DIAMOND OFFSHORE DRILLING INC
Form 10-Q
April 27, 2011

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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 March 31, 2011

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 1-13926

DIAMOND OFFSHORE DRILLING, INC.

(Exact name of registrant as specified in its charter)

Delaware	76-0321760
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

15415 Katy Freeway
Houston, Texas
77094
(Address of principal executive offices)
(Zip Code)
(281) 492-5300
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

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

As of April 20, 2011 Common stock, $0.01 par value per share 139,027,039 shares

DIAMOND OFFSHORE DRILLING, INC.
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QUARTER ENDED MARCH 31, 2011

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements.

DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share and per share data)

	March 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 493,221	$ 464,393
Marketable securities	500,564	612,346
Accounts receivable, net of allowance for bad debts	550,750	609,606
Prepaid expenses and other current assets	159,602	177,153
Total current assets	1,704,137	1,863,498
Drilling and other property and equipment, net of accumulated depreciation	4,225,999	4,283,792
Long-term receivable	15,003	35,361
Other assets	666,764	544,333
Total assets	$ 6,611,903	$ 6,726,984
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 66,511	$ 99,236
Accrued liabilities	288,588	469,190
Taxes payable	37,423	57,862
Total current liabilities	392,522	626,288
Long-term debt	1,495,650	1,495,593
Deferred tax liability	528,164	542,258
Other liabilities	203,022	201,133
Total liabilities	2,619,358	2,865,272
Commitments and contingencies (Note 9)		
Stockholders equity:		
Common stock (par value $0.01, 500,000,000 shares authorized; 143,943,839 shares issued and 139,027,039 shares outstanding at March 31, 2011; 143,943,624 shares issued and 139,026,824 shares outstanding at December 31, 2010)	1,439	1,439
Additional paid-in capital	1,973,781	1,972,550

Retained earnings	2,127,333	1,998,995
Accumulated other comprehensive gain	4,405	3,141
Treasury stock, at cost (4,916,800 shares at March 31, 2011 and December 31, 2010)	(114,413)	(114,413)
Total stockholders equity	3,992,545	3,861,712
Total liabilities and stockholders equity	$ 6,611,903	$ 6,726,984

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

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DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Revenues:		
Contract drilling	$ 788,873	$ 844,438
Revenues related to reimbursable expenses	17,516	15,243
Total revenues	806,389	859,681
Operating expenses:		
Contract drilling, excluding depreciation	362,364	306,227
Reimbursable expenses	16,950	14,705
Depreciation	101,173	97,402
General and administrative	17,725	16,654
Bad debt recovery	(8,447)	(1,100)
Gain on disposition of assets	(2,641)	(884)
Total operating expenses	487,124	433,004
Operating income	319,265	426,677
Other income (expense):		
Interest income	450	1,282
Interest expense	(22,044)	(22,321)
Foreign currency transaction gain (loss)	(1,606)	461
Other, net	784	(87)
Income before income tax expense	296,849	406,012
Income tax expense	(46,237)	(115,159)
Net income	$ 250,612	$ 290,853
Income per share:		
Basic	$ 1.80	$ 2.09
Diluted	$ 1.80	$ 2.09

Weighted-average shares outstanding:		
Shares of common stock	139,027	139,026
Dilutive potential shares of common stock	26	103
Total weighted-average shares outstanding assuming dilution	139,053	139,129
Cash dividends declared per share of common stock	$ 0.875	$ 2.00

