DIAMOND OFFSHORE DRILLING INC
Form 10-Q
October 30, 2007

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

(Mark One)

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

For the quarterly period ended September 30, 2007

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 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.

As of October 25, 2007 Common stock, $0.01 par value per share 138,820,382 shares

DIAMOND OFFSHORE DRILLING, INC.
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QUARTER ENDED SEPTEMBER 30, 2007

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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 per share data)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 304,627	$ 524,698
Marketable securities	375,394	301,159
Accounts receivable	545,249	567,474
Rig spare parts and supplies	51,215	48,801
Prepaid expenses and other	77,119	39,415
Total current assets	1,353,604	1,481,547
Drilling and other property and equipment, net of accumulated depreciation	2,864,997	2,628,453
Other assets	26,261	22,839
Total assets	$ 4,244,862	$ 4,132,839
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 9,420	$
Accounts payable	115,441	122,000
Accrued liabilities	168,115	184,978
Taxes payable	40,037	26,531
Total current liabilities	333,013	333,509
Long-term debt	503,011	964,310
Deferred tax liability	409,136	448,227
Other liabilities	103,623	67,285
Total liabilities	1,348,783	1,813,331
Commitments and contingencies (Note 8)		
Stockholders equity:		
Common stock (par value $0.01, 500,000,000 shares authorized, 143,631,625 shares issued and 138,714,825 shares outstanding at September 30, 2007; 134,133,776 shares issued and 129,216,976 shares outstanding at December 31, 2006)	1,436	1,341

Additional paid-in capital	1,823,946	1,299,846
Retained earnings	1,185,013	1,137,151
Accumulated other comprehensive gain (loss)	97	(4,417)
Treasury stock, at cost (4,916,800 shares at September 30, 2007 and December 31, 2006)	(114,413)	(114,413)
Total stockholders equity	2,896,079	2,319,508
Total liabilities and stockholders equity	$ 4,244,862	$ 4,132,839

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,	
	2007	2006	2007	2006
Revenues:				
Contract drilling	$ 628,246	$ 498,453	$ 1,854,085	$ 1,431,496
Revenues related to reimbursable expenses	15,716	16,003	46,936	42,878
Total revenues	643,962	514,456	1,901,021	1,474,374
Operating expenses:				
Contract drilling	282,100	224,883	719,833	599,271
Reimbursable expenses	13,584	13,982	40,226	37,083
Depreciation	57,565	49,757	171,605	148,858
General and administrative	13,105	9,959	37,245	29,786
(Gain) loss on disposition of assets	(363)	(272)	(5,418)	2,191
Total operating expenses	365,991	298,309	963,491	817,189
Operating income	277,971	216,147	937,530	657,185
Other income (expense):				
Interest income	8,735	10,037	26,127	26,843
Interest expense	(2,334)	(6,128)	(16,959)	(18,678)
Gain (loss) on sale of marketable securities, net	1,763	149	1,755	(53)
Other, net	2,112	2,842	2,517	6,608
Income before income tax expense	288,247	223,047	950,970	671,905
Income tax expense	(82,724)	(58,597)	(269,370)	(186,413)
Net income	$ 205,523	$ 164,450	$ 681,600	$ 485,492
Income per share:				
Basic	$ 1.48	$ 1.27	$ 4.96	$ 3.76
Diluted	$ 1.48	$ 1.19	$ 4.93	$ 3.52
Weighted-average shares outstanding:				

Shares of common stock	138,683	129,172	137,484	129,110
Dilutive potential shares of common stock	307	9,617	1,432	9,664
Total weighted-average shares outstanding	138,990	138,789	138,916	138,774

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

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DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)
(In thousands, except number of shares and per share data)

	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive Gain	Treasury Stock		Total Stockholders
	Shares	Amount	Capital	Earnings	(Loss)	Shares	Amount	Equity
January 1, 2007, before adoption of FIN 48	134,133,776	$1,341	$1,299,846	$1,137,151	$(4,417)	4,916,800	$(114,413)	$2,319,508
Cumulative effect of adopting FIN 48				(28,422)				(28,422)
January 1, 2007	134,133,776	1,341	1,299,846	1,108,729	(4,417)	4,916,800	(114,413)	2,291,086
Net income				681,600				681,600
Dividends to stockholders ($4.375 per share)				(605,316)				(605,316)
Conversion of long-term debt	9,210,809	92	453,799					453,891
Reversal of deferred tax liability related to imputed interest on converted debentures			52,104					52,104
Stock options exercised	287,040	3	9,470					9,473
Stock-based compensation, net			8,727					8,727
Gain on investments, net					(12)			(12)
Pension plan termination					4,526			4,526
	143,631,625	$1,436	$1,823,946	$1,185,013	$ 97	4,916,800	$(114,413)	$2,896,079

September 30, 2007

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,	
	2007	2006
Operating activities:		
Net income	$ 681,600	$ 485,492
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	171,605	148,858
(Gain) loss on disposition of assets	(5,418)	2,191
(Gain) loss on sale of marketable securities, net	(1,755)	53
Deferred tax provision	10,583	17,017
Accretion of discounts on marketable securities	(9,233)	(8,999)
Amortization/write-off of debt issuance costs	9,231	648
Amortization of debt discounts	178	309
Stock-based compensation expense	3,266	2,281
Excess tax benefits from stock-based payment arrangements	(4,280)	(1,156)
Deferred income, net	11,897	1,590
Deferred expenses, net	(20,229)	6,610
Other items, net	3,977	(1,143)
Changes in operating assets and liabilities:		
Accounts receivable	24,905	(91,135)
Rig spare parts and supplies and other current assets	(33,939)	(12,854)
Accounts payable and accrued liabilities	8,328	29,724
Taxes payable	22,777	(43,348)
Net cash provided by operating activities	873,493	536,138
Investing activities:		
Capital expenditures	(451,331)	(367,718)
Proceeds from disposition of assets, net of disposal costs	7,658	(349)
Proceeds from sale and maturities of marketable securities	2,314,111	1,638,092
Purchases of marketable securities	(2,377,377)	(1,727,185)
Proceeds from settlement of forward contracts	4,889	4,517
Net cash used by investing activities	(502,050)	(452,643)
Financing activities:		
Payment of quarterly and special dividends	(605,316)	(242,006)
Proceeds from stock options exercised	9,522	2,944
Excess tax benefits from stock-based payment arrangements	4,280	1,156
Net cash used by financing activities	(591,514)	(237,906)

Net change in cash and cash equivalents	(220,071)	(154,411)
Cash and cash equivalents, beginning of period	524,698	842,590
Cash and cash equivalents, end of period	$ 304,627	$ 688,179

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

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, 2006 (File No. 1-13926).

