

UNIVERSAL HEALTH SERVICES INC

Form 10-Q

November 08, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(MARK ONE)

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

For the quarterly period ended September 30, 2007

OR

**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 1-10765

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**UNIVERSAL HEALTH SERVICES, INC.**

(Exact name of registrant as specified in its charter)

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**DELAWARE**  
(State or other jurisdiction of

incorporation or organization)

**UNIVERSAL CORPORATE CENTER**

**367 SOUTH GULPH ROAD**

**23-2077891**  
(I.R.S. Employer

Identification No.)

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**KING OF PRUSSIA, PENNSYLVANIA 19406**

(Address of principal executive offices) (Zip Code)

**Registrant's telephone number, including area code (610) 768-3300**

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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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common shares outstanding, as of October 31, 2007:

Class A	3,328,404
Class B	50,007,970
Class C	335,800
Class D	23,890

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**Table of Contents****PART I. FINANCIAL INFORMATION****UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

(amounts in thousands, except per share amounts)

(unaudited)

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net revenues	\$ 1,180,217	\$ 1,043,457	\$ 3,556,794	\$ 3,125,419
Operating charges:				
Salaries, wages and benefits	510,917	459,099	1,520,489	1,336,087
Other operating expenses	265,534	211,875	748,979	708,932
Supplies expense	162,342	146,944	506,946	400,271
Provision for doubtful accounts	110,451	97,901	312,583	260,090
Depreciation and amortization	46,548	40,961	135,417	120,360
Lease and rental expense	17,920	16,184	50,701	48,247
Hurricane related expenses	82	4,172	707	14,432
Hurricane insurance recoveries		(4,172)		(14,432)
	1,113,794	972,964	3,275,822	2,873,987
Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes	66,423	70,493	280,972	251,432
Interest expense, net	12,881	6,140	38,643	23,362
Hurricane insurance recoveries in excess of expenses		(130,328)		(167,359)
Minority interests in earnings of consolidated entities	9,784	14,948	32,651	37,617
Income before income taxes	43,758	179,733	209,678	357,812
Provision for income taxes	14,756	65,704	79,062	132,420
Income from continuing operations	29,002	114,029	130,616	225,392
Loss from discontinued operations, net of income taxes	(148)	(84)	(183)	(104)
Net income	\$ 28,854	\$ 113,945	\$ 130,433	\$ 225,288
Basic earnings per share:				
From continuing operations	\$ 0.54	\$ 2.01	\$ 2.44	\$ 4.11
From discontinued operations	0.00	0.00	0.00	0.00
Total basic earnings per share	\$ 0.54	\$ 2.01	\$ 2.44	\$ 4.11
Diluted earnings per share:				
From continuing operations	\$ 0.54	\$ 2.00	\$ 2.43	\$ 3.89
From discontinued operations	0.00	0.00	0.00	0.00
Total diluted earnings per share	\$ 0.54	\$ 2.00	\$ 2.43	\$ 3.89

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Weighted average number of common shares basic	53,481	56,794	53,491	54,764
Add: Shares for conversion of convertible debentures				4,168
Other share equivalents	148	207	190	227
Weighted average number of common shares and equivalents diluted	53,629	57,001	53,681	59,159

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

**Table of Contents****UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollar amounts in thousands)

(unaudited)

	September 30, 2007	December 31, 2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 13,574	\$ 14,939
Accounts receivable, net	631,527	595,009
Supplies	70,874	64,532
Other current assets	30,172	19,113
Deferred and prepaid income taxes	60,733	34,913
Total current assets	806,880	728,506
Property and equipment	2,971,787	2,665,209
Less: accumulated depreciation	(1,077,280)	(980,124)
	1,894,507	1,685,085
Other assets:		
Goodwill	753,846	719,991
Deferred charges	6,824	7,262
Other	136,871	136,198
	\$ 3,598,928	\$ 3,277,042
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Current maturities of long-term debt	\$ 3,329	\$ 1,938
Accounts payable and accrued liabilities	554,582	491,309
Federal and state taxes		9,204
Total current liabilities	557,911	502,451
Other noncurrent liabilities	353,328	340,815
Minority interests	203,412	174,061
Long-term debt	900,628	821,363
Deferred income taxes	48,810	35,888
Commitments and contingencies		
Common stockholders' equity	1,534,839	1,402,464
	\$ 3,598,928	\$ 3,277,042

See accompanying notes to these condensed consolidated financial statements.



**Table of Contents****UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

(unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 130,433	\$ 225,288
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation & amortization	135,417	120,360
Accretion of discount on convertible debentures		6,364
Gain on sale of assets	(2,200)	
Hurricane insurance recoveries		(137,862)
Hurricane related expenses		4,894
Changes in assets & liabilities, net of effects from acquisitions and dispositions:		
Accounts receivable	(17,359)	(85,132)
Accrued interest	9,055	7,519
Accrued and deferred income taxes	(6,374)	36,745
Other working capital accounts	47,558	8,157
Other assets and deferred charges	37	6,943
Other	4,923	11,413
Minority interest in earnings of consolidated entities, net of distributions	9,041	15,223
Accrued insurance expense, net of commercial premiums paid	45,275	61,378
Payments made in settlement of self-insurance claims	(33,025)	(31,270)
Net cash provided by operating activities	322,781	250,020
<b>Cash Flows from Investing Activities:</b>		
Property and equipment additions, net of disposals	(263,366)	(233,008)
Acquisition of property and businesses	(103,159)	(45,654)
Hurricane insurance recoveries received		144,571
Proceeds received from sales of assets	5,268	
Purchase of minority ownership interest in majority owned business	(14,762)	
Net cash used in investing activities	(376,019)	(134,091)
<b>Cash Flows from Financing Activities:</b>		
Reduction of long-term debt	(103,846)	(141,804)
Additional borrowings	170,000	248,645
Issuance of common stock	1,041	4,205
Repurchase of common shares	(14,386)	(220,343)
Dividends paid	(12,917)	(13,090)
Financing costs	(148)	(2,020)
Net cash received for termination of derivatives		3,393
Capital contributions from minority member	12,129	11,939
Net cash provided by (used in) financing activities	51,873	(109,075)
<b>(Decrease) Increase in cash and cash equivalents</b>	<b>(1,365)</b>	<b>6,854</b>



