Investments

We classify investments available for current operations as current assets in the accompanying balance sheets, and we classify investments held for long-term purposes as noncurrent assets. We adjust the amortized cost of debt securities for amortization of premiums and accretion of discounts to maturity. That amortization is included in interest income. We include realized gains and losses on our investments in other income (expense)—net. The cost of securities sold is based on the specific identification method. We include interest earned on securities in interest income.

Investments in Unconsolidated Affiliates

We generally use the equity method of accounting for affiliates in which our investment ownership ranges from 20% to 50%, and in which we do not exercise control over the entity. Currently, most of our investments in affiliates that are not consolidated are recorded using the equity method.

Accounts Receivable

Accounts Receivable—Trade, Net

A summary of contract receivables is as follows:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (in thousands) | |
| Contract receivables: | | |
| Contracts in progress | $ 176,754 | $ 192,745 |

| | | |
|---|---|---|
| Completed contracts | 34,821 | 77,248 |
| Retainages | 86,883 | 127,698 |
| Unbilled | 4,304 | 14,571 |
| Less allowances | (31,743 ) | (30,404 ) |
| Accounts receivable—trade, net | $ 271,019 | $ 381,858 |

We expect to invoice our unbilled receivables once certain milestones or other metrics are reached, and we expect to collect all unbilled amounts. We believe that our provision for losses on uncollectible accounts receivable is adequate for our credit loss exposure.

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Contract retainages generally represent amounts withheld by our customers until project completion, in accordance with the terms of the applicable contracts. The following is a summary of retainages on our contracts:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (in thousands) | |
| Retainages expected to be collected within one year | $86,883 | $127,698 |
| Retainages expected to be collected after one year | 132,248 | 65,365 |
| Total retainages | $219,131 | $193,063 |

We have included in accounts receivable—trade, net, retainages expected to be collected within one year.

Accounts Receivable—Other

A summary of accounts receivable— other is as follows:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Other taxes receivable | $26,874 | $ 14,934 |
| Receivables from unconsolidated affiliates | 19,842 | 36,181 |
| Accrued unbilled revenue | 13,278 | 15,696 |
| Intercompany unbilled cost | 7,248 | 5,373 |
| Employee receivables | 4,286 | 4,532 |
| Foreign currency forward contracts | 328 | 11,641 |
| Other | 3,885 | 916 |
| Accounts receivable-other | $75,741 | $ 89,273 |

Employee receivables are expected to be collected within 12 months, and any allowance for doubtful accounts on our accounts receivable—other is based on our estimate of the amount of probable losses due to the inability to collect these amounts (based on historical collection experience and other available information). As of September 30, 2014 and December 31, 2013, no such allowance for doubtful accounts was recorded.

Contracts in Progress and Advance Billings on Contracts

Contracts in progress were $336.9 million and $426.0 million at September 30, 2014 and December 31, 2013, respectively. Advance billings on contracts were $200.3 million at September 30, 2014 and $278.9 million at December 31, 2013. A detail of the components of contracts in progress and advance billings on contracts is as follows:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Costs incurred less costs of revenue recognized | $103,467 | $65,113 |
| Revenues recognized less billings to customers | 233,453 | 360,873 |
| Contracts in Progress | $336,920 | $425,986 |

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Billings to customers less revenue recognized | $680,962 | $466,205 |
| Costs incurred less costs of revenue recognized | (480,704) | (187,276) |
| Advance Billings on Contracts | $200,258 | $278,929 |

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Other Non-Current Assets

We have included debt issuance costs in other non-current assets. The current portion of debt-issuance costs has been included in other current assets. We amortize debt issuance costs as interest expense on a straight-line basis over the life of the related debt. The following summarizes the changes in the carrying amount of these assets:

| | Nine months ended September 30, 2014 | Year ended December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Balance at beginning of period | $14,951 | $ 13,761 |
| Debt issuance costs | 46,914 | 4,905 |
| Former Credit Agreement debt issuance cost write off | (11,913) | - |
| Amortization of interest expense | (7,628) | (3,715) |
| | 42,324 | 14,951 |
| Less: Current portion | (11,244) | - |
| Noncurrent portion | $31,080 | $ 14,951 |

Also included in other non-current assets is long-term deferred drydock expenses, long-term prepaid rent and other prepaid expenses.

Fair Value of Financial Instruments

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. An established hierarchy for inputs is used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in valuing the asset or liability and are developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors that market participants would use in valuing the asset or liability.

Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

- Level 1—inputs are based on quoted prices for identical instruments traded in active markets.
- Level 2—inputs are based on quoted prices for similar instruments in active markets, quoted prices for similar or identical instruments in inactive markets and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets and liabilities.
- Level 3—inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models and similar valuation techniques.

The carrying amounts that we have reported for financial instruments, including cash and cash equivalents, accounts receivables and accounts payable approximate their fair values. See Note 6 for additional information regarding fair value measurements.

Derivative Financial Instruments

Our worldwide operations give rise to exposure to changes in certain market conditions, which may adversely impact our financial performance. When we deem it appropriate, we use derivatives as a risk management tool to mitigate the potential impacts of certain market risks. The primary market risk we manage through the use of derivative instruments is movement in foreign currency exchange rates. We use foreign currency derivative contracts to reduce the impact of changes in foreign currency exchange rates on our operating results. We use these instruments to hedge our exposure associated with revenues and/or costs on our long-term contracts and other cash flow exposures that are denominated in currencies other than our operating entities' functional currencies. We do not hold or issue financial instruments for trading or other speculative purposes.

In certain cases, contracts with our customers contain provisions under which some payments from our customers are denominated in U.S. Dollars and other payments are denominated in a foreign currency. In general, the payments denominated in a foreign currency are designed to compensate us for costs that we expect to incur in such foreign currency. In these cases, we may use derivative instruments to reduce the risks associated with foreign currency exchange rate fluctuations arising from differences in timing of our foreign currency cash inflows and outflows. See Note 5 for additional information regarding derivative financial instruments.