As of October 25, 2007, Loews Corporation, or Loews, owned 50.5% 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, or SEC. 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.

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.

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 gains (losses) 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).

Derivative Financial Instruments

Our derivative financial instruments include foreign currency forward exchange contracts and a contingent interest provision that is embedded in our 1.5% Convertible Senior Debentures Due 2031, or 1.5% Debentures, issued on April 11, 2001. See Note 4.

Supplementary Cash Flow Information

We paid interest on long-term debt totaling $25.2 million and $29.1 million for the nine months ended September 30, 2007 and 2006, respectively.

We paid $224.0 million and $199.4 million in U.S. income taxes during the nine months ended September 30, 2007 and 2006, respectively. We received refunds of $11.4 million in U.S. income taxes during the nine months ended September 30, 2006. We paid $27.5 million and $5.2 million in foreign income taxes, net of foreign tax refunds, during the nine months ended September 30, 2007 and 2006, respectively.

We recorded income tax benefits of $5.5 million and $1.6 million related to employee stock plan exercises during the first nine months of 2007 and 2006, respectively.

During the nine months ended September 30, 2007 and 2006, the holders of $450.5 million and $20,000, respectively, in aggregate principal amount of our 1.5% Debentures elected to convert their outstanding debentures into shares of our common stock.

During the nine months ended September 30, 2007 and 2006, the holders of $1.5 million and $12.1 million accreted, or carrying, value through the date of conversion, respectively, of our Zero Coupon Convertible Debentures due 2020, or Zero Coupon Debentures, elected to convert their outstanding debentures into shares of our common stock. The aggregate principal amount at maturity of our Zero Coupon Debentures converted during the nine months ended September 30, 2007 and 2006 was $2.4 million and $19.9 million, respectively.. See Note 7.

Capitalized Interest

We capitalize interest cost for the construction and upgrade of qualifying assets. In April 2005 and July 2006, we began capitalizing interest on expenditures related to the upgrades of the *Ocean Endeavor* and the *Ocean Monarch*, respectively, for ultra-deepwater service. We ceased capitalizing interest related to the *Ocean Endeavor* upon completion of the upgrade in March 2007. In December 2005 and January 2006, we began capitalizing interest on expenditures related to the construction of our two jack-up rigs, the *Ocean Scepter* and *Ocean Shield*, respectively.

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,**	
	2007	**2006**	**2007**	**2006**
	(In thousands)			
Total interest cost including amortization of debt issuance costs	$ 6,943	$ 8,895	$ 30,083	$25,577
Capitalized interest	(4,609)	(2,767)	(13,124)	(6,899)
Total interest expense as reported	$ 2,334	$ 6,128	$ 16,959	$18,678

Debt Issuance Costs

Debt issuance costs are included in our Consolidated Balance Sheets in Prepaid expenses and other and Other assets, depending on the maturity of the associated debt, and are amortized over the respective terms of the related debt. Interest expense for the nine months ended September 30, 2007 includes $8.9 million in debt issuance costs that we wrote-off in connection with the conversions of our 1.5% Debentures and Zero Coupon Debentures into shares of our common stock during the nine months ended September 30, 2007. See *Supplementary Cash Flow Information* and Note 7.

Treasury Stock

Depending on market conditions, we may, from time to time, purchase shares of our common stock in the open market or otherwise. We account for the purchase of treasury stock using the cost method, which reports the cost of the shares acquired in Treasury stock as a deduction from stockholders equity in our Consolidated Balance Sheets. We did not repurchase any shares of our outstanding common stock during the nine months ended September 30, 2007 or 2006.

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Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(In thousands)			
Net income	$205,523	$164,450	$681,600	$485,492
Other comprehensive gains (losses), net of tax:				
Pension adjustment upon plan termination			4,526	
Unrealized holding gain on investments	94	80	179	118
Reclassification adjustment for gain included in net income			(191)	(62)
Comprehensive income	$205,617	$164,530	$686,114	$485,548

The tax related to the change in unrealized holding gains on investments was approximately $50,000 and $43,000 for the quarters ended September 30, 2007 and 2006, respectively.

The tax related to the pension adjustment upon plan termination for the nine months ended September 30, 2007 was $2.4 million. The tax related to the change in unrealized holding gain on investments was approximately $96,000 and $64,000 for the nine months ended September 30, 2007 and 2006, respectively. The tax effect on the reclassification adjustment for net gains included in net income was approximately $103,000 and $33,000 for the nine months ended September 30, 2007 and 2006, respectively.

Currency Translation

Our functional currency is the U.S. dollar. Currency translation adjustments and transaction gains and losses, including gains and losses from the settlement of foreign currency forward exchange contracts, are reported as Other income (expense) in our Consolidated Statements of Operations. For the three and nine months ended September 30, 2007, we recognized net foreign currency exchange gains of $2.1 million and $2.4 million, respectively. For the three and nine months ended September 30, 2006, we recognized net foreign currency exchange gains of $3.1 million and $7.2 million, respectively. See Note 4.

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 estimated 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 two 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 currently.

From time to time, we may receive fees from our customers for capital improvements to our rigs. 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.

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Stock-Based Compensation

Our Second Amended and Restated 2000 Stock Option Plan, as amended, or Stock Plan, provides for the issuance of either incentive stock options or non-qualified stock options to our employees, consultants and non-employee directors. Our Stock Plan also authorizes the award of stock appreciation rights, or SARs, in tandem with stock options or separately. Effective January 1, 2006, we adopted the Financial Accounting Standards Board, or FASB, revised Statement of Financial Accounting Standards, or SFAS, No. 123, Accounting for Stock-Based Compensation, or SFAS 123 (R), which requires that compensation cost related to share-based payment transactions be recognized in our financial statements. As a result of adopting SFAS 123 (R), Operating income and Income before income tax for the three and nine months ended September 30, 2007 were reduced by $1.3 million and $3.3 million, respectively. Reductions in Operating income and Income before income tax, as a consequence of the adoption of SFAS 123 (R), for the three and nine months ended September 30, 2006 were $0.8 million and $2.3 million, respectively.

During the three months ended September 30, 2007, we began using the Black Scholes model to value SARs that were granted during the period. We had previously used the Binomial Option pricing model to value stock options and SARs. The change in valuation technique was necessitated by our decision to change our stock option administrator. There was no material impact to our consolidated results of operations, financial position or cash flows as a result of the change in valuation techniques.

