DIAMOND OFFSHORE DRILLING INC
Form 10-Q
July 29, 2008

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 June 30, 2008

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, a non-accelerated filer, or a smaller reporting company. See the 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 July 25, 2008	Common stock, $0.01 par value per share	139,001,050 shares

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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)

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 541,580	$ 637,961
Marketable securities	199,086	1,301
Accounts receivable	674,091	522,808
Prepaid expenses and other current assets	135,999	103,120
Total current assets	1,550,756	1,265,190
Drilling and other property and equipment, net of accumulated depreciation	3,278,724	3,040,063
Other assets	37,055	36,212
Total assets	$ 4,866,535	$ 4,341,465
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$	$ 3,563
Accounts payable	84,969	132,243
Payable for securities purchased	197,837	
Accrued liabilities	287,536	235,521
Taxes payable	52,527	81,684
Total current liabilities	622,869	453,011
Long-term debt	503,158	503,071
Deferred tax liability	419,894	397,629
Other liabilities	109,731	110,687
Total liabilities	1,655,652	1,464,398
Commitments and contingencies (Note 10)		
Stockholders equity:		
Common stock (par value $0.01, 500,000,000 shares authorized, 143,906,598 shares issued and 138,989,798 shares outstanding at June 30, 2008; 143,787,206 shares issued and 138,870,406 shares outstanding at December 31, 2007)	1,439	1,438

Additional paid-in capital	1,841,529	1,831,492
Retained earnings	1,482,295	1,158,535
Accumulated other comprehensive gain	33	15
Treasury stock, at cost (4,916,800 shares at June 30, 2008 and December 31, 2007)	(114,413)	(114,413)
Total stockholders equity	3,210,883	2,877,067
Total liabilities and stockholders equity	$ 4,866,535	$ 4,341,465

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenues:				
Contract drilling	$ 936,626	$ 635,927	$ 1,706,966	$ 1,225,839
Revenues related to reimbursable expenses	17,746	12,948	33,508	31,220
Total revenues	954,372	648,875	1,740,474	1,257,059
Operating expenses:				
Contract drilling	273,436	221,941	558,443	434,398
Reimbursable expenses	17,346	12,361	32,534	29,977
Depreciation	70,661	58,335	139,711	114,040
General and administrative	15,768	12,174	31,490	24,140
Gain on disposition of assets	(226)	(3,553)	(277)	(5,055)
Total operating expenses	376,985	301,258	761,901	597,500
Operating income	577,387	347,617	978,573	659,559
Other income (expense):				
Interest income	2,941	7,599	7,314	17,392
Interest expense	(1,895)	(3,770)	(3,237)	(14,625)
Loss on sale of marketable securities, net	(2)	(5)	(3)	(8)
Other, net	12,490	1,012	14,196	405
Income before income tax expense	590,921	352,453	996,843	662,723
Income tax expense	(174,638)	(100,526)	(289,935)	(186,646)
Net income	$ 416,283	$ 251,927	$ 706,908	$ 476,077
Income per share:				
Basic	$ 3.00	$ 1.82	$ 5.09	$ 3.48
Diluted	$ 2.99	$ 1.81	$ 5.08	$ 3.46
Weighted-average shares outstanding:				

Shares of common stock	138,959	138,447	138,916	136,875
Dilutive potential shares of common stock	124	481	152	2,004
Total weighted-average shares outstanding	139,083	138,928	139,068	138,879

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

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

	Six Months Ended June 30,	
	2008	**2007**
Operating activities:		
Net income	$ 706,908	$ 476,077
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	139,711	114,040
Gain on disposition of assets	(277)	(5,055)
Loss on sale of marketable securities, net	3	8
Deferred tax provision	22,762	4,845
Accretion of discounts on marketable securities	(838)	(4,702)
Amortization/write-off of debt issuance costs	304	9,115
Amortization of debt discounts	120	120
Stock-based compensation expense	3,209	1,921
Excess tax benefits from stock-based payment arrangements	(1,081)	(3,475)
Deferred income, net	2,113	5,025
Deferred expenses, net	(4,650)	(16,318)
Other items, net	(2,477)	4,403
Changes in operating assets and liabilities:		
Accounts receivable	(150,283)	61,593
Prepaid expenses and other current assets	(27,292)	(18,051)
Accounts payable and accrued liabilities	(69,927)	(72,959)
Taxes payable	(24,219)	27,365
Net cash provided by operating activities	594,086	583,952
Investing activities:		
Capital expenditures	(319,879)	(230,321)
Proceeds from disposition of assets, net of disposal costs	1,131	7,677
Proceeds from sale and maturities of marketable securities	650,022	1,146,719
Purchases of marketable securities	(649,107)	(842,597)
Proceeds from settlement of forward contracts	7,496	3,457
Net cash (used in) provided by investing activities	(310,337)	84,935
Financing activities:		
Payment of dividends	(382,648)	(587,980)
Proceeds from stock plan exercises	1,510	7,657
Excess tax benefits from stock-based payment arrangements	1,081	3,475
Redemption of 1.5% Debentures	(73)	
Net cash used in financing activities	(380,130)	(576,848)

Net change in cash and cash equivalents	(96,381)	92,039
Cash and cash equivalents, beginning of period	637,961	524,698
Cash and cash equivalents, end of period	$ 541,580	$ 616,737

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, 2007 (File No. 1-13926).

As of July 25, 2008, 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, 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. See Note 5.

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

At June 30, 2008, our derivative financial instruments included foreign currency forward exchange contracts. See Notes 4 and 5.

Supplementary Cash Flow Information

We paid interest on long-term debt totaling $12.6 million and $12.7 million for the six months ended June 30, 2008 and 2007, respectively.

We paid $235.0 million and $126.7 million in U.S. income taxes during the six months ended June 30, 2008 and 2007, respectively. We paid $62.1 million and $24.4 million in foreign income taxes, net of foreign tax refunds, during the six months ended June 30, 2008 and 2007, respectively.

Cash payments for capital expenditures for the six months ended June 30, 2008, included $43.0 million of capital expenditures that were accrued but unpaid at December 31, 2007. Cash payments for capital expenditures for the six months ended June 30, 2007 included $32.9 million of capital expenditures that were accrued but unpaid at December 31, 2006. Capital expenditures that were accrued but not paid as of June 30, 2008, totaled $101.3

million. We have included this amount in Accrued liabilities in our Consolidated Balance Sheets at June 30, 2008.

We recorded income tax benefits of $1.3 million and $4.4 million related to employee stock plan exercises during the six months ended June 30, 2008 and 2007, respectively.

During the six months ended June 30, 2008, the holders of $3.5 million in aggregate principal amount of our 1.5% Senior Convertible Debentures Due 2031, or 1.5% Debentures, and the holders of approximately $33,000 accreted, or carrying, value through the date of conversion of our Zero Coupon Convertible Debentures due 2020, or Zero Coupon Debentures, elected to convert their outstanding debentures into shares of our common stock. See Note 9.

During the six months ended June 30, 2007, the holders of $450.4 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.

Capitalized Interest

We capitalize interest cost for the construction and upgrade of qualifying assets. During the six months ended June 30, 2008 and 2007, we capitalized interest on qualifying expenditures related to the upgrade of the *Ocean Monarch* for ultra-deepwater service and the construction of our two jack-up rigs, the *Ocean Scepter* and the *Ocean Shield* (through its completion in May 2008). In addition, we capitalized interest costs on qualifying expenditures related to the upgrade of the *Ocean Endeavor* through completion of the upgrade in March 2007.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2008	**2007**	**2008**	**2007**
		(In thousands)		
Total interest cost including amortization of debt issuance costs	$ 7,186	$ 6,856	$ 14,052	$23,140
Capitalized interest	(5,291)	(3,086)	(10,815)	(8,515)
Total interest expense as reported	$ 1,895	$ 3,770	$ 3,237	$14,625

Debt Issuance Costs

Debt issuance costs are included in our Consolidated Balance Sheets in Prepaid expenses and other current assets 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 both the three and six months ended June 30, 2008 included $84,000, in debt issuance costs that we wrote-off in connection with the conversions and final redemption of our 1.5% Debentures and the conversions of our Zero Coupon Debentures into shares of our common stock during 2008. Interest expense for the three and six months ended June 30, 2007 included $48,000 and $8.9 million, respectively, in debt issuance costs that were written off in connection with conversions of our 1.5% Debentures and Zero Coupon Debentures during the respective periods of 2007.

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 six months ended June 30, 2008 or 2007.

Comprehensive Income

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
Net income	$416,283	$251,927	$706,908	$476,077
Other comprehensive gains (losses), net of tax:				
Pension adjustment upon plan termination		4,526		4,526
Unrealized holding (loss) gain on investments	9	(2)	18	85
Reclassification adjustment for gain included in net income		(80)		(191)
Comprehensive income	$416,292	$256,371	$706,926	$480,497

The tax related to the change in unrealized holding gains on investments was approximately $5,000 and $10,000 for the three and six months ended June 30, 2008, respectively.

The tax related to the change in unrealized holding loss on investments was approximately $1,000 for the three months ended June 30, 2007. The tax related to the change in unrealized holding gains on investments was approximately $46,000 for the six months ended June 30, 2007. The tax effect on the reclassification adjustment for net gains included in net income was $43,000 and $103,000 for the three and six months ended June 30, 2007, respectively. The tax related to the pension adjustment upon plan termination for the three and six months ended June 30, 2007 was $2.4 million.

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 six months ended June 30, 2008, we recognized net foreign currency exchange gains of $12.5 million and $14.4 million, respectively. For the three and six months ended June 30, 2007, we recognized net foreign currency exchange gains of $0.9 million and $0.3 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 as incurred.

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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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.

Previously reported amounts for Reimbursable expenses in our Consolidated Statements of Operations for the three and six months ended June 30, 2007 have been adjusted to include $1.8 million and $3.3 million, respectively, in reimbursable catering expense to conform to the current year presentation. These amounts were previously reported as Contract drilling expense in our Consolidated Statements of Operations. This reclassification had no effect on total operating expenses, operating income or net income for the three and six months ended June 30, 2007.

Recent Accounting Pronouncements

In May 2008, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 162, The Hierarchy of Generally Accepted Accounting Principles, or SFAS 162. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP (the GAAP hierarchy). The FASB does not expect SFAS 162 to result in a change in current practice, as the intent of SFAS 162 is to direct the GAAP hierarchy to the reporting entity (rather than its auditor) and to place the GAAP hierarchy within the accounting literature established by the FASB. This statement is effective 60 days following SEC approval of the Public Company Accounting Oversight Board Amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.

In May 2008, the FASB issued FASB Staff Position, or FSP, Accounting Principles Board, or APB, 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement), or FSP APB 14-1. FSP APB 14-1 applies to convertible debt instruments that, by their stated terms, may be settled in cash upon conversion (including partial cash settlement). The FSP requires bifurcation of the instrument into a debt component that is initially valued at fair value and an equity component. The debt component is accreted to par value using the effective yield method, and accretion is reported as a component of interest expense. The equity component is not subsequently revalued as long as it continues to qualify for equity treatment. FSP APB 14-1 is effective for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years on a retrospective basis for all periods presented. We are currently evaluating the impact that adopting FSP APB 14-1 will have on our results of operations and financial position.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, or SFAS 161. SFAS 161 changes the reporting requirements for derivative instruments and hedging activities under SFAS No. 133, Accounting for Derivatives and Hedging Activities, or SFAS 133, by requiring enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments are accounted for under SFAS 133 and (c) the effect of derivative instruments and hedging activities on an entity s financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008; however, early application is encouraged. We are in the process of reviewing the enhanced disclosure requirements under SFAS 161.

2. Earnings Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands, except per share data)			
Net income basic (numerator):	$416,283	$251,927	$706,908	$476,077
Effect of dilutive potential shares				
1.5% Debentures	10	31	11	3,829
Zero Coupon Debentures	5	12	8	38
Net income including conversions diluted (numerator)	$416,298	$251,970	$706,927	$479,944
Weighted average shares basic (denominator):	138,959	138,447	138,916	136,875
Effect of dilutive potential shares				
1.5% Debentures	5	381	38	1,893
Zero Coupon Debentures	52	52	52	56
Stock options/SARs	67	48	62	55
Weighted average shares including conversions - diluted (denominator)	139,083	138,928	139,068	138,879
Earnings per share:				
Basic	$ 3.00	$ 1.82	$ 5.09	$ 3.48
Diluted	$ 2.99	$ 1.81	$ 5.08	$ 3.46

Our computation of diluted earnings per share, or EPS, for the three and six months ended June 30, 2008 excludes 140,607 and 149,178 stock appreciation rights, or SARs, respectively. The inclusion of such potentially dilutive shares in the computation of diluted EPS would have been antidilutive for the periods presented.

Our computation of diluted EPS for the three months ended June 30, 2007 excludes stock options representing 25,278 shares of common stock and 188,342 SARs. Our computation of diluted EPS for the six months ended June 30, 2007 excludes stock options representing 46,253 shares of common stock and 171,564 SARs. The inclusion of such potentially dilutive shares in the computation 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. See Note 5.

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

	June 30, 2008		
	Amortized Cost	Unrealized Gain	Market Value
		(In thousands)	
Debt securities issued by the U.S. Treasury due within one year	$ 197,837	$ 18	$ 197,855
Mortgage-backed securities	1,199	32	1,231
Total	$ 199,036	$ 50	$ 199,086

	December 31, 2007		
	Amortized Cost	Unrealized Gain	Market Value
		(In thousands)	
Mortgage-backed securities	$ 1,277	$ 24	$ 1,301

Our investments at June 30, 2008 included $197.8 million in U.S. Treasury Bills purchased at month end that did not settle until July 2008. Accordingly, we have recorded a $197.8 million liability in our Consolidated Balance Sheets as a Payable for securities purchased relating to these investments.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
Proceeds from sales	$ 99,992	$ 132	$ 100,022	$ 696,719
Proceeds from maturities	250,000	250,000	550,000	450,000
Gross realized gains				42
Gross realized losses	(2)	(5)	(3)	(50)

4. Derivative Financial Instruments

Foreign Currency Forward Exchange Contracts

Our international operations expose us to foreign exchange risk associated with our costs payable in foreign currencies 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 foreign currencies on specified dates.

During the three and six months ended June 30, 2008, we settled several of our obligations under various foreign currency forward exchange contracts, which resulted in net realized gains totaling $6.7 million and $7.5 million, respectively. During the three and six months ended June 30, 2007, we recognized net realized gains of $1.0 million and $3.5 million, respectively, on settlement of foreign currency forward exchange contracts during the period. As of June 30, 2008, we had foreign currency forward exchange contracts outstanding, which aggregated $227.5 million, that require us to purchase the equivalent of $64.4 million in Australian dollars, $59.7 million in Brazilian reais, $72.6 million in British pounds sterling, $10.5 million in Mexican pesos and $20.3 million in Norwegian kroner at various times through January 2009. See Note 5.