Foreign Currency Translation

We translate assets and liabilities of our foreign operations, other than operations in highly inflationary economies, into U.S. Dollars at period-end exchange rates, and we translate income statement items at average exchange rates for the periods presented. We record adjustments resulting from the translation of foreign currency financial statements as a component of accumulated other comprehensive income (loss) (“AOCI”), net of tax.

Earnings per Share

We have computed earnings per common share on the basis of the weighted average number of common shares, and, where dilutive, common share equivalents, outstanding during the indicated periods. See Note 8 for our earnings per share computations.

Accumulated Other Comprehensive Loss

The components of AOCI included in stockholders’ equity are as follows:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Foreign currency translation adjustments | $(5,276) | $(2,562) |
| Net gain on investments | 238 | 238 |
| Net loss on derivative financial instruments | (63,003) | (45,386) |
| Unrecognized losses on benefit obligations | (82,123) | (92,421) |
| Accumulated other comprehensive loss | $(150,164) | $(140,131) |

The following tables present the components of AOCI and the amounts that were reclassified during the period:

2014 period

| For the three months ended September 30, 2014 | Foreign currency gain (loss) | Unrealized holding loss on investment | Deferred gain (loss) on derivatives[1] | Defined benefit pension plans loss[2] | TOTAL |
|---|---|---|---|---|---|
| | (in thousands) | | | | |
| Balance, June 30, 2014 | $(3,821) | $ 245 | $ (30,090) | $(85,555) | $(119,221) |
| Other comprehensive income (loss) before reclassification | (1,455) | (7) | (39,563) | - | (41,025) |

| | | | | | |
|---|---|---|---|---|---|
| Amounts reclassified from AOCI | - | - | 6,650 | 3,432 | 10,082 |
| Net current period other comprehensive income (loss) | (1,455) | (7) | (32,913) | 3,432 | (30,943) |
| Balance, September 30, 2014 | $(5,276) | $ 238 | $ (63,003) | $(82,123) | $(150,164) |

| For the nine months ended September 30, 2014 | Foreign currency gain (loss) | Unrealized holding loss on investment | Deferred gain (loss) on derivatives[(1)] | Defined benefit pension plans loss[(2)] | TOTAL |
|---|---|---|---|---|---|
| | (in thousands) | | | | |
| Balance, December 31, 2013 | $(2,562) | $ 238 | $ (45,386) | $(92,421) | $(140,131) |
| Other comprehensive income (loss) before reclassification | (2,714) | - | (26,764) | - | (29,478) |
| Amounts reclassified from AOCI | - | - | 9,147 | 10,298 | 19,445 |
| Net current period other comprehensive income (loss) | (2,714) | - | (17,617) | 10,298 | (10,033) |
| Balance, September 30, 2014 | $(5,276) | $ 238 | $ (63,003) | $(82,123) | $(150,164) |

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2013 period

| For the three months ended September 30, 2013 | Foreign currency gain (loss) | Unrealized holding loss on investment | Deferred gain (loss) on derivatives[1] | Defined benefit pension plans loss[2] | TOTAL |
|---|---|---|---|---|---|
| Balance, June 30, 2013 | $(2,886) | $ (1,875 ) | $ (58,316 ) | $(93,596 ) | $(156,673) |
| Other comprehensive income (loss) before reclassification | (1,245) | 158 | 24,767 | - | $23,680 |
| Amounts reclassified from AOCI | - | - | 320 | 3,438 | $3,758 |
| Net current period other comprehensive income (loss) | (1,245) | 158 | 25,087 | 3,438 | 27,438 |
| Balance, September 30, 2013 | $(4,131) | $ (1,717 ) | $ (33,229 ) | $(90,158 ) | $(129,235) |

| For the nine months ended September 30, 2013 | Foreign currency gain (loss) | Unrealized holding loss on investment | Deferred gain (loss) on derivatives[1] | Defined benefit pension plans loss[2] | TOTAL |
|---|---|---|---|---|---|
| | (in thousands) | | | | |
| Balance, December 31, 2012 | $(3,366) | $ (2,316 ) | $ 11,735 | $(100,466) | $(94,413 ) |
| Other comprehensive income (loss) before reclassification | (765 ) | 599 | (46,246 ) | - | $(46,412 ) |
| Amounts reclassified from AOCI | - | - | 1,282 | 10,308 | $11,590 |
| Net current period other comprehensive income (loss) | (765 ) | 599 | (44,964 ) | 10,308 | (34,822 ) |
| Balance, September 30, 2013 | $(4,131) | $ (1,717 ) | $ (33,229 ) | $(90,158 ) | $(129,235) |

(1) Refer to Note 5 for additional details.
(2) Refer to Note 4 for additional details.
(3) Reclassified to cost of operations and gain on foreign currency, net.
(4) Reclassified to selling, general and administrative expenses.

Recently Issued Accounting Standards

In August 2014, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern” ("ASU 2014-15"). Currently, there is no guidance in effect under U.S. GAAP regarding management's responsibility to assess whether there is substantial doubt about an entity's ability to continue as a going concern. Under ASU 2014-15, we will be required to assess our ability to continue as a going concern each interim and annual reporting period and provide certain disclosures if there is substantial doubt about our ability to continue as a going concern, including management's plan to alleviate the substantial doubt. ASU 2014-15 is effective for annual periods ending after December 15, 2016 and interim periods thereafter with early adoption permitted. We are currently assessing the impact of the adoption of ASU 2014-15 on our future financial statements and related disclosures.