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.

Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, or SFAS 159, which provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. GAAP has required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The objective of SFAS 159 is to help mitigate this type of volatility in the earnings by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with complex hedge accounting provisions. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We have completed our evaluation of the impact of applying SFAS 159 on our financial statements and have determined that the adoption of SFAS 159 will not have a material impact on our consolidated results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, or SFAS 157, which establishes a separate framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS 157 was issued to eliminate the diversity in practice that exists due to the different definitions of fair value and the limited guidance for applying those definitions in GAAP that are dispersed among the many accounting pronouncements that require fair value measurements. SFAS 157 does not require any new fair value measurements; however, its adoption may result in changes to current practice. Changes resulting from the application of SFAS 157 relate to the definition of fair value, the methods used to measure fair value and the expanded disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, rather than an entity-specific measurement. It also establishes a fair value hierarchy that distinguishes between (i) market participant assumptions developed based on market data obtained from independent sources and (ii) the reporting entity s own assumptions about market participant assumptions developed based on the best information available under the circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, including interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting

entity has not yet issued financial statements for that fiscal year, including interim periods. We have completed our

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evaluation of the impact of applying SFAS 157 on our financial statements and have determined that the adoption of SFAS 157 will not have a material impact on our consolidated results of operations, financial position or cash flows.

2. Earnings Per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
	(In thousands, except per share data)			
Net income basic (numerator):	$205,523	$164,450	$681,600	$485,492
Effect of dilutive potential shares				
1.5% Debentures	8	778	3,388	2,532
Zero Coupon Debentures	6	27	45	203
Net income including conversions diluted (numerator)	$205,537	$165,255	$685,033	$488,227
Weighted average shares basic (denominator):	138,683	129,172	137,484	129,110
Effect of dilutive potential shares				
1.5% Debentures	194	9,383	1,320	9,383
Zero Coupon Debentures	52	94	55	128
Stock options and SARs	61	140	57	153
Weighted average shares including conversions diluted (denominator)	138,990	138,789	138,916	138,774
Earnings per share:				
Basic	$ 1.48	$ 1.27	$ 4.96	$ 3.76
Diluted	$ 1.48	$ 1.19	$ 4.93	$ 3.52

Our computations of diluted earnings per share, or EPS, for the three months ended September 30, 2007 exclude 172,494 SARs. Our computations of diluted EPS for the nine months ended September 30, 2007 exclude stock options representing 30,666 shares of common stock and 171,878 SARs. The inclusion of such potentially dilutive shares in the computations of diluted EPS would have been antidilutive for the periods presented.

Our computations of diluted EPS for the three months ended September 30, 2006 exclude stock options representing 79,708 shares of common stock and 78,750 SARs. Our computations of diluted EPS for the nine months ended September 30, 2006 exclude stock options representing 67,606 shares of common stock and 35,769 SARs. The inclusion of such potentially dilutive shares in the computations of diluted EPS would have been antidilutive for the periods presented.

3. 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.

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

	September 30, 2007		
	Amortized Cost	Unrealized Gain (Loss)	Market Value
		(In thousands)	
Debt securities issued by the U.S. Treasury and other U.S. government agencies:			
Due within one year	$373,819	$ 139	$373,958
Mortgage-backed securities	1,426	10	1,436
Total	$375,245	$ 149	$375,394

	December 31, 2006		
	Amortized Cost	Unrealized Gain (Loss)	Market Value
		(In thousands)	
Debt securities issued by the U.S. Treasury and other U.S. government agencies:			
Due within one year	$299,252	$ 170	$299,422
Mortgage-backed securities	1,740	(3)	1,737
Total	$300,992	$ 167	$301,159

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(In thousands)			
Proceeds from sales	$992,392	$296,303	$1,689,111	$888,092
Proceeds from maturities	175,000	400,000	625,000	750,000
Gross realized gains	1,768	157	1,810	162
Gross realized losses	(5)	(8)	(55)	(215)

4. Derivative Financial Instruments

Foreign Currency Forward Exchange Contracts

Our international operations expose us to foreign exchange risk, primarily associated with our costs payable in foreign currencies, primarily for employee compensation and purchases from foreign suppliers. We utilize foreign exchange forward contracts to reduce our forward exchange risk. A foreign currency forward exchange contract obligates a contract holder to exchange predetermined amounts of specified foreign currencies at specified foreign exchange rates on specified dates.

During the three and nine months ended September 30, 2007, we settled several of our obligations under various foreign currency forward exchange contracts, which resulted in net realized gains totaling $1.4 million and $4.9 million, respectively. We realized net gains totaling $2.5 million and $4.5 million during the three and nine months ended September 30, 2006, respectively, upon settlement of foreign currency forward exchange contracts during the periods. As of September 30, 2007, we had foreign currency forward exchange contracts outstanding, which aggregated $36.6 million, that require us to purchase the equivalent of $11.0 million in Australian dollars, $8.7 million in Brazilian reais, $5.0 million in British pounds sterling, $6.3 million in Mexican pesos and $5.6 million in Norwegian kroner at various times through January 2008.

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These forward contracts are derivatives as defined by SFAS No. 133, Accounting for Derivatives and Hedging Activities, or SFAS 133. SFAS 133 requires that each derivative be 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 hedge accounting, the gains and losses are reflected in income in the same period as offsetting losses and gains on the qualifying hedged positions. The forward contracts that we entered into in 2005 through 2007 did not qualify for hedge accounting. In accordance with SFAS 133, we recorded net pre-tax unrealized gains of $0.6 million and $2.6 million in our Consolidated Statements of Operations for the three and nine months ended September 30, 2007, respectively, as Other income (expense) to adjust the carrying value of these derivative financial instruments to their fair value. We recorded net pre-tax unrealized gains of $1.0 million and $3.6 million for the three and nine months ended September 30, 2006, respectively, as Other income (expense) to adjust the carrying value of these derivative financial instruments to their fair value at September 30, 2006. We have presented the $2.6 million fair value of these foreign currency forward exchange contracts at both September 30, 2007 and December 31, 2006 as Prepaid expenses and other in our Consolidated Balance Sheets.

Contingent Interest

Our 1.5% Debentures, of which $9.4 million aggregate principal amount were outstanding as of September 30, 2007, contain a contingent interest provision. The contingent interest component is an embedded derivative as defined by SFAS 133 and accordingly must be split from the host instrument and recorded at fair value on the balance sheet. The contingent interest component had no value at issuance, at December 31, 2006 or at September 30, 2007.

