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

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, 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 October 20, 2011	Common stock, $0.01 par value per share	139,027,209 shares

DIAMOND OFFSHORE DRILLING, INC.
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QUARTER ENDED SEPTEMBER 30, 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)

	September 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 348,003	$ 464,393
Marketable securities	801,931	612,346
Accounts receivable, net of allowance for bad debts	622,949	609,606
Prepaid expenses and other current assets	157,389	177,153
Total current assets	1,930,272	1,863,498
Drilling and other property and equipment, net of accumulated depreciation	4,605,748	4,283,792
Long-term receivable		35,361
Other assets	303,215	544,333
Total assets	$ 6,839,235	$ 6,726,984
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 59,169	$ 99,236
Accrued liabilities	279,209	469,190
Taxes payable	34,583	57,862
Total current liabilities	372,961	626,288
Long-term debt	1,495,765	1,495,593
Deferred tax liability	519,980	542,258
Other liabilities	189,914	201,133
Total liabilities	2,578,620	2,865,272
Commitments and contingencies (Note 9)		
Stockholders equity:		
Common stock (par value $0.01, 500,000,000 shares authorized; 143,944,009 shares issued and 139,027,209 shares outstanding at September 30, 2011; 143,943,624 shares issued and 139,026,824 shares outstanding at December 31, 2010)	1,439	1,439
Additional paid-in capital	1,976,294	1,972,550

Retained earnings	2,406,188	1,998,995
Accumulated other comprehensive gain (loss)	(8,893)	3,141
Treasury stock, at cost (4,916,800 shares at September 30, 2011 and December 31, 2010)	(114,413)	(114,413)
Total stockholders equity	4,260,615	3,861,712
Total liabilities and stockholders equity	$ 6,839,235	$ 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 September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Contract drilling	$ 861,511	$ 748,998	$ 2,520,030	$ 2,405,175
Revenues related to reimbursable expenses	16,666	50,726	54,032	76,833
Total revenues	878,177	799,724	2,574,062	2,482,008
Operating expenses:				
Contract drilling, excluding depreciation	391,369	350,555	1,141,739	1,008,551
Reimbursable expenses	16,206	50,313	52,443	75,397
Depreciation	101,175	99,117	303,523	297,265
General and administrative	14,879	16,999	48,976	50,502
Bad debt expense (recovery)	4,734	(2,048)	(5,413)	(5,946)
Gain on disposition of assets	(463)	(32,392)	(4,344)	(33,425)
Total operating expenses	527,900	482,544	1,536,924	1,392,344
Operating income	350,277	317,180	1,037,138	1,089,664
Other income (expense):				
Interest income	2,024	395	3,565	2,154
Interest expense	(15,874)	(22,567)	(60,144)	(66,221)
Foreign currency transaction gain (loss)	(1,442)	3,724	(4,603)	194
Other, net	(136)	(166)	(232)	(287)
Income before income tax expense	334,849	298,566	975,724	1,025,504
Income tax expense	(77,995)	(100,042)	(201,672)	(311,734)
Net income	$ 256,854	$ 198,524	$ 774,052	$ 713,770
Income per share:				
Basic	$ 1.85	$ 1.43	$ 5.57	$ 5.13
Diluted	$ 1.85	$ 1.43	$ 5.57	$ 5.13
Weighted-average shares outstanding:				

Shares of common stock	139,027	139,027	139,027	139,026
Dilutive potential shares of common stock	14	10	21	55
Total weighted-average shares outstanding	139,041	139,037	139,048	139,081
Cash dividends declared per share of common stock	$ 0.875	$ 0.875	$ 2.625	$ 4.375