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These forward contracts are derivatives as defined by 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. None of the forward contracts that we entered into qualified for hedge accounting. In accordance with SFAS 133, we recorded net pre-tax unrealized gains of $8.3 million and $9.5 million in our Consolidated Statements of Operations for the three and six months ended June 30, 2008, respectively, as Other income (expense) to adjust the carrying value of these derivative financial instruments to their fair value. We have presented the $9.6 million fair value of our outstanding foreign currency forward exchange contracts as Prepaid expenses and other current assets in our Consolidated Balance Sheets at June 30, 2008.

We recorded net pre-tax unrealized gains of $1.4 million and $2.0 million for the three and six months ended June 30, 2007, respectively, as Other income (expense) to adjust the carrying value of our derivative financial instruments held at June 30, 2007 to their fair value.

5. Fair Value Disclosures

Effective January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements, or SFAS 157, which requires additional disclosures about our assets and liabilities that are measured at fair value. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices for identical instruments in active markets. Level 1 assets include short-term investments such as money market funds and U.S. Treasury Bills. Our Level 1 assets at June 30, 2008 included cash held in money market funds of $528.0 million and investments in U.S. Treasury Bills of $197.8 million.

Level 2 Quoted market prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. Level 2 assets and liabilities include over-the-counter foreign currency forward exchange contracts that are valued using a model-derived valuation technique and mortgage-backed securities.

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. Level 3 assets and liabilities generally include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation or for which there is a lack of transparency as to the inputs used.

Assets measured at fair value on a recurring basis are summarized below:

	June 30, 2008			
	Fair Value Measurements Using			Assets at Fair value
	Level 1	Level 2	Level 3	
	(In thousands)			
Assets:				
Short-term investments	$725,824	$	$	$725,824
Mortgage-backed securities		1,231		1,231
Forward exchange contracts		9,563		9,563

Total assets	$725,824	$10,794	$	$736,618

6. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following:

	June 30, 2008	December 31, 2007
	(In thousands)	
Rig spare parts and supplies	$ 50,599	$ 50,699
Deferred mobilization costs	22,807	17,295
Prepaid insurance	24,035	11,444
Deferred tax assets	9,006	9,006
Vendor prepayments	8,093	7,296
Deposits	5,012	2,292
Prepaid taxes	2,616	1,681
Forward exchange contracts	9,563	2
Other	4,268	3,405
Total	$135,999	$103,120

7. Drilling and Other Property and Equipment

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

	June 30, 2008	December 31, 2007
	(In thousands)	
Drilling rigs and equipment	$ 4,932,364	$ 4,540,797
Construction work-in-progress	435,166	453,093
Land and buildings	26,591	24,123
Office equipment and other	32,006	29,742
Cost	5,426,127	5,047,755
Less: accumulated depreciation	(2,147,403)	(2,007,692)
Drilling and other property and equipment, net	$ 3,278,724	$ 3,040,063

Construction work-in-progress at June 30, 2008 consisted of $285.9 million related to the major upgrade of the *Ocean Monarch* to ultra-deepwater service and $149.3 million related to the construction of the *Ocean Scepter*, including accrued capital expenditures aggregating $69.0 million related to these two projects. We anticipate that the *Ocean Scepter* will begin drilling operations in the third quarter of 2008 and that the upgrade of the *Ocean Monarch* will be completed in late 2008. Construction of the *Ocean Shield* was completed in the second quarter of 2008.

8. Accrued Liabilities

Accrued liabilities consist of the following:

	June 30, 2008	December 31, 2007
	(In thousands)	
Accrued project/upgrade expenses	$139,365	$ 95,778
Payroll and benefits	65,491	52,975
Deferred revenue	32,389	36,134
Interest payable	10,385	10,413

Personal injury and other claims	9,714	8,692
Other	30,192	31,529
Total	$287,536	$235,521

9. Long-Term Debt

Long-term debt consists of the following:

	June 30, 2008	December 31, 2007
	(In thousands)	
Zero Coupon Debentures (due 2020)	$ 3,967	$ 3,931
1.5% Debentures (due 2031)		3,563
5.15% Senior Notes (due 2014)	249,594	249,566
4.875% Senior Notes (due 2015)	249,597	249,574
	503,158	506,634
Less: Current maturities		3,563
Total	$503,158	$503,071

The aggregate maturities of long-term debt for each of the five years subsequent to June 30, 2008 are as follows:

(In thousands)	
2008	$
2009	
2010	3,967
2011	
2012	
Thereafter	499,191
Total	$503,158

Debt Conversions. During the period from January 1, 2008 to April 14, 2008, the holders of $3.5 million in aggregate principal amount of our 1.5% Debentures elected to convert their outstanding debentures into shares of our common stock. We issued 71,144 shares of our common stock pursuant to these conversions. On April 15, 2008, we completed the redemption of all of our outstanding 1.5% Debentures, and, as a result, redeemed for cash the remaining $73,000 aggregate principal amount of our 1.5% Debentures.

During the first six months of 2008, the holders of approximately $33,000 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 430 shares of our common stock pursuant to these conversions during the first six months of 2008. The aggregate principal amount at maturity of our Zero Coupon Debentures converted during the six months ended June 30, 2008 was $50,000.

At June 30, 2008, there was $6.0 million aggregate principal amount at maturity, or $4.0 million accreted, or carrying, value, of our Zero Coupon Debentures outstanding.

10. 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, 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 and 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. 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.

We are one of several unrelated defendants in lawsuits 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.

Various other claims have been filed against us in the ordinary course of business. In the opinion of our management, the pending or known threatened claims, actions or proceedings against us are not expected to have a material adverse effect on our consolidated financial position, results of operations and 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. At June 30, 2008, our loss reserves related to our Brazilian operations aggregated $7.1 million, of which $2.0 million and $5.1 million were recorded in Accrued liabilities and Other liabilities, respectively, in our Consolidated Balance Sheets. Loss reserves related to our Brazilian operations totaled $8.5 million at December 31, 2007, of which $1.9 million was recorded in Accrued liabilities and $6.6 million was recorded in Other liabilities in our Consolidated Balance Sheets.

We intend to defend these matters vigorously; however, we cannot predict with certainty the outcome or effect of any litigation matters specifically described above or any other pending litigation or claims. There can be no assurance as to the ultimate outcome of these lawsuits.

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. The Jones Act is a federal law that permits seamen to seek compensation for certain injuries during the course of their employment on a vessel and governs the liability of vessel operators and marine employers for the work-related injury or death of an employee. We estimate our aggregate reserve for personal injury claims based on our historical losses and utilizing various actuarial models. At June 30, 2008, our estimated liability for personal injury claims was $29.7 million, of which $9.2 million and $20.5 million were recorded in Accrued liabilities and Other liabilities, respectively, in our Consolidated Balance Sheets. At December 31, 2007, we had recorded loss reserves for personal injury claims aggregating $32.0 million, of which $8.5 million and $23.5 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 June 30, 2008, we had purchase obligations aggregating approximately $109 million related to the major upgrade of the *Ocean Monarch* and construction of the *Ocean Scepter*. We expect to complete funding of these projects in 2008. However, the actual timing of these expenditures will vary based on the completion of various construction milestones, which are beyond our control.

We had no other purchase obligations for major rig upgrades or any other significant obligations at June 30, 2008, except for those related to our direct rig operations, which arise during the normal course of business.

11. Segments and Geographic Area Analysis

Although we provide contract drilling services with 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 of such services, in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(In thousands)			
High Specification Floaters	$354,218	$264,027	$ 635,289	$ 510,408
Intermediate Semisubmersibles	464,598	246,232	837,820	469,958
Jack-ups	117,810	125,668	233,857	245,473
Total contract drilling revenues	936,626	635,927	1,706,966	1,225,839
Revenues related to reimbursable expenses	17,746	12,948	33,508	31,220
Total revenues	$954,372	$648,875	$1,740,474	$1,257,059

Geographic Areas

At June 30, 2008, our drilling rigs were located offshore eleven 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 June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(In thousands)			
United States	$396,048	$356,506	$ 719,561	$ 688,750
Foreign:				
Europe/Africa/Mediterranean	172,077	121,283	309,608	219,744
South America	158,067	53,325	285,604	104,738
Australia/Asia/Middle East	147,793	87,432	254,768	181,742
Mexico	80,387	30,329	170,933	62,085
Total revenues	$954,372	$648,875	$1,740,474	$1,257,059

12. 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 and operated, directly or indirectly, by Diamond Offshore International Limited, a Cayman Islands subsidiary, which we wholly own. Because it was our intention to indefinitely reinvest the earnings of the subsidiary in foreign activities, no U.S. federal income taxes were provided on these earnings in years subsequent to its formation until December 2007, except to the extent that such earnings were immediately subject to U.S. federal income taxes. In December 2007, this subsidiary made a non-recurring distribution of $850.0 million to its U.S. parent and we recognized U.S. federal income tax on the portion of the earnings of the subsidiary that had not previously been subjected to U.S. federal income tax. As of December 31, 2007, the amount of previously untaxed earnings of this subsidiary was zero. Notwithstanding the non-recurring distribution made in December

2007, it remains our intention to indefinitely reinvest future earnings of this subsidiary to finance foreign activities. Consequently no U.S. federal income taxes were provided in the six months ended June 30, 2008 on the earnings of this subsidiary except to the extent that such earnings were immediately subject to U.S. federal income taxes.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. During the three and six months ended June 30, 2008 we recognized tax expense of $1.9 million and $2.8 million, respectively, for uncertain tax positions related to fiscal 2008. During the three and six months ended June 30, 2007 we recognized tax expense of $1.7 million and $2.0 million, respectively, for uncertain tax positions related to fiscal 2007. There were no new uncertain tax positions or significant changes in existing uncertain tax positions during the six months ended June 30, 2008.

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, 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 45 offshore drilling rigs. Our fleet currently consists of 30 semisubmersibles, 14 jack-ups and one drillship. We expect to take delivery of the premium jack-up drilling rig, the *Ocean Scepter*, in the third quarter of 2008. The rig is currently located in Brownsville, Texas, where it is being commissioned and waiting for the arrival of a heavy-lift vessel for its mobilization to an international destination for a term contract expected to begin in the third quarter of 2008.

Overview

Industry Conditions

Demand for crude oil remained strong against tight commodity supply during the second quarter of 2008, contributing to record high oil prices and providing continuing and increasing incentive for oil and gas exploration worldwide. In response, our customers are continuing the push into virgin, deepwater horizons that rising commodity prices initiated in mid-2004, and that has been more recently bolstered by major new domestic and international discoveries and significant additional lease acquisitions of offshore acreage.

This is the most extensive up-cycle the offshore drilling industry has experienced. It has led to record high demand for all types of offshore drilling rigs, and with demand for equipment exceeding supply, unprecedented high dayrates for our rigs.

Floaters

As a result, the majority of our mid-water (intermediate) and deepwater (high-specification) semisubmersible rigs are fully contracted for the remainder of 2008, and 92% of our floater equipment is contracted or subject to Letters of Intent, or LOIs, for 2009. Additionally, contracts or LOIs for 66% of our floating rigs extend at least until 2010, with 8% of our floating units having contracts or LOIs extending into the 2014-2015 timeframe. At the same time, we continue to see customer demand for multi-year contracts at competitive dayrates for our entire floater fleet, particularly for floater rigs with relatively near-term availability. Collectively, the actions of our customers, together with the other discussed market factors, support our belief that the outlook for mid-water and deepwater drilling rigs remains favorable.

International Jack-ups

The industry s jack-up market is divided between an international sector and a domestic sector, with the international sector generally characterized by contracts of longer duration and higher prices, compared to the generally shorter term and lower priced domestic sector. To date in 2008, we have seen relatively steady demand for jack-ups worldwide with generally level pricing internationally. As a result, we believe that the increase in rig supply due to the delivery of speculative new-build units can be absorbed by the international sector through the end of 2008. However, we believe that jack-up rig supply growth could be of concern in the international sector during 2009 and beyond.

U.S. Gulf of Mexico Jack-ups

In the domestic jack-up sector, higher natural gas prices and tighter rig supply allowed the domestic jack-up fleet to experience improved utilization and dayrates during the first and second quarters of 2008, compared to the second half of 2007. As a result, all of our domestic jack-up units are now contracted at least through the third quarter of 2008, which includes the typical peak of the hurricane season. We believe the outlook for domestic jack-ups remains favorable, absent a decline in natural gas pricing; however, the well-to-well nature of the market persists.

Contract Drilling Backlog

The following table reflects our contract drilling backlog as of July 24, 2008, February 7, 2008 (the date reported in our Annual Report on Form 10-K for the year ended December 31, 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 previously-disclosed LOIs. An LOI is subject to customary conditions, including the execution of a definitive agreement, and as such may not result in a binding contract. 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. No revenue is generally earned during periods of downtime for regulatory surveys. 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.

	July 24, 2008	**February 7, 2008**	**July 26, 2007**
		(In thousands)	
Contract Drilling Backlog			
High-Specification Floaters (1)	$ 4,535,000	$ 4,448,000	$ 3,888,000
Intermediate Semisubmersibles (1)	6,199,000	5,985,000	4,712,000
Jack-ups	543,000	421,000	452,000
Total	$ 11,277,000	$ 10,854,000	$ 9,052,000

(1) Contract drilling backlog as of July 24, 2008 includes an aggregate $1.0 billion in contract drilling revenue relating to expected future work under LOIs of which $672.0 million and $351.0 million is expected to be earned by our high-specification floaters and intermediate semisubmersibles, respectively.

The following table reflects the amount of our contract drilling backlog by year as of July 24, 2008.

		For the Years Ending December 31,			
	Total	2008 (1)	2009	2010	2011 - 2015
			(In thousands)		
Contract Drilling Backlog					
High-Specification Floaters (2)	$ 4,535,000	$ 677,000	$ 1,478,000	$ 1,092,000	$ 1,288,000
Intermediate Semisubmersibles (3)	6,199,000	836,000	1,762,000	1,446,000	2,155,000
Jack-ups	543,000	250,000	279,000	14,000	
Total	$ 11,277,000	$ 1,763,000	$ 3,519,000	$ 2,552,000	$ 3,443,000

(1) Represents a six-month period beginning July 1, 2008.