5. Drilling and Other Property and Equipment

Cost and accumulated depreciation of drilling and other property and equipment are summarized as follows:

	September 30, 2007	December 31, 2006
	(In thousands)	
Drilling rigs and equipment	$ 4,379,526	$ 3,896,585
Construction work-in-progress	381,098	459,824
Land and buildings	18,936	17,353
Office equipment and other	29,483	27,132
Cost	4,809,043	4,400,894
Less: accumulated depreciation	(1,944,046)	(1,772,441)
Drilling and other property and equipment, net	$ 2,864,997	$ 2,628,453

Construction work-in-progress at September 30, 2007 consisted of $139.5 million related to the major upgrade of the *Ocean Monarch* to ultra-deepwater service and $241.6 million related to the construction of two new jack-up drilling units, the *Ocean Scepter* and the *Ocean Shield*. We anticipate delivery of the *Ocean Shield* and *Ocean Scepter* late in the first quarter of 2008 and during the second quarter of 2008, respectively. We expect the upgrade of the *Ocean Monarch* to be completed in late 2008.

The *Ocean Endeavor* arrived in the U.S. Gulf of Mexico late in the second quarter of 2007 and commenced drilling operations in early July 2007. Consequently, we transferred $249.6 million in construction work-in-progress to drilling rigs and equipment in the second quarter of 2007.

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6. Accrued Liabilities

Accrued liabilities consist of the following:

	September 30, 2007	December 31, 2006
	(In thousands)	
Payroll and benefits	$ 55,234	$ 42,496
Accrued project/upgrade costs	53,713	67,308
Deferred revenue	20,170	13,887
Personal injury and other claims	8,547	9,934
Interest payable	4,204	11,823
Hurricane related expenses and deferred gains	1,380	8,328
Other	24,867	31,202
Total	$168,115	$184,978

7. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2007	December 31, 2006
	(In thousands)	
Zero Coupon Debentures (due 2020)	$ 3,897	$ 5,302
1.5% Debentures (due 2031)	9,420	459,967
5.15% Senior Notes (due 2014)	249,552	249,513
4.875% Senior Notes (due 2015)	249,562	249,528
	512,431	964,310
Less: Current maturities	9,420	
Total	$503,011	$964,310

Certain of our long-term debt payments may be accelerated due to certain rights that the holders of our debt securities have to put the securities to us. The holders of our outstanding 1.5% Debentures have the right to require us to purchase all or a portion of their outstanding debentures on April 15, 2008 at a price equal to 100% of the principal amount of the debentures to be repurchased plus accrued and unpaid interest to such date. In addition, the holders of our Zero Coupon Debentures have the right to require us to purchase all or a portion of their outstanding debentures on June 6, 2010 at a price equal to $706.82 per $1,000 principal amount at maturity of the debentures.

The aggregate maturities of long-term debt for each of the five years subsequent to September 30, 2007 are as follows:

(In thousands)	
2007	$
2008	9,420
2009	
2010	3,897

2011	
Thereafter	499,114
	512,431
Less: Current maturities	9,420
Total	$503,011

Debt Conversions. During the first nine months of 2007, the holders of $450.5 million in aggregate principal amount of our 1.5% Debentures and the holders of $1.5 million accreted, or carrying, value through the date of conversion of our Zero Coupon Debentures elected to convert their outstanding debentures into shares of our common stock. We issued 9,210,809 shares of our common stock pursuant to these conversions during the first nine

months of 2007. The aggregate principal amount at maturity of our Zero Coupon Debentures converted during the nine months ended September 30, 2007 was $2.4 million.

At September 30, 2007, there was $6.0 million aggregate principal amount at maturity ($3.9 million accreted, or carrying, value) of our Zero Coupon Debentures outstanding.

As a result of the conversions of our 1.5% Debentures, we reversed a $52.1 million non-current deferred tax liability during the first nine months of 2007 related to interest expense imputed on these debentures for U.S. federal income tax return purposes. See Note 10.

8. Commitments and Contingencies

Various claims have been filed against us in the ordinary course of business, including claims by offshore workers alleging personal injuries. In accordance with SFAS No. 5, Accounting for Contingencies, or SFAS 5, we have assessed each claim or exposure to determine the likelihood that the resolution of the matter might ultimately result in an adverse effect on our financial condition, results of operations or cash flows. When we determine that an unfavorable resolution of a matter is probable and such amount of loss can be determined, we record a reserve for the estimated loss at the time that both of these criteria are met. Our management believes that we have established adequate reserves for any liabilities that may reasonably be expected to result from these claims.

Litigation. We are a defendant in a lawsuit filed in January 2005 in the U.S. District Court for the Eastern District of Louisiana on behalf of Total E&P USA, Inc. and several oil companies alleging that our semisubmersible rig, the *Ocean America*, damaged a natural gas pipeline in the Gulf of Mexico during Hurricane Ivan in 2004. The plaintiffs seek damages from us including, but not limited to, loss of revenue, that are currently estimated to be in excess of $100 million, together with interest, attorneys fees and costs. We deny any liability for plaintiffs alleged loss and do not believe that ultimate liability, if any, resulting from this litigation will have a material adverse effect on our financial condition, results of operations or cash flows. In addition, we have given notice of the claim to our insurance underwriters. Our deductible for this type of claim is $2.0 million.

We are one of several unrelated defendants in a lawsuit filed in the Circuit Courts of the State of Mississippi alleging that defendants manufactured, distributed or utilized drilling mud containing asbestos and, in our case, allowed such drilling mud to have been utilized aboard our offshore drilling rigs. The plaintiffs seek, among other things, an award of unspecified compensatory and punitive damages. We expect to receive complete defense and indemnity from Murphy Exploration & Production Company pursuant to the terms of our 1992 asset purchase agreement with them. We are unable to estimate our potential exposure, if any, to these lawsuits at this time but do not believe that ultimate liability, if any, resulting from this litigation will have a material adverse effect on our financial condition, results of operations or cash flows.

Various other claims have been filed against us in the ordinary course of business. In the opinion of our management, no pending or known threatened claims, actions or proceedings against us are expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Other. Our operations in Brazil have exposed us to various claims and assessments related to our personnel, customs duties and municipal taxes, among other things, that have arisen in the ordinary course of business. During the second quarter of 2007, we reviewed our estimated reserve for personnel taxes in Brazil based on current facts and circumstances and adjusted our estimated reserve in accordance with SFAS 5. Accordingly, we recorded a $6.5 million reduction in Contract drilling expense in our Consolidated Statements of Operations in the second quarter of 2007 as a result of our change in estimate. At September 30, 2007, our reserves related to our Brazilian operations aggregated $8.4 million, of which $2.0 million and $6.4 million were recorded in Accrued liabilities and Other liabilities, respectively, in our Consolidated Balance Sheets. Reserves related to our Brazilian operations totaled $14.2 million at December 31, 2006, of which $0.5 million was recorded in Accrued liabilities and $13.7 million was recorded in Other liabilities in our Consolidated Balance Sheets.

Personal Injury Claims. Our deductible for liability coverage for personal injury claims, which primarily results from Jones Act liability in the Gulf of Mexico, is $5.0 million per occurrence, with no aggregate deductible. We engage experts to assist us in estimating our aggregate reserve for personal injury claims based on our historical losses and utilizing various actuarial models. At September 30, 2007, our estimated liability for personal injury claims was $36.4 million, of which $8.6 million and $27.8 million were recorded in Accrued liabilities and Other liabilities,

respectively, in our Consolidated Balance Sheets. At December 31, 2006, we had recorded loss reserves for personal injury claims aggregating $35.0 million, of which $9.9 million and $25.1 million were recorded in

Accrued liabilities and Other liabilities, respectively, in our Consolidated Balance Sheets. The eventual settlement or adjudication of these claims could differ materially from our estimated amounts due to uncertainties such as:

- the severity of personal injuries claimed;
- significant changes in the volume of personal injury claims;
- the unpredictability of legal jurisdictions where the claims will ultimately be litigated;
- inconsistent court decisions; and
- the risks and lack of predictability inherent in personal injury litigation.

Purchase Obligations. As of September 30, 2007, we had purchase obligations aggregating approximately $243 million related to the major upgrade of the *Ocean Monarch* and construction of two new jack-up rigs, the *Ocean Scepter* and *Ocean Shield*. We anticipate that expenditures related to these shipyard projects will be approximately $50 million and $193 million for the remainder of 2007 and in 2008, respectively. However, the actual timing of these expenditures will vary based on the completion of various construction milestones and the timing of the delivery of equipment, which are beyond our control.

We had no other purchase obligations for major rig upgrades or any other significant purchase obligations at September 30, 2007, except for those related to our direct rig operations, which arise during the normal course of business.

9. Segments and Geographic Area Analysis

We manage our business on the basis of one reportable segment, contract drilling of offshore oil and gas wells. Although we provide contract drilling services from different types of offshore drilling rigs and also provide such services in many geographic locations, we have aggregated these operations into one reportable segment based on the similarity of economic characteristics among all divisions and locations, including the nature of services provided and the type of customers for such services.

Revenues from contract drilling services by equipment-type are listed below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(In thousands)			
High-Specification Floaters	$258,679	$191,786	$ 769,087	$ 545,702
Intermediate Semisubmersibles	255,795	189,521	725,753	562,324
Jack-ups	113,772	117,146	359,245	323,470
Total contract drilling revenues	628,246	498,453	1,854,085	1,431,496
Revenues related to reimbursable expenses	15,716	16,003	46,936	42,878
Total revenues	$643,962	$514,456	$1,901,021	$1,474,374

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Geographic Areas

At September 30, 2007, our drilling rigs were located offshore twelve countries in addition to the United States. As a result, we are exposed to the risk of changes in social, political and economic conditions inherent in foreign operations and our results of operations and the value of our foreign assets are affected by fluctuations in foreign currency exchange rates. Revenues by geographic area are presented by attributing revenues to the individual country or areas where the services were performed.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(In thousands)			
United States	$315,626	$293,094	$1,004,376	$ 838,180
Foreign:				
Europe/Africa/Mediterranean	126,741	61,206	346,485	176,334
Australia/Asia/Middle East	110,610	92,280	292,352	246,498
South America	61,174	48,869	165,912	151,010
Mexico	29,811	19,007	91,896	62,352
Total revenues	$643,962	$514,456	$1,901,021	$1,474,374

10. Income Taxes

Our net income tax expense or benefit is a function of the mix between our domestic and international pre-tax earnings or losses, respectively, as well as the mix of international tax jurisdictions in which we operate. Certain of our international rigs are owned or operated, directly or indirectly, by Diamond Offshore International Limited, a Cayman Islands company which is one of our wholly owned subsidiaries. Earnings from this subsidiary are reinvested internationally and remittance to the U.S. is indefinitely postponed. Consequently, no U.S. tax expense or benefits were recognized on these earnings or losses in 2007 or 2006.

We recognized income tax expense of $82.7 million on pre-tax income of $288.2 million during the three months ended September 30, 2007 compared to income tax expense of $58.6 million on pre-tax income of $223.0 million for the three months ended September 30, 2006. Our estimated annual effective tax rate was 27.9% as of September 30, 2007 and 28.1% as of September 30, 2006. Income tax expense for the three months ended September 30, 2007 also included expense of $4.4 million related to 2006 return to provision adjustments.

We recognized income tax expense of $269.4 million on pre-tax income of $951.0 million during the nine months ended September 30, 2007 compared to income tax expense of $186.4 million on pre-tax income of $671.9 million for the same period in 2006. Income tax expense for the nine months ended September 30, 2007 also included expense of $4.4 million related to 2006 return to provision adjustments. Income tax expense for the nine months ended September 30, 2006 was reduced by 2005 return to provision adjustments of $2.2 million.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or FIN 48, on January 1, 2007. As a result of the implementation of FIN 48, we recognized a long-term tax receivable of $2.6 million and a long-term tax liability of $31.1 million for uncertain tax positions, the net of which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	Long term Tax Receivable	Long term Tax Payable	Net Liability for Uncertain Tax Positions

			(In thousands)		
Balance at January 1, 2007	$ 2,642	$	(31,064)	$	(28,422)
Additions based on tax positions related to the current year	373		(4,181)		(3,808)
Balance at September 30, 2007	$ 3,015	$	(35,245)	$	(32,230)

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At September 30, 2007 all $32.2 million of the net unrecognized tax benefits would affect the effective tax rate if recognized.

We record interest related to accrued unrecognized tax benefits in interest expense and recognize penalties associated with uncertain tax positions in our tax expense. During the three and nine months ended September 30, 2007, we recognized $0.2 million and $1.1 million of interest expense related to uncertain tax positions, respectively. Penalty related tax expense for uncertain tax positions during the three and nine months ended September 30, 2007 was $0.2 million and $0.4 million, respectively. At September 30, 2007, we had $13.3 million accrued for the payment of interest and penalties in our Consolidated Balance Sheets.