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

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DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Three Months Ended March 31,	
	2011	**2010**
Operating activities:		
Net income	$ 250,612	$ 290,853
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	101,173	97,402
Gain on disposition of assets	(2,641)	(884)
Loss (gain) on sale of marketable securities, net	(783)	1
Gain on foreign currency forward exchange contracts	(1,826)	(2,099)
Deferred tax provision	(14,774)	(4,843)
Accretion of discounts on marketable securities	(181)	(73)
Amortization of debt issuance costs	219	211
Amortization of debt discounts	57	89
Stock-based compensation expense	1,236	1,938
Deferred income, net	(11,021)	55,063
Deferred expenses, net	22,597	(30,246)
Other assets, noncurrent	897	(5,024)
Other liabilities, noncurrent	870	5,419
Proceeds from settlement of foreign currency forward exchange contracts designated as accounting hedges	1,826	2,099
Changes in operating assets and liabilities:		
Accounts receivable	79,759	(44,875)
Prepaid expenses and other current assets	(1,479)	5,052
Accounts payable and accrued liabilities	(32,753)	(19,762)
Taxes payable	12,691	114,560
Net cash provided by operating activities	406,479	464,881
Investing activities:		
Capital expenditures	(61,743)	(107,798)
Deposits for construction of new rigs	(308,854)	
Proceeds from disposition of assets, net of disposal costs	2,786	989
Proceeds from sale and maturities of marketable securities	1,362,016	1,200,053
Purchases of marketable securities	(1,249,835)	(1,349,900)
Net cash used in investing activities	(255,630)	(256,656)
Financing activities:		
Debt issuance costs and arrangement fees		(98)
Payment of dividends	(122,021)	(278,597)

Proceeds from stock plan exercises		107
Net cash used in financing activities	(122,021)	(278,588)
Net change in cash and cash equivalents	28,828	(70,363)
Cash and cash equivalents, beginning of period	464,393	376,417
Cash and cash equivalents, end of period	$ 493,221	$ 306,054

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

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DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. General Information

The unaudited consolidated financial statements of Diamond Offshore Drilling, Inc. and subsidiaries, which we refer to as Diamond Offshore, we, us or our, should be read in conjunction with our Annual Report on Form 10-K f the year ended December 31, 2010 (File No. 1-13926).

As of April 20, 2011, Loews Corporation, or Loews, owned 50.4% of the outstanding shares of our common stock.

Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the U.S., or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, pursuant to such rules and regulations, they do not include all disclosures required by GAAP for complete financial statements. The consolidated financial information has not been audited but, in the opinion of management, includes all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the consolidated balance sheets, statements of operations and statements of cash flows at the dates and for the periods indicated. Results of operations for interim periods are not necessarily indicative of results of operations for the respective full years.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimated.

Reclassifications

Certain amounts applicable to the prior periods have been reclassified to conform to the classifications currently followed. Such reclassifications do not affect earnings.

Cash and Cash Equivalents, Marketable Securities

We consider short-term, highly liquid investments that have an original maturity of three months or less and deposits in money market mutual funds that are readily convertible into cash to be cash equivalents. See Note 6.

We classify our investments in marketable securities as available for sale and they are stated at fair value in our Consolidated Balance Sheets. Accordingly, any unrealized gains and losses, net of taxes, are reported in our Consolidated Balance Sheets in Accumulated other comprehensive gain until realized. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity and such adjustments are included in our Consolidated Statements of Operations in Interest income. The sale and purchase of securities are recorded on the date of the trade. The cost of debt securities sold is based on the specific identification method. Realized gains or losses, as well as any declines in value that are judged to be other than temporary, are reported in our Consolidated Statements of Operations in Other income (expense).

The effect of exchange rate changes on cash balances held in foreign currencies was not material for the three months ended March 31, 2011 and 2010.

Provision for Bad Debts

We record a provision for bad debts on a case-by-case basis when facts and circumstances indicate that a customer receivable may not be collectible. In establishing these reserves, we consider historical and other factors that predict collectability, including write-offs, recoveries and the monitoring of credit quality. Such provision is reported as a component of Operating expense in our Consolidated Statements of Operations. See Note 2.

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Derivative Financial Instruments

Our derivative financial instruments consist of foreign currency forward exchange, or FOREX, contracts which we may designate as cash flow hedges. In accordance with GAAP, each derivative contract is stated in the balance sheet at its fair value with gains and losses reflected in the income statement except that, to the extent the derivative qualifies for and is designated as an accounting hedge, the gains and losses are reflected in income in the same period as offsetting gains and losses on the qualifying hedged positions. We report such realized gains and losses as a component of Contract drilling, excluding depreciation expense in our Consolidated Statements of Operations to offset the impact of foreign currency fluctuations in our expenditures in local foreign currencies in the countries in which we operate.

Realized gains or losses upon settlement of derivative contracts not designated as cash flow hedges are reported as Foreign currency transaction gain (loss) in our Consolidated Statements of Operations. See Notes 5 and 6.

Impairment of Long-Lived Assets

We evaluate our property and equipment for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We utilize a probability-weighted cash flow analysis in testing an asset for potential impairment. Our assumptions and estimates underlying this analysis include the following:

- dayrate by rig;
- utilization rate by rig (expressed as the actual percentage of time per year that the rig would be used);
- the per day operating cost for each rig if active, ready-stacked or cold-stacked;
- the estimated maintenance, inspection or other costs associated with a rig returning to work;
- salvage value for each rig; and
- estimated proceeds that may be received on disposition of the rig.

Based on these assumptions and estimates, we develop a matrix by assigning probabilities to various combinations of assumed utilization rates and dayrates.

During the first quarter of 2011, we cold stacked an intermediate semisubmersible rig, the *Ocean Epoch*, in Malaysia. The cold stacking of the *Ocean Epoch*, which had previously been operating offshore Australia, increased the number of cold stacked rigs in our fleet to eight. We performed an impairment review of this rig using the methodology described above, and based on our analyses, concluded that this rig was not subject to impairment at March 31, 2011.

In addition to the *Ocean Epoch* that was cold stacked in the first quarter of 2011, our current cold stacked fleet consists of one independent-leg, cantilevered and three mat-supported jack-up rigs (all in the U.S. Gulf of Mexico, or GOM) and three intermediate semisubmersible rigs (two in the GOM and one in Malaysia). We believe that there have been no changes in circumstances that indicate that the carrying values of these cold stacked rigs may not be recoverable.

Management s assumptions are an inherent part of our asset impairment evaluation and the use of different assumptions could produce results that differ from those reported.

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Comprehensive Income

A reconciliation of net income to comprehensive income is as follows:

	Three Months Ended March 31,	
	2011	2010
	(In thousands)	
Net income	$250,612	$290,853
Other comprehensive gains (losses), net of tax:		
FOREX contracts:		
Unrealized holding gain	3,040	137
Reclassification adjustment for gain included in net income	(1,408)	(1,085)
Investments in marketable securities:		
Unrealized holding gain (loss)	6	(4)
Reclassification adjustment for (gain) loss included in net income	(374)	
Comprehensive income	$251,876	$289,901

The tax related to the change in unrealized holding gain on FOREX contracts for the three months ended March 31, 2011 and 2010 was approximately $1.6 million and $74,000, respectively. The tax related to the reclassification adjustment for FOREX contracts included in net income for the three months ended March 31, 2011 and 2010 was approximately $758,000 and $584,000, respectively.

The tax related to the change in unrealized holding gain on investments was approximately $3,000 for the three months ended March 31, 2011 and the tax benefit related to the change in unrealized holding loss on investments was approximately $2,000 for the three months ended March 31, 2010. The tax effect on the reclassification adjustment for net gains included in net income was approximately $201,000 for the three months ended March 31, 2011.

Foreign Currency

Our functional currency is the U.S. dollar. Foreign currency transaction gains and losses, including gains and losses from the settlement of FOREX contracts not designated as accounting hedges, are reported as Foreign currency transaction gain (loss) in our Consolidated Statements of Operations. For the three-month periods ended March 31, 2011 and 2010, we recognized net foreign currency transaction gain (loss) of $(1.6) million and $0.5 million, respectively. See Note 5.