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers”. This ASU will supersede most of the existing revenue recognition requirements in U.S. GAAP and will require entities to recognize revenue at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. It also requires significantly expanded disclosures regarding the qualitative and quantitative information of an entity’s nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. ASU No. 2014-09 is effective for us for annual and interim reporting periods beginning after December 15, 2016, with early application not permitted. We have the choice to apply it either retrospectively to each reporting period presented or by recognizing the cumulative effect of applying it at the date of initial application (January 1, 2017) and not adjusting comparative information. We are currently evaluating the requirements of this ASU and have not yet determined its impact on our consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, “Presentation of Financial Statements and Property, Plant, and Equipment — Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity”, which amends the definition of a discontinued operation by raising the threshold for a disposal to qualify as discontinued operations. ASU 2014-08 will also require entities to provide additional disclosures about discontinued operations as well as disposal transactions that do not meet the discontinued operations criteria. The pronouncement is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014. Early adoption is permitted. We are currently assessing the impact of the adoption of ASU 2014-08 on our future financial statements and related disclosures.

NOTE 2—ACQUISITION AND DISPOSITIONS

Acquisition

During the quarter ended March 31, 2013, we entered into a share purchase agreement to acquire all of the issued and outstanding shares of capital stock of Deepsea Group Limited, a United Kingdom-based company that provides subsea and other engineering services to international energy companies, primarily through offices in the United Kingdom and the United States. Total consideration was approximately $9.0 million, which includes cash ($6.0 million) and the delivery of 313,580 restricted shares of MII common stock (out of treasury). The transaction was accounted for using the acquisition method and, accordingly, assets acquired and liabilities assumed were recorded at their respective fair values.

During the quarter ended December 31, 2013, we entered into two joint ventures with TH Heavy Engineering Berhad (“THHE”), whereby we acquired a 30% interest in a subsidiary of THHE, THHE Fabricators Sdn. Bhd., and THHE acquired a 30% interest in our Malaysian subsidiary, Berlian McDermott Sdn. Bhd. Accounting for these transactions is preliminary at September 30, 2014 and is pending finalization of these transactions by the end of 2014. As of September 30, 2014, we recorded an equity method investment of approximately $25.5 million, a non-controlling interest of approximately $20.9 million and an increase in capital in excess of par value of approximately $4.6 million arising from these transactions.

Non-Core Asset Sales and Vessel-Impairment Charges

During the quarter ended September 30, 2014, we committed to a plan to sell vessel equipment, including dynamic positioning thrusters and a deepwater pipelay winch system. These items of equipment were part of upgrades to one of our marine vessels. We cancelled those upgrades in December 31, 2013. Assets classified as held for sale are no longer depreciated.

We previously committed to a plan to sell four of our multi-function marine vessels, specifically the Bold Endurance, DB 16, DB 26 and the DLB KP1. During the three months ended September 30, 2014, we completed the sale of the DB16 for aggregate cash proceeds of approximately $16.1 million, resulting in a gain of approximately $4.7 million. During the quarter ended March 31, 2014, we completed the sale of the DLB KP1 for aggregate cash proceeds of approximately $8.4 million, resulting in a gain of approximately $6.4 million. During the nine months ended September 30, 2013, we completed the sale of the Bold Endurance and the DB 26 for aggregate cash proceeds of approximately $32.0 million, resulting in an aggregate gain of approximately $12.5 million.

In April 2014, we completed the sale of our Harbor Island facility near Corpus Christi, Texas for proceeds of approximately $31.7 million, resulting in a gain of approximately $25.0 million, which has been recognized in our Americas segment.

In June 2014, as part of our plan to discontinue utilization of our Morgan City facility, we disposed of several assets, including certain equipment, for aggregate cash proceeds of approximately $13.6 million, resulting in an aggregate gain of approximately $11.4 million, of which approximately $1.3 million was recorded in connection with our Americas restructuring, discussed below. This portion of the gain pertained to impairments previously recorded in the six months ended June 30, 2013 in connection with the Americas restructuring.

Also in June 2014, we cancelled a pipelay system originally intended for the Construction Support Vessel 108 ("CSV 108"), which resulted in a $10.7 million improvement to the cancellation cost estimate included in the $37.8 million of vessel-impairment charges recognized during the quarter ended December 31, 2013.

Americas and Corporate Restructuring

We commenced a restructuring of our Americas operations during the quarter ended June 30, 2013, which involves our Morgan City, Louisiana, Houston, Texas, New Orleans, Louisiana and Brazil locations. The restructuring involves, among other things, reductions of management, administrative, fabrication and engineering personnel, and discontinued utilization of the Morgan City facility. Future fabrication operations in the Americas segment are expected to be executed using the Altamira, Mexico facility. In addition, we exited our joint venture operation in Brazil. Costs associated with our Americas restructuring activities primarily include severance and other personnel-related costs, costs associated with exiting the joint venture in Brazil, asset impairment and relocation costs, environmental reserves and future unutilized lease costs.

In October 2013, we announced certain executive management changes that became effective during the fourth quarter of 2013. In March 2014, we changed our organizational structure to orient around offshore and subsea business activities through four primary geographic regions. Costs associated with our corporate reorganization activities will primarily include severance, relocation and other personnel-related costs and costs for advisors.