(2) Includes an aggregate $672.0 million in contract drilling revenue of which $17.0 million, $401.0 million and $254.0 million are expected to be earned during the remainder of 2008 and during 2009 and 2010, respectively, relating to expected future work under LOIs.

(3) Includes an aggregate $351.0 million in contract drilling revenue of which $21.0 million is expected to be earned during the remainder of

2008 and $99.0 million, $95.0 million, $95.0 million and $41.0 million are expected to be earned in 2009 to 2012, respectively, relating to future work under LOIs.

The following table reflects the percentage of rig days committed by year as of July 24, 2008. 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 Scepter* and *Ocean Monarch*.

	For the Years Ending December 31,			
	2008 (1)	**2009**	**2010**	**2011 - 2015**
Rig Days Committed (2)				
High-Specification Floaters	100%	91%	63%	15%
Intermediate Semisubmersibles	99%	93%	68%	22%
Jack-ups	80%	32%	2%	

(1) Represents a six-month period beginning July 1, 2008.

(2) Includes approximately 900 and 600 scheduled shipyard, survey and mobilization days for the remainder of 2008 and 2009, respectively, or 12% and 5% or our total rig days committed for the remainder of 2008 and 2009, respectively.

General

Our revenues vary based on the number of days our fleet is utilized and the dayrates earned. Utilization 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.

The two most significant variables affecting revenues are dayrates for rigs and rig utilization rates, each of which is a function of rig supply and demand in the marketplace. 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.

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 causes 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, as well as from quarter to quarter.

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 rigs located in the United Kingdom, or U.K., and Norwegian sectors of the North Sea.

During the second half of 2008, we expect that nine of our rigs will undergo regulatory inspections and will be out of service for approximately 500 days in the aggregate, including downtime for planned maintenance projects. (We expect to spend an additional approximately 400 days during the second half of 2008 for the mobilization of rigs, completion of contract modifications and for extended maintenance projects not performed in conjunction with regulatory surveys. See Overview Contract Drilling Backlog.)

Under our current insurance policy that expires on May 1, 2009, our deductible for physical damage 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. Accordingly, our insurance coverage for all physical damage to our rigs and equipment caused by named windstorms in the U.S. Gulf of Mexico for the policy period ending May 1, 2009 is limited to $125.0 million. If named windstorms in the U.S. Gulf of Mexico cause significant damage to our rigs or equipment or to the property of others for which we may be liable, it could have a material adverse effect on our financial position, results of operations and cash flows.

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, 2007. There were no material changes to these policies during the six months ended June 30, 2008.

Results of Operations

Although we perform contract drilling services with different types of drilling rigs and in many geographic locations, there is a similarity of economic characteristics among all our divisions and locations, including the nature of services provided and the type of customers for our services. We believe that the combination of our drilling rigs into one reportable segment is the appropriate aggregation in accordance with the Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 131, Disclosures about Segments of an Enterprise and Related Information. However, for purposes of this discussion and analysis of our results of operations, we provide greater detail with respect to the types of rigs in our fleet and the geographic regions in which they operate to enhance the reader s understanding of our financial condition, changes in financial condition and results of operations.

Three Months Ended June 30, 2008 and 2007

Comparative data relating to our revenue and operating expenses by equipment type are listed below. We have reclassified certain amounts applicable to the prior period to conform to the classifications we currently follow. These reclassifications do not affect earnings.

	Three Months Ended June 30, 2008	2007	Favorable/ (Unfavorable)
		(In thousands)	
CONTRACT DRILLING REVENUE			
High-Specification Floaters	$ 354,218	$ 264,027	$ 90,191
Intermediate Semisubmersibles	464,598	246,232	218,366
Jack-ups	117,810	125,668	(7,858)
Total Contract Drilling Revenue	$ 936,626	$ 635,927	$300,699
Revenues Related to Reimbursable Expenses	$ 17,746	$ 12,948	$ 4,798
CONTRACT DRILLING EXPENSE			
High-Specification Floaters	$ 89,503	$ 69,722	$ (19,781)
Intermediate Semisubmersibles	131,539	108,049	(23,490)
Jack-ups	48,834	42,362	(6,472)
Other	3,560	1,808	(1,752)
Total Contract Drilling Expense	$ 273,436	$ 221,941	$ (51,495)
Reimbursable Expenses	$ 17,346	$ 12,361	$ (4,985)
OPERATING INCOME			
High-Specification Floaters	$ 264,715	$ 194,305	$ 70,410
Intermediate Semisubmersibles	333,059	138,183	194,876
Jack-ups	68,976	83,306	(14,330)
Other	(3,560)	(1,808)	(1,752)
Reimbursable expenses, net	400	587	(187)
Depreciation	(70,661)	(58,335)	(12,326)
General and administrative expense	(15,768)	(12,174)	(3,594)
Gain on disposition of assets	226	3,553	(3,327)

Total Operating Income	$ 577,387	$ 347,617	$229,770
Other income (expense):			
Interest income	2,941	7,599	(4,658)
Interest expense	(1,895)	(3,770)	1,875
Loss on sale of marketable securities	(2)	(5)	3
Other, net	12,490	1,012	11,478
Income before income tax expense	590,921	352,453	238,468
Income tax expense	(174,638)	(100,526)	(74,112)
NET INCOME	$ 416,283	$ 251,927	$164,356

Demand remained strong for our high-specification floaters and intermediate semisubmersible rigs in all markets and geographic regions during the second quarter of 2008. The continued high overall utilization and historically high dayrates for our floater fleet contributed to an overall increase in our net income of $164.4 million, or 65%, to $416.3 million in the second quarter of 2008 compared to $251.9 million in the same period of 2007.

In many of the floater markets in which we operate, average dayrates increased as our rigs began operating under contracts at higher dayrates than those earned during the second quarter of 2007, resulting in the generation of additional contract drilling revenues by our fleet. Although the market is currently improving, our jack-up rigs in the U.S. Gulf of Mexico, or GOM, earned lower dayrates during the second quarter of 2008 compared to the same quarter in 2007 when rates for our jack-ups averaged in the low $90,000 range. Utilization, however, improved slightly compared to the second quarter of 2007. Total contract drilling revenues in the second quarter of 2008 increased $300.7 million, or 47%, to $936.6 million compared to $635.9 million in the same period a year earlier.

Total contract drilling expenses increased $51.5 million, or 23%, in the second quarter of 2008, compared to the same period in 2007. Overall cost increases for maintenance and repairs between the 2008 and 2007 periods reflect the impact of high, sustained utilization of our drilling units across our fleet, higher maintenance costs, contract preparation and mobilization costs, as well as the inclusion of normal operating costs for the recently upgraded *Ocean Endeavor,* which returned to service in the GOM in the third quarter of 2007, and the newly constructed *Ocean Shield*, which began operating offshore Malaysia in the second quarter of 2008. The increase in overall operating and overhead costs also reflects the impact of higher prices throughout the offshore drilling industry and its support businesses, including higher costs associated with hiring and retaining skilled personnel for our worldwide offshore fleet.

Depreciation and general and administrative expense increased $15.9 million to $86.4 million in the aggregate during the second quarter of 2008, or 23% compared to the second quarter of 2007, due to a higher depreciable asset base and higher compensation and consulting costs during 2008.

High-Specification Floaters.

	Three Months Ended June 30, 2008	2007	Favorable/ (Unfavorable)
		(In thousands)	
HIGH-SPECIFICATION FLOATERS:			
CONTRACT DRILLING REVENUE			
GOM	$282,074	$216,236	$ 65,838
Australia/Asia/Middle East	20,552	16,555	3,997
South America	51,592	31,236	20,356
Total Contract Drilling Revenue	$354,218	$264,027	$ 90,191
CONTRACT DRILLING EXPENSE			
GOM	$ 50,394	$ 41,782	$ (8,612)
Australia/Asia/Middle East	7,928	6,743	(1,185)
South America	31,181	21,197	(9,984)
Total Contract Drilling Expense	$ 89,503	$ 69,722	$(19,781)
OPERATING INCOME	$264,715	$194,305	$ 70,410

GOM. Revenues generated by our high-specification floaters operating in the GOM increased $65.8 million during the second quarter of 2008 compared to the same period in 2007. Average operating revenue per day for our rigs in this market, excluding the *Ocean Endeavor*, increased to $410,000 during the second quarter of 2008 compared to $359,800 in the second quarter of 2007, resulting in additional revenues of $30.8 million. Excluding the *Ocean Endeavor*, six of our seven other high-specification semisubmersible rigs in the GOM are currently operating at dayrates higher than those they earned during the second quarter of 2007. The *Ocean Endeavor* generated revenues of $22.9 million in the GOM in the second quarter of 2008.

Average utilization for our high-specification rigs operating in the GOM, excluding the *Ocean Endeavor*, increased from 94% in the second quarter of 2007 to 99% in the second quarter of 2008, resulting in a $12.1 million increase in revenues comparing the quarters. The increase in utilization was primarily the result of scheduled downtime for special surveys for the *Ocean Star* (19 days) and the *Ocean Baroness* (5 days) during the second quarter of 2007 compared to full utilization for both of these rigs during the second quarter of 2008.

Operating costs during the second quarter of 2008 for our high-specification floaters in the GOM increased $8.6 million to $50.4 million (including $3.7 million in incremental operating expenses for the *Ocean Endeavor*) compared to the second quarter of 2007. Operating costs for the second quarter of 2008 also include higher labor, benefits and other personnel-related costs for all of our rigs operating in the GOM as compared to the same period in 2007.

Australia/Asia/Middle East. Revenues generated by the *Ocean Rover,* our high-specification rig operating offshore Malaysia, increased $4.0 million in the second quarter of 2008, as compared to the same period in 2007, primarily due to a higher operating dayrate earned by the rig during the 2008 period.

South America. Revenues earned by our high-specification floaters operating offshore Brazil increased $20.4 million compared to the second quarter of 2007 to $51.6 million in the second quarter of 2008, primarily due to a higher dayrate earned by the *Ocean Alliance*. Average operating revenue per day increased from $182,600 during the second quarter of 2007 to $451,600 during the second quarter of 2008 and contributed additional revenues of $31.1 million. The increase in revenue was partially offset by a decline in utilization as a result of 64 days of unpaid downtime during the second quarter of 2008 for repairs to the propulsion system on the *Ocean Clipper* ($10.7 million).

Contract drilling expense for our operations in Brazil increased $10.0 million during the second quarter of 2008 compared to the same period in 2007. This increase was primarily due to inspection and repair costs for the *Ocean Clipper*.

Intermediate Semisubmersibles.

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Favorable/ (Unfavorable)
	(In thousands)		
INTERMEDIATE SEMISUBMERSIBLES:			
CONTRACT DRILLING REVENUE			
GOM	$ 47,832	$ 60,142	$ (12,310)
Mexico	53,443	15,406	38,037
Australia/Asia/Middle East	110,825	49,814	61,011
Europe/Africa/Mediterranean	146,023	98,781	47,242
South America	106,475	22,089	84,386
Total Contract Drilling Revenue	$464,598	$246,232	$218,366
CONTRACT DRILLING EXPENSE			
GOM	$ 11,270	$ 14,856	$ 3,586
Mexico	11,931	13,777	1,846
Australia/Asia/Middle East	30,479	27,039	(3,440)
Europe/Africa/Mediterranean	37,942	35,118	(2,824)
South America	39,917	17,259	(22,658)
Total Contract Drilling Expense	$131,539	$108,049	$ (23,490)
OPERATING INCOME	$333,059	$138,183	$194,876

GOM. Revenues generated during the second quarter of 2008 by our intermediate semisubmersible fleet decreased $12.3 million compared to the same period in 2007, primarily as a result of the relocation of three of our rigs (*Ocean Voyager* and *Ocean New Era* to Mexico and *Ocean Concord* to Brazil) from the GOM during the fourth quarter of 2007. These rigs generated revenues of $52.6 million during the second quarter of 2007. The *Ocean Ambassador* relocated to the GOM from offshore Mexico during the second quarter of 2008 and generated revenue of $20.7 million. The *Ocean Saratoga* (which remained in the GOM for both the 2007 and 2008 periods) generated $19.6 million in additional revenues during the second quarter of 2008 compared to the same period in 2007 when it was out of service for 26 days completing a service life extension project.

Contract drilling expenses in the GOM decreased by $3.6 million during the second quarter of 2008 compared to the second quarter of 2007 primarily due to the absence of operating costs ($10.8 million) for the *Ocean Voyager*, *Ocean New Era* and *Ocean Concord*. The overall decrease in contract drilling expenses for the second quarter of 2008 was partially offset by the inclusion of normal operating expenses for the *Ocean Ambassador* and costs associated with contract preparation activities for the *Ocean Yorktown*.

Mexico. Transfers of our intermediate semisubmersibles into and out of the Mexico region prior to or during the second quarter of 2008 resulted in a net reduction of one rig in the region. We currently have two intermediate semisubmersible rigs working for PEMEX Exploración Y Producción, or PEMEX, at higher dayrates than those previously earned in the region. The aggregate changes in our offshore fleet in Mexico resulted in a net increase in revenues of $38.0 million during the second quarter of 2008 compared to the same quarter of 2007.

Australia/Asia/Middle East. Our intermediate semisubmersibles working in the Australia/Asia/Middle East region generated revenues of $110.8 million in the second quarter of 2008 compared to revenues of $49.8 million in the same period of 2007. The $61.0 million increase in operating revenue was primarily due to an increase in average operating revenue per day from $147,000 during the second quarter of 2007 to $306,100 during the second quarter in 2008, which generated additional revenues of $57.3 million during the 2008 period. The increase in average operating revenue per day is attributable to our three intermediate semisubmersibles operating offshore Australia earning a higher contractual dayrate during the second quarter of 2008, as compared to the same period in 2007.

Average utilization in this region increased to 99% during the second quarter of 2008 from 91% during the second quarter of 2007, resulting in the generation of $4.1 million in additional revenues during the 2008 period.

Contract drilling expense for the Australia/Asia/Middle East region increased $3.4 million in the second quarter of 2008 compared to the second quarter of 2007. Operating costs for the *Ocean Patriot* increased $3.1 million, primarily due to inspection costs related to the rig s special survey in 2008 and higher normal operating costs associated with operating offshore Australia during the second quarter of 2008. During the comparable quarter of 2007, the *Ocean Patriot* operated offshore New Zealand at a lower cost structure.