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)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Operating activities:		
Net income	$ 774,052	$ 713,770
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	303,523	297,265
Gain on disposition of assets	(4,344)	(33,425)
(Gain) loss on sale of marketable securities, net	(780)	5
Gain on foreign currency forward exchange contracts	(9,593)	(1,924)
Deferred tax provision	(15,798)	14,918
Accretion of discounts on marketable securities	(39)	(421)
Amortization of debt issuance costs	659	665
Amortization of debt discounts	172	222
Stock-based compensation expense	3,749	4,821
Deferred income, net	(46,127)	41,768
Deferred expenses, net	62,836	(77,372)
Other assets, noncurrent	(165)	7,804
Other liabilities, noncurrent	964	10,413
Proceeds from settlement of foreign currency forward exchange contracts designated as accounting hedges	9,593	1,924
Changes in operating assets and liabilities:		
Accounts receivable	20,055	141,726
Prepaid expenses and other current assets	(20,137)	(16,023)
Accounts payable and accrued liabilities	(43,845)	10,146
Taxes payable	44,368	(166,389)
Net cash provided by operating activities	1,079,143	949,893
Investing activities:		
Capital expenditures (including rig construction)	(643,305)	(312,995)
Proceeds from disposition of assets, net of disposal costs	5,128	186,333
Proceeds from sale and maturities of marketable securities	4,862,108	3,700,176
Purchases of marketable securities	(5,051,538)	(4,099,525)
Net cash used in investing activities	(827,607)	(526,011)
Financing activities:		
Redemption of zero coupon debentures		(4,238)
Payment of dividends	(367,930)	(611,668)
Other	4	41

Net cash used in financing activities	(367,926)	(615,865)
Net change in cash and cash equivalents	(116,390)	(191,983)
Cash and cash equivalents, beginning of period	464,393	376,417
Cash and cash equivalents, end of period	$ 348,003	$ 184,434

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 October 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) Other, net.

The effect of exchange rate changes on cash balances held in foreign currencies was not material for the nine months ended September 30, 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 expenses in our Consolidated Statements of Operations. See Note 2.

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. For the three-month and nine-month periods ended September 30, 2011 and 2010, we recognized no foreign currency transaction gain (loss) attributable to FOREX contracts not designated as cash flow hedges. See Notes 5 and 6.

Capitalized Interest

We capitalize interest cost for the construction and upgrade of qualifying assets. Commencing in August 2011, we began capitalizing interest on qualifying expenditures related to the construction of three drillships with expected deliveries in 2013 and 2014. There were no qualifying expenditures during the nine months ended September 30, 2010. See Note 7.

A reconciliation of our total interest cost to Interest expense as reported in our Consolidated Statements of Operations is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
Total interest cost including amortization of debt issuance costs	$ 20,364	$ 22,567	$ 64,634	$ 66,221
Capitalized interest	(4,490)		(4,490)	
Total interest expense as reported	$ 15,874	$ 22,567	$ 60,144	$ 66,221

Property, Plant and Equipment

We carry our drilling and other property and equipment at cost. Maintenance and routine repairs are charged to income currently while replacements and betterments, which upgrade or increase the functionality of our existing equipment and that significantly extend the useful life of an existing asset, are capitalized. Significant judgments, assumptions and estimates may be required in determining whether or not such replacements and betterments meet the criteria for capitalization and in determining useful lives and salvage values of such assets. Changes in these judgments, assumptions and estimates could produce results that differ from those reported. Historically, the amount of capital additions requiring significant judgments, assumptions or estimates has not been significant. Depreciation is amortized up to applicable salvage values by applying the straight-line method over the remaining estimated useful lives. During the nine months ended September 30, 2011 and the year ended December 31, 2010, we capitalized $136.3 million and $379.8 million, respectively, in replacements and betterments of our drilling fleet, resulting from numerous projects ranging from $25,000 to $50 million per project.

We evaluate our property and equipment for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable (such as cold stacking a rig or excess spending over budget on a new-build or major rig upgrade). 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 annual cost for rig replacements and/or enhancement programs;

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 using several different utilization/dayrate scenarios, to each of which we have assigned a probability of occurrence. The sum of our utilization scenarios (which include active, warm stacked and cold stacked) and probability of occurrence scenarios both equal 100% in the aggregate. We reevaluate our cold-stacked rigs annually, and we update the matrices for each of our cold stacked rigs at each year end and modify our assumptions giving consideration to the length of time the rig has been cold stacked, the current and expected market for the type of rig and expectations of future oil and gas prices. Further, to test sensitivity, we consider the impact of a 5% reduction in assumed dayrates for the cold-stacked rigs (holding all other assumptions and estimates in the model constant). We would not necessarily record an impairment if the sensitivity analysis indicated potential cash flows would be insufficient to recover our carrying value. We would assess other qualitative factors including industry, regulatory and other relevant conditions to determine whether an impairment or further disclosure is warranted.