The following table presents total amounts incurred during the nine months ended September 30, 2014, as well as amounts incurred from the inception of our restructuring efforts up to September 30, 2014 and amounts expected to be incurred in the future by major type of cost and by segment.

| | Incurred in three months ended September 30, 2014 | Incurred in nine months ended September 30, 2014 | Incurred from restructuring inception to September 30, 2014 | Estimate of remaining amounts to be incurred | Total |
|---|---|---|---|---|---|
| Americas | | | | | |
| Impairments and write offs | $ 100 | $ (1,240) | $ 12,923 | $ 77 | $ 13,000 |
| Severance and other personnel-related costs | (155) | 3,099 | 12,744 | 456 | 13,200 |
| Morgan City environmental reserve | - | - | 5,925 | - | 5,925 |
| Morgan City yard-related expenses | 2,879 | 5,528 | 9,703 | 6,297 | 16,000 |
| Other | - | - | 158 | 4,717 | 4,875 |
| | $ 2,824 | $ 7,387 | $ 41,453 | $ 11,547 | $ 53,000 |
| | | | | | |
| Corporate | | | | | |
| Severance and other personnel-related costs | $ 53 | $ 961 | $ 2,622 | $ 378 | $ 3,000 |
| Legal and other advisor fees | 1,117 | 3,034 | 3,034 | 4,236 | 7,270 |
| Other | 730 | 730 | 730 | - | 730 |
| | 1,900 | 4,725 | 6,386 | 4,614 | 11,000 |
| | | | | | |
| Total | $ 4,724 | $ 12,112 | $ 47,839 | $ 16,161 | $ 64,000 |

Accrued liabilities associated with restructuring activities were approximately $5.3 million and $8.0 million as of September 30, 2014 and December 31, 2013, respectively.

NOTE 3—LONG-TERM DEBT AND NOTES PAYABLE

During April 2014, we refinanced our existing obligations, and replaced in its entirety, our then existing $950.0 million credit agreement (the “Former Credit Agreement”) with a new credit agreement (the “New Credit Agreement”), which provides for:

· a $400.0 million first-lien, first-out three-year letter of credit facility (the “LC Facility”); and
· a $300.0 million first-lien, second-out five-year term loan (the “Term Loan”).

Additionally, during April 2014, we completed the following new financing transactions:

- the issuance of $500.0 million of second-lien seven-year senior secured notes.
- the issuance of $287.5 million of tangible equity units composed of (1) three-year amortizing, senior unsecured notes, in an aggregate principal amount of $47.5 million, and (2) prepaid common stock purchase contracts.

With the completion of these financing transactions in April 2014, we terminated the bridge loan commitment we had obtained from an affiliate of Goldman, Sachs, & Co. (“Goldman Sachs”). As a result of the termination of the bridge loan commitment, the fee we previously paid to Goldman Sachs to obtain the bridge loan commitment was recognized as interest expense in the first half of 2014. Due to the replacement of the Former Credit Agreement, the unamortized issuance fees related to the Former Credit Agreement were also recognized as interest expense in the first half of 2014. The total additional interest expense related to these items was approximately $28.0 million.

The Former Credit Agreement provided for revolving credit borrowings and issuances of letters of credit in an aggregate outstanding amount of up to $950.0 million. Proceeds from borrowings under the Former Credit Agreement were available for working capital needs and other general corporate purposes. At December 31, 2013, there were no borrowings outstanding, and letters of credit issued under the Former Credit Agreement totaled $214.3 million. At December 31, 2013, there was $735.7 million available for borrowings or to meet letter of credit requirements under the Former Credit Agreement. During the year ended December 31, 2013, our outstanding borrowings under the Former Credit Agreement did not exceed $80.0 million, and we had average outstanding borrowings under the Former Credit Agreement of approximately $23.5 million, with an average interest rate of 2.28%. In addition, at December 31, 2013, we had $96.9 million in outstanding unsecured bilateral letters of credit. At March 31, 2014, there was $250.0 million of revolving credit borrowings outstanding under the Former Credit Agreement, all of which were repaid during April 2014.

New Credit Facilities

The indebtedness and other obligations under the New Credit Agreement are unconditionally guaranteed on a senior secured basis by substantially all of our wholly owned subsidiaries, other than our captive insurance subsidiary (collectively, the “Guarantors”). In connection with the New Credit Agreement, we paid certain fees to the lenders thereunder, as well as certain arrangement fees to the arrangers and agents for the New Credit Agreement, which we have capitalized and are amortizing to interest expense over the respective terms of the LC Facility and the Term Loan. We also paid certain fees to the initial purchasers of the senior secured notes and to the underwriter of the tangible equity units referred to below, which we have capitalized and are amortizing to interest expense over the respective terms of the related indebtedness.

LC Facility and Cash-Collateralized Bilateral Letters of Credit

The LC Facility provides for an initial letter of credit capacity of $400.0 million and allows for uncommitted increases in capacity of $100.0 million through December 31, 2014 and an additional $100.0 million thereafter, potentially increasing the total capacity to $600.0 million through the term of the LC Facility. Letters of credit issuable under the LC Facility support the obligations of McDermott and its affiliates and joint ventures. The aggregate amount of the LC Facility available for financial letters of credit is capped at 25% of the total LC Facility. As of September 30, 2014, the aggregate face amount of letters of credit issued under the LC Facility was $192.9 million. There were no financial letters of credit issued under the LC facility as of September 30, 2014.

In addition, the LC Facility permits us to deposit up to $300.0 million with letter of credit issuers to cash collateralize letters of credit issued on a bilateral basis outside the credit facility. As of September 30, 2014, we had an aggregate face amount of approximately $134.0 million of such letters of credit outstanding supported by cash collateral, including financial letters of credit of $19.8 million. We have included the supporting cash collateral in restricted cash and cash equivalents in the accompanying condensed consolidated balance sheet as of September 30, 2014.

The LC Facility is secured on a first-lien, first-out basis (with relative priority over the Term Loan) by pledges of the capital stock of all the Guarantors and mortgages on, or other security interests in, substantially all the tangible and intangible assets of our company and the Guarantors, subject to specific exceptions.

The LC Facility contains various customary affirmative covenants, as well as specific affirmative covenants, including specific reporting requirements and a requirement for ongoing periodic financial reviews by a financial advisor. The LC Facility also requires compliance with various negative covenants, including limitations with respect to the incurrence of other indebtedness and liens, restrictions on acquisitions, capital expenditures and other investments, restrictions on sale/leaseback transactions and restrictions on prepayments of other indebtedness.