Europe/Africa/Mediterranean. Operating revenue for our intermediate semisubmersibles working in the Europe/Africa/Mediterranean region increased $47.2 million in the second quarter of 2008 compared to the same period in 2007 primarily due to higher dayrates earned by three of our four rigs operating in the North Sea (both U.K. and Norwegian sectors). Average operating revenue per day for our three U.K. semisubmersibles increased from $217,300 in the second quarter of 2007 to $323,100 in the second quarter of 2008, contributing $28.8 million in additional revenue in the 2008 quarter. The *Ocean Vanguard* began a two-year contract early in the second quarter of 2008 at a higher dayrate than previously contracted and contributed $19.1 million in additional revenues.

Contract drilling expense for our intermediate semisubmersible rigs operating in the Europe/Africa/Mediterranean markets increased $2.8 million in the second quarter of 2008 compared to the second quarter of 2007, primarily due to higher labor and benefits costs, repairs and normal operating costs incurred in 2008 for our rigs operating in the North Sea (both U.K. and Norwegian sectors).

South America. Revenues generated by our intermediate semisubmersibles working in the South American region increased $84.4 million to $106.5 million in the second quarter of 2008 from $22.1 million in the second quarter of 2007. During the second quarter of 2008, we had five rigs operating in the region compared to only two rigs operating in the region during the same period in 2007. During 2007, we relocated the *Ocean Whittington* (Brazil), *Ocean Concord* (Brazil) and the *Ocean Worker* (Trinidad and Tobago) to this region where they generated aggregate revenues of $85.1 million in the second quarter of 2008. None of these rigs generated revenues in the South America region during the second quarter of 2007.

Operating expenses for our operations in the South American region increased $22.7 million in the second quarter of 2008, as compared to the second quarter of 2007, primarily due to normal operating costs for the three additional rigs that we moved to the region in 2007 ($18.9 million). In addition, we incurred $1.7 million of operating expenses for the *Ocean Yorktown,* which we moved to Brazil from the GOM in the second quarter of 2008.

Jack-Ups.

	Three Months Ended June 30, 2008	2007	Favorable/ (Unfavorable)
		(In thousands)	
JACK-UPS:			
CONTRACT DRILLING REVENUE			
GOM	$ 48,395	$ 67,180	$(18,785)
Mexico	26,943	14,923	12,020
Australia/Asia/Middle East	16,417	21,063	(4,646)
Europe/Africa/Mediterranean	26,055	22,502	3,553
Total Contract Drilling Revenue	$117,810	$125,668	$ (7,858)
CONTRACT DRILLING EXPENSE			
GOM	$ 23,048	$ 27,768	$ 4,720
Mexico	7,913	3,666	(4,247)
Australia/Asia/Middle East	11,621	6,619	(5,002)
Europe/Africa/Mediterranean	6,252	4,309	(1,943)
Total Contract Drilling Expense	$ 48,834	$ 42,362	$ (6,472)
OPERATING INCOME	$ 68,976	$ 83,306	$(14,330)

GOM. Revenue generated by our jack-up rigs operating in the GOM decreased $18.8 million during the second quarter of 2008 compared to the second quarter of 2007. The decline in revenues is primarily due to the relocation of two of our jack-up rigs from the GOM to other markets, namely, the *Ocean King* to Croatia in the third quarter of 2007 and the *Ocean Columbia* to Mexico in the first quarter of 2008. These two rigs generated $13.8 million in revenues while operating in the GOM during the second quarter of 2007. In addition, average operating revenue per day in the second quarter of 2008, excluding the *Ocean King* and *Ocean Columbia*, decreased to $76,500 from $91,100 in the second quarter of 2007, resulting in an $8.2 million decrease in revenue from the same period a year earlier.

Average utilization (excluding the *Ocean King* and *Ocean Columbia*) increased from 92% during the second quarter of 2007 to 99% during the second quarter of 2008, resulting in an increase in revenues of $3.2 million. The increase in utilization was primarily due to an improvement in market conditions in the GOM. Our jack-up fleet in the GOM had no ready-stack days during the second quarter of 2008 compared to an aggregate 45 ready-stack days during the same period in 2007.

Contract drilling expense in the GOM decreased $4.7 million during the second quarter of 2008 compared to the same period in 2007. The overall decrease in operating costs during the second quarter of 2008 was primarily attributable to the absence of operating costs in the GOM for the *Ocean King* and *Ocean Columbia*, which reduced operating expenses by $3.8 million.

Mexico. Revenue and contract drilling expense from our jack-up rigs operating in Mexico increased $12.0 million and $4.2 million, respectively, in the second quarter of 2008 compared to the second quarter of 2007 primarily due to the operation of the *Ocean Columbia* offshore Mexico. The *Ocean Columbia* generated $11.5 million in revenues and incurred $4.0 million in operating expenses during the second quarter of 2008.

Australia/Asia/Middle East. Revenue generated by our jack-up rigs operating in the Australia/Asia/Middle East region decreased $4.6 million in the second quarter of 2008 compared to the same period in 2007 primarily due to the temporary ready-stacking of the *Ocean Heritage* ($13.0 million) at the end of the first quarter of 2008 until its mobilization to Egypt in late June 2008.

Our newly constructed jack-up rig, the *Ocean Shield*, began operating offshore Malaysia during the second quarter of 2008, generating $7.3 million in revenues and $4.1 in contract drilling expenses.

Europe/Africa/Mediterranean. Revenue generated by our jack-up rigs operating in the Europe/Africa/Mediterranean region increased $3.6 million during the second quarter of 2008 compared to the same period in 2007. The *Ocean King*, which relocated to Croatia in the third quarter of 2007, generated $10.1 million in incremental revenues in the region. The favorable contribution by the *Ocean King* was partially offset by a $6.6 million reduction in revenues generated by the *Ocean Spur*. During the second quarter of 2007, revenues for the *Ocean Spur* included a $6.6 million lump-sum demobilization fee earned in connection with the completion of its contract offshore Tunisia.

Depreciation.

Depreciation expense increased $12.3 million to $70.7 million during the second quarter of 2008 compared to $58.3 million during the same period in 2007 primarily due to depreciation associated with capital additions in 2007 and 2008.

General and Administrative Expense.

We incurred general and administrative expense of $15.8 million in the second quarter of 2008 compared to $12.2 million in the same period in 2007. The $3.6 million increase in overhead costs between the periods was primarily due to an increase in payroll costs resulting from higher compensation, staffing increases and engineering consulting fees, partially offset by lower legal fees resulting from an insurance reimbursement related to certain litigation.

Interest Expense.

We recorded interest expense during the second quarter of 2008 of $1.9 million, representing a $1.9 million decrease in interest cost compared to the same period in 2007. This decrease was primarily attributable to more interest cost capitalized to our qualifying rig upgrades and construction projects as compared to the same period in 2007.

Other Income and Expense (Other, net).

Included in Other, net are foreign currency translation adjustments and transaction gains and losses and other income and expense items, among other things, which are not attributable to our drilling operations. The components of Other, net fluctuate based on the level of activity, as well as fluctuations in foreign currencies. During the three months ended June 30, 2008 and 2007, we recognized net foreign currency exchange gains of $12.6 million and $0.9 million, respectively.

Income Tax Expense.

Our estimated annual effective tax rate for the three months ended June 30, 2008 was 29.1%, compared to the 28.2% effective tax rate for the comparable period in 2007.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. During the three months ended June 30, 2008 and June 30, 2007 we recognized tax expense of $1.9 million and $1.7 million, respectively, for uncertain tax positions related to the respective fiscal periods. There were no new uncertain tax positions or significant changes in existing uncertain tax positions during the quarter ended June 30, 2008.

Six Months Ended June 30, 2008 and 2007

Comparative data relating to our revenue and operating expenses by equipment type are listed below. We have reclassified certain amounts applicable to the prior period to conform to the classifications we currently follow. These reclassifications do not affect earnings.

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Favorable/ (Unfavorable)
		(In thousands)	
CONTRACT DRILLING REVENUE			
High-Specification Floaters	$ 635,289	$ 510,408	$ 124,881
Intermediate Semisubmersibles	837,820	469,958	367,862
Jack-ups	233,857	245,473	(11,616)
Total Contract Drilling Revenue	$1,706,966	$1,225,839	$ 481,127
Revenues Related to Reimbursable Expenses	$ 33,508	$ 31,220	$ 2,288
CONTRACT DRILLING EXPENSE			
High-Specification Floaters	$ 180,458	$ 131,508	$ (48,950)
Intermediate Semisubmersibles	275,510	210,035	(65,475)
Jack-ups	95,101	82,956	(12,145)
Other	7,374	9,899	2,525
Total Contract Drilling Expense	$ 558,443	$ 434,398	$(124,045)
Reimbursable Expenses	$ 32,534	$ 29,977	$ (2,557)
OPERATING INCOME			
High-Specification Floaters	$ 454,831	$ 378,900	$ 75,931
Intermediate Semisubmersibles	562,310	259,923	302,387
Jack-ups	138,756	162,517	(23,761)
Other	(7,374)	(9,899)	2,525
Reimbursable expenses, net	974	1,243	(269)
Depreciation	(139,711)	(114,040)	(25,671)
General and administrative expense	(31,490)	(24,140)	(7,350)
Gain on disposition of assets	277	5,055	(4,778)
Total Operating Income	$ 978,573	$ 659,559	$ 319,014
Other income (expense):			
Interest income	7,314	17,392	(10,078)
Interest expense	(3,237)	(14,625)	11,388
Loss on sale of marketable securities	(3)	(8)	5
Other, net	14,196	405	13,791

Income before income tax expense	996,843	662,723	334,120
Income tax expense	(289,935)	(186,646)	(103,289)
NET INCOME	$ 706,908	$ 476,077	$ 230,831

Demand remained strong for our high-specification floaters and intermediate semisubmersible rigs in all markets and geographic regions during the first half of 2008. The continued high overall utilization and historically high dayrates for our floater fleet contributed to an overall increase in our net income of $230.8 million, or 48%, to $706.9 million in the first six months of 2008 compared to $476.1 million in the same period of 2007.

In many of our floater markets, average dayrates increased as our rigs began operating under contracts at higher dayrates than those earned during the first half of 2007, resulting in the generation of additional contract drilling revenues. However, overall revenue increases were negatively impacted by the effect of downtime associated with scheduled shipyard projects and mandatory inspections or surveys. In addition, although the GOM jack-up market is currently improving, our jack-ups earned lower dayrates during the first half of 2008 compared to the same period of 2007 despite an increase in utilization during the 2008 period. Total contract drilling revenues in the first half of 2008 increased $481.1 million, or 39%, to $1.7 billion compared to $1.2 billion in the same period a year earlier.

Total contract drilling expenses increased $124.0 million, or 29%, in the first six months of 2008, compared to the same period in 2007. Overall cost increases for maintenance and repairs between the 2008 and 2007 periods reflect the impact of high, sustained utilization of our drilling units across our fleet, additional survey and related maintenance costs, contract preparation and mobilization costs, as well as the inclusion of normal operating costs for the *Ocean Endeavor* and the *Ocean Shield*. The increase in overall operating and overhead costs also reflects the impact of higher prices throughout the offshore drilling industry and its support businesses, including higher costs associated with hiring and retaining skilled personnel for our worldwide offshore fleet.

Depreciation and general and administrative expense increased $33.0 million to $171.2 million in the aggregate during the first half of 2008, or 24%, compared to the first half of 2007, due to a higher depreciable asset base and higher payroll and consulting costs during 2008.

High-Specification Floaters.

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Favorable/ (Unfavorable)
		(In thousands)	
HIGH-SPECIFICATION FLOATERS:			
CONTRACT DRILLING REVENUE			
GOM	$518,057	$410,606	$107,451
Australia/Asia/Middle East	38,195	36,320	1,875
South America	79,037	63,482	15,555
Total Contract Drilling Revenue	$635,289	$510,408	$124,881
CONTRACT DRILLING EXPENSE			
GOM	$103,757	$ 78,124	$ (25,633)
Australia/Asia/Middle East	14,377	12,549	(1,828)
South America	62,324	40,835	(21,489)
Total Contract Drilling Expense	$180,458	$131,508	$ (48,950)
OPERATING INCOME	$454,831	$378,900	$ 75,931

GOM. Revenues generated by our high-specification floaters operating in the GOM increased $107.5 million during the first half of 2008 compared to the same period in 2007, primarily due to higher average dayrates earned during the 2008 period ($65.7 million). Average operating revenue per day for our rigs in this market, excluding the *Ocean Endeavor*, increased to $394,200 during the first half of 2008 compared to $337,700 in the first half of 2007. Excluding the *Ocean Endeavor*, six of our seven other high-specification semisubmersible rigs in the GOM are currently operating at dayrates higher than those earned during the first half of 2007. The *Ocean Endeavor* began operating in the GOM during the third quarter of 2007 and generated revenues of $44.1 million during the first six months of 2008.

Average utilization for our high-specification rigs operating in the GOM, excluding the *Ocean Endeavor*, decreased slightly from 95% in the first half of 2007 to 94% in the first half of 2008, resulting in a $2.3 million decline in revenues comparing the periods.

Operating costs during the first half of 2008 for our high-specification floaters in the GOM increased $25.6 million to $103.8 million (including $11.5 million in incremental operating expenses for the *Ocean Endeavor*) compared to the first half of 2007. Operating costs for the first six months of 2008 also included costs associated with a special survey of the *Ocean Victory*, as well as higher labor, benefits and other personnel-related costs for our rigs operating in the GOM compared to the same period in 2007.

Australia/Asia/Middle East. Revenues generated by the *Ocean Rover,* our high-specification rig operating offshore Malaysia, increased $1.9 million in the first half of 2008 compared to the same period in 2007. The revenue increase is primarily due to the *Ocean Rover* earning a higher average rate per day during the first six months of 2008, compared to the same period in 2007, as it alternated to a higher dayrate drilling program for a greater period of time during 2008.

South America. Revenues earned by our high-specification floaters operating offshore Brazil during the first half of 2008 increased $15.6 million compared to the first half of 2007. Average operating revenue per day increased from $182,900 during the first half of 2007 to $325,300 during the first half of 2008 due to a higher dayrate earned by the *Ocean Alliance* during the 2008 period, contributing additional revenues of $35.4 million. A decline in utilization from 96% for the first half of 2007 to 67% for the comparable period in 2008 reduced revenues by $19.8 million during the first six months of 2008. The decrease in utilization during 2008 is primarily the result of 106 days of incremental unpaid downtime for the *Ocean Clipper* for a planned special survey and repairs to its propulsion system.

Contract drilling expense for our operations in Brazil increased $21.5 million during the first half of 2008 compared to the same period in 2007. The increase in costs is primarily due to inspection, related repair and other costs associated with the surveys for both the *Ocean Alliance* and the *Ocean Clipper*, equipment repairs and higher personnel and related costs.

Intermediate Semisubmersibles.