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Cash and cash equivalents, beginning of period	14,939	7,963
<b>Cash and cash equivalents, end of period</b>	<b>\$ 13,574</b>	<b>\$ 14,817</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Interest paid	\$ 35,991	\$ 18,073
Income taxes paid, net of refunds	\$ 83,894	\$ 95,412

See accompanying notes to these condensed consolidated financial statements.

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**UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) General**

This Report on Form 10-Q is for the Quarterly period ended September 30, 2007. In this Quarterly Report, we, us, our and the Company refer to Universal Health Services, Inc. and its subsidiaries.

You should carefully review the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, expects, plans, anticipates, believes, estimates, potential, or continue or the negative of those words and other comparable words. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks related to healthcare industry trends and those detailed in our filings with the Securities and Exchange Commission including those set forth in our Annual Report on Form 10-K for the year ended December 31, 2006 in Item 1A-Risk Factors and in Item 7-Forward Looking Statements and Risk Factors. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

The condensed consolidated financial statements include the accounts of our majority-owned subsidiaries and partnerships and limited liability companies controlled by us, or our subsidiaries, as managing general partner or managing member. The condensed consolidated financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. The balance sheet at December 31, 2006 has been derived from the audited financial statements. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements, significant accounting policies and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**(2) Relationship with Universal Health Realty Income Trust and Related Party Transactions**

***Relationship with Universal Health Realty Income Trust:***

At September 30, 2007, we held approximately 6.7% of the outstanding shares of Universal Health Realty Income Trust (the Trust). We serve as Advisor to the Trust under an annually renewable advisory agreement pursuant to the terms of which, we conduct the Trust's day-to-day affairs, provide administrative services and present investment opportunities. In addition, certain of our officers and directors are also officers and/or directors of the Trust. Management believes that it has the ability to exercise significant influence over the Trust, therefore we account for our investment in the Trust using the equity method of accounting. We earned an advisory fee from the Trust, which is included in net revenues in the accompanying condensed consolidated statements of income, of approximately \$355,000 and \$364,000 during the three month periods ended September 30, 2007 and 2006, respectively, and approximately \$1.1 million during each of the nine month periods ended September 30, 2007 and 2006. Our pre-tax share of income from the Trust was \$299,000 and \$1.3 million during the three month periods ended September 30, 2007 and 2006, respectively, and \$1.2 million and \$2.1 million during the nine month periods ended September 30, 2007 and 2006, respectively. The carrying value of this investment was \$10.0 million at September 30, 2007 and \$10.2 million at December 31, 2006, and is included in other assets in the accompanying condensed consolidated balance sheets. The market value of this investment was \$28.0 million at September 30, 2007 and \$30.7 million at December 31, 2006.

Total rent expense under the operating leases on the hospital facilities with the Trust was \$3.9 million during each of the three month periods ended September 30, 2007 and 2006 and \$12.0 million and \$11.9 million during the nine month periods ended September 30, 2007 and 2006, respectively. In addition, certain of our subsidiaries are tenants in several medical office buildings owned by limited liability companies in which the Trust holds non-controlling ownership interests.

The Trust commenced operations in 1986 by purchasing certain properties from us and immediately leasing the properties back to our respective subsidiaries. Most of the leases were entered into at the time the Trust commenced operations and provided for initial terms of 13 to 15 years with up to six additional 5-year renewal terms. Each lease also provided for additional or bonus rental, as discussed below. In 1998, the lease for

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McAllen Medical Center was amended to provide that the last two renewal terms would also be fixed at the initial agreed upon rental. This lease amendment was in connection with

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certain concessions granted by us with respect to the renewal of other leases. The base rents are paid monthly and the bonus rents are computed and paid on a quarterly basis, based upon a computation that compares current quarter revenue to a corresponding quarter in the base year. The leases with our subsidiaries are unconditionally guaranteed by us and are cross-defaulted with one another.

Pursuant to the terms of the leases with the Trust, we have the option to renew the leases at the lease terms described above by providing notice to the Trust at least 90 days prior to the termination of the then current term. In addition, we have rights of first refusal to: (i) purchase the respective leased facilities during and for 180 days after the lease terms at the same price, terms and conditions of any third-party offer, or; (ii) renew the lease on the respective leased facility at the end of, and for 180 days after, the lease term at the same terms and conditions pursuant to any third-party offer. We also have the right to purchase the respective leased facilities at the end of the lease terms or any renewal terms at the appraised fair market value. In addition, during 2006, as part of the overall exchange and substitution transaction relating to Chalmette Medical Center, which was completed during the third quarter of 2006, as well as the early five year lease renewals on Southwest Healthcare System-Inland Valley Campus ( Inland Valley ), Wellington Regional Medical Center, McAllen Medical Center and The Bridgeway, the Trust agreed to amend the Master Lease to include a change of control provision. The change of control provision grants us the right, upon one month notice should a change of control of the Trust occur, to purchase any or all of the four leased hospital properties at their appraised fair market value purchase price.