Revenue Recognition

Revenue from our dayrate drilling contracts is recognized as services are performed. In connection with such drilling contracts, we may receive fees (either lump-sum or dayrate) for the mobilization of equipment. These fees are earned as services are performed over the initial term of the related drilling contracts. We defer mobilization fees received, as well as direct and incremental mobilization costs incurred, and amortize each, on a straight line basis, over the term of the related drilling contracts (which is the period we estimate to be benefited from the mobilization activity). Straight line amortization of mobilization revenues and related costs over the initial term of the related drilling contracts (which generally range from 2 to 60 months) is consistent with the timing of net cash flows generated from the actual drilling services performed. Absent a contract, mobilization costs are recognized as incurred.

From time to time, we may receive fees from our customers for capital improvements to our rigs (either lump-sum or dayrate). We defer such fees received in Accrued liabilities and Other liabilities in our Consolidated Balance Sheets and recognize these fees into income on a straight-line basis over the period of the related drilling contract. We capitalize the costs of such capital improvements and depreciate them over the estimated useful life of the asset.

We record reimbursements received for the purchase of supplies, equipment, personnel services and other services provided at the request of our customers in accordance with a contract or agreement, for the gross amount

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billed to the customer, as Revenues related to reimbursable expenses in our Consolidated Statements of Operations.

Income Taxes

Certain of our international rigs are owned and operated, directly or indirectly, by Diamond Offshore International Limited, or DOIL, a Cayman Islands subsidiary which we wholly own. Since forming this subsidiary in 2002, it has been our intention to indefinitely reinvest the earnings of the subsidiary to finance foreign activities. Consequently, no U.S. federal income taxes have been provided on these earnings except to the extent that such earnings were immediately subject to U.S. federal income taxes and except for the earnings of Diamond East Asia Limited, or DEAL, a wholly-owned subsidiary of DOIL. It had been our intention to repatriate the earnings of DEAL to the U.S. and, accordingly, we provided U.S. income taxes on its earnings. However, a tax law provision that expired at the end of 2009, but was subsequently signed back into law by the President of the United States on December 17, 2010, in conjunction with our decisions in the fourth quarter of 2010 and in the first quarter of 2011 to build two new drillships overseas, caused us to reassess our intent to repatriate the earnings of DEAL to the U.S. We now plan to reinvest the earnings of DEAL internationally through another of our foreign companies, and consequently, we are no longer providing U.S. income taxes on its earnings. During the three months ended March 31, 2011, we reversed approximately $15.0 million of U.S. income taxes that had been provided in prior periods for the earnings of DEAL.

2. Supplemental Financial Information

Consolidated Balance Sheet Information

Accounts receivable, net of allowance for bad debts, consist of the following:

	March 31, 2011	December 31, 2010
	(In thousands)	
Trade receivables	$547,174	$633,224
Value added tax receivables	7,428	5,003
Unbilled third party claims	51	45
Related party receivables	400	538
Other	826	2,704
	555,879	641,514
Allowance for bad debts	(5,129)	(31,908)
Total	$550,750	$609,606

During the three months ended March 31, 2011 and 2010, we recovered $8.4 million and $1.1 million, respectively, associated with the reserves for bad debts recorded in previous years. No additional allowances were deemed necessary for each of the three-month periods ended March 31, 2011 and 2010.

In addition, during the three months ended March 31, 2011, we offset $18.4 million in previously reserved trade receivables against the allowance for bad debts as we had exhausted all methods of recovery against this customer.

Prepaid expenses and other current assets consist of the following:

	March 31, 2011	December 31, 2010
	(In thousands)	
Rig spare parts and supplies	$ 54,905	$ 50,288
Deferred mobilization costs	73,939	76,868
Prepaid insurance	3,957	9,587
Deferred tax assets	9,557	9,557
Deposits	951	827
Prepaid taxes	5,123	20,347

FOREX contracts	6,791	4,326
Other	4,379	5,353
Total	$159,602	$177,153

Accrued liabilities consist of the following:

	March 31, 2011	December 31, 2010
	(In thousands)	
Accrued capital project/upgrade costs	$ 10,727	$ 28,947
Payroll and benefits	73,360	76,041
Deferred revenue	68,130	69,825
Rig operating expenses	72,873	81,820
Interest payable	29,422	21,219
Personal injury and other claims	8,415	11,758
Accrued drillship construction installment		154,427
Other	25,661	25,153
Total	$288,588	$469,190

At December 31, 2010, we had accrued the first installment payable under a turnkey construction agreement with Hyundai Heavy Industries Co., Ltd., or Hyundai, of $154.4 million and recorded the related noncurrent asset in an equal amount in Other assets in our Consolidated Balance Sheets. See Note 9.

Consolidated Statement of Cash Flows Information

We paid interest on long-term debt totaling $12.5 million for each of the three-month periods ended March 31, 2011 and 2010. During the three months ended March 31, 2010, we paid $0.9 million in interest on assessments from the Internal Revenue Service.

We did not pay any U.S. federal income taxes during the three-month period ended March 31, 2011 and paid $0.5 million in the three-month period ended March 31, 2010. We paid $48.5 million and $37.3 million in foreign income taxes, net of foreign tax refunds, during the three months ended March 31, 2011 and 2010, respectively. We received a refund for state income taxes of $0.1 million during the three months ended March 31, 2010.

Capital expenditures for the three months ended March 31, 2011 included $28.9 million that was accrued but unpaid at December 31, 2010. Capital expenditures for the three months ended March 31, 2010 included $64.9 million that was accrued but unpaid at December 31, 2009. Capital expenditures that were accrued but not paid as of March 31, 2011 totaled $10.7 million. We have included this amount in Accrued liabilities in our Consolidated Balance Sheets at March 31, 2011.

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3. Earnings Per Share

A reconciliation of the numerators and the denominators of our basic and diluted per-share computations follows:

	Three Months Ended March 31, 2011	2010
	(In thousands, except per share data)	
Net income basic (numerator):	$250,612	$290,853
Effect of dilutive potential shares		
Convertible debentures		24
Net income including conversions diluted (numerator)	$250,612	$290,877
Weighted average shares basic (denominator):	139,027	139,026
Effect of dilutive potential shares		
Convertible debentures		52
Stock options and SARs	26	51
Weighted average shares including conversions diluted (denominator)	139,053	139,129
Earnings per share:		
Basic	$ 1.80	$ 2.09
Diluted	$ 1.80	$ 2.09

Our computation of diluted earnings per share, or EPS, excludes stock options representing 8,000 shares of common stock and 758,976 stock appreciation rights, or SARs, for the three months ended March 31, 2011. Our computation of diluted EPS for the three months ended March 31, 2010 excludes 441,037 SARs. The inclusion of such potentially dilutive shares in the computation of diluted EPS would have been antidilutive for the periods presented.

4. Marketable Securities

We report our investments as current assets in our Consolidated Balance Sheets in Marketable securities, representing the investment of cash available for current operations. See Note 6.

Our investments in marketable securities are classified as available for sale and are summarized as follows:

	March 31, 2011		
	Amortized Cost	Unrealized Gain	Market Value
		(In thousands)	
U.S. Treasury Bills (due within one year)	$499,982	$ 7	$499,989
Mortgage-backed securities	520	55	575
Total	$500,502	$ 62	$500,564

	December 31, 2010		
	Amortized	Unrealized	Market

	Cost	Gain	Value
		(In thousands)	
U.S. Treasury Bills (due within one year)	$599,965	$ 15	$599,980
Corporate bonds	11,200	560	11,760
Mortgage-backed securities	553	53	606
Total	$611,718	$ 628	$612,346

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Proceeds from sales and maturities of marketable securities and gross realized gains and losses are summarized as follows:

	Three Months Ended March 31,