	Six Months Ended June 30, 2008	2007	Favorable/ (Unfavorable)
		(In thousands)	
INTERMEDIATE SEMISUBMERSIBLES:			
CONTRACT DRILLING REVENUE			
GOM	$ 75,132	$107,897	$ (32,765)
Mexico	119,672	31,526	88,146
Australia/Asia/Middle East	179,956	104,835	75,121
Europe/Africa/Mediterranean	256,493	184,444	72,049
South America	206,567	41,256	165,311
Total Contract Drilling Revenue	$837,820	$469,958	$367,862
CONTRACT DRILLING EXPENSE			
GOM	$ 17,235	$ 33,592	$ 16,357
Mexico	31,302	27,150	(4,152)
Australia/Asia/Middle East	71,557	50,050	(21,507)
Europe/Africa/Mediterranean	75,853	67,881	(7,972)
South America	79,563	31,362	(48,201)
Total Contract Drilling Expense	$275,510	$210,035	$ (65,475)
OPERATING INCOME	$562,310	$259,923	$302,387

GOM. Revenues generated during the first six months of 2008 by our intermediate semisubmersible fleet decreased $32.8 million compared to the same period in 2007, primarily as a result of the relocation of three of our rigs from the GOM (*Ocean Voyager* and *Ocean New Era* to Mexico and *Ocean Concord* to Brazil) after the second quarter of 2007. During the first half of 2007, these three rigs generated revenues of $100.3 million while operating in the GOM. The decline in revenues was partially offset by the addition of $20.7 million in revenues earned by the *Ocean Ambassador*, which relocated to the GOM during the second quarter of 2008. In addition, the *Ocean Saratoga* generated $46.9 million in additional revenues during the first half of 2008 compared to the same period in 2007 when it was out of service for 116 days completing a service life extension project.

Contract drilling expenses in the GOM decreased by $16.4 million during the first half of 2008 compared to the same period in 2007, primarily due to the absence of operating costs for the *Ocean Voyager*, *Ocean New Era* and *Ocean Concord* ($21.2 million) which relocated to other markets during 2007 and costs associated with the life extension project for the *Ocean Whittington* that was completed in the second quarter of 2007. The overall decrease in contract drilling expenses in the first half of 2008 was partially offset by normal operating expenses for the *Ocean Ambassador* and *Ocean Saratoga* and costs associated with contract preparations for the *Ocean Yorktown* prior to its mobilization to Brazil in May 2008.

Mexico. Offshore Mexico, three of our intermediate semisubmersible rigs completed their contracts with PEMEX after the second quarter of 2007 and relocated out of the region. In addition, during the fourth quarter of 2007, we relocated two semisubmersible units from the GOM to Mexico; the *Ocean New Era* and *Ocean Voyager* are currently working for PEMEX at dayrates substantially higher than rates earned by our semisubmersible rigs in this region in the first half of 2007. Average operating revenue per day increased to $281,800 for the six months ended June 30, 2008 compared to $60,200 per day for the comparable period in 2007. The net change in rigs between periods, combined with higher dayrates, generated $88.1 million additional revenues during the first six months of 2008 compared to the 2007 period.

Our operating costs in Mexico increased by $4.2 million in the first six months of 2008 compared to the same period in 2007, primarily due to the inclusion of costs to mobilize the *Ocean Ambassador* from Mexico to the GOM after completion of its contract with PEMEX at the end of the first quarter of 2008 and amortization of deferred mobilization costs associated with the mobilization of the *Ocean New Era* and *Ocean Voyager* into Mexico. In addition, we incurred higher agency fees, which are generally based on a percentage of revenue, during the first half of 2008 as a result of the increase in revenue generated in the region.

Australia/Asia/Middle East. Our intermediate semisubmersibles working in the Australia/Asia/Middle East region generated revenues of $180.0 million during the first half of 2008 compared to revenues of $104.8 million in the same period in 2007. The $75.1 million increase in operating revenue was primarily due to an increase in average operating revenue per day from $151,300 during the first half of 2007 to $273,700 during the first half of 2008, which generated additional revenues of $77.1 million during 2008. The increase in average operating revenue per day is primarily attributable to our three intermediate semisubmersibles operating offshore Australia commencing long-term contracts during the 2008 period at higher dayrates than those previously earned during the first half of 2007. A slight decrease in utilization from 94% for the first six months of 2007 to 90% for the comparable period of 2008 was due to differences in scheduled downtime for surveys, shipyard work and mobilizations and resulted in a revenue reduction of $1.0 million during the first half of 2008 compared to the same period in 2007.

Contract drilling expense for the Australia/Asia/Middle East region increased $21.5 million in the first six months of 2008 compared to the first six months of 2007, primarily due to higher normal operating costs for the *Ocean Patriot* operating offshore Australia during the first half of 2008 compared to operating offshore New Zealand during the comparable period of 2007 and inspection and related repair costs associated with its 5-year survey during early 2008. In addition, operating costs in this region reflected higher labor and personnel-related costs during the first half of 2008 compared to the same period in the prior year. The increase in overall operating costs was partially offset by lower costs for the *Ocean General* during the first six months of 2008 due to the absence of shipyard and mobilization costs incurred during the first half of 2007.

Europe/Africa/Mediterranean. Operating revenue for our intermediate semisubmersibles working in the Europe/Africa/Mediterranean region increased $72.0 million in the first half of 2008 compared to the same period in 2007 primarily due to higher dayrates earned by our four rigs operating in the North Sea (both U.K. and Norwegian sectors). Average operating revenue per day for our North Sea semisubmersibles increased from $190,000 in the first half of 2007 to $293,100 in the first half of 2008, contributing $72.7 million in additional revenue in 2008 compared to the same period in 2007.

Contract drilling expense for our intermediate semisubmersible rigs operating in the Europe/Africa/Mediterranean markets increased $8.0 million in the first half of 2008 compared to the first half of 2007, primarily due to higher labor and benefits costs for all of our rigs in these markets, higher repair and normal operating costs incurred in 2008 for our North Sea rigs and higher costs related to the *Ocean Vanguard* operating offshore Ireland for a portion of the first six months of 2008.

South America. Revenues generated by our intermediate semisubmersibles working in the South American region increased $165.3 million to $206.6 million in the first six months of 2008 from $41.3 million in the first six months of 2007. During the first half of 2008, we had five rigs operating in the region compared to only two rigs operating in the region during the same period in 2007. Following the first quarter of 2007, we relocated the *Ocean Whittington* (Brazil), *Ocean Concord* (Brazil) and the *Ocean Worker* (Trinidad and Tobago) to this region where they generated aggregate revenues of $162.1 million in the first half of 2008.

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Operating expenses for our operations in the South American region increased $48.2 million in the first half of 2008, compared to the first half of 2007, primarily due to the inclusion of normal operating costs for the three additional rigs in the region ($41.0 million), as well as higher labor and other personnel-related expenses, freight, repair and maintenance costs for our other two semisubmersible rigs in this market. In addition, we incurred $1.7 million in costs associated with the mobilization and ready-stacking of the *Ocean Yorktown,* which relocated from the GOM in the second quarter of 2008 for long-term work expected to commence in the third quarter of 2008.

Jack-Ups.

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Favorable/ (Unfavorable)
		(In thousands)	
JACK-UPS:			
CONTRACT DRILLING REVENUE			
GOM	$ 92,864	$139,027	$(46,163)
Mexico	51,260	30,559	20,701
Australia/Asia/Middle East	36,617	40,587	(3,970)
Europe/Africa/Mediterranean	53,116	35,300	17,816
Total Contract Drilling Revenue	$233,857	$245,473	$(11,616)
CONTRACT DRILLING EXPENSE			
GOM	$ 47,203	$ 52,882	$ 5,679
Mexico	16,938	7,465	(9,473)
Australia/Asia/Middle East	18,773	14,146	(4,627)
Europe/Africa/Mediterranean	12,187	8,463	(3,724)
Total Contract Drilling Expense	$ 95,101	$ 82,956	$(12,145)
OPERATING INCOME	$138,756	$162,517	$(23,761)

GOM. Revenue generated by our jack-up rigs operating in the GOM decreased $46.2 million during the first half of 2008 compared to the first half of 2007. The decline in revenues is primarily due to the relocation of the *Ocean King* (Croatia) and the *Ocean Columbia* (Mexico) after the second quarter of 2007. These two rigs generated $34.9 million in revenues while operating in the GOM during the first six months of 2007. In addition, average operating revenue per day in the first half of 2008, excluding the *Ocean King* and *Ocean Columbia*, decreased to $75,400 from $93,200 in the first half of 2007, resulting in a $20.1 million decrease in revenue from the same period a year earlier.

Average utilization (excluding the *Ocean King* and *Ocean Columbia*) increased from 88% during the first half of 2007 to 97% during the first half of 2008, resulting in an increase in revenues of $8.8 million. The increase in utilization was primarily due to an improvement in market conditions in the GOM that resulted in fewer ready-stack days for our jack-up fleet between wells during the first six months of 2008 (22 days) compared to the same period in 2007 (135 days).

Contract drilling expense in the GOM decreased $5.7 million during the first half of 2008 compared to the same period in 2007. The overall decrease in operating costs during the first half of 2008 was due to the absence of operating costs in the GOM for the *Ocean King* and *Ocean Columbia*, which reduced operating expenses by $11.1 million. The reduction in overall operating costs was partially offset by higher labor and benefits costs, higher maintenance and repair costs and higher overhead costs for our remaining rigs in the GOM during the first half of 2008 compared to the first half of 2007. In addition, we incurred $0.8 million in start-up costs associated with the anticipated completion of the *Ocean Scepter*.

Mexico. Revenue and contract drilling expense from our rigs operating in Mexico increased $20.7 million and $9.5 million, respectively, in the first half of 2008 compared to the first half of 2007 primarily due to the operation of the *Ocean Columbia* offshore Mexico, beginning in the first quarter of 2008. The *Ocean Columbia* generated $20.0 million in revenues and incurred $9.0 million in operating expenses during the first half of 2008.

Australia/Asia/Middle East. Revenue generated by our jack-up rigs operating in the Australia/Asia/Middle East region decreased $4.0 million in the first half of 2008 compared to the same period in 2007, primarily due to the temporary ready-stacking of the *Ocean Heritage* in a shipyard in Qatar beginning in March 2008 prior to its departure for Egypt in late June 2008 ($12.5 million).

In addition, our newly constructed jack-up rig, the *Ocean Shield*, began operating in Malaysia during the second quarter of 2008 and generated $7.3 million in revenues and $4.1 million in contract drilling expenses.

Europe/Africa/Mediterranean. Revenue generated by our jack-up rigs operating in the Europe/Africa/Mediterranean region increased $17.8 million during the first half of 2008 compared to the same period in 2007. The *Ocean King*, operating under a two-year bareboat charter offshore Croatia that began in the third quarter of 2007, generated $20.7 million revenues during the first half of 2008.

In addition, the *Ocean Spur*, which operated offshore Egypt during the first half of 2008 and in both Tunisia and Egypt during the first half of 2007, generated $2.9 million less in revenues during the 2008 period compared to 2007, primarily due to the recognition of other operating revenues associated with its contract offshore Tunisia in 2007. The overall decrease in the *Ocean Spur s* revenue during the first half of 2008 was partially offset by the effect of a higher contracted dayrate operating offshore Egypt compared to operating offshore Tunisia during the majority of the first six months of 2007.

Contract drilling expense in the Europe/Africa/Mediterranean region increased by $3.7 million during the first half of 2008 compared to the first half of 2007 primarily due to the inclusion of operating costs for the *Ocean King*. Operating costs for the *Ocean Spur* included costs associated with an intermediate survey during 2008 and higher labor and benefits costs, agency fees and overhead costs associated with operating in Egypt during 2008 compared to operating in Tunisia during the majority of the first half of 2007.

Depreciation.

Depreciation expense increased $25.7 million to $139.7 million during the first half of 2008 compared to $114.0 million during the same period in 2007 primarily due to depreciation associated with capital additions in 2007 and 2008.

General and Administrative Expense.

We incurred general and administrative expense of $31.5 million in the first half of 2008 compared to $24.1 million in the same period in 2007. The $7.4 million increase in overhead costs between the periods was primarily due to an increase in payroll costs resulting from higher compensation and staffing increases and engineering and tax consulting fees, partially offset by lower legal fees resulting from an insurance reimbursement related to certain litigation.

Gain on Disposition of Assets.

We recognized a net gain of $0.3 million on the sale and disposition of assets during the first half of 2008 compared to a net gain of $5.1 million in the first half of 2007 primarily for the recognition of gains on insurance settlements.

Interest Expense.

We recorded interest expense during the first six months of 2008 of $3.2 million, representing an $11.4 million decrease in interest cost compared to the same period in 2007. This decrease was primarily attributable to lower interest cost associated with our 1.5% Convertible Senior Debentures Due 2031, or 1.5% Debentures, which we redeemed in April 2008 and a greater amount of interest capitalized in the first half of 2008 related to our qualifying rig upgrades and construction of our two new jack-up rigs. Interest expense for the first half of 2007 included $8.9 million in debt issuance costs that we wrote off in connection with conversions during the period of our 1.5% Debentures and our Zero Coupon Convertible Debentures due 2020, or Zero Coupon Debentures, into shares of our common stock.

Other Income and Expense (Other, net).

Included in Other, net are foreign currency translation adjustments and transaction gains and losses and other income and expense items, among other things, which are not attributable to our drilling operations. The components of Other, net fluctuate based on the level of activity, as well as fluctuations in foreign currencies. During the six months ended June 30, 2008 and 2007, we recognized net foreign currency exchange gains of $14.4 million and net foreign currency exchange losses of $0.3 million, respectively.

Income Tax Expense.

Our estimated annual effective tax rate for the six months ended June 30, 2008 was 29.1%, compared to the 28.2% effective tax rate for the same period in 2007.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. During the six months ended June 30, 2008 and June 30, 2007 we recognized tax expense of $2.8 million and $2.0 million, respectively, for uncertain tax positions related to the respective fiscal periods. There were no new uncertain tax positions or significant changes in existing uncertain tax positions during the six months ended June 30, 2008.

Sources of Liquidity and Capital Resources

Our principal sources of liquidity and capital resources are cash flows from our operations and our cash reserves. We may also make use of our $285 million credit facility for cash liquidity. See *$285 Million Revolving Credit Facility*.

At June 30, 2008, we had $541.6 million in Cash and cash equivalents and $199.1 million in Marketable securities, representing our investment of cash available for current operations. Our Consolidated Balance Sheets at June 30, 2008 also included a $197.8 million Payable for securities purchased relating to investments purchased on June 30, 2008 that did not settle until the subsequent month.

Cash Flows from Operations. Our internally generated cash flow is directly related to our business and the geographic regions in which we operate. Deterioration in the offshore drilling market or poor operating results may result in reduced cash flows from operations. The dayrates we receive for our drilling rigs and rig utilization rates are a function of rig supply and demand in the marketplace, which is generally correlated with the price of oil and natural gas. Demand for drilling services is dependent upon the level of expenditures by oil and gas companies for offshore exploration and development, a variety of political and economic factors and availability of rigs in a particular geographic region. As utilization rates increase, dayrates tend to increase as well as reflecting the lower supply of available rigs, and vice versa. These external factors which affect our cash flows from operations are not within our control and are difficult to predict. For a description of other factors that could affect our cash flows from operations, see Overview Industry Conditions, Forward-Looking Statements.

$285 Million Revolving Credit Facility. We maintain a $285 million syndicated, 5-year senior unsecured revolving credit facility, or Credit Facility, for general corporate purposes, including loans and performance or standby letters of credit.

Loans under the Credit Facility bear interest at a rate per annum equal to, at our election, either (i) the higher of the prime rate or the federal funds rate plus 0.5% or (ii) the London Interbank Offered Rate, or LIBOR, plus an applicable margin, varying from 0.20% to 0.525%, based on our current credit ratings. Under our Credit Facility, we also pay, based on our current credit ratings, and as applicable, other customary fees, including, but not limited to, a facility fee on the total commitment under the Credit Facility regardless of usage and a utilization fee that applies if the aggregate of all loans outstanding under the Credit Facility equals or exceeds 50% of the total commitment under the facility. Changes in credit ratings could lower or raise the fees that we pay under the Credit Facility.

The Credit Facility contains customary covenants, including, but not limited to, the maintenance of a ratio of consolidated indebtedness to total capitalization, as defined in the Credit Facility, of not more than 60% at the end of each fiscal quarter and limitations on liens, mergers, consolidations, liquidation and dissolution, changes in lines of business, swap agreements, transactions with affiliates and subsidiary indebtedness.

Based on our current credit ratings at June 30, 2008, the applicable margin on LIBOR loans would have been 0.24%. As of June 30, 2008, there were no loans outstanding under the Credit Facility; however, $54.2 million in letters of credit were issued and outstanding under the Credit Facility.

Liquidity and Capital Requirements

Our liquidity and capital requirements are primarily a function of our working capital needs, capital expenditures and debt service requirements. We determine the amount of cash required to meet our capital commitments by evaluating the need to upgrade rigs to meet specific customer requirements and by evaluating our ongoing rig equipment replacement and enhancement programs, including water depth and drilling capability upgrades. We believe that our operating cash flows and cash reserves will be sufficient to meet both our working capital requirements and our capital commitments over the next twelve months; however, we will continue to make periodic assessments based on industry conditions and will adjust capital spending programs if required.

In addition, we may, from time to time, issue debt or equity securities, or a combination thereof, to finance capital expenditures, the acquisition of assets and businesses or for general corporate purposes. Our ability to effect any such issuance will be dependent on our results of operations, our current financial condition, current market conditions and other factors beyond our control. Additionally, we may also make use of our Credit Facility to finance capital expenditures or for other general corporate purposes.

Purchase Obligations Related to Rig Construction/Modifications.

Purchase Obligations. As of June 30, 2008 we had purchase obligations aggregating approximately $109 million related to the major upgrade of the *Ocean Monarch* and construction of the *Ocean Scepter*. We expect to complete funding of these projects in 2008. 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 June 30, 2008 except for those related to our direct rig operations, which arise during the normal course of business.

Other Commercial Commitments Letters of Credit.

We were contingently liable as of June 30, 2008 in the amount of $154.2 million under certain performance, bid, supersedeas and custom bonds and letters of credit, including $54.2 million in letters of credit issued under our Credit Facility. During 2008 we purchased two additional bonds totaling $11.9 million from a related party after obtaining competitive quotes. Premiums and fees associated with these bonds totaled $57,000. Agreements relating to approximately $89.8 million of performance bonds can require collateral at any time. As of June 30, 2008, we had not been required to make any collateral deposits with respect to these agreements. The remaining agreements do not require collateral except in events of default. On our behalf, banks have issued letters of credit securing certain of these bonds.

Credit Ratings.

Our current credit rating is Baa1 for Moody s Investors Services and A- for Standard & Poor s. Although our long-term ratings continue at investment grade levels, lower ratings would result in higher rates for borrowings under our Credit Facility and could also result in higher interest rates on future debt issuances.

Capital Expenditures.

The upgrade of the *Ocean Monarch* continues in Singapore with expected delivery of the upgraded rig late in the fourth quarter of 2008. We expect to spend approximately $310 million to modernize this rig of which $229.4 million had been spent through June 30, 2008.

Construction of our two high-performance, premium jack-up rigs, the *Ocean Scepter* and the *Ocean Shield*, has been completed. The *Ocean Shield* is currently operating offshore Malaysia while the *Ocean Scepter* is being commissioned. We expect the *Ocean Scepter* to begin operating under contract during the third quarter of 2008. The aggregate expected cost for both rigs is approximately $320 million, including drill pipe and capitalized interest, of which $293.7 million had been spent through June 30, 2008.

We have budgeted approximately $540 million in additional capital expenditures in 2008 associated with our ongoing rig equipment replacement and enhancement programs, equipment required for our long-term international contracts and other corporate requirements. During the first six months of 2008, we spent approximately $190 million on our continuing rig capital maintenance program (other than rig upgrades and new construction) and to meet other corporate capital expenditure requirements, including approximately $37 million towards modification of certain of our rigs to meet contractual requirements. We expect to finance our 2008 capital expenditures through the use of our existing cash balances or internally generated funds. From time to time, however, we may also make use of our Credit Facility to finance capital expenditures.

Off-Balance Sheet Arrangements.

At June 30, 2008 and December 31, 2007, we had no off-balance sheet debt or other arrangements.

Historical Cash Flows

The following is a discussion of our historical cash flows from operating, investing and financing activities for the quarter ended June 30, 2008 compared to the same quarter in 2007.

Net Cash Provided by Operating Activities.

	Six Months Ended June 30,		
	2008	2007	Change
		(In thousands)	
Net income	$ 706,908	$ 476,077	$ 230,831
Net changes in operating assets and liabilities	(271,721)	(2,052)	(269,669)
Loss on sale of marketable securities	3	8	(5)
Depreciation and other non-cash items, net	158,896	10#160;	

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(In thousands)	For the Quarter Ended March 31, 2012 Plumbing & Refrigeration Segment	OEM Segment	Corporate and Eliminations	Total
Net sales	$ 315,354	$ 270,976	$ (8,662)	$ 577,668
Cost of goods sold	265,471	236,200	(8,496)	493,175
Depreciation and amortization	4,145	3,059	325	7,529
Selling, general, and administrative expense	18,980	6,992	5,630	31,602
Insurance settlement	(1,500)	—	—	(1,500)
Operating income	28,258	24,725	(6,121)	46,862
Interest expense				(2,637)
Other income, net				254
Income before income taxes				$ 44,479

Note 7 – Employee Benefits

The Company sponsors several qualified and nonqualified pension plans and other postretirement benefit plans for certain of its employees. The components of net periodic benefit cost are as follows:

(In thousands)	For the Quarter Ended March 30, 2013	March 31, 2012
Pension benefits:		
Service cost	$ 375	$ 360
Interest cost	2,030	2,219
Expected return on plan assets	(2,798)	(2,713)
Amortization of net loss	992	943
Net periodic benefit cost	$ 599	$ 809
Other benefits:		
Service cost	$ 68	$ 75
Interest cost	280	309
Amortization of prior service cost	2	—
Amortization of net (gain) loss	(26)	3
Net periodic benefit cost	$ 324	$ 387

Note 8 – Income Taxes

The Company's effective tax rate for the first quarter of 2013 was 34 percent compared with 26 percent for the same period last year. Factors that explain the difference between the effective tax rate and what would be computed using the U.S. federal statutory tax rate for the first quarter of 2013 were: (i) the U.S. production activities deduction of $1.2 million; (ii) decreases in valuation allowances of $0.5 million; and (iii) the effect of foreign tax rates lower than statutory tax rates and other foreign adjustments of $0.3 million. These items were partially offset by the provision for state income taxes, net of the federal benefit, of $1.1 million.

For the first quarter of 2012, the difference between the effective tax rate and the U.S. federal statutory tax rate relates primarily to: (i) the U.S. production activities deduction of $1.2 million; (ii) decreases in tax contingencies of $0.9 million; (iii) decreases in valuation allowances of $0.8 million; and (iv) the effect of foreign tax rates lower than statutory tax rates and other foreign adjustments of $2.6 million. These items were partially offset by the provision for state income taxes, net of the federal benefit, of $1.3 million.

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Due to ongoing federal and state income tax audits and potential lapses of the statutes of limitations in various taxing jurisdictions, it is reasonably possible that unrecognized tax benefits may decrease in the next twelve months by up to $0.7 million, all of which could impact the effective tax rate, if recognized. Total unrecognized tax benefits including derecognized deferred tax assets at the end of the first quarter were $3.5 million, including $0.2 million of accrued interest.

The Company files a consolidated U.S. federal income tax return and numerous consolidated and separate-company income tax returns in many state, local, and foreign jurisdictions. The statute of limitations is open for the Company's federal tax return and most state income tax returns for 2009 and all subsequent years. The Internal Revenue Service has audited the Company's 2009 and 2010 consolidated U.S. federal income tax returns, the results of which were immaterial to the consolidated financial statements. The statutes of limitations for certain state and foreign returns are open for earlier tax years due to ongoing audits and differing statute periods. While the Company believes that it is adequately reserved for possible future audit adjustments, the final resolution of these examinations cannot be determined with certainty and could result in final settlements that differ from current estimates.

Note 9 – Derivative Instruments and Hedging Activities

Cash Flow Hedges

Copper and brass represent the largest component of the Company's variable costs of production. The cost of these materials is subject to global market fluctuations caused by factors beyond the Company's control. The Company occasionally enters into forward fixed-price arrangements with certain customers; the risk of these arrangements is generally managed with commodity futures contracts. The Company accounts for these futures contracts in accordance with ASC 815, Derivatives and Hedging (ASC 815). These futures contracts have been designated as cash flow hedges. The fair value of open futures contracts is recognized as a component of accumulated other comprehensive income until the position which corresponds to the period when the related hedged transaction is recognized in earnings. Should these contracts no longer meet hedge criteria in accordance with ASC 815, either through lack of effectiveness or because the hedged transaction is no longer probable of occurring, all deferred gains and losses related to the hedge would be immediately reclassified from accumulated other comprehensive income into earnings. In the next twelve months, the Company will reclassify into earnings realized gains or losses of cash flow hedges; at March 30, 2013, the net value included in other comprehensive income (OCI) was approximately a $1.4 million loss.

At March 30, 2013, the Company held open futures contracts to purchase approximately $28.4 million of copper over the next nine months related to fixed price sales orders. The fair value of those futures contracts was a $1.4 million loss position, which was determined by obtaining quoted market prices (Level 1 hierarchy as defined by ASC 820, Fair Value Measurements and Disclosures (ASC 820)).

Derivative instruments designated as cash flow hedges under ASC 815 are reflected in the Condensed Consolidated Financial Statements as follows:

	March 30, 2013		
(In thousands)	Location		Fair value
Commodity contracts	Other current liabilities:	Loss positions	$ (1,371)

December 29, 2012

(In thousands)		Location	Fair value
Commodity contracts	Other current liabilities:	Gain positions	$ 172
		Loss positions	(420)

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The following tables summarize activities related to the Company's commodity contract derivative instruments classified as cash flow hedges:

(In thousands)	(Loss) Gain Recognized in Accumulated OCI (Effective Portion), Net of Tax For the Quarter Ended March 30, 2013	March 31, 2012
Commodity contracts	$ (657)	$ 1,287

(In thousands)	(Gain) Loss Reclassified from Accumulated OCI into Income (Effective Portion), Net of Tax For the Quarter Ended March 30, 2013	March 31, 2012
Commodity contracts:		
Cost of goods sold	$ (78)	$ (374)

Fair Value Hedges

The Company enters into futures contracts to protect the value of inventory against market fluctuations. The Company accounts for these futures contracts in accordance with ASC 815. These futures contracts have been designated as fair value hedges. For fair value hedges, the changes in value of the hedging derivative, as well as the changes in value of the related hedged item due to the risk being hedged, are reflected in current earnings. Hedge ineffectiveness is reflected in current earnings in the period in which it occurs. At March 30, 2013, the Company held open futures contracts to sell approximately $49.5 million of copper over the next six months related to copper inventory. The fair value of those futures contracts was a $3.7 million gain position and is recorded as an other current asset. The fair value was determined by obtaining quoted market prices (Level 1 hierarchy as defined by ASC 820).

The following tables summarize the gains (losses) on the Company's inventory fair value hedges:

(In thousands)	Gains (Losses) on Fair Value Hedges for the Quarter Ended March 30, 2013 Location	Amount
Gain on the derivatives designated and qualifying fair value hedges:		
Commodity Contracts	Cost of goods sold	$ 3,333
(Loss) on the hedged item designated and qualifying fair value hedges:		
Inventory	Cost of goods sold	$ (2,885)

Foreign Currency Hedges

During 2012, the Company entered into contracts to purchase heavy machinery and equipment. These contracts are denominated in euros. To protect itself against adverse exchange rate fluctuations, the Company has entered into forward contracts to purchase euros. At March 30, 2013, the Company held open forward contracts to purchase approximately 6.5 million euros over the next 14 months. The fair value was determined by obtaining quoted market prices (Level 1 hierarchy as defined by ASC 820).

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(In thousands)		March 30, 2013 Location	Fair value
Firm commitment	Other current assets:	Gain positions	$ 53
Foreign currency contracts	Other current liabilities:	Loss positions	(53)

(In thousands)		December 29, 2012 Location	Fair value
Foreign currency contracts	Other current assets:	Gain positions	$ 307
Firm commitment	Other current liabilities:	Loss positions	(307)

Interest Rate Swap

On February 20, 2013, the Company entered into a two-year forward-starting interest rate swap agreement with an effective date of January 12, 2015, and an underlying notional amount of $200.0 million, pursuant to which the Company receives variable interest payments based on one-month LIBOR and pays fixed interest at a rate of 1.4 percent. Based on the Company's current variable premium pricing on its Term Loan Facility, the all-in fixed rate on the effective date is 2.7 percent. The interest rate swap will mature on December 11, 2017, and is structured to fix the interest rate risk associated with the Company's floating-rate, LIBOR-based Term Loan Facility Agreement. The swap was designated and accounted for as a cash flow hedge from inception.

The fair value of the interest rate swap is estimated based on the present value of the difference between expected cash flows calculated at the contracted interest rate and the expected cash flows at the current market interest rate using observable benchmarks for LIBOR forward rates at the end of the period (Level 2 hierarchy as defined by ASC 820). The effective portion of the mark-to-market gain or loss is reported as a component of accumulated OCI and subsequently reclassified into earnings when the hedged transactions occur and affect earnings. Interest payable and receivable under the swap agreement will be accrued and recorded as an adjustment to interest expense.

The following tables summarize activities related to the interest rate swap agreement derivative instruments classified as a cash flow hedge:

	(Loss) Gain Recognized in Accumulated OCI (Effective Portion), Net of Tax For the Quarter Ended	
(In thousands)	March 30, 2013	March 31, 2012
Interest rate swap	$ (999)	$ —

The Company enters into futures contracts that closely match the terms of the underlying transactions. As a result, the ineffective portion of the open hedge contracts through March 30, 2013 was not material to the Condensed Consolidated Statements of Income.

The Company does not offset fair value of amounts for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral.

Note 10 – Accumulated Other Comprehensive Income

During the first quarter of 2013, the Company adopted ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (ASU 2013-02). Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of accumulated OCI by component. In addition, an entity is required to present significant amounts reclassified out of accumulated OCI by the respective line items of net income.

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Changes in accumulated OCI by component, net of taxes and noncontrolling interest, were as follows:

(In thousands)	For the Quarter Ended March 30, 2013 Cumulative translation adjustment	Unrealized (losses)/gains on derivatives	Minimum pension/OPEB liability adjustment	Unrealized gains on equity investments	Total
Beginning balance	$ (3,033)	$ (166)	$ (39,527)	$ 103	$ (42,623)
Other comprehensive income before reclassifications	(5,290)	(1,650)	890	41	(6,009)
Amounts reclassified from accumulated OCI	—	(74)	649	—	575
Net current-period other comprehensive income	(5,290)	(1,724)	1,539	41	(5,434)
Ending balance	$ (8,323)	$ (1,890)	$ (37,988)	$ 144	$ (48,057)

Reclassification adjustments out of accumulated OCI were as follows:

(In thousands)	For the Quarter Ended March 30, 2013 Amount reclassified from Accumulated OCI	Affected line item
Unrealized gains on derivatives:		
Closed positions, commodity contracts	$ (90)	Cost of goods sold
	16	Income tax expense
	(74)	Net of tax
	—	Noncontrolling interest
	$ (74)	Net of tax and noncontrolling interest
Amortization of employee benefit items:		
Amortization of net loss	$ 968	Selling, general, and administrative expense
	(319)	Income tax expense
	649	Net of tax
	—	Noncontrolling interest
	$ 649	Net of tax and noncontrolling interest

Note 11 – Recently Issued Accounting Standards

In December 2011, the Financial Accounting Standards Board (FASB) issued amendments to ASU 2011-11, Balance Sheet (Topic 210); Disclosures about Offsetting Assets and Liabilities. The amendments in this update are designed to enhance disclosures by requiring improved information about financial instruments and derivative instruments that are either (a) offset in accordance with certain right to set-off conditions prescribed by current accounting guidance or (b) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with current accounting guidance. The amendments to ASU 2011-11 will be effective for the first interim or annual period beginning on or after January 1, 2013. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial position, results of operations, or cash flows.

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In March 2013, the FASB issued ASU 2013-05, Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity, an amendment to FASB Accounting Standards ASC Topic 830, Foreign Currency Matters. The update clarifies that complete or substantially complete liquidation of a foreign entity is required to release the cumulative translation adjustment (CTA) for transactions occurring within a foreign entity. However, transactions impacting investments in a foreign entity may result in a full or partial release of CTA even though complete or substantially complete liquidation of the foreign entity has not occurred. Furthermore, for transactions involving step acquisitions, the CTA associated with the previous equity-method investment will be fully released when control is obtained and consolidation occurs. This ASU is effective for fiscal years beginning after December 15, 2013. The Company will apply the guidance prospectively to derecognition events occurring after the effective date. The adoption of ASU 2013-05 is not expected to have a significant impact on the Company’s consolidated financial position, results of operations, or cash flows.

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

General Overview

The Company is a leading manufacturer of copper, brass, plastic, and aluminum products. The range of these products is broad: copper tube and fittings; brass and copper alloy rod, bar, and shapes; aluminum and brass forgings; aluminum and copper impact extrusions; plastic pipe, fittings and valves; refrigeration valves and fittings; fabricated tubular products; and steel nipples. The Company also resells imported brass and plastic plumbing valves, malleable iron fittings, faucets and plumbing specialty products. Mueller’s operations are located throughout the United States and in Canada, Mexico, Great Britain, and China.

The Company’s businesses are aggregated into two reportable segments: the Plumbing & Refrigeration segment and the Original Equipment Manufacturers (OEM) segment. For disclosure purposes, as permitted under ASC 280, Segment Reporting, certain operating segments are aggregated into reportable segments. The Plumbing & Refrigeration segment is composed of Standard Products (SPD), European Operations, and Mexican Operations. The OEM segment is composed of Industrial Products (IPD), Engineered Products Division (EPD), and Mueller-Xingrong. Certain administrative expenses and expenses related primarily to retiree benefits at inactive operations are combined into the Corporate and Eliminations classification. These reportable segments are described in more detail below.

SPD manufactures and sells copper tube, copper and plastic fittings, line sets, plastic pipe, and valves in North America and sources products for import distribution in North America. European Operations manufacture copper tube in Europe, which is sold in Europe and the Middle East; activities also include import distribution in the U.K. and Ireland. Mexican Operations consist of pipe nipple manufacturing and import distribution businesses including product lines of malleable iron fittings and other plumbing specialties. The Plumbing & Refrigeration segment sells products to wholesalers in the heating, ventilation, and air-conditioning (HVAC), plumbing, and refrigeration markets, to distributors to the manufactured housing and recreational vehicle industries, and to building material retailers.

The OEM segment manufactures and sells brass and copper alloy rod, bar, and shapes; aluminum and brass forgings; aluminum and copper impact extrusions; refrigeration valves and fittings; fabricated tubular products; and gas valves and assemblies. Mueller–Xingrong manufactures engineered copper tube primarily for air-conditioning applications; these products are sold primarily to OEM’s located in China. The OEM segment sells its products primarily to original equipment manufacturers, many of which are in the HVAC, plumbing, and refrigeration markets.

New housing starts and commercial construction are important determinants of the Company's sales to the HVAC, refrigeration, and plumbing markets because the principal end use of a significant portion of the Company's products is in the construction of single and multi-family housing and commercial buildings. Repairs and remodeling projects are also important drivers of underlying demand for these products.

The majority of the Company's manufacturing facilities operated below capacity during 2012 and the first quarter of 2013 due to reduced demand for the Company's products arising from the general economic conditions in the U.S. and foreign markets that the Company serves. The U.S. housing and residential construction market has not fully recovered from the economic downturn during 2008 and 2009. The recent years from 2009 through 2011 had the lowest recorded housing starts since recordkeeping began in 1959. From 1959 through 2007, annual housing starts averaged over 1.5 million units. Commercial construction has also declined significantly in recent years, and, in fact, many categories remain at levels lower than a decade ago. These conditions have significantly affected the demand for virtually all of the Company's core products in recent years.

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Residential construction activity improved in 2012 and the improvement continues into 2013, but is still at levels below historical averages. Recovery in the near-term is expected, but may be tempered by continuing high rates of unemployment and tighter lending standards. Per the U.S. Census Bureau, actual housing starts in the U.S. were 211 thousand for the first quarter of 2013, up from 155 thousand for the first quarter of 2012. The March 2013 seasonally adjusted annual rate of new housing starts was 1.0 million compared with the March 2012 rate of 706 thousand. Mortgage rates have remained at low levels during 2013 and 2012, as the average 30-year fixed mortgage rate was 3.50 percent for the first three months of 2013 and 3.66 percent for the twelve months ended December 2012.

The private non-residential construction sector, which includes offices, industrial and retail projects, began showing modest improvement in 2012 after declines of two percent in 2011, 25 percent in 2010 and 16 percent in 2009. According to the U.S. Census Bureau, the seasonally adjusted annual value of private nonresidential construction put in place was $309.6 billion in February 2013 compared to actual private non-residential value of construction put in place of $327.5 billion for 2012. The Company expects that most of these conditions will gradually improve, but at an irregular pace.

Profitability of certain of the Company’s product lines depends upon the “spreads” between the cost of raw material and the selling prices of its products. The open market prices for copper cathode and scrap, for example, influence the selling price of copper tube, a principal product manufactured by the Company. The Company attempts to minimize the effects on profitability from fluctuations in material costs by passing through these costs to its customers. The Company’s earnings and cash flow are dependent upon these spreads that fluctuate based upon market conditions.

Earnings and profitability are also impacted by unit volumes that are subject to market trends, such as substitute products, imports, technologies, and market share. In core product lines, the Company intensively manages its pricing structure while attempting to maximize its profitability. From time-to-time, this practice results in lost sales opportunities and lower volume. For plumbing systems, plastics are the primary substitute product; these products represent an increasing share of consumption. U.S. consumption of copper tube is still predominantly supplied by U.S. manufacturers. For certain air-conditioning and refrigeration applications, aluminum based systems are the primary substitution threat. The Company cannot predict the acceptance or the rate of switching that may occur. In recent years, brass rod consumption in the U.S. has declined due to the outsourcing of many manufactured products from offshore regions.

Results of Operations

During the first quarter of 2013, the Company’s net sales were $559.7 million, which compares with net sales of $577.7 million over the same period of 2012. The decrease was primarily attributable to lower unit sales volume in the OEM segment and the decrease in base metal prices, primarily copper. Of the $18.0 million decrease in net sales, approximately $12.1 million was attributable to lower unit volume, while $8.8 million was attributable to lower net selling prices in the Company’s core product lines. Net selling prices generally fluctuate with changes in raw material costs. Changes in raw material costs are generally passed through to customers by adjustments to selling prices. The Comex average copper price in the first quarter of 2013 was approximately $3.60 per pound, or 4.8 percent less than the first quarter of 2012 average of $3.78 per pound.

Cost of goods sold was $482.9 million in the first quarter of 2013 compared with $493.2 million in the same period of 2012. Consistent with the factors noted above regarding net sales, the year-over-year decrease was due primarily to decreased sales volume in core product lines and the decrease in the price of copper, the Company’s principal raw material. In addition, in 2012 the Company recognized a gain from LIFO liquidation that resulted in a reduction of approximately $8.0 million to cost of sales, or $0.13 per diluted share benefit after tax.

Depreciation and amortization increased from $7.5 million in the first quarter of 2012 to $8.2 million in the first quarter of 2013. This is due to an increase in capital spending during 2012. During the first quarter of 2012, the Company settled the business interruption portion of its claim related to the July 2009 explosion at the copper tube facility in Fulton, Mississippi and recognized a $1.5 million gain.

Interest expense decreased to $0.6 million in the first quarter of 2013 from $2.6 million for the same period in 2012. This decrease was primarily due to lower interest rates on outstanding debt at the end of each quarter. In addition, during the first quarter of 2013 the Company capitalized interest expense related to certain capital projects.

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Other income, net was $3.2 million in the first quarter of 2013 compared with income of $0.3 million for the same period in 2012. This increase was primarily related to a $3.0 million gain on the sale of non-operating property during 2013.

The Company's effective tax rate for the first quarter of 2013 was 34 percent compared with 26 percent for the same period last year. Factors that explain the difference between the effective tax rate and what would be computed using the U.S. federal statutory tax rate for the first quarter of 2013 were: (i) the U.S. production activities deduction of $1.2 million; (ii) decreases in valuation allowances of $0.5 million; and (iii) the effect of foreign tax rates lower than statutory tax rates and other foreign adjustments of $0.3 million. These items were partially offset by the provision for state income taxes, net of the federal benefit, of $1.1 million.

For the first quarter of 2012, the difference between the effective tax rate and the U.S. federal statutory tax rate relates primarily to: (i) the U.S. production activities deduction of $1.2 million; (ii) decreases in tax contingencies of $0.9 million; (iii) decreases in valuation allowances of $0.8 million; and (iv) the effect of foreign tax rates lower than statutory tax rates and other foreign adjustments of $2.6 million. These items were partially offset by the provision for state income taxes, net of the federal benefit, of $1.3 million.

The Company's earnings per share were favorably affected by the repurchase of 10.4 million shares from Leucadia National Corporation in September of 2012. By this purchase, the outstanding shares were reduced from 38.5 million shares to 28.1 million shares.

Plumbing & Refrigeration Segment

First quarter net sales by the Plumbing & Refrigeration segment decreased 1.1 percent to $311.8 million in 2013 from $315.4 million in 2012. Of the $3.6 million decrease in net sales, approximately $5.1 million was attributable to lower net selling prices in the segment's core product lines consisting primarily of copper tube, line sets, and fittings, offset by an increase of approximately $2.9 million due to higher unit volume. Cost of goods sold decreased from $265.5 million in the first quarter of 2012 to $264.8 million in the same period of 2013, which was also due to decreasing raw material prices, primarily copper, offset by higher volume. Depreciation and amortization in the first quarter increased from $4.1 million in 2012 to $4.2 million in 2013 resulting from an increase in capital spending during 2012, primarily related to the facilities impacted by the fire in Wynne, Arkansas during 2011. Selling, general, and administrative expenses increased from $19.0 million in the first quarter of 2012 to $20.1 million in the first quarter of 2013. The increase is primarily due to increased employment costs, including incentive compensation, offset by foreign currency transaction gains. Operating income for the segment decreased to $22.6 million in the first quarter of 2013 from $28.3 million in the first quarter of 2012. The decrease in operating income from 2012 was primarily due to the recognition of an $8.0 million LIFO gain and the $1.5 million insurance settlement in the first quarter of 2012. This decrease was offset by higher margins in 2013.

OEM Segment

The OEM segment's first quarter net sales were $253.8 million in 2013 compared with $271.0 million in 2012. The decrease was due primarily to lower sales volume and lower net selling prices resulting from lower average costs of raw materials. Of the $17.2 million decrease in net sales, approximately $15.0 million was attributable to lower sales volume and approximately $3.7 million was due to lower net selling prices in the segment's core product lines of brass rod, forgings, impacts, and commercial tube. This was offset by an increase in sales for the other product lines in the segment. Cost of goods sold decreased to $223.9 million in the first quarter of 2013 from $236.2 million in the same period of 2012, which was also due to the decrease in sales volume and average costs of raw materials. Depreciation and amortization increased slightly from $3.1 million to $3.4 million resulting from increased capital spending in

2012. First quarter selling, general, and administrative expenses were $6.2 million in 2013, compared to $7.0 million for the same period in 2012. The decrease is primarily due to decreased employment costs, offset by foreign currency transaction losses. Operating income decreased from $24.7 million in the first quarter of 2012 to $20.3 million in the same period of 2013, due primarily to lower sales volume and decreased unit spreads.

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Liquidity and Capital Resources

Cash used in operating activities during the three months ended March 30, 2013 totaled $14.9 million, which was primarily attributable to increased receivables of $42.7 million and decreased current liabilities of $5.4 million, partially offset by consolidated net income of $26.4 million plus depreciation and amortization of $8.3 million. The fluctuations in receivables and current liabilities are primarily due to an increase in volume in certain businesses during the first quarter of 2013.

During the first three months of 2013, cash used in investing activities totaled $21.6 million. The major components of net cash used in investing activities included deposits of $14.8 million into restricted cash balances and capital expenditures of $9.8 million, offset by $3.0 million in proceeds from the sale of properties.

Net cash provided by financing activities totaled $22.4 million, which consists primarily of $26.1 million received from the issuance of debt by Mueller-Xingrong, partially offset by $3.5 million used for payment of regular quarterly dividends to stockholders of the Company.

The Company has significant environmental remediation obligations. The performance of these obligations is expected to occur over a minimum of 20 years. Cash used for environmental remediation activities was approximately $244 thousand during the first three months of 2013. The Company expects to spend approximately $1.7 million for the remainder of 2013 for ongoing environmental remediation activities. The timing of a potential payment for a $9.5 million settlement offer related to the Southeast Kansas Sites has not yet been determined.

The Company's credit agreement provides for an unsecured $350.0 million revolving credit facility (the Revolving Credit Facility) and a $200.0 million Term Loan Facility, both maturing on December 11, 2017. The Revolving Credit Facility backed approximately $10.9 million in letters of credit at the end of the quarter. As of March 30, 2013, the Company's total debt was $260.6 million or 31.9 percent of its total capitalization.

Covenants contained in the Company's financing obligations require, among other things, the maintenance of minimum levels of tangible net worth and the satisfaction of certain minimum financial ratios. As of March 30, 2013, the Company was in compliance with all of its debt covenants.

The Company declared and paid a quarterly cash dividend of 12.5 cents per common share in the first quarter of 2013. Payment of dividends in the future is dependent upon the Company's financial condition, cash flows, capital requirements, earnings, and other factors.

Management believes that the credit agreement, cash generated by operations, and currently available cash and cash equivalents of $183.9 million will be adequate to meet the Company's normal future capital expenditures and operational needs. The Company's current ratio was 2.8 to 1 at March 30, 2013.

The Company's Board of Directors has extended, until October 2013, its authorization to repurchase up to ten million shares of the Company's common stock through open market transactions or through privately negotiated transactions. The Company has no obligation to repurchase any shares and may cancel, suspend, or extend the time period for the repurchase of shares at any time. Any repurchases will be funded primarily through existing cash and cash from operations. The Company may hold any shares repurchased in treasury or use a portion of the repurchased shares for employee benefit plans, as well as for other corporate purposes. From its initial authorization in 1999 through March 30, 2013, the Company had repurchased approximately 2.4 million shares under this authorization.

There have been no significant changes in the Company's contractual cash obligations reported at December 29, 2012.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to market risk from changes in raw material and energy costs, interest rates, and foreign currency exchange rates. To reduce such risks, the Company may periodically use financial instruments. All hedging transactions are authorized and executed pursuant to policies and procedures. Further, the Company does not buy or sell financial instruments for trading purposes.

Cost and Availability of Raw Materials and Energy

Copper and brass represent the largest component of the Company's variable costs of production. The cost of these materials is subject to global market fluctuations caused by factors beyond the Company's control. Significant increases in the cost of metal, to the extent not reflected in prices for the Company's finished products, or the lack of availability could materially and adversely affect the Company's business, results of operations, and financial condition.

The Company occasionally enters into forward fixed-price arrangements with certain customers. The Company may utilize futures contracts to hedge risks associated with these fixed-price arrangements. The Company may also utilize futures contracts to manage price risk associated with inventory. Depending on the nature of the hedge, changes in the fair value of the futures contracts will either be offset against the change in fair value of the inventory through earnings or recognized as a component of other comprehensive income and reflected in earnings upon the sale of inventory. Periodic value fluctuations of the contracts generally offset the value fluctuations of the underlying fixed-price transactions or inventory. At March 30, 2013, the Company held open futures contracts to purchase approximately $28.4 million of copper over the next nine months related to fixed-price sales orders and to sell approximately $49.5 million of copper over the next six months related to copper inventory.

The Company may enter into futures contracts or forward fixed-price arrangements with certain vendors to manage price risk associated with natural gas purchases. The effective portion of gains and losses with respect to these positions are deferred in stockholders' equity as a component of accumulated other comprehensive income and reflected in earnings upon consumption of natural gas. Periodic value fluctuations of the contracts generally offset the value fluctuations of the underlying natural gas prices. At March 30, 2013, the Company held no open futures contracts to purchase natural gas.

Interest Rates

At March 30, 2013, the Company had variable-rate debt outstanding of $260.6 million. At these borrowing levels, a hypothetical 10 percent increase in interest rates would have had an insignificant unfavorable impact on the Company's pretax earnings and cash flows. The primary interest rate exposures on floating-rate debt are based on LIBOR and on the base-lending rate published by the People's Bank of China. There was no fixed rate debt outstanding as of March 30, 2013.

The Company has reduced its exposure to increases in LIBOR by entering into interest rate swap contracts. These contracts have been designated as cash flow hedges. The fair value of these contracts have been recorded in the Condensed Consolidated Balance Sheets, and the related gains and losses on the contracts are deferred in stockholders' equity as a component of other comprehensive income. Deferred gains or losses on the contracts will be recognized in interest expense in the period in which the related interest payment being hedged is expensed. The interest rate swap agreement has an effective date of January 12, 2015.

Foreign Currency Exchange Rates

Foreign currency exposures arising from transactions include firm commitments and anticipated transactions denominated in a currency other than an entity's functional currency. The Company and its subsidiaries generally enter into transactions denominated in their respective functional currencies. The Company may utilize certain futures or forward contracts with financial institutions to hedge foreign currency transactional exposures. Gains and losses with respect to these positions are deferred in stockholders' equity as a component of accumulated other comprehensive income and reflected in earnings upon collection of receivables. At March 30, 2013, the Company had open futures contracts with a financial institution to sell approximately 2.9 million Canadian dollars and 1.7 million euros through June 2013. It also held open futures contracts to buy approximately 6.5 million euros over the next 14 months.

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The Company's primary foreign currency exposure arises from foreign-denominated revenues and profits and their translation into U.S. dollars. The primary currencies to which the Company is exposed include the Canadian dollar, the British pound sterling, the euro, the Mexican peso, and the Chinese renminbi. The Company generally views as long-term its investments in foreign subsidiaries with a functional currency other than the U.S. dollar. As a result, the Company generally does not hedge these net investments.

Cautionary Statement Regarding Forward Looking Information

Statements in this Quarterly Report on Form 10-Q that are not strictly historical may be "forward-looking" statements, which involve risks and uncertainties. These include economic and currency conditions, continued availability of raw materials and energy, market demand, pricing, competitive and technological factors, and the availability of financing, among others, as set forth in the Company's filings with the Securities and Exchange Commission (SEC). The words "outlook," "estimate," "project," "intend," "expect," "believe," "target," and similar expressions are intended to i forward-looking statements. The reader should not place undue reliance on forward-looking statements, which speak only as of the date of this report. The Company has no obligation to publicly update or revise any forward-looking statements to reflect events after the date of this report.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure information required to be disclosed in Company reports filed under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in Company reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures pursuant to Rule 13a-15(e) of the Exchange Act as of March 30, 2013. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective as of March 30, 2013 to ensure that information required to be disclosed in Company reports filed under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms and (ii) accumulated and communicated to management, including the Company's principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the Company's fiscal quarter ending March 30, 2013, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION
Item 1. Legal Proceedings

General

The Company is involved in certain litigation as a result of claims that arose in the ordinary course of business. Additionally, the Company may realize the benefit of certain legal claims and litigation in the future; these gain contingencies are not recognized in the Condensed Consolidated Financial Statements.

Extruded Metals Class Action

A purported class action was filed in Michigan Circuit Court by Gaylord L. Miller, and all others similarly situated, against Extruded in March 2012 under nuisance, negligence, and gross negligence theories. It is brought on behalf of all persons in the City of Belding, Michigan, whose property rights have allegedly been interfered with by fallout and/or dust and/or noxious odors, allegedly attributable to Extruded's operations. Plaintiffs allege that they have suffered interference with the use and enjoyment of their properties. They seek compensatory and exemplary damages and injunctive relief. The court has not yet been asked to certify a class. The Company has reached a settlement in principle that, if approved by the court, will result in the dismissal of the action. The Company and Plaintiffs are preparing documents that will embody the settlement. It is expected that Plaintiffs will file a motion for court approval of the settlement in the near future. Should the settlement not be consummated or approved, the Company will complete its discovery, oppose Plaintiffs' expected class certification motion, and seek dismissal of Plaintiffs' claims. Until the settlement is consummated and approved, or until the court rules on key motions (should the settlement not be consummated or approved), the Company is unable to determine the impact, if any, that this matter will have on its financial position, results of operations, or cash flows.

Environmental Matters

Non-Operating properties:

East Chicago, Indiana USS Lead Superfund site

U.S.S. Lead Refinery, Inc. (Lead Refinery), a non-operating wholly owned subsidiary of MRRC, has conducted corrective action and interim remedial activities and studies (collectively, Site Activities) at Lead Refinery's East Chicago, Indiana site pursuant to the Resource Conservation and Recovery Act. Site Activities, which began in December 1996, have been substantially concluded. Lead Refinery is required to perform monitoring and maintenance activities with respect to Site Activities pursuant to a post-closure permit issued by the Indiana Department of Environmental Management (IDEM) effective as of March 2, 2013. Lead Refinery spent approximately $0.1 million annually in 2012, 2011 and 2010 with respect to this site. Approximate costs to comply with the post-closure permit, including associated general and administrative costs, are between $2.4 million and $3.6 million over the next 20 years.

On April 9, 2009, pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), the EPA added the Lead Refinery site, and properties surrounding the Lead Refinery site, to the National Priorities List (NPL). The NPL is a list of priority sites where the EPA has determined that there has been a release or threatened release of hazardous substances that warrant investigation and, if appropriate, remedial action. The NPL does not assign liability to any party including the owner or operator of a property placed on the NPL. The placement of a site on the NPL does not necessarily mean that remedial action must be taken. On July 17, 2009, Lead Refinery received a written notice from the EPA that the agency is of the view that Lead Refinery may be a PRP under

CERCLA in connection with the release or threat of release of hazardous substances including lead into properties surrounding the Lead Refinery site. The EPA has identified two other PRPs in connection with the release or threat of release of hazardous substances into properties surrounding the Lead Refinery site. PRPs under CERCLA include current and former owners and operators of a site, persons who arranged for disposal or treatment of hazardous substances at a site, or persons who accepted hazardous substances for transport to a site. In November 2012, the EPA adopted a remedy in connection with properties surrounding the Lead Refinery site. The EPA has estimated that the cost to implement the November 2012 remedy will be $29.9 million.

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The Company monitors EPA releases and periodically communicates with the EPA to inquire of the status of the investigation and cleanup of the Lead Refinery site. As of March 30, 2013, the EPA has not conducted an investigation of the Lead Refinery site, proposed remedies for the Lead Refinery site, or informed Lead Refinery that it is a PRP at the Lead Refinery site. Until the extent of remedial action is determined for the Lead Refinery site, the Company is unable to determine the likelihood of a material adverse outcome or the amount or range of a potential loss with respect to placement of the Lead Refinery site and adjacent properties on the NPL. Lead Refinery lacks the financial resources needed to undertake any investigations or remedial action that may be required by the EPA pursuant to CERCLA.

Item 1A. Risk Factors

The Company is exposed to risk as it operates its businesses. To provide a framework to understand the operating environment of the Company, we have provided a brief explanation of the more significant risks associated with our businesses in our 2012 Annual Report on Form 10-K. There have been no material changes in risk factors that were previously disclosed in our 2012 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

The Company's Board of Directors has extended, until October 2013, its authorization to repurchase up to ten million shares of the Company's common stock through open market transactions or through privately negotiated transactions. The Company has no obligation to repurchase any shares and may cancel, suspend, or extend the time period for the repurchase of shares at any time. Any repurchases will be funded primarily through existing cash and cash from operations. The Company may hold any shares repurchased in treasury or use a portion of the repurchased shares for employee benefit plans, as well as for other corporate purposes. From its initial authorization in 1999 through March 30, 2013, the Company had repurchased approximately 2.4 million shares under this authorization. Below is a summary of the Company's stock repurchases for the period ended March 30, 2013.

	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
				7,647,030(1)
December 30, 2012 – January 26, 2013	894(2)	$ 50.54	—	
	2,724(2)	$ 54.02	—	

January 27 – February 23, 2013			
February 24 – March 30, 2013	12,079 (2)	$ 52.80	—

(1) Shares available to be purchased under the Company’s ten million share repurchase authorization until October 2013. The extension of the authorization was announced on October 26, 2012.

(2) Shares tendered to the Company by holders of stock-based awards in payment of the purchase price and/or withholding taxes upon exercise and/or vesting.

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Item 6. Exhibits

31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.INS	XBRL Instance Document
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Presentation Linkbase Document
101.SCH	XBRL Taxonomy Extension Schema

Items 3, 4, and 5 are not applicable and have been omitted.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MUELLER INDUSTRIES, INC.

	/s/ Jeffrey A. Martin
	Jeffrey A. Martin
April 26, 2013	Chief Financial Officer and Treasurer
Date	(Principal Financial and Accounting Officer)
	/s/ Richard W. Corman
April 26, 2013	Richard W. Corman
Date	Vice President – Controller

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EXHIBIT INDEX

Exhibits	Description
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32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.INS	XBRL Instance Document
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Presentation Linkbase Document
101.SCH	XBRL Taxonomy Extension Schema