The table below details the renewal options and terms for each of our four hospital facilities leased from the Trust:

Hospital Name	Type of Facility	Annual	End of Lease Term	Renewal
		Minimum		Term
McAllen Medical Center	Acute Care	\$ 5,485,000	December, 2011	20(a)
Wellington Regional Medical Center	Acute Care	\$ 3,030,000	December, 2011	20(b)
Southwest Healthcare System, Inland Valley Campus	Acute Care	\$ 2,597,000(d)	December, 2011	20(b)
The Bridgeway	Behavioral Health	\$ 930,000	December, 2014	10(c)

- (a) We have four 5-year renewal options at existing lease rates (through 2031).
- (b) We have two 5-year renewal options at existing lease rates (through 2021) and two 5-year renewal options at fair market value lease rates (2022 through 2031).
- (c) We have two 5-year renewal options at fair market value lease rates (2015 through 2024).
- (d) Excludes incremental rent on the additional real property assets in excess of \$11.0 million, being constructed at Inland Valley that were transferred to the Trust as part of the asset exchange and substitution transaction completed during the third quarter of 2006.

**Other Related Party Transactions:**

Our Chairman of the Board of Directors and Chief Executive Officer ( CEO ) is a member of the Board of Directors of Broadlane, Inc. ( Broadlane ). Broadlane provides contracting and other supply chain services to us and various other healthcare organizations. Our contract with Broadlane is scheduled to expire on December 31, 2007. In addition, we along with certain of our Board of Directors and members of our executive management team, own approximately 6% of the outstanding shares of Broadlane. The carrying value of our investment in Broadlane is approximately \$12 million as of September 30, 2007.

A member of our Board of Directors and member of the Executive Committee is Of Counsel to the law firm used by us as our principal outside counsel. This Board member is also the trustee of certain trusts for the benefit of our CEO and his family. This law firm also provides personal legal services to our CEO.

We invested \$3.3 million for a 25% ownership interest in an information technology company that provides laboratory information system and order management technology to many of our acute care hospitals. We also committed to pay this company a license fee which has a remaining commitment of \$4.5 million as of September 30, 2007.

**(3) Other Noncurrent and Minority Interest Liabilities**

Other noncurrent liabilities include the long-term portion of our professional and general liability, workers compensation reserves, and pension liability.

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As of September 30, 2007 and December 31, 2006, the minority interest liability of \$203.4 million and \$174.1 million, respectively, consists primarily of: (i) an outside ownership interest of approximately 28% in four acute care facilities located in Las Vegas, Nevada that are in operation and a fifth that is currently under construction and expected to be completed and opened in early 2008; (ii) a 20% outside ownership in an acute care facility located in Washington D.C., and; (iii) an outside ownership interest of approximately 10% in an acute care facility located in Laredo, Texas.

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In connection with the five acute care facilities located in Las Vegas, Nevada, the outside owners have certain put rights that may require the respective limited liabilities companies (LLCs) to purchase the minority member's interests upon the occurrence of: (i) certain specified financial conditions falling below established thresholds; (ii) breach of the management contract by the managing member (a subsidiary of ours), or; (iii) if the minority member's ownership percentage is reduced to less than certain thresholds.

**(4) Long-term debt**

We have an \$800 million, unsecured non-amortizing revolving credit agreement, as amended, (Credit Agreement) which is scheduled to expire on July 28, 2011. In April, 2007, the Credit Agreement was amended to increase commitments from \$650 million to \$800 million. The Credit Agreement includes a \$100 million sub-limit for letters of credit. The interest rate on the borrowings is determined, at our option, as either: (i) the one, two, three or six month London Inter-Bank Offer Rate (LIBOR) plus a spread of 0.33% to 0.575%; (ii) at the higher of the Agent's prime rate or the federal funds rate plus 0.50%, or; (iii) a competitive bid rate. A facility fee ranging from 0.07% to 0.175% is required on the total commitment. The applicable margins over LIBOR and the facility fee are based upon our credit ratings from Standard & Poor's Ratings Services and Moody's Investors Service, Inc. At September 30, 2007, the applicable margin over the LIBOR rate was .50% and the commitment fee was .125%. There are no compensating balance requirements. As of September 30, 2007, we had \$253 million of borrowings outstanding under our revolving credit agreement and \$47 million of outstanding letters of credit. As of September 30, 2007, we had \$500 million of available borrowing capacity pursuant to the terms of our Credit Agreement.

In August of 2007, we entered into a \$200 million accounts receivable securitization program (Securitization) with a group of conduit lenders and liquidity banks. The patient accounts receivable for substantially all of our acute care hospitals serve as collateral for the outstanding borrowings. The interest rate on the borrowings is based on the commercial paper rate plus a spread of .25%. The initial term of this Securitization is 364 days and the term can be extended for incremental 364 day periods upon mutual agreement of the parties. The Securitization has a term-out feature that can be exercised by us if the banks do not extend the Securitization which would extend the maturity date to June 30, 2010. Under the terms of the term-out provision, the borrowing rate would be the same as our Credit Agreement rate. Outstanding borrowings which can be refinanced through available borrowings under the terms of our Credit Agreement are classified as long-term on our condensed consolidated balance sheet. As of September 30, 2007, there were \$170 million of borrowings outstanding pursuant to this program.