The LC Facility requires us to generate consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”) of at least certain specified amounts over the term of the facility. The LC Facility also requires us to maintain a ratio of fair market value of vessel collateral to the sum of (1) the outstanding principal amount of the Term Loan, (2) the aggregate amount of undrawn financial letters of credit outstanding under the LC Facility, (3) all drawn but unreimbursed letters of credit under the LC Facility, and (4) mark-to-market foreign exchange exposure that is not cash secured of at least 1.20:1.00. The LC Facility also specifies maximum capital expenditures over the term of the facility and requires us to maintain at least $200.0 million of minimum available cash, at the end of each quarter. We were in compliance with the covenants under the LC Facility as of September 30, 2014.

The LC Facility provides for a commitment fee of 0.50% per year on the unused portion of the LC Facility and letter of credit fees at an annual rate of 2.25% for performance letters of credit and 4.50% for financial letters of credit, as well as customary issuance fees and other fees and expenses.

Term Loan

The Term Loan is secured on a first-lien, second-out basis (with the LC Facility having relative priority over the Term Loan) by pledges of the capital stock of all the Guarantors and mortgages on, or other security interests in, substantially all tangible and intangible assets of our company and the Guarantors, subject to specific exceptions. As of September 30, 2014, we had $299.3 million in borrowings outstanding under the Term Loan agreement, of which $3.0 million was classified as current notes payable.

The Term Loan requires mandatory prepayments from: (1) the proceeds from the sale of assets, as well as insurance proceeds, in each case subject to certain exceptions, to the extent such proceeds are not reinvested in our business within 365 days of receipt; (2) net cash proceeds from the incurrence of indebtedness not otherwise permitted under the New Credit Agreement; and (3) 50% of amounts deemed to be “excess cash flow,” subject to specified adjustments. The Term Loan also requires quarterly amortization payments equal to $750,000. The Term Loan also provides for a prepayment premium if we prepay or re-price the Term Loan prior to April 16, 2015.

The Term Loan requires compliance with various customary affirmative and negative covenants. We must also maintain a ratio of “ownership adjusted fair market value” of marine vessels to the sum of (1) the outstanding principal amount of the Term Loan and (2) the aggregate principal amount of unreimbursed drawings and advances under the LC Facility of at least 1.75:1.00. As of September 30, 2014, we were in compliance with all of the covenants under the Term Loan.

The Term Loan was incurred with 25 basis points of original issue discount and bears interest at a floating rate, which can be, at our option, either: (1) a LIBOR rate for a specified interest period (subject to a LIBOR “floor” of 1.00%) plus an applicable margin of 4.25%; or (2) an alternate base rate (subject to a base rate “floor” of 2.00%) plus an applicable margin of 3.25%.

Senior Notes

During April 2014 we issued $500.0 million in aggregate principal amount of 8.000% senior secured notes due 2021 (the “Notes”) in a private placement in accordance with Rule 144A and Regulation S under the Securities Act of 1933, as amended. Interest on the Notes is payable semi-annually in arrears on May 1 and November 1 of each year, beginning on November 1, 2014, at an annual rate of 8%. The Notes are scheduled to mature on May 1, 2021. As of September 30, 2014, there was $500.0 million of Senior Notes outstanding.

The Notes are unconditionally guaranteed on a senior secured basis by the Guarantors, and the Notes are secured on a second-lien basis by pledges of capital stock of certain of our subsidiaries and mortgages and other security interests covering (1) specified marine vessels owned by certain of the Guarantors and (2) substantially all the other tangible and intangible assets of our company and the Guarantors, subject to exceptions for certain assets.

At any time or from time to time on or after May 1, 2017, at our option, we may redeem the Notes, in whole or in part, at the redemption prices (expressed as percentages of principal amount of the Notes to be redeemed) set forth below, together with accrued and unpaid interest to the redemption date, if redeemed during the 12-month period beginning May 1 of the years indicated:

| Year | Percentage |
|---|---|
| 2017 | 104% |
| 2018 | 102% |
| 2019 and thereafter | 100% |

The Indenture governing the Notes contains covenants that, among other things, limit our ability and the ability of our restricted subsidiaries to: (1) incur or guarantee additional indebtedness or issue preferred stock; (2) make investments or certain other restricted payments; (3) pay dividends or distributions on capital stock or purchase or redeem subordinated indebtedness; (4) sell assets; (5) create restrictions on the ability of our restricted subsidiaries to pay dividends or make other payments to us; (6) create certain liens; (7) sell all or substantially all of our assets or merge or consolidate with or into other companies; (8) enter into transactions with affiliates; and (9) create unrestricted subsidiaries. Many of those covenants would become suspended if the Notes were to attain an investment grade rating from both Moody's Investors Service, Inc. and Standard and Poor's Ratings Services and no default has occurred. The covenants mentioned above are subject to a number of important exceptions and limitations.

Tangible Equity Units

During April 2014, we issued 11,500,000 6.25% tangible equity units ("Units"), each with a stated amount of $25.00. Each Unit consists of (1) a prepaid common stock purchase contract and (2) a senior amortizing note due April 1, 2017 (each an "Amortizing Note") that has an initial principal amount of $4.1266 per Amortizing Note, bears interest at a rate of 7.75% per annum and has a final scheduled installment payment date of April 1, 2017.

The prepaid common stock purchase contracts were accounted for as additional paid-in capital totaling $240.0 million. As of September 30, 2014, the Amortizing Notes were recorded as long-term debt totaling $44.1 million, of which $15.0 million was classified as current notes payable.

Each prepaid common stock purchase contract will automatically settle on April 1, 2017, unless settled earlier: (1) at the holder's option, upon which we will deliver shares of our common stock, based on the applicable settlement rate and applicable market value of our stock as determined under the purchase contract; or (2) at our option, upon which we will deliver shares of our common stock, based upon the stated maximum settlement rate of 3.5562 shares per Unit, subject to adjustment. Potential dilutive common shares that may be issued for the settlement of the common stock purchase contracts totaled 40.9 million at September 30, 2014, based on the maximum number of shares issuable per Unit. The potential minimum number of shares issuable is 33.4 million, which represents 2.9030 per Unit. The maximum and minimum settlement rates for the Units are subject to adjustment for certain dilutive events.

North Ocean Financing

North Ocean 105

On September 30, 2010, MII, as guarantor, and North Ocean 105 AS, in which we have a 75% ownership interest, as borrower, entered into a financing agreement to finance a portion of the construction costs of the NO105. The agreement provides for borrowings of up to $69.4 million, bearing interest at 2.76% per year, and requires principal repayment in 17 consecutive semi-annual installments, which commenced on October 1, 2012. Borrowings under the agreement are secured by, among other things, a pledge of all of the equity of North Ocean 105 AS, a mortgage on the NO 105, and a lien on substantially all of the other assets of North Ocean 105 AS. MII unconditionally guaranteed all amounts to be borrowed under the agreement. As of September 30, 2014 and December 31, 2013, there was $53.1 million and $57.2 million, respectively, in borrowings outstanding under this agreement, of which (as of each date) approximately $8.2 million was classified as current notes payable.

North Ocean 102

In December 2009, J. Ray McDermott, S.A. ("JRMSA"), a wholly owned subsidiary of MII, entered into a vessel-owning joint venture transaction with Oceanteam ASA. JRMSA had guaranteed approximately 50% of this debt based on its ownership percentages in the vessel-owning companies. The outstanding debt bore interest at a rate equal to the three-month LIBOR (which was subject to reset every three months) plus a margin of 3.315%. JRMSA paid in full the approximately $31.4 million notes payable balance upon maturity during January 2014. JRMSA expects to exercise its option to purchase Oceanteam ASA's 50% ownership interest in the vessel-owing companies in December 2014. As of December 31, 2013, we reported consolidated notes payable of $31.4 million on our consolidated balance sheet, all of which was classified as current notes payable and paid in full in early 2014.

Unsecured Bilateral Letters of Credit and Bank Guarantees

In 2012, McDermott Middle East, Inc. and MII executed a general reimbursement agreement in favor of a bank located in the UAE relating to issuances of bank guarantees in support of contracting activities in the Middle East and India. As of September 30, 2014 and December 31, 2013, bank guarantees issued under these arrangements totaled $57.4 million and $55.8 million, respectively. In 2007 and in 2012, JRMSA and MII executed general unsecured reimbursement agreements in favor of three institutions that were lenders under the Former Credit Agreement relating to issuances of letters of credit in support of contracting activities, primarily in Asia and the Middle East. Letters of credit issued under two of these arrangements have either been replaced by letters of credit under the LC Facility or cash collateralized. The letters of credit issued under these arrangements totaled $12.0 million and $39.8 million as of September 30, 2014 and December 31, 2013, respectively.

On April 20, 2012, McDermott and one of its wholly owned subsidiaries, McDermott Australia Pty. Ltd. ("McDermott Australia"), entered into a secured Letter of Credit Reimbursement Agreement (the "Reimbursement Agreement") with Australia and New Zealand Banking Group Limited ("ANZ"). In accordance with the terms of the Reimbursement

Agreement, ANZ issued letters of credit in the aggregate amount of approximately $109.0 million to support McDermott Australia's performance obligations under contractual arrangements relating to a field development project. The obligations of McDermott and McDermott Australia under the Reimbursement Agreement are secured by McDermott Australia's interest in the contractual arrangements and certain related assets. During the nine months ended September 30, 2014, we replaced these letters of credit with letters of credit and cash collateralized letters of credit under the LC Facility.

Surety Bonds

In 2012 and 2011, MII executed general agreements of indemnity in favor of surety underwriters based in Mexico relating to surety bonds issued in support of contracting activities of J. Ray McDermott de Mèxico, S.A. de C.V. and McDermott, Inc., both subsidiaries of MII. As of September 30, 2014 and December 31, 2013, bonds issued under these arrangements totaled $51.1 million and $43.5 million, respectively. In October 2013, MII executed general agreements of indemnity in favor of surety underwriters relating to surety bonds in support of vessels operating in Brazil. The project requiring these bonds was completed during the quarter ended June 30, 2014, allowing us to cancel the outstanding bonds. Accordingly, as of September 30, 2014, there were no bonds issued under these arrangements. As of December 31, 2013, the bonds issued under these arrangements totaled $106.3 million.

Long-term debt and notes payable obligations

A summary of our long-term debt obligations are as follows:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (In thousands) | |
| Long-term debt consists of: | | |
| Senior Notes | $500,000 | $ - |
| Term Loan | 299,250 | - |
| NO 105 Construction Financing | 53,104 | 57,189 |
| Amortizing Notes | 44,121 | - |
| Capital lease obligation | 3,073 | - |
| Other financing | 743 | - |
| NO 102 Construction Financing | - | 31,373 |
| | 900,291 | 88,562 |
| Less: Amounts due within one year | 27,002 | 39,543 |
| Total long-term debt | $873,289 | $ 49,019 |

NOTE 4—PENSION PLANS

Although we currently provide retirement benefits for most of our U.S. employees through sponsorship of the McDermott Thrift Plan, some of our longer-term U.S. employees and former employees are entitled to retirement benefits under the McDermott (U.S.) Retirement Plan, a non-contributory qualified defined benefit pension plan (the “McDermott Plan”), and several non-qualified supplemental defined benefit pension plans. The McDermott Plan and the non-qualified supplemental defined benefit pension plans are collectively referred to herein as the “Domestic Plans.” The McDermott Plan has been closed to new participants since 2006, and benefit accruals were frozen completely in 2010.

We also sponsor a defined benefit pension plan established under the laws of the Commonwealth of the Bahamas, the J. Ray McDermott, S.A. Third Country National Employees Pension Plan (the “TCN Plan”), which provides retirement benefits for certain of our current and former foreign employees. Effective August 1, 2011, new entry into the TCN Plan was closed, and effective December 31, 2011, benefit accruals under the TCN Plan were frozen. Effective January 1, 2012, we established a new global defined contribution plan to provide retirement benefits to non-U.S. expatriate employees who may have otherwise obtained benefits under the TCN Plan.

Retirement benefits under the McDermott Plan and the TCN Plan are generally based on final average compensation and years of service, subject to the applicable freeze in benefit accruals under the plans. Our funding policy is to fund the plans as recommended by the respective plan actuaries and in accordance with the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), or other applicable law. The Pension Protection Act of 2006 (“PPA”) amended ERISA and modified the funding requirements for certain defined benefit pension plans including the McDermott Plan. Funding provisions under the PPA accelerated funding requirements are applicable to the McDermott Plan to ensure full funding of benefits accrued.

Net periodic (benefit) cost for the Domestic Plans and the TCN Plan includes the following components:

| | Domestic Plans Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 30, | | September 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Unaudited) (In thousands) | | | |
| Interest cost | $6,743 | $5,999 | $20,230 | $17,997 |
| Expected return on plan assets | (6,875) | (9,577) | (20,626) | (28,730) |
| Recognized net actuarial loss and other | 3,552 | 2,932 | 10,658 | 8,798 |
| Net periodic (benefit) cost | $3,420 | $(646) | $10,262 | $(1,935) |

| | TCN Plan Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 30, | | September 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Unaudited) (In thousands) | | | |
| Interest cost | $475 | $466 | $1,425 | $1,400 |
| Expected return on plan assets | (741) | (651) | (2,221) | (1,952) |
| Recognized net actuarial loss and other | (73) | 507 | (221) | 1,522 |
| Net periodic (benefit) cost | $(339) | $322 | $(1,017) | $970 |

NOTE 5—DERIVATIVE FINANCIAL INSTRUMENTS

We enter into derivative financial instruments primarily to hedge certain firm purchase commitments and forecasted transactions denominated in foreign currencies. We record these contracts at fair value on our condensed consolidated balance sheets. Depending on the hedge designation at the inception of the contract, the related gains and losses on these contracts are either: (1) deferred as a component of AOCI until the hedged item is recognized in earnings; (2) offset against the change in fair value of the hedged firm commitment through earnings; or (3) recognized immediately in earnings. At inception and on an ongoing basis, we assess the hedging relationship to determine its effectiveness in offsetting changes in cash flows or fair value attributable to the hedged risk. We exclude from our assessment of effectiveness the portion of the fair value of the forward contracts attributable to the difference between spot exchange rates and forward exchange rates. The ineffective portion of a derivative’s change in fair value and any portion excluded from the assessment of effectiveness are immediately recognized in earnings. Gains and losses on derivative financial instruments that are immediately recognized in earnings are included as a component of gain (loss) on foreign currency-net in our condensed consolidated statements of operations.

As of September 30, 2014, the majority of our foreign currency forward contracts were designated as cash flow hedging instruments. In addition, we deferred approximately $63.0 million of net losses on these derivative financial instruments in AOCI, and we expect to reclassify approximately $33.1 million of deferred losses out of AOCI by September 2015, as hedged items are recognized. The notional value of our outstanding derivative contracts totaled $893.5 million at September 30, 2014, with maturities extending through 2017. Of this amount, approximately $525.7 million is associated with various foreign currency expenditures we expect to incur on one of our Asia Pacific segment EPCI projects. These instruments consist of contracts to purchase or sell foreign-denominated currencies. As of September 30, 2014, the fair value of these contracts was in a net liability position totaling $30.4 million. The fair value of outstanding derivative instruments is determined using observable financial market inputs, such as quoted market prices, and is classified as Level 2 in nature.

The following tables summarize our derivative financial instruments:

Asset and Liability Derivatives

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (in thousands) | |
| Derivatives Designated as Hedges: | | |
| Location: | | |
| Accounts receivable-other | $ 328 | $ 11,641 |
| Other assets | 1 | 1,647 |
| Total asset derivatives | $ 329 | $ 13,288 |
| | | |
| Accounts payable | $ 15,283 | $ 20,209 |
| Other liabilities | 15,484 | 21,846 |
| Total liability derivatives | $ 30,767 | $ 42,055 |

The Effects of Derivative Instruments on our Financial Statements

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (in thousands) | | (in thousands) | |
| Derivatives Designated as Hedges: | | | | |
| Amount of gain/(loss) recognized in other comprehensive income (loss) | $ (39,563) | $ 24,743 | $ (26,764) | $ (46,270) |
| Income (loss) reclassified from AOCI into income: effective portion | | | | |
| Location | | | | |
| Cost of operations | $ 6,788 | $ (270) | $ 7,283 | $ (1,101) |
| Gain(loss) recognized in income (loss): ineffective portion and amount excluded from effectiveness testing | | | | |
| Location | | | | |
| Gain (loss) on foreign currency—net | $ (386) | $ 3,136 | $ 3,842 | $ 7,578 |

NOTE 6—FAIR VALUE MEASUREMENTS

The following is a summary of our available-for-sale securities measured at fair value:

| | September 30, 2014 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| | (in thousands) | | | |
| Mutual funds[1] | $2,213 | $ - | $2,213 | $ - |
| Commercial paper | 400 | - | 400 | - |
| Total | $2,613 | $ - | $2,613 | $ - |

| | December 31, 2013 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| | (in thousands) | | | |
| Mutual funds[1] | $2,173 | $ - | $2,173 | $- |
| Commercial paper | 3,699 | - | 3,699 | - |
| Asset-backed securities and collateralized mortgage obligations[2] | 7,639 | - | 2,082 | 5,557 |
| Total | $13,511 | $ - | $7,954 | $5,557 |

(1) Various U.S. equities and other investments managed under mutual funds
(2) Asset-backed and mortgage-backed securities with maturities of up to 26 years

Our Level 2 investments consist primarily of commercial paper, asset-backed commercial paper notes backed by a pool of mortgage-backed securities and mutual funds. The fair value of our Level 2 investments was determined using a market approach which is based on quoted prices and other information for similar or identical instruments.

Our Level 3 investment consists of asset-backed commercial paper notes backed by a pool of mortgage-backed securities. The fair value of this Level 3 investment was based on the calculation of an overall weighted-average valuation, using the prices of the underlying individual securities. Individual securities in the pool were valued based on market observed prices, where available. If market prices were not available, prices of similar securities backed by similar assets were used.

Changes in Level 3 Instrument

The following is a summary of the changes in our Level 3 instrument measured on a recurring basis for the three months and nine months ended September 30, 2014 and September 30, 2013:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (in thousands) | | | |
| Balance at beginning of period | $- | $5,902 | $5,557 | $6,343 |
| Total realized and unrealized gains | | 79 | 1,248 | 307 |
| Sales and principal repayments | | (326) | (6,805) | (995) |
| Balance at end of period | $- | $5,655 | $- | $5,655 |

Unrealized Gains and Losses on Investments

Our net unrealized gain on investments was $0.2 million as of September 30, 2014 and December 31, 2013. During the year ended December 31, 2013, we recognized other than temporary impairment of $1.6 million on the asset-backed securities and collateralized mortgage obligations. The amount of investments in an unrealized loss position for less than twelve months was not significant for either of the periods presented.

Other Financial Instruments

We used the following methods and assumptions in estimating our fair value disclosures for our other financial instruments:

Cash and cash equivalents and restricted cash and cash equivalents. The carrying amounts that we have reported in the accompanying condensed consolidated balance sheets for cash, cash equivalents and restricted cash and cash equivalents approximate their fair values and are classified as Level 1 within the fair value hierarchy.

Short-term and long-term debt. The fair value of debt instruments is classified as Level 2 within the fair value hierarchy and is valued using a market approach based on quoted prices for similar instruments traded in active markets. Where quoted prices are not available, the income approach is used to value these instruments based on the present value of future cash flows discounted at estimated borrowing rates for similar debt instruments or on estimated prices based on current yields for debt issues of similar quality and terms.

Forward contracts. The fair value of forward contracts is classified as Level 2 within the fair value hierarchy and is valued using observable market parameters for similar instruments traded in active markets. Where quoted prices are not available, the income approach is used to value forward contracts, which discounts future cash flows based on current market expectations and credit risk.

The estimated fair values of certain of our financial instruments are as follows:

| | September 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (In thousands) | | | |
| Balance Sheet Instruments | | | | |
| Cash and cash equivalents | $643,951 | $643,951 | $118,702 | $118,702 |
| Restricted cash and cash equivalents | $239,315 | $239,315 | $23,652 | $23,652 |
| Investments | $2,613 | $2,613 | $13,511 | $13,511 |
| Debt | $(900,291) | $(894,536) | $(88,562) | $(90,005) |
| Forward contracts | $(30,438) | $(30,438) | $(28,767) | $(28,767) |

NOTE 7—STOCK-BASED COMPENSATION

Equity instruments are measured at fair value on the grant date. Stock-based compensation expense is generally recognized on a straight-line basis over the requisite service periods of the awards. Compensation expense is based on awards we expect to ultimately vest. Therefore, we have reduced compensation expense for estimated forfeitures based on our historical forfeiture rates. Our estimate of forfeitures is determined at the grant date and is revised if our actual forfeiture rate is materially different from our estimate.

We use a Black-Scholes model to determine the fair value of certain share-based awards, such as stock options. Additionally, we use a Monte Carlo model to determine the fair value of certain share-based awards that contain market and performance-based conditions. The use of these models requires highly subjective assumptions, such as assumptions about the expected life of the award, vesting probability, expected dividend yield and the volatility of our stock price.

Total stock-based compensation expense, net recognized for the three months and nine months ended September 30, 2014 and September 30, 2013 is as follows:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 30, | | September 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands) | | (In thousands) | |
| Stock Options | $280 | $1,050 | $1,401 | $3,250 |
| Restricted Stock Units | 3,304 | 2,702 | 11,269 | 7,689 |
| Performance Shares | (802) | 1,630 | (257) | 4,553 |
| | $2,782 | $5,382 | $12,413 | $15,492 |

Included in stock-based compensation expense, net is a reversal of prior recognized expense resulting from personnel severance arrangements of $1.3 million and $2.0 million as of the three and nine months ended September 30, 2014, respectively, which are recorded in restructuring expenses in the condensed consolidated statements of operations.

NOTE 8—EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per common share:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands, except share and per share amounts) | | | |
| Net loss attributable to McDermott International, Inc. | $(33,684) | $(64,070) | $(94,467) | $(192,940) |
| Weighted average common shares (basic) | 237,429,394 | 236,257,920 | 237,262,044 | 236,132,847 |
| Effect of dilutive securities: | | | | |
| Stock options, restricted stock and restricted stock units | - | - | - | - |
| Adjusted weighted average common shares and assumed exercises of stock options and vesting of stock awards (diluted) | 237,429,394 | 236,257,920 | 237,262,044 | 236,132,847 |
| Basic loss per share | | | | |
| Net loss attributable to McDermott International Inc. | (0.14) | (0.27) | (0.40) | (0.82) |