In several of the international locations in which we operate, certain of our wholly owned subsidiaries enter into agreements with other of our wholly owned subsidiaries to provide specialized services and equipment in support of our foreign operations. We apply a transfer pricing methodology to determine the amount to be charged for providing the services and equipment. In most cases, there are alternative transfer pricing methodologies that could be applied to these transactions and, if applied, could result in different chargeable amounts. Taxing authorities in the various foreign locations in which we operate could apply one of the alternative transfer pricing methodologies that could result in an increase to our income tax liabilities with respect to tax returns that remain subject to examination.

We file income tax returns in the U.S. federal jurisdiction, various state jurisdictions and various foreign jurisdictions. Tax years that remain subject to examination by these jurisdictions include years 2000 to 2006. We are currently under audit in several of these jurisdictions including an audit by the Internal Revenue Service of years 2004 and 2005.

The Brazilian tax authorities are auditing our income tax returns for the periods 2000 to 2005. We have received an initial audit report for tax year 2000 disallowing various deductions claimed in the tax return. The tax auditors have issued an assessment for tax year 2000 of approximately $1.5 million, including interest and penalty. We have appealed the tax assessment and are awaiting the outcome of the appeal. We do not anticipate that any adjustments resulting from the tax audit will have a material impact on our consolidated results of operations, financial position or cash flows.

During the nine months ended September 30, 2007, the holders of certain of our debentures elected to convert them into shares of our common stock. (See Note 7.) As a result of the conversions of our 1.5% Debentures, we reversed a non-current deferred tax liability of $52.1 million which was accounted for as an increase to Additional paid-in capital. The reversal related to interest expense imputed on these debentures for U.S. federal income tax return purposes.

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11. Pension Plan

The defined benefit pension plan established by Arethusa (Off-Shore) Limited, or Arethusa, effective October 1, 1992 was frozen on April 30, 1996. At that date all participants were deemed fully vested in the plan, which covered substantially all U.S. citizens and U.S. permanent residents who were employed by Arethusa.

We obtained Pension Benefit Guarantee Corporation approval to terminate the plan in the second quarter of 2007 and have entered into an irrevocable contract with an insurance company to transfer the responsibility for making payments of plan benefits to the insurance company. Thus, we no longer have any liability for benefits to participants under the plan. As a result of terminating the plan, we recorded a one-time settlement expense of approximately $4 million during the nine months ended September 30, 2007 in Contract drilling expense in our Consolidated Statements of Operations.

Components of net periodic benefit costs recorded during the periods were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(In thousands)			
Interest cost	$	$ 263	$ 692	$ 789
Expected return on plan assets		(340)	(625)	(1,020)
Amortization of unrecognized loss		76	171	228
Net periodic pension expense	$	$ (1)	$ 238	$ (3)

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

The following discussion should be read in conjunction with our unaudited consolidated financial statements (including the notes thereto) included elsewhere in this report and our audited consolidated financial statements and the notes thereto, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 1A, Risk Factors included in our Annual Report on Form 10-K for the year ended December 31, 2006 and Item 1A, Risk Factors included in our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007. References to Diamond Offshore, we, us or our mean Diamond Offshore Drilling, Inc., a Delaware corporation, and its subsidiaries.

We are a leader in deep water drilling with a fleet of 44 offshore drilling rigs. Our fleet currently consists of 30 semisubmersibles, 13 jack-ups and one drillship. In addition, we have two jack-up drilling units on order at shipyards in Brownsville, Texas (*Ocean Scepter*) and Singapore (*Ocean Shield*). We expect delivery of the *Ocean Shield* and the *Ocean Scepter* during the first and second quarters of 2008, respectively.

Overview

Industry Conditions

Worldwide demand for our mid-water (intermediate) and deepwater (high-specification) semisubmersible rigs remained strong during the third quarter of 2007. The jack-up market in the U.S. Gulf of Mexico, or GOM, however, continues to experience reduced demand, resulting in downward pricing pressure and some of our rigs being ready-stacked for a period of time between wells. Exclusive of the GOM jack-up market, which accounted for nine percent of our total revenue for the quarter ended September 30, 2007, solid fundamental market conditions remain in place for all classes of our offshore drilling rigs worldwide.

Gulf of Mexico. The *Ocean Worker* completed its contract with PEMEX Exploración Y Producción, or PEMEX, during the third quarter of 2007 and returned to the GOM for a five-year survey and preparation for six-month term work in Trinidad that is expected to begin in the fourth quarter of 2007. In addition, the *Ocean New Era* and the *Ocean Voyager* underwent five-year surveys and preparation for 2-1/2 year contracts in Mexico ending in early 2010. The *Ocean New Era* began operating in the Mexican sector of the Gulf of Mexico, or Mexican GOM, in late October 2007, and the *Ocean Voyager* is expected to commence drilling operations for PEMEX during the fourth quarter of 2007. The terms of the drilling contracts in Mexico with PEMEX expose us to greater risks than we normally assume, such as exposure to increased environmental liability and potential early termination.

In the GOM, the market for our high-specification semisubmersible equipment remains firm. One of our high-specification rigs is contracted for work in the GOM until the beginning of the second quarter of 2008, while the remaining seven rigs currently located in the GOM have contracts that extend into late 2008 and beyond, including one at a dayrate as high as $500,000 for future work. In many cases, these contracts also include unpriced option periods that have not yet been exercised or expired.

The dayrates for our four intermediate semisubmersibles currently located in the GOM have reached as high as $300,000 for a six-month contract beginning in the fourth quarter of 2007; however strong international demand offering significant term length has led us to contract three of these units for future work outside the GOM. As a result, we continue to view the deepwater and intermediate markets in the GOM as under-supplied and believe that the GOM semisubmersible market will remain strong during the remainder of 2007.

Our jack-up fleet in the GOM continued to experience lower utilization during the third quarter of 2007, compared to the second quarter of 2007, as three of our rigs were ready-stacked for a period of time during the third quarter of 2007, and dayrates declined slightly from those earned during the previous quarter. As of October 25, 2007, four of our eight jack-ups in the GOM were on contract. The international market for jack-ups remains strong, however, and as a result we mobilized the *Ocean King* to offshore Croatia during the third quarter of 2007 (see *Australia/Asia/Middle East/Mediterranean*). In addition, the *Ocean Columbia* received an approximately 18-month contract with PEMEX in the Mexican GOM for work that is expected to commence in the fourth quarter of 2007. The *Ocean Columbia* is currently in a shipyard in the GOM undergoing contract preparation activities. We believe that the current market environment for jack-up rigs in the GOM will persist at least through the fourth quarter of 2007.

Brazil. Two of our rigs currently operating offshore Brazil are working under term contracts that expire in 2009, and two additional rigs are operating under contracts expiring in 2010. The *Ocean Whittington* began work in

Brazil during the third quarter of 2007 under a contract expiring in 2012. Petróleo Brasileiro S.A., or Petrobras, is continuing to seek additional intermediate semisubmersible rigs. The *Ocean Concord* and the *Ocean Yorktown* are expected to begin work late in the fourth quarter of 2007 and in the second quarter of 2008, respectively. Under its contract the *Ocean Concord* can earn a variable performance bonus in addition to the dayrate for a maximum daily compensation in the mid-$250,000 range, excluding a lump-sum mobilization fee. The *Ocean Yorktown* can earn a variable performance bonus in addition to the dayrate for a maximum daily compensation in the high $260,000 range, excluding a lump-sum mobilization fee. However, we can provide no assurance that the maximum compensation specified in these contracts will actually be achieved. We expect the Brazilian semisubmersible market to remain strong during the remainder of 2007.

North Sea. Effective industry utilization remains at 100 percent in the North Sea where we have three semisubmersible rigs in the United Kingdom, or U.K., and one semisubmersible unit in Norway. Indicating the strength of this market, one of our four rigs in the North Sea is working under contract until the second quarter of 2009, and the other three rigs have term contracts that extend into 2010.

Australia/Asia/Middle East/Mediterranean. We currently have five semisubmersible rigs and one jack-up unit operating in the Australia/Asia market, and three jack-up rigs and one semisubmersible rig located in the Middle East/Mediterranean sector. The *Ocean Rover* has a two-year commitment at a dayrate in the low $450,000 range that will keep the high-specification floater in Malaysia for two additional years commencing in the first quarter of 2009. In the Australia market, the *Ocean Patriot* and the *Ocean Epoch* are committed to work offshore Australia until 2010. The *Ocean Patriot* has a two-year contract, plus an option, for work expected to begin in the fourth quarter of 2008 at a dayrate in a range between $380,000 and $420,000. Contract drilling backlog for the *Ocean Epoch* includes a one-year contract for work expected to begin in the first quarter of 2008 at a dayrate in a range between $330,000 and $365,000 and an 18-month contract, plus an option, for work beginning in early 2009 at a dayrate in the low $350,000 range. In the jack-up market, the *Ocean King* has been awarded a contract for a two-year bareboat charter in Croatia. Under the agreement, the rig will earn a dayrate in the high $100,000 range for work expected to commence in the fourth quarter of 2007. We believe that the Australia/Asia/Middle East and Mediterranean markets will remain strong during the remainder of 2007.

Contract Drilling Backlog

The following table reflects our contract drilling backlog as of October 25, 2007 and July 26, 2007 (the date reported in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2007) and reflects both firm commitments (typically represented by signed contracts), as well as letters of intent, or LOIs. An LOI is subject to customary conditions, including the execution of a definitive agreement. Contract drilling backlog is calculated by multiplying the contracted operating dayrate by the firm contract period and adding one-half of any potential rig performance bonuses. Our calculation also assumes full utilization of our drilling equipment for the contract period (excluding scheduled shipyard and survey days); however, the amount of actual revenue earned and the actual periods during which revenues are earned will be different than the amounts and periods shown in the tables below due to various factors. Utilization rates, which generally approach 95-98% during contracted periods, can be adversely impacted by downtime due to various operating factors including, but not limited to, weather conditions and unscheduled repairs and maintenance. Contract drilling backlog excludes revenues for mobilization, demobilization, contract preparation and customer reimbursables. Changes in our contract drilling backlog between periods is a function of both the performance of work on term contracts, as well as the extension or modification of existing term contracts and the execution of additional contracts.

	October 25, 2007	July 26, 2007
	(In thousands)	
Contract Drilling Backlog		
High-Specification Floaters	$ 3,657,000	$ 3,888,000
Intermediate Semisubmersibles	4,450,000	4,712,000
Jack-ups	432,000	452,000

Total	$ 8,539,000	$ 9,052,000

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The following table reflects the amount of our contract drilling backlog by year based on our firm commitments as of October 25, 2007.

	Total	For the Years Ending December 31, 2007[1]	2008	2009	2010 - 2013
		(In thousands)			
Contract Drilling Backlog					
High-Specification Floaters	$ 3,657,000	$ 250,000	$ 1,164,000	$ 950,000	$ 1,293,000
Intermediate Semisubmersibles	4,450,000	326,000	1,586,000	1,368,000	1,170,000
Jack-ups	432,000	82,000	266,000	84,000	
Total	$ 8,539,000	$ 658,000	$ 3,016,000	$ 2,402,000	$ 2,463,000

(1) Represents a three-month period beginning October 1, 2007.

The following table reflects the percentage of rig days committed by year as of October 25, 2007. The percentage of rig days committed is calculated as the ratio of total days committed under contracts and LOIs, as well as scheduled shipyard, survey and mobilization days for all rigs in our fleet to total available days (number of rigs multiplied by the number of days in a particular year). Total available days have been calculated based on the expected delivery dates for the *Ocean Monarch* and our two newbuild jack-up rigs, the *Ocean Scepter* and *Ocean Shield*.

	For the Years Ending December 31, 2007[1]	2008	2009	2010 - 2013
Rig Days Committed [2]				
High-Specification Floaters	100%	94%	63%	19%
Intermediate Semisubmersibles	100%	85%	70%	16%
Jack-ups	73%	32%	11%	

(1) Represents a three-month period beginning October 1, 2007.

(2) Includes approximately 696, 449 and 101 scheduled shipyard, survey and mobilization days for 2007,

2008 and 2009,
respectively.

General

Our revenues vary based on the number of days our fleet is utilized and the dayrates earned. Utlization and dayrates earned are a function of global and regional balance between supply of rigs and demand. When a rig is idle, no dayrate is earned and revenues will decrease as a result. Revenues can also be affected as a result of the acquisition or disposal of rigs, required surveys and shipyard upgrades. In order to improve utilization or realize higher dayrates, we may mobilize our rigs from one market to another. However, during periods of mobilization, revenues may be adversely affected. As a response to changes in the balance of supply and demand, we may withdraw a rig from the market by stacking it or may reactivate a rig stacked previously, which may decrease or increase revenues, respectively.

As utilization rates increase, dayrates tend to increase as well, reflecting the lower supply of available rigs, and vice versa. Demand for drilling services is dependent upon the level of expenditures set by oil and gas companies for offshore exploration and development, as well as a variety of political and economic factors. The availability of rigs in a particular geographical region also affects both dayrates and utilization rates. These factors are not within our control and are difficult to predict.

We recognize revenue from dayrate drilling contracts as services are performed. In connection with such drilling contracts, we may receive fees (either lump-sum or dayrate) for the mobilization of equipment. We earn these fees 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 estimated to be benefited from the mobilization activity). Straight-line amortization of mobilization revenues and related costs over the term of the related drilling contracts (which generally range from two 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 currently.

From time to time, we may receive fees from our customers for capital improvements to our rigs. We defer such fees and recognize them into income on a straight-line basis over the period of the related drilling contract as a component of contract drilling revenue. We capitalize the costs of such capital improvements and depreciate them over the estimated useful life of the improvement.

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We receive reimbursements 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. We record these reimbursements at the gross amount billed to the customer, as Revenues related to reimbursable expenses in our Consolidated Statements of Operations included in Item 1 of Part I of this report.

Operating Income. Our operating income is primarily affected by revenue factors, but is also a function of varying levels of operating expenses. Our operating expenses represent all direct and indirect costs associated with the operation and maintenance of our drilling equipment. The principal components of our operating costs are, among other things, direct and indirect costs of labor and benefits, repairs and maintenance, freight, regulatory inspections, boat and helicopter rentals and insurance. Labor and repair and maintenance costs represent the most significant components of our operating expenses. In general, our labor costs increase primarily due to higher salary levels, rig staffing requirements, and costs associated with labor regulations in the geographic regions in which our rigs operate. We have experienced and continue to experience upward pressure on salaries and wages as a result of the strengthening offshore drilling market and increased competition for skilled workers. In response to these market conditions we have implemented retention programs, including increases in compensation.

Costs to repair and maintain our equipment fluctuate depending upon the type of activity the drilling unit is performing, as well as the age and condition of the equipment and the regions in which our rigs are working..

Operating expenses generally are not affected by changes in dayrates, and short-term reductions in utilization do not necessarily result in lower operating expenses. For instance, if a rig is to be idle for a short period of time, few decreases in operating expenses may actually occur since the rig is typically maintained in a prepared or ready-stacked state with a full crew. In addition, when a rig is idle, we are responsible for certain operating expenses such as rig fuel and supply boat costs, which are typically costs of the operator when a rig is under contract. However, if the rig is to be idle for an extended period of time, we may reduce the size of a rig s crew and take steps to cold stack the rig, which lowers expenses and partially offsets the impact on operating income. We recognize, as incurred, operating expenses related to activities such as inspections, painting projects and routine overhauls that meet certain criteria and which maintain rather than upgrade our rigs. These expenses vary from period to period. Costs of rig enhancements are capitalized and depreciated over the expected useful lives of the enhancements. Higher depreciation expense decreases operating income in periods subsequent to capital upgrades.

Periods of high, sustained utilization may result in cost increases for maintenance and repairs in order to maintain our equipment in proper, working order. In addition, during periods of high activity and dayrates, higher prices generally pervade the entire offshore drilling industry and its support businesses, which cause our costs for goods and services to increase.

Our operating income is negatively impacted when we perform certain regulatory inspections, which we refer to as a 5-year survey, or special survey, that are due every five years for each of our rigs. Operating revenue decreases because these surveys are performed during scheduled downtime in a shipyard. Operating expenses increase as a result of these surveys due to the cost to mobilize the rigs to a shipyard, inspection costs incurred and repair and maintenance costs. Repair and maintenance costs may be required resulting from the survey or may have been previously planned to take place during this mandatory downtime. The number of rigs undergoing a 5-year survey will vary from year to year.

In addition, operating income may be negatively impacted by intermediate surveys, which are performed at interim periods between 5-year surveys. Intermediate surveys are generally less extensive in duration and scope than a 5-year survey. Although an intermediate survey may require some downtime for the drilling rig, it normally does not require dry-docking or shipyard time, except for our rigs located in the North Sea which require shipyard time.

Mobilization costs are a significant component of our survey-related costs. Mobilization, survey and maintenance costs incurred during the first three quarters of 2007 should not be taken as indicative of future quarterly costs for such activities.

Effective May 1, 2007, we renewed our principal insurance policies. For physical damage coverage, our deductible is $75.0 million per occurrence (or lower for some rigs if they are declared a constructive total loss). For physical damage due to named windstorms in the U.S. Gulf of Mexico, there is an annual aggregate limit of $125.0 million. If named windstorms in the U.S. Gulf of Mexico cause significant damage to our rigs or equipment, it

could have a material adverse effect on our financial position, results of operations or cash flows.

Construction and Capital Upgrade Projects. We capitalize interest cost for the construction and upgrade of qualifying assets in accordance with Statement of Financial Accounting Standards, or SFAS, No. 34, Capitalization of Interest Cost, or SFAS 34. During 2006 and 2005, we began capitalizing interest on our two capital upgrade projects and the construction of our two new jack-up rigs. Pursuant to SFAS 34, the period of interest capitalization covers the duration of the activities required to make the asset ready for its intended use, and the capitalization period ends when the asset is substantially complete and ready for its intended use. In 2006 we began capitalizing interest on expenditures related to the capital upgrade of the *Ocean Monarch* and the construction of our two jack-up rigs, and in 2005, we began capitalizing interest on expenditures related to the upgrade of the *Ocean Endeavor*. See Note 1 General Information *Capitalized Interest* to our consolidated financial statements included in Item 1 of Part I of this report.

The upgrade of the *Ocean Endeavor* has been completed and the rig arrived in the GOM late in the second quarter of 2007, where it is currently operating. We have capitalized interest costs related to this upgrade through the end of March 2007 and began depreciating the newly upgraded rig effective April 1, 2007. As a result of the completion of the upgrade of the *Ocean Endeavor*, we anticipate that depreciation and interest expense in 2007 will increase by approximately $6 million (representing nine months of expense) and $2.5 million, respectively.

Critical Accounting Estimates

Our significant accounting policies are discussed in Note 1 of our notes to consolidated financial statements included in Item 1 of Part I of this report and in Note 1 of our notes to audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. There were no material changes to these policies during the nine months ended September 30, 2007.

Results of Operations
Three Months Ended September 30, 2007 and 2006

Comparative data relating to our revenues and operating expenses by equipment type are listed below.

	Three Months Ended September 30,		Favorable/
	2007	2006	(Unfavorable)
	(In thousands)		
CONTRACT DRILLING REVENUE			
High-Specification Floater			