PATTERSON UTI ENERGY INC
Form 10-Q
November 06, 2006

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

Form 10-Q

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 0-22664

Patterson-UTI Energy, Inc.
(Exact name of registrant as specified in its charter)

DELAWARE	**75-2504748**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
4510 LAMESA HIGHWAY, SNYDER, TEXAS	**79549**
(Address of principal executive offices)	*(Zip Code)*

(325) 574-6300
(Registrant s telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

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 þ Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

158,890,535 shares of common stock, $0.01 par value, as of October 31, 2006

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

ITEM 1. ***Financial Statements***

The following unaudited condensed consolidated financial statements include all adjustments which, in the opinion of management, are necessary in order to make such financial statements not misleading.

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006	December 31, 2005
	(Unaudited) (In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 16,945	$ 136,398
Accounts receivable, net of allowance for doubtful accounts of $6,288 at September 30, 2006 and $2,199 at December 31, 2005	511,001	422,002
Inventory	36,083	27,907
Deferred tax assets, net	44,528	26,382
Other	53,407	25,168
Total current assets	661,964	637,857
Property and equipment, at cost, net	1,328,795	1,053,845
Goodwill	99,056	99,056
Other	5,074	5,023
Total assets	$ 2,094,889	$ 1,795,781
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable:		
Trade	$ 152,573	$ 113,226
Accrued revenue distributions	14,512	13,379
Other	6,654	5,294
Accrued federal and state income taxes payable	15,519	11,034
Accrued expenses	150,669	112,476
Total current liabilities	339,927	255,409
Borrowings under line of credit	65,000	
Deferred tax liabilities, net	186,507	169,188

Other	4,426	4,173
Total liabilities	595,860	428,770
Commitments and contingencies (see Note 10)		
Stockholders equity:		
Preferred stock, par value $.01; authorized 1,000,000 shares, no shares issued		
Common stock, par value $.01; authorized 300,000,000 shares with 176,616,631 and 175,909,274 issued and 159,906,735 and 172,441,178 outstanding at September 30, 2006 and December 31, 2005, respectively	1,766	1,759
Additional paid-in capital	674,903	672,151
Deferred Compensation		(9,287)
Retained earnings	1,202,744	719,113
Accumulated other comprehensive income	11,581	8,565
Treasury stock, at cost, 16,709,896 and 3,468,096 shares at September 30, 2006 and December 31, 2005, respectively	(391,965)	(25,290)
Total stockholders equity	1,499,029	1,367,011
Total liabilities and stockholders equity	$ 2,094,889	$ 1,795,781

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

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PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Unaudited) (In thousands, except per share amounts)		(Unaudited) (In thousands, except per share amounts)	
Operating revenues:				
Contract drilling	$ 577,047	$ 401,046	$ 1,616,100	$ 1,025,938
Pressure pumping	40,462	27,640	107,800	66,358
Drilling and completion fluids	46,163	29,819	155,221	88,812
Oil and natural gas	9,986	10,234	29,083	28,146
	673,658	468,739	1,908,204	1,209,254
Operating costs and expenses:				
Contract drilling	267,345	202,956	737,021	558,607
Pressure pumping	20,960	15,662	56,545	38,648
Drilling and completion fluids	36,183	24,062	120,418	71,857
Oil and natural gas	3,222	2,365	11,241	6,953
Depreciation, depletion and impairment	49,215	39,545	140,245	112,319
Selling, general and administrative	13,777	10,565	39,428	30,157
Embezzlement costs, net of recoveries	(1,512)	5,431	2,941	12,193
Other operating expenses	2,563	707	3,948	2,590
	391,753	301,293	1,111,787	833,324
Operating income	281,905	167,446	796,417	375,930
Other income (expense):				
Interest income	948	944	5,579	2,011
Interest expense	(363)	(56)	(476)	(179)
Other	88	19	231	39
	673	907	5,334	1,871
Income before income taxes and cumulative effect of change in accounting principle	282,578	168,353	801,751	377,801
Income tax expense (benefit):				
Current	106,151	66,574	288,476	145,513
Deferred	(9,563)	(4,526)	(2,974)	(6,263)

		96,588		62,048		285,502		139,250
Income before cumulative effect of change in accounting principle		185,990		106,305		516,249		238,551
Cumulative effect of change in accounting principle, net of related income tax expense of $398						687		
Net income	$	185,990	$	106,305	$	516,936	$	238,551
Income before cumulative effect of change in accounting principle:								
Basic	$	1.14	$	0.62	$	3.07	$	1.40
Diluted	$	1.12	$	0.61	$	3.03	$	1.38
Net income per common share:								
Basic	$	1.14	$	0.62	$	3.08	$	1.40
Diluted	$	1.12	$	0.61	$	3.03	$	1.38
Weighted average number of common shares outstanding:								
Basic		163,412		171,613		168,036		169,846
Diluted		165,742		174,587		170,339		173,211

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

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PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(Unaudited)
(In thousands)

	Common Stock Number of Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance, December 31, 2005	175,909	$ 1,759	$ 672,151	$ (9,287)	$ 719,113	$ 8,565	$ (25,290)	$ 1,367,011
Issuance of restricted stock	613	6	(6)					
Exercise of stock options	133	1	1,413					1,414
Tax benefit for stock option exercises			922					922
Stock based compensation, net of cumulative effect of change in accounting principle			9,710					9,710
Forfeitures of restricted shares	(39)							
Elimination of deferred compensation due to change in accounting principle			(9,287)	9,287				
Foreign currency translation adjustment, net of tax of $1,673						3,016		3,016
Payment of cash dividends					(33,305)			(33,305)
							(366,675)	(366,675)

Purchases of treasury stock								
Net income					516,936			516,936
Balance, September 30, 2006	176,616	$ 1,766	$ 674,903	$	$ 1,202,744	$ 11,581	$ (391,965)	$ 1,499,029

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

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PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN CASH FLOWS

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net income	$ 516,936	$ 238,551
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and impairment	140,245	112,319
Dry holes and abandonments	3,709	
Provision for bad debts	4,200	416
Deferred income tax benefit	(2,576)	(6,263)
Tax benefit related to exercise of stock options		24,047
Stock based compensation expense	9,710	2,121
Gain on disposal of assets	(437)	(1,253)
Changes in operating assets and liabilities, net of business acquired:		
Accounts receivable	(92,069)	(148,825)
Inventory and other current assets	(36,086)	(4,044)
Accounts payable	40,280	48,568
Income taxes payable/receivable	4,789	29,660
Accrued expenses	23,798	22,662
Other liabilities	1,613	1,513
Net cash provided by operating activities	614,112	319,472
Cash flows from investing activities:		
Purchases of property and equipment	(423,422)	(262,723)
Acquisitions, net of cash received		(73,577)
Proceeds from disposal of property and equipment	7,983	12,502
Change in other assets		1,766
Net cash used in investing activities	(415,439)	(322,032)
Cash flows from financing activities:		
Purchases of treasury stock	(352,393)	
Dividends paid	(33,305)	(20,441)
Proceeds from exercise of stock options	1,414	42,299
Tax benefit related to exercise of stock options	922	
Proceeds from borrowings under line of credit	65,000	
Debt issuance costs	(341)	
Net cash provided by (used in) financing activities	(318,703)	21,858

Effect of foreign exchange rate changes on cash	577	(458)
Net increase (decrease) in cash and cash equivalents	(119,453)	18,840
Cash and cash equivalents at beginning of period	136,398	112,371
Cash and cash equivalents at end of period	$ 16,945	$ 131,211
Supplemental disclosure of cash flow information:		
Net cash paid during the period for:		
Interest expense	$ 476	$ 179
Income taxes	$ 272,541	$ 85,824

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

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Consolidation and Presentation

The interim condensed consolidated financial statements include the accounts of Patterson-UTI Energy, Inc. (the Company) and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The interim condensed consolidated financial statements have been prepared by management of the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such rules and regulations, although the Company believes the disclosures included herein are adequate to make the information presented not misleading. In the opinion of management, all adjustments which are of a normal recurring nature considered necessary for presentation of the information have been included. The Unaudited Condensed Consolidated Balance Sheet as of December 31, 2005, as presented herein, was derived from the audited balance sheet of the Company. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

The Company s former Chief Financial Officer (former CFO) has pleaded guilty to criminal charges and has been sentenced and is serving a term of imprisonment arising out of his embezzlement of funds totaling approximately $77.5 million from the Company over a period of more than five years, ending November 3, 2005. The accompanying prior periods were previously restated to reflect the effects of the embezzlement in the periods of occurrence. Continuing professional and other costs related to the embezzlement are being recognized as operating costs when incurred. In the three months ended September 30, 2006, the Company recovered $2.0 million from its insurance carrier related to the embezzlement loss.

The U.S. dollar is the functional currency for all of the Company s operations except for its Canadian operations, which use the Canadian dollar as their functional currency. The effects of exchange rate changes are reflected in accumulated other comprehensive income, which is a separate component of stockholders equity (see Note 3 of these Notes to Unaudited Condensed Consolidated Financial Statements).

The Company provides a dual presentation of its net income per common share in its Unaudited Condensed Consolidated Statements of Income: Basic net income per common share (Basic EPS) and diluted net income per common share (Diluted EPS). Basic EPS excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding. Diluted EPS is based on the weighted-average number of common shares outstanding plus the impact of dilutive instruments, including stock options, warrants and restricted shares using the treasury stock method. For the three and nine months ended September 30, 2006, options to purchase 800,000 shares of common stock were excluded from the calculation of Diluted EPS as their inclusion would have been anti-dilutive. For the three and nine months ended September 30, 2005, all potentially dilutive instruments were included in the calculation of Diluted EPS. The following table presents information necessary to calculate net income per share for the three and nine months ended September 30, 2006 and 2005 as well as cash

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

dividends per share paid during the three and nine months ended September 30, 2006 and 2005 (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	$ 185,990	$ 106,305	$ 516,936	$ 238,551
Weighted average number of common shares outstanding	163,412	171,613	168,036	169,846
Basic net income per common share	$ 1.14	$ 0.62	$ 3.08	$ 1.40
Weighted average number of common shares outstanding	163,412	171,613	168,036	169,846
Dilutive effect of stock options and restricted shares	2,330	2,974	2,303	3,365
Weighted average number of diluted common shares outstanding	165,742	174,587	170,339	173,211
Diluted net income per common share	$ 1.12	$ 0.61	$ 3.03	$ 1.38
Cash dividends per common share(a)	$ 0.08	$ 0.04	$ 0.20	$ 0.12

(a) During March 2006, June 2006 and September 2006, cash dividends of $6.9 million, $13.4 million and $13.0 million, respectively, were paid on outstanding shares of 172,654,128, 167,660,960 and 162,800,466, respectively. During March 2005, June 2005 and September 2005, cash dividends of $6.7 million, $6.8 million and $6.9 million, respectively, were paid on outstanding shares of 168,679,334 , 169,741,460 and 172,591,361, respectively.

The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year.

2. Stock-based Compensation

The Company adopted Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R)), on January 1, 2006 and recognizes the cost of share-based payments under the fair-value-based method. The Company uses share-based payments to compensate employees and non-employee directors. All awards have been equity instruments in the form of stock options or restricted stock awards and include only service conditions. The Company issues shares of common stock when vested stock option awards are exercised and when restricted stock awards are granted. As a result of the initial adoption of FAS 123(R), the Company recognized income due to the cumulative effect of this change in accounting principle of $687,000, net of taxes of $398,000, related to previously expensed amortization of unvested restricted stock grants. For the three months ended September 30, 2006, the Company recognized $3.3 million in stock-based compensation expense and a related income tax benefit of $1.1 million. For the nine months ended September 30, 2006, the Company recognized $10.8 million in stock-based compensation expense and a related income tax benefit of $3.5 million and recognized a benefit in the form of a cumulative effect of change in accounting principle associated with the adoption of FAS 123(R) of $687,000, net of the related tax expense of $398,000.

During 2005, the Company s shareholders approved the Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan (the 2005 Plan) and the Board of Directors adopted a resolution that no future grants would

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

be made under any of the Company s six other previously existing plans. The Company s share-based compensation plans at September 30, 2006 follow:

Plan Name	Shares Authorized for Grant	Options & Restricted Shares Outstanding	Shares Available for Grant
Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan	6,250,000	1,546,952	4,127,961
Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan, as amended (1997 Plan)		5,097,985	
Amended and Restated Patterson-UTI Energy, Inc. 2001 Long-Term Incentive Plan (2001 Plan)		771,977	
Amended and Restated Non-Employee Director Stock Option Plan of Patterson-UTI Energy, Inc. (Non-Employee Director Plan)		180,000	
Amended and Restated Patterson-UTI Energy, Inc. 1996 Employee Stock Option Plan (1996 Plan)		95,800	
Patterson-UTI Energy, Inc., 1993 Incentive Stock Plan, as amended (1993 Plan)		125,800	

A summary of the 2005 Plan follows:

The Compensation Committee of the Board of Directors administers the plan.

All employees including officers and directors are eligible for awards.

The Compensation Committee determines the vesting schedule for awards. Awards typically vest over 1 year for non-employee directors and 3 to 4 years for employees.

The Compensation Committee sets the term of awards and no option term can exceed 10 years.

All options granted under the plan are granted with an exercise price equal to or greater than the fair market value of the Company s common stock at the time the option is granted.

The plan provides for awards of incentive stock options, non-incentive stock options, tandem and freestanding stock appreciation rights, restricted stock awards, other stock unit awards, performance share awards, performance unit awards and dividend equivalents. As of September 30, 2006, only non-incentive stock options and restricted stock awards had been granted under the plan.

Options granted under the 1997 Plan vest over three or five years as dictated by the Compensation Committee. These options typically had terms of ten years. All options were granted with an exercise price equal to the fair market value of the related common stock at the time of grant. Restricted Stock Awards granted under the 1997 Plan vest over four years.

Options granted under the 2001 Plan vest over five years as dictated by the Compensation Committee. These options had terms of ten years. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant. Restricted Stock Awards granted under the 2001 Plan vest over four years.

Options granted under the Non-Employee Director Plan vest on the first anniversary of the option grant. Non-Employee Director Plan options have five year terms. All options were granted with an exercise price equal to the fair market value of the related common stock at the time of grant.

Options granted under the 1996 plan vested over one, four and five years as dictated by the Compensation Committee. These options had terms of five or ten years as dictated by the Compensation Committee. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant.

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Options granted under the 1993 Plan typically had terms of 10 years and vested over five years in 20% increments beginning at the end of the first year. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant.

Stock Options. The Company accounted for all stock options under the intrinsic value method prior to January 1, 2006. Accordingly, no compensation expense was recognized in prior periods for stock options because they had no intrinsic value when granted as exercise prices were equal to the grant date market value of the related common stock. The Modified Prospective Application (MPA) method is being applied to transition from the intrinsic value method to the fair-value-based method for stock options. The effects of the application of the MPA method follow:

Previously reported amounts and disclosures are not affected.

Compensation cost, net of estimated forfeitures for the unvested portion of awards outstanding at January 1, 2006, is recognized under the fair-value-based method as the awards vest. Compensation cost is based on the grant-date fair value of stock options as calculated for the Company s previously reported pro forma disclosures under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123).

The fair-value based method is applied to new awards and to awards outstanding at January 1, 2006 that are modified, repurchased or cancelled after that date, if any.

The Company estimates grant date fair values of stock options using the Black-Scholes-Merton valuation model (Black-Scholes), except for stock options granted prior to 1996 that are not subject to FAS 123(R) and were not subject to FAS 123 pro forma disclosures. Volatility assumptions are based on the historic volatility of the Company s common stock over the most recent period equal to the expected term of the options as of the date the options were granted. The expected term assumptions are based on the Company s experience with respect to employee stock option activity. Dividend yield assumptions are based on the expected dividends at the time the options were granted. The risk-free interest rate assumptions are determined by reference to United States Treasury yields. Weighted-average assumptions used to estimate grant date fair values for stock options granted in the three and nine month periods ended September 30, 2006 and 2005 follow:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Volatility	33.59%	N/A	33.18%	26.95%
Expected term (in years)	4.00	N/A	4.00	4.00
Dividend yield	1.14%	N/A	1.09%	0.65%
Risk-free interest rate	4.91%	N/A	4.87%	3.84%

No stock options were granted during the three months ended September 30, 2005.

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PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock option activity from January 1, 2006 to September 30, 2006 follows:

			September 30, 2006	
	Underlying Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Yrs)	Aggregate Intrinsic Value ($000 s)
Outstanding at January 1, 2006	6,338,043	$ 14.37		
Granted	800,000	$ 28.54		
Exercised	(133,309)	$ 10.61		
Forfeited	(15,800)	$ 11.65		
Expired	(5,587)	$ 7.62		
Cancelled(a)	(360,833)	$ 14.83		
Outstanding at September 30, 2006	6,622,514	$ 16.15	6.43	$ 54,756
Exercisable at September 30, 2006	5,322,080	$ 13.76	5.78	$ 53,452

(a) Represents vested stock options held by the former CFO which were cancelled by the Company s Board of Directors.

The weighted-average grant-date fair value of stock options granted and the aggregate intrinsic value of stock options exercised during the three and nine month periods ended September 30, 2006 and 2005 follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Weighted-average grant-date fair value of stock options granted	$ 8.58	$ N/A	$ 8.62	$ 6.33
Aggregate intrinsic value of stock options exercised ($000 s)	$ 417	$ 28,118	$ 2,759	$ 69,315

As of September 30, 2006, options to purchase 1,300,434 shares were outstanding and not vested. Of these non-vested options, approximately 1,273,000 are expected to ultimately vest. Additional information as of September 30, 2006 with respect to these options that are expected to vest follows:

Aggregate intrinsic value	$ 1.3 million
Weighted-average remaining contractual term	9.07 years
Weighted-average remaining expected term	3.08 years
Weighted-average remaining vesting period	2.14 years
Unrecognized compensation cost	$ 9.3 million

Restricted Stock. Under all restricted stock awards to date, shares were issued when granted, nonvested shares are subject to forfeiture for failure to fulfill service conditions and nonforfeitable dividends are paid on nonvested restricted shares. Restricted stock awards prior to January 1, 2006 were valued at the grant date market value of the underlying common stock, recognized as contra equity deferred compensation and amortized to expense under the graded-vesting method. Implementation of FAS 123(R) did not change the accounting for the Company s nonvested stock awards, except as follows:

Prior to January 1, 2006, forfeitures were recognized as they occurred;

From January 1, 2006 forward, forfeitures are estimated in the determination of periodic compensation cost; and

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contra equity deferred compensation was reversed against paid-in-capital at January 1, 2006 and compensation expense is recognized as attributed to each period.

The Company uses the graded-vesting attribution method to determine periodic compensation cost from restricted stock awards.

Restricted stock activity from January 1, 2006 to September 30, 2006 follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2006	623,150	$ 21.44
Granted	613,400	$ 30.46
Vested	(1,198)	$ 14.73
Forfeited	(39,352)	$ 26.15
Nonvested at September 30, 2006	1,196,000	$ 25.92

As of September 30, 2006, approximately 949,000 shares of nonvested restricted stock outstanding are expected to vest. Additional information as of September 30, 2006 with respect to these shares that are expected to vest follows:

Aggregate intrinsic value	$ 22.6 million
Weighted-average remaining vesting period	2.76 years
Unrecognized compensation cost	$ 16.5 million

Dividends on Equity Awards. Nonforfeitable dividends paid on equity awards are recognized as follows:

Dividends are recognized as reductions of retained earnings for the portion of equity awards expected to vest.

Dividends are recognized as additional compensation cost for the portion of equity awards that are not expected to vest or that ultimately do not vest.

Vesting expectations, in regard to these dividend payments, correspond with forfeiture rate assumptions used to recognize compensation cost. Accordingly, when the Company adjusts forfeiture rate assumptions or when actual forfeitures are ultimately recognized, related dividends are reflected as additional compensation expense as opposed to being charged directly to retained earnings.

Prior Period Pro Forma Disclosures. Prior to January 1, 2006, the Company accounted for share-based compensation under the intrinsic value method. Other than the restricted stock discussed above, no additional share-based compensation expense was reflected in prior period earnings since the exercise price was equal to the grant-date market value of the underlying common stock for all stock options granted prior to January 1, 2006. The effect

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of share-based compensation, as if the Company had applied the fair-value-based method proscribed by FAS 123, on net income and earnings per share for prior periods presented follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 106,305	$ 238,551
Add back: Share-based employee compensation cost, net of related tax effects, included in net income as reported	639	1,339
Deduct: Share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards	(3,426)	(9,484)
Pro-forma net income	$ 103,518	$ 230,406
Net income per common share:		
Basic, as reported	$ 0.62	$ 1.40
Basic, pro-forma	$ 0.60	$ 1.36
Diluted, as reported	$ 0.61	$ 1.38
Diluted, pro-forma	$ 0.59	$ 1.33

3. Comprehensive Income

The following table illustrates the Company s comprehensive income including the effects of foreign currency translation adjustments for the three and nine months ended September 30, 2006 and 2005 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	$ 185,990	$ 106,305	$ 516,936	$ 238,551
Other comprehensive income:				
Foreign currency translation adjustment related to our Canadian operations, net of tax	478	2,286	3,016	1,319
Comprehensive income, net of tax	$ 186,468	$ 108,591	$ 519,952	$ 239,870

4. Property and Equipment

Property and equipment consisted of the following at September 30, 2006 and December 31, 2005 (in thousands):

	September 30, 2006	December 31, 2005
Equipment	$ 2,021,601	$ 1,633,911
Oil and natural gas properties	86,143	79,079
Buildings	29,052	22,490
Land	6,104	5,611
	2,142,900	1,741,091
Less accumulated depreciation and depletion	(814,105)	(687,246)
Property and equipment, at cost, net	$ 1,328,795	$ 1,053,845

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PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Business Segments

Our revenues, operating profits and identifiable assets are primarily attributable to four business segments: (i) contract drilling of oil and natural gas wells, (ii) pressure pumping services, (iii) drilling and completion fluid services to operators in the oil and natural gas industry, and (iv) the exploration, development, acquisition and production of oil and natural gas. Each of these segments represents a distinct type of business based upon the type and nature of services and products offered. These segments have separate management teams which report to the Company s chief executive officer and have distinct and identifiable revenues and expenses. Separate financial data for each of our four business segments is provided below (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Contract drilling(a)	$ 578,653	$ 401,626	$ 1,620,322	$ 1,028,230
Pressure pumping	40,462	27,640	107,800	66,358
Drilling and completion fluids(b)	46,317	29,842	155,639	88,994
Oil and natural gas	9,986	10,234	29,083	28,146
Total segment revenues	675,418	469,342	1,912,844	1,211,728
Elimination of intercompany revenues(a)(b)	(1,760)	(603)	(4,640)	(2,474)
Total revenues	$ 673,658	$ 468,739	$ 1,908,204	$ 1,209,254
Income before income taxes:				
Contract drilling	$ 264,924	$ 163,109	$ 751,977	$ 367,721
Pressure pumping	13,493	7,691	34,592	15,779
Drilling and completion fluids	6,558	2,746	25,038	8,261
Oil and natural gas	3,276	4,098	6,977	10,532
	288,251	177,644	818,584	402,293
Corporate and other	(5,295)	(4,060)	(15,278)	(11,580)
Other operating expenses	(2,563)	(707)	(3,948)	(2,590)
Embezzlement costs, net of recoveries(c)	1,512	(5,431)	(2,941)	(12,193)
Interest income	948	944	5,579	2,011
Interest expense	(363)	(56)	(476)	(179)
Other	88	19	231	39
Income before income taxes and cumulative effect of change in accounting principle	$ 282,578	$ 168,353	$ 801,751	$ 377,801

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	September 30, 2006	December 31, 2005
Identifiable assets:		
Contract drilling	$ 1,787,241	$ 1,421,779
Pressure pumping	100,721	72,536
Drilling and completion fluids	104,076	90,904
Oil and natural gas	62,786	60,785
	2,054,824	1,646,004
Corporate and other(d)	40,065	149,777
Total assets	$ 2,094,889	$ 1,795,781

(a) Includes contract drilling intercompany revenues of approximately $1.6 million and $580,000 for the three months ended September 30, 2006 and 2005, respectively, and approximately $4.2 million and $2.3 million for the nine months ended September 30, 2006 and 2005, respectively.

(b) Includes drilling and completion fluids intercompany revenues of approximately $154,000 and $23,000 for the three months ended September 30, 2006 and 2005, respectively, and approximately $418,000 and $182,000 for the nine months ended September 30, 2006 and 2005, respectively .

(c) The Company s former CFO has pleaded guilty to criminal charges and has been sentenced and is serving a term of imprisonment arising out of his embezzlement of funds totaling approximately $77.5 million from the Company over a period of more than five years, ending November 3, 2005. Embezzlement costs, net of recoveries include embezzled funds and other costs incurred as a result of the embezzlement. In the three months ended September 30, 2006, the Company recovered $2.0 million from its insurance carrier related to the embezzlement loss.

(d) Corporate assets primarily include cash on hand managed by the parent corporation and certain deferred federal income tax assets.

6. Goodwill

Goodwill is evaluated at least annually to determine if the fair value of recorded goodwill has decreased below its carrying value. At December 31, 2005 the Company performed its annual goodwill evaluation and determined no adjustment to impair goodwill was necessary. Goodwill as of September 30, 2006 and December 31, 2005 is as follows (in thousands):

	September 30, 2006	December 31, 2005

Contract Drilling:				
Goodwill at beginning of period	$	89,092	$	89,092
Changes to goodwill				
Goodwill at end of period		89,092		89,092
Drilling and completion fluids:				
Goodwill at beginning of period	$	9,964	$	9,964
Changes to goodwill				
Goodwill at end of period		9,964		9,964
Total goodwill	$	99,056	$	99,056

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Accrued Expenses

Accrued expenses consisted of the following at September 30, 2006 and December 31, 2005 (in thousands):

	September 30, 2006	December 31, 2005
Workers compensation liability	$ 62,737	$ 47,107
Salaries, wages, payroll taxes and benefits	38,074	33,816
Sales, use and other taxes	11,647	9,484
Insurance, other than workers compensation	13,734	11,365
Other	24,477	10,704
Accrued expenses	$ 150,669	$ 112,476

8. Asset Retirement Obligation

Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations, (SFAS No. 143), requires that the Company record a liability for the estimated costs to be incurred in connection with the abandonment of oil and natural gas properties in the future. The following table describes the changes to our asset retirement obligations during the nine months ended September 30, 2006 and 2005 (in thousands):

	September 30, 2006	September 30, 2005
Balance at beginning of year	$ 1,725	$ 2,358
Liabilities incurred	83	61
Liabilities settled	(48)	(801)
Accretion expense	41	55
Asset retirement obligation at end of period	$ 1,801	$ 1,673

9. Borrowings Under Line of Credit

On August 2, 2006, the Company entered into an agreement to amend its $200 million unsecured revolving line of credit (LOC). In connection with this amendment, the borrowing capacity under this LOC was increased to $375 million. No significant changes were made to the terms of the LOC including the interest to be paid on outstanding balances and financial covenants.

As of September 30, 2006, borrowings of $65.0 million have been advanced under the LOC. The weighted average interest rate on borrowings outstanding at September 30, 2006 was 8.25%.

10. Commitments, Contingencies and Other Matters

The Company maintains letters of credit in the aggregate amount of approximately $60 million for the benefit of various insurance companies as collateral for retrospective premiums and retained losses which could become payable under the terms of the underlying insurance contracts. These letters of credit expire at various times during each calendar year. No amounts have been drawn under the letters of credit.

As of September 30, 2006, the Company has remaining non-cancelable commitments to purchase $240 million of equipment through 2007.

A receiver has been appointed to identify the assets of our former CFO in connection with his embezzlement of Company funds. The receiver is liquidating the assets and will propose a plan to distribute the proceeds. While the Company believes it has a claim for at least the full amount of funds embezzled from the Company, other creditors have asserted or may assert claims with respect to the assets held by the receiver.

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In December 2005, two derivative actions were filed in Texas state court in Scurry County, Texas, and in May 2006, a derivative action was filed in federal court in Lubbock, Texas, in each case, against the directors of the Company, alleging that the directors breached their fiduciary duties to the Company as a result of alleged failure to timely discover the embezzlement. The Board of Directors formed a special litigation committee to review and inquire about these allegations and recommend the Company s response, if any. Further legal proceedings in these suits were stayed pending completion of the work of the special litigation committee. Settlement negotiations are taking place. The lawsuits seek recovery on behalf of and for the Company and do not seek recovery from the Company.

The Company is party to various other legal proceedings arising in the normal course of its business. The Company does not believe that the outcome of these proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition.

11. Stockholders Equity

On March 2, 2006, the Company s Board of Directors approved a cash dividend on its common stock in the amount of $0.04 per share. The cash dividend of approximately $6.9 million was paid on March 30, 2006 to holders of record on March 15, 2006. On April 26, 2006, the Company s Board of Directors approved an increase in its quarterly cash dividend from $0.04 to $0.08 on each outstanding share of its common stock. This dividend of approximately $13.4 million was paid on June 30, 2006 to holders of record on June 15, 2006. On August 2, 2006, the Company s Board of Directors approved a cash dividend on its common stock in the amount of $0.08 per share. This dividend of approximately $13.0 million was paid on September 29, 2006 to holders of record on September 14, 2006. The amount and timing of all future dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial condition, terms of the Company s credit facilities and other factors.

On March 27, 2006, the Company s Board of Directors increased the Company s previously authorized stock buyback program to allow for future purchases of up to $200 million of the Company s outstanding common stock. During the second quarter of 2006, the Company completed the authorized buyback with the purchase of 6,704,800 shares of its common stock at a cost of approximately $200 million. On August 2, 2006, the Company s Board of Directors again increased the Company s previously authorized stock buyback program to allow for future purchases of up to $250 million of the Company s outstanding common stock. During the three months ended September 30, 2006, the Company purchased 6,537,000 shares of its common stock at a cost of approximately $167 million. As of September 30, 2006, the Company is authorized to purchase approximately $83 million of the Company s outstanding common stock under the stock buyback program. Shares purchased under the stock buyback program have been accounted for as treasury stock.

12. Subsequent Events

On October 31, 2006, the Company s Board of Directors approved a quarterly cash dividend of $0.08 on each outstanding share of its common stock. The dividend is to be paid on December 29, 2006 to holders of record as of December 14, 2006.

13. Recently Issued Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements and 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 is effective for fiscal years beginning after December 15, 2006 and will be effective for the company as of January 1, 2007. The application of this standard is not expected to be material.

PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. FAS 157 will be effective for the Company in the quarter ending March 31, 2008. The application of FAS 157 is not expected to have a material impact to the Company.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements. The roll-over method focuses primarily on the impact of a misstatement on the income statement (including the reversing effect of prior year misstatements) but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. The Company currently uses the iron-curtain method for quantifying identified financial statement misstatements. In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company s financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it requires quantification of errors under both the iron curtain and the roll-over methods. The Company will apply the provisions of SAB 108 in the quarter ending December 31, 2006 and the impact is not expected to be material.

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ITEM 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Management Overview We are a leading provider of contract services to the North American oil and natural gas industry. Our services primarily involve the drilling, on a contract basis, of land-based oil and natural gas wells and, to a lesser extent, we provide pressure pumping services and drilling and completion fluid services. In addition to the aforementioned contract services, we also engage in the development, exploration, acquisition and production of oil and natural gas. For the three and nine months ended September 30, 2006 and 2005, our operating revenues consisted of the following (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2006		2005		2006		2005	
Contract drilling	$ 577,047	86%	$ 401,046	86%	$ 1,616,100	84%	$ 1,025,938	85%
Pressure pumping	40,462	6	27,640	6	107,800	6	66,358	6
Drilling and completion fluids	46,163	7	29,819	6	155,221	8	88,812	7
Oil and natural gas								