As of September 30, 2011, we had eight cold stacked rigs with an aggregate net book value of approximately $87.6 million. Of our cold stacked rigs, four were jack-up rigs, consisting of three mat-supported rigs and one independent-leg, cantilevered rig (all in the U.S. Gulf of Mexico, or GOM), and four were intermediate semisubmersible rigs (two in the GOM and two in Malaysia), including the *Ocean Epoch*, which was cold stacked in the first quarter of 2011. As of December 31, 2010, we had seven cold stacked rigs with an aggregate net book value of approximately $78.0 million. We performed an impairment review for each of these rigs using the methodology described above. Based on our analyses, we have concluded that these rigs were not subject to impairment at September 30, 2011 and December 31, 2010, respectively.

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.

Comprehensive Income

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

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(In thousands)			
Net income	$ 256,854	$ 198,524	$ 774,052	$ 713,770
Other comprehensive gains (losses), net of tax:				
FOREX contracts:				
Unrealized holding (loss) gain	(11,221)	3,608	(3,538)	348
Reclassification adjustment for loss (gain) included in net income	(3,115)	(116)	(8,064)	(845)
Investments in marketable securities:				
Unrealized holding (loss) gain	(55)	(9)	(54)	(31)
Reclassification adjustment for loss (gain) included in net income	1	13	(378)	14

Comprehensive income	$ 242,464	$ 202,020	$ 762,018	$ 713,256

Foreign Currency

Our functional currency is the U.S. dollar. Foreign currency transaction gains and losses are reported as Foreign currency transaction gain (loss) in our Consolidated Statements of Operations. For the three-month and nine-month periods ended September 30, 2011, we recognized net foreign currency transaction (losses) of $(1.4) million and $(4.6) million, respectively. For the three-month and nine-month periods ended September 30, 2010, we recognized net foreign currency transaction gains of $3.7 million and $0.2 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 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 late 2010 and the first half of 2011 to build three 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 nine months ended September 30, 2011, we reversed approximately $15.0 million of U.S. income taxes that had been provided in prior periods for the earnings of DEAL.

Recently Issued Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2011-05, Comprehensive Income (Topic 220): *Presentation of Comprehensive Income*, or ASU 2011-05, which eliminates the option to present components of other comprehensive income, or OCI, as part of the statement of changes in stockholders equity, requires the presentation of each component of net income and each component of OCI either in a single continuous statement or in two separate but consecutive statements and also requires presentation of reclassification adjustments on the face of the financial statement. ASU 2011-05 is effective for interim and annual periods beginning after December 15, 2011; however, early adoption is permitted. The adoption of ASU 2011-05 will not have an effect on our financial position, results of operations or cash flows.

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, or ASU 2011-04. ASU 2011-04 clarifies existing fair value measurement and disclosure requirements, amends certain fair value measurement principles and requires additional disclosures about fair value measurements. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011. We will incorporate any additional disclosures in our annual financial statements for the year ending December 31, 2012.

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2. Supplemental Financial Information

Consolidated Balance Sheet Information

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

	September 30, 2011	December 31, 2010
	(In thousands)	
Trade receivables	$ 621,012	$ 633,224
Value added tax receivables	6,952	5,003
Unbilled third party claims	445	45
Related party receivables	2,443	538
Other	264	2,704
	631,116	641,514
Allowance for bad debts	(8,167)	(31,908)
Total	$ 622,949	$ 609,606

In September 2011, we recorded a $5.7 million provision for bad debts to reserve a portion of the uncollected balance of receivables from one of our current customers in Egypt. During the three-month and nine-month periods ended September 30, 2011, we recovered $1.0 million and $11.1 million, respectively, in previously reserved bad debts. Recoveries during the first nine months of 2011 included $8.5 million in final payments from a previous customer in the North Sea and $2.6 million from another customer in Egypt for whom we no longer work. In addition, during 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 the North Sea customer.

During the three-month and nine-month periods ended September 30, 2010, we recovered $2.0 million and $5.9 million, respectively, in previously reserved bad debts. Recoveries during the first nine months of 2010 included $1.0 million from a previous customer in the North Sea and $4.9 million from a previous customer in Egypt. No allowances were deemed necessary for the three-month and nine-month periods ended September 30, 2010.

Prepaid expenses and other current assets consist of the following:

	September 30, 2011	December 31, 2010
	(In thousands)	
Rig spare parts and supplies	$ 50,857	$ 50,288
Deferred mobilization costs	60,005	76,868
Prepaid insurance	20,409	9,587
Deferred tax assets	9,557	9,557
Deposits	1,574	827
Prepaid taxes	5,515	20,347
FOREX contracts	236	4,326
Other	9,236	5,353
Total	$ 157,389	$ 177,153