On June 30, 2006, we issued \$250 million of senior notes (the Notes) which have a 7.125% coupon rate and mature on June 30, 2016. Interest on the Notes is payable semiannually in arrears on June 30 and December 30 of each year.

During 2001, we issued \$200 million of senior notes which have a 6.75% coupon rate and which mature on November 15, 2011. The interest on the senior notes is paid semiannually in arrears on May 15 and November 15 of each year. The senior notes can be redeemed in whole at any time and in part from time to time.

**(5) Commitments and Contingencies*****Professional and General Liability Claims and Property Insurance***

As of September 30, 2007, the total accrual for our professional and general liability claims was \$259 million (\$257 million net of expected recoveries), of which \$32 million is included in current liabilities. As of December 31, 2006, the total accrual for our professional and general liability claims was \$248 million (\$245 million net of expected recoveries), of which \$32 million is included in current liabilities. Included in other assets was \$2 million as of September 30, 2007 and \$3 million as of December 31, 2006, related to estimated expected recoveries from various state guaranty funds in connection with professional and general liability claims payments related to a former commercial insurer which was placed in receivership during 2002. During the second quarter of 2007, based upon the results of a third-party actuarial analysis, we recorded an \$18 million reduction to our prior year reserves for professional and general liability self-insured claims. This favorable change in our estimated future claims payments was partially due to the favorable impact of medical malpractice tort reform experienced in several states in which we operate as well as a decrease in obstetrical-related claims due to a company-wide patient safety initiative in this high-risk specialty.

Effective April 1, 2007, we have commercial property insurance policies covering catastrophic losses resulting from windstorm damage up to \$100 million per occurrence. Losses resulting from non-named windstorms are subject to a \$250,000 deductible. Losses resulting from named windstorms are subject to a 5% deductible based upon the declared value of the property. In addition, we have commercial property insurance policies covering catastrophic losses resulting from earthquake and flood damage, each subject to annual aggregate limitations of \$100 million. Earthquake losses are subject to a \$250,000 deductible for our facilities located in all states except California, Alaska and Puerto Rico. Earthquake losses sustained at facilities located in California, Alaska and Puerto Rico are subject to a 5% deductible based upon the declared value of the property. Flood losses have a \$250,000 deductible except in FEMA designated flood zones A and V (which are located in certain

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sections of Florida, Oklahoma and Texas) in which case the losses are subject to a \$500,000 deductible. Due to a sharp increase in property losses experienced nationwide in recent years, the cost of commercial property insurance

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has increased significantly. As a result, catastrophic coverage for earthquake and flood has been limited to annual aggregate losses (as opposed to per occurrence losses). Given these insurance market conditions, there can be no assurance that a continuation of these unfavorable trends, or a sharp increase in uninsured property losses sustained by us, will not have a material adverse effect on our future results of operations.

As of September 30, 2007, we were party to certain off balance sheet arrangements consisting of standby letters of credit and surety bonds. Our outstanding letters of credit and surety bonds as of September 30, 2007 totaled \$79 million consisting of: (i) \$74 million related to our self-insurance programs; (ii) \$4 million consisting primarily of collateral for outstanding bonds of an unaffiliated third-party and public utility, and; (iii) \$1 million of debt guarantees related to entities in which we own a minority interest.

We have a long-term contract with a third party that expires in 2012, to provide certain data processing services for our acute care and behavioral health facilities.

### ***Legal Proceedings***

We are subject to claims and suits in the ordinary course of business, including those arising from care and treatment afforded by our hospitals and are party to various other litigation, as outlined below.

#### ***Investigation of South Texas Health System affiliates:***

We and our South Texas Health System affiliates, which operate McAllen Medical Center, McAllen Heart Hospital, Edinburg Regional Medical Center and certain other affiliates, were served with a subpoena dated November 21, 2005, issued by the Office of Inspector General of the Department of Health and Human Services (OIG). At that time, the Civil Division of the U.S. Attorney's office in Houston, Texas indicated that the subpoena was part of an investigation under the False Claims Act of compliance with Medicare and Medicaid rules and regulations pertaining to the employment of physicians and the solicitation of patient referrals from physicians from January 1, 1999 to the date of the subpoena related to the South Texas Health System. On March 9, 2007, an additional subpoena was served upon us by the OIG requesting documents concerning the Medicare cost reports for the South Texas Health System affiliates. On February 16, 2007, our South Texas Health System affiliates were served with a search warrant in connection with what we have been advised is a related criminal Grand Jury investigation concerning the production of documents. At that time, the government obtained various documents and other property related to the facilities. Follow-up Grand Jury subpoenas for documents and witnesses and other requests for information were subsequently served on South Texas Health System facilities and certain employees.

Over the last several weeks, at our request, our legal representatives have met with representatives of the civil and criminal divisions of the United States Attorney's Office for the Southern District of Texas to discuss the status of these matters. Our representatives have been advised that the government is continuing its investigations. We believe that, based on those discussions and its investigations to date, the government is focused on certain arrangements entered into by the South Texas Health System affiliates which the government believes may have violated Medicare and Medicaid rules and regulations pertaining to payments to physicians and the solicitation of patient referrals from physicians and other matters relating to payments to various individuals which may have constituted improper or illegal payments. We believe that the government is also focusing its investigation to determine whether the South Texas Health System affiliates and certain individuals illegally failed to fully comply with the original OIG subpoena. We are in the process of investigating these matters and are cooperating with the investigations and intend to respond to the matters raised with us. We are unable to evaluate the existence or extent of any potential financial exposure in connection with this matter at this time.

We monitor all aspects of our business and have developed a comprehensive ethics and compliance program that is designed to meet or exceed applicable federal guidelines and industry standards. Because the law in this area is complex and constantly evolving, governmental investigation or litigation may result in interpretations that are inconsistent with industry practices, including ours. Although we believe our policies, procedures and practices comply with governmental regulations, no assurance can be given that we will not be subjected to further inquiries or actions, or that we will not be faced with sanctions, fines or penalties in connection with the investigation of our South Texas Health System affiliates. Even if we were to ultimately prevail, the government's inquiry and/or action in connection with this matter could have a material adverse effect on our future operating results.

#### ***Lasko-Hoellinger, et al, v. UHS of Delaware, Inc. et al, and other related matter:***

On November 1, 2005, our management company and several of our facilities located in California, including Inland Valley Medical Center, Rancho Springs Medical Center, Del Amo Hospital and Corona Regional Medical Center (Hospitals) were named as defendants in a wage and hour lawsuit filed in Los Angeles Superior Court under the caption *Lasko-Hoellinger, et al v. UHS of Delaware, Inc., et al*. Del Amo Hospital was subsequently dismissed from the case. While two of the four original plaintiffs in that case voluntarily requested that they be dismissed as



plaintiffs from that lawsuit, the remaining two

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plaintiffs sought to have the matter certified as a class action. The remaining plaintiffs alleged, among other things, that they were entitled to recover damages from the Hospitals for missed breaks and other alleged violations of various California Labor Code sections and applicable wage orders for a period of at least one year prior to the filing of the case. During 2006, we recorded an estimated \$10 million pre-tax provision in connection with this and another related matter (\$2 million during the first quarter of 2006 and \$8 million during the fourth quarter of 2006). During the third quarter of 2007, this case and the related matter were settled for a combined total of \$10.4 million.

The healthcare industry is subject to numerous laws and regulations which include, among other things, matters such as government healthcare participation requirements, various licensure and accreditations, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government action has increased with respect to investigations and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by healthcare providers. Providers that are found to have violated these laws and regulations may be excluded from participating in government healthcare programs, subjected to fines or penalties or required to repay amounts received from government for previously billed patient services. Although we believe our policies, procedures and practices comply with governmental regulations, no assurance can be given that we will not be subjected to governmental inquiries or actions. Even if we were to ultimately prevail, the government's inquiries and/or actions could have a material adverse effect on our future operating results.

**(6) Segment Reporting**

Our reportable operating segments consist of acute care hospital services and behavioral health care services. The Other segment column below includes centralized services including information services, purchasing, reimbursement, accounting, taxation, legal, advertising, design and construction, and patient accounting as well as the operating results for our other operating entities including outpatient surgery and radiation centers. The chief operating decision making group for our acute care hospital services and behavioral health care services is comprised of the President and Chief Executive Officer, and the lead executives of each operating segment. The lead executives for each operating segment also manage the profitability of each respective segment's various facilities. The operating segments are managed separately because each operating segment represents a business unit that offers different types of healthcare services or operates in different healthcare environments. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies included in our Annual Report on Form 10-K for the year ended December 31, 2006.

	Three Months ended September 30, 2007			
	Acute Care	Behavioral		Total
	Hospital	Health		
	Services	Services	Other	Consolidated
(Dollar amounts in thousands)				
Gross inpatient revenues	\$ 2,095,327	\$ 452,223		\$ 2,547,550
Gross outpatient revenues	\$ 900,787	\$ 54,470	\$ 20,648	\$ 975,905
Total net revenues	\$ 863,206	\$ 285,013	\$ 31,998	\$ 1,180,217
Income/(loss) before income taxes	\$ 37,040	\$ 50,670	\$ (43,952)	\$ 43,758
Total assets as of 9/30/07	\$ 2,333,690	\$ 935,194	\$ 330,044	\$ 3,598,928
Licensed beds	5,417	7,485		12,902
Available beds	5,110	7,453		12,563
Patient days	290,968	506,466		797,434
Admissions	64,817	30,156		94,973
Average length of stay	4.5	16.8		8.4

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	Nine Months ended September 30, 2007			
	Acute Care	Behavioral		Total
	Hospital	Health		
	Services	Services	Other	Consolidated
	(Dollar amounts in thousands)			
Gross inpatient revenues	\$ 6,458,535	\$ 1,339,098		\$ 7,797,633
Gross outpatient revenues	\$ 2,666,277	\$ 173,558	\$ 60,965	\$ 2,900,800
Total net revenues	\$ 2,609,743	\$ 847,578	\$ 99,473	\$ 3,556,794
Income/(loss) before income taxes	\$ 177,773	\$ 163,003	\$ (131,098)	\$ 209,678
Total assets as of 9/30/07	\$ 2,333,690	\$ 935,194	\$ 330,044	\$ 3,598,928
Licensed beds	5,417	7,269		12,686
Available beds	5,110	7,229		12,339
Patient days	886,844	1,489,301		2,376,145
Admissions	197,722	89,182		286,904
Average length of stay	4.5	16.7		8.3

	Three Months ended September 30, 2006			
	Acute Care	Behavioral		Total
	Hospital	Health		
	Services	Services	Other	Consolidated
	(Dollar amounts in thousands)			
Gross inpatient revenues	\$ 1,813,162	\$ 416,515		\$ 2,229,677
Gross outpatient revenues	\$ 717,752	\$ 47,809	\$ 21,906	\$ 787,467
Total net revenues	\$ 777,632	\$ 254,170	\$ 11,655	\$ 1,043,457
Income/(loss) before income taxes	\$ 171,694	\$ 47,475	\$ (39,436)	\$ 179,733
Total assets as of 9/30/06	\$ 2,126,231	\$ 765,102	\$ 257,694	\$ 3,149,027
Licensed beds	5,139	6,640		11,779
Available beds	4,858	6,582		11,440
Patient days	268,537	467,860		736,397
Admissions	60,656	28,100		88,756
Average length of stay	4.4	16.6		8.3

	Nine Months ended September 30, 2006			
	Acute Care	Behavioral		Total
	Hospital	Health		
	Services	Services	Other	Consolidated
	(Dollar amounts in thousands)			
Gross inpatient revenues	\$ 5,607,700	\$ 1,244,739		\$ 6,852,439
Gross outpatient revenues	\$ 2,147,156	\$ 154,605	\$ 63,571	\$ 2,365,332
Total net revenues	\$ 2,323,560	\$ 767,416	\$ 34,443	\$ 3,125,419
Income/(loss) before income taxes	\$ 322,820	\$ 152,577	\$ (117,585)	\$ 357,812
Total assets as of 9/30/06	\$ 2,126,231	\$ 765,102	\$ 257,694	\$ 3,149,027
Licensed beds	5,047	6,492		11,539
Available beds	4,756	6,434		11,190
Patient days	819,711	1,386,299		2,206,010
Admissions	184,374	84,100		268,474
Average length of stay	4.4	16.5		8.2

**(7) Earnings Per Share Data ( EPS ) and Stock Based Compensation**

Basic earnings per share are based on the weighted average number of common shares outstanding during the period. Diluted earnings per share are based on the weighted average number of common shares outstanding during the period adjusted to give effect to common stock equivalents.



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The following table sets forth the computation of basic and diluted earnings per share for the periods indicated (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30,			
	(amounts in thousands)			
	2007	2006	2007	2006
<b>Basic:</b>				
Income from continuing operations	\$ 29,002	\$ 114,029	\$ 130,616	\$ 225,392
Less: Dividends on unvested restricted stock, net of taxes	(18)	(20)	(62)	(63)
Income from continuing operations basic	\$ 28,984	\$ 114,009	\$ 130,554	\$ 225,329
Loss from discontinued operations	(148)	(84)	(183)	(104)
Net income basic	\$ 28,836	\$ 113,925	\$ 130,371	\$ 225,225
<b>Diluted:</b>				
Income from continuing operations	\$ 29,002	\$ 114,029	\$ 130,616	\$ 225,392
Less: Dividends on unvested restricted stock, net of taxes	(18)	(20)	(62)	(63)
Add: Debenture interest, net of taxes				4,902
Income from continuing operations diluted	\$ 28,984	\$ 114,009	\$ 130,554	\$ 230,231
Loss from discontinued operations	(148)	(84)	(183)	(104)
Net income diluted	\$ 28,836	\$ 113,925	\$ 130,371	\$ 230,127
Weighted average number of common shares	53,481	56,794	53,491	54,764
Net effect of dilutive stock options and grants based on the treasury stock method	148	207	190	227
Assumed conversion of discounted convertible debentures				4,168
Weighted average number of common shares and equivalents	53,629	57,001	53,681	59,159
<b>Earnings Per Basic Share:</b>				
From continuing operations	\$ 0.54	\$ 2.01	\$ 2.44	\$ 4.11
From discontinued operations	0.00	0.00	0.00	0.00
Total earnings per basic share	\$ 0.54	\$ 2.01	\$ 2.44	\$ 4.11
<b>Earnings Per Diluted Share:</b>				
From continuing operations	\$ 0.54	\$ 2.00	\$ 2.43	\$ 3.89
From discontinued operations	0.00	0.00	0.00	0.00
Total earnings per diluted share	\$ 0.54	\$ 2.00	\$ 2.43	\$ 3.89

**Stock-Based Compensation:** During the three months ending September 30, 2007 and 2006, compensation cost of \$2.1 million (\$1.3 million after-tax) and \$1.7 million (\$1.1 million after-tax), respectively, was recognized related to outstanding stock options. During the nine months ending September 30, 2007 and 2006, compensation costs of \$6.6 million (\$4.1 million after-tax) and \$4.9 million (\$3.1 million after-tax), respectively, was recognized related to outstanding stock options. In addition, during the three months ended September 30, 2007 and 2006, compensation costs of \$1.8 million (\$1.1 million after-tax) and \$1.3 million (\$824,000 after-tax), respectively, was recognized related to restricted stock, and during the nine months ended September 30, 2007 and 2006, compensation costs of \$5.9 million (\$3.6 million after taxes) and \$4.1 million (\$2.6 million after taxes) was recognized related to restricted stock. As of September 30, 2007 there was \$26.4 million of unrecognized compensation cost related to unvested options and restricted stock which is expected to be recognized over the remaining weighted

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average vesting period of 2.5 years. During the third quarter of 2007, there were 52,000 stock options, net of cancellations, granted under this plan with a weighted-average grant-date fair value of \$11.84 per option. There were no restricted stock shares granted during the third quarter of 2007. During the nine months of 2007, there were 77,000 stock options, net of cancellations, granted under this plan with a weighted-average grant-date fair value of \$12.41 per option and 11,125 of restricted stock granted with a weighted-average grant date fair value of \$59.32 per share.

### **(8) Comprehensive Income**

Comprehensive income or loss is recorded in accordance with the provisions of SFAS No. 130, Reporting Comprehensive Income. SFAS No. 130 establishes standards for reporting comprehensive income and its components in financial statements. Comprehensive income (loss) is comprised of net income, changes in unrealized gains or losses on derivative financial instruments and foreign currency translation adjustments.

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(amounts in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Net income	\$ 28,854	\$ 113,945	\$ 130,433	\$ 225,288
Other comprehensive income (loss):				
Unrealized derivative gains on cash flow hedges, net of taxes		(86)		2,049
Recognition of derivative gains on cash flow hedges, net of taxes	(84)		(252)	
Comprehensive income	\$ 28,770	\$ 113,859	\$ 130,181	\$ 227,337

**(9) Dispositions and Acquisitions of assets and businesses***Acquisitions and divestitures during the nine months ended September 30, 2007:*

During the first nine months of 2007, we paid \$103 million to acquire:

certain assets of Texoma Healthcare System located in Texas, including a 234-bed acute-care hospital, a 60-bed behavioral health hospital, a 21-bed freestanding rehabilitation hospital and TexomaCare, a 34-physician group practice structured as a 501A corporation (acquired during the first quarter of 2007);

a previously leased, real property assets of a behavioral health facility located in Ohio (acquired during the first quarter of 2007);

a 52-bed behavioral health facility located in Delaware (acquired during the second quarter of 2007);

a 97-bed behavioral health facility located in Pennsylvania (acquired during the third quarter of 2007), and;

a 78-bed behavioral health facility located in Utah (acquired during the third quarter of 2007).

Also, during the first quarter of 2007, we received \$5 million in connection with the sale of vacant real property located in McAllen, Texas resulting in a \$2 million pre-tax gain which is included in our financial results for the nine months ended September 30, 2007.

*Acquisitions during the nine months ended September 30, 2006:*

During the first nine months of 2006, we paid \$46 million to acquire:

the assets of behavioral health care facilities located in Florida and Georgia (acquired during the first quarter of 2006);

a 128-bed behavioral health facility in Utah (acquired during the third quarter of 2006);

the assets of an 86-bed behavioral health facility in Colorado (acquired during the third quarter of 2006), and;

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a medical office building in Nevada (acquired during the third quarter of 2006).

### (10) Dividends

A dividend of \$.08 per share or \$4.3 million in the aggregate was declared by the Board of Directors on July 19, 2007 and was paid on September 17, 2007 to shareholders of record as of August 31, 2007.

### (11) Pension Plan

The following table shows the components of net periodic pension cost for our defined benefit pension plan as of September 30, 2007 and 2006 (amounts in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	2006	September 30, 2007	2006
Service cost	\$ 336	\$ 348	\$ 1,008	\$ 1,044
Interest cost	1,091	1,100	3,273	3,300
Expected return on assets	(1,193)	(935)	(3,579)	(2,805)
Recognized actuarial loss	280	444	840	1,332
<b>Net periodic pension cost</b>	<b>\$ 514</b>	<b>\$ 957</b>	<b>\$ 1,542</b>	<b>\$ 2,871</b>



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During the nine months ended September 30, 2007, we made contributions of \$5.7 million to our pension plan.

**(12) Income Taxes**

We adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income taxes, ( FIN 48 ) effective January 1, 2007. As a result of the implementation of FIN 48, we recognized a \$12 million decrease in the liability for unrecognized tax benefits. This decrease in the liability resulted in an increase to the January 1, 2007 balance of retained earnings of approximately \$12 million. As of January 1, 2007, after the implementation of FIN 48, our unrecognized tax benefits were approximately \$6 million. The amount, if recognized, that would affect the effective tax rate is approximately \$4 million.

During the third quarter of 2007, the estimated liabilities for uncertain tax positions (including accrued interest) were reduced due to the lapse of the statute of limitations of various taxing authorities resulting in a net income tax benefit of approximately \$2 million.

We recognize accrued interest and penalties associated with uncertain tax positions as part of the tax provision. As of January 1, 2007, we had approximately \$1 million of accrued interest and penalties. As of September 30, 2007, we have less than \$1 million of accrued interest and penalties. The U.S. federal statute of limitations remains open for the 2004 and subsequent years. Foreign and U.S. state and local jurisdictions have statutes of limitations generally ranging from 3 to 4 years. The statute of limitations on certain jurisdictions could expire within the next twelve months. It is reasonably possible that the amount of unrecognized tax benefits will change during the next 12 months due to the closing of the statute of limitations and that change, if it were to occur, could have a favorable impact on our results of operations.

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

**Overview**

Our principal business is owning and operating, through our subsidiaries, acute care hospitals, behavioral health centers, surgical hospitals, ambulatory surgery centers and radiation oncology centers. As of September 30, 2007, we owned and/or operated or had under construction, 31 acute care hospitals (including 2 new facilities currently being constructed and 4 closed facilities located in Louisiana, as discussed below) and 113 behavioral health centers located in 32 states, Washington, DC and Puerto Rico. Since the third quarter of 2005, four of our acute care facilities in Louisiana were severely damaged and remain closed and non-operational as a result of Hurricane Katrina. As part of our ambulatory treatment centers division, we manage and/or own outright or in partnerships with physicians, 11 surgical hospitals and surgery and radiation oncology centers located in 6 states and Puerto Rico.

Net revenues from our acute care hospitals, surgical hospitals, surgery centers and radiation oncology centers accounted for 74% and 75% of our consolidated net revenues during the three month periods ended September 30, 2007 and 2006, respectively, and 74% and 75% during the nine month periods ended September 30, 2007 and 2006, respectively. Net revenues from our behavioral health care facilities accounted for 24% of our consolidated net revenues during each of the three month periods ended September 30, 2007 and 2006, respectively, and 24% and 25% during the nine month periods ended September 30, 2007 and 2006, respectively. Approximately 2% of our consolidated net revenues during each of the three and nine month period ended September 30, 2007 were recorded in connection with a construction management contract pursuant to the terms of which we are building a newly constructed acute care hospital for an unrelated third party.

Services provided by our hospitals include general surgery, internal medicine, obstetrics, emergency room care, radiology, oncology, diagnostic care, coronary care, pediatric services, pharmacy services and behavioral health services. We provide capital resources as well as a variety of management services to our facilities, including central purchasing, information services, finance and control systems, facilities planning, physician recruitment services, administrative personnel management, marketing and public relations.

**Forward-Looking Statements and Risk Factors**

This Quarterly Report contains forward-looking statements that reflect our current estimates, expectations and projections about our future results, performance, prospects and opportunities. Forward-looking statements include, among other things, the information concerning our possible future results of operations, business and growth strategies, financing plans, expectations that regulatory developments or other matters will not have a material adverse effect on our business or financial condition, our competitive position and the effects of competition, the projected growth of the industry in which we operate, and the benefits and synergies to be obtained from our completed and any future acquisitions, and statements of our goals and objectives, and other similar expressions concerning matters that are not historical facts. Words such as may, will, should, could, would, predicts, potential, continue, expects, anticipates, future, intends, plans, projects and similar expressions, as well as statements in future tense, identify forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by which, such performance or results will be achieved. Forward-looking information is based on information available at the time and/or our good faith belief with respect to future events, and is subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in the statements. Such factors include, among other things, the following:

our ability to comply with existing laws and government regulations and/or changes in laws and government regulations;

possible unfavorable changes in the levels and terms of reimbursement for our charges by third party payors or government programs, including Medicare or Medicaid;

an increase in the number of uninsured and self-pay patients treated at our acute care facilities that unfavorably impacts our ability to satisfactorily and timely collect our self-pay patient accounts;

our ability to enter into managed care provider agreements on acceptable terms;

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the outcome of known and unknown litigation, government investigations, and liabilities and other claims asserted against us, including the government's ongoing investigations of our South Texas Health Systems affiliates;

national, regional and local economic and business conditions;

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competition from other healthcare providers, including physician owned facilities in certain markets, including McAllen/Edinburg, Texas, the site of one of our largest acute care facilities;

technological and pharmaceutical improvements that increase the cost of providing, or reduce the demand for healthcare;

our ability to attract and retain qualified personnel, nurses, physicians and other healthcare professionals and the impact on our labor expenses resulting from a shortage of nurses and other healthcare professionals;

demographic changes;

our ability to successfully integrate and improve our recent acquisitions and the availability of suitable acquisitions and divestiture opportunities;

a significant portion of our revenues is produced by a small number of our facilities;

the availability and terms of capital to fund the growth of our business;

some of our acute care facilities continue to experience decreasing inpatient admission trends;

our financial statements reflect large amounts due from various commercial and private payors and there can be no assurance that failure of the payors to remit amounts due to us will not have a material adverse effect on our future results of operations;

the ability to obtain adequate levels of general and professional liability insurance on current terms;

changes in our business strategies or development plans;

fluctuations in the value of our common stock, and;

other factors referenced herein or in our other filings with the Securities and Exchange Commission.

Given these uncertainties, risks and assumptions, you are cautioned not to place undue reliance on such forward-looking statements. Our actual results and financial condition could differ materially from those expressed in, or implied by, the forward-looking statements.

Forward-looking statements speak only as of the date the statements are made. We assume no obligation to publicly update any forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as may be required by law. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this cautionary statement.

**Critical Accounting Policies and Estimates**

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The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and accompanying notes. We consider our critical accounting policies to be those that require us to make significant judgments and estimates when we prepare our consolidated financial statements, including the following:

**Revenue recognition:** We record revenues and related receivables for health care services at the time the services are provided. Medicare and Medicaid revenues represented 39% of our net patient revenues during each of the three month periods ended September 30, 2007 and 2006 and 37% during each of the nine month periods ended September 30, 2007 and 2006. Revenues from managed care entities, including health maintenance organizations and managed Medicare and Medicaid programs accounted for 44% and 41% of our net patient revenues during the three month periods ended September 30, 2007 and 2006, respectively, and 44% and 42% during the nine month periods ended September 30, 2007 and 2006, respectively.

We report net patient service revenue at the estimated net realizable amounts from patients and third-party payors and others for services rendered. We have agreements with third-party payors that provide for payments to us at amounts different from our established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Estimates of contractual allowances under managed care plans are based upon the payment terms specified in the related contractual agreements. We closely monitor our historical collection rates, as well as changes in applicable laws, rules and regulations and contract terms, to assure that provisions are made using the most accurate information available. However, due to the complexities involved in these estimations, actual payments from payors may be different from the amounts we estimate and record.

We estimate our Medicare and Medicaid revenues using the latest available financial information, patient utilization data, government provided data and in accordance with applicable Medicare and Medicaid payment rules and regulations. The

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laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation and as a result, there is at least a reasonable possibility that recorded estimates will change by material amounts in the near term. Certain types of payments by the Medicare program and state Medicaid programs (e.g. Medicare Disproportionate Share Hospital, Medicare Allowable Bad Debts and Inpatient Psychiatric Services) are subject to retroactive adjustment in future periods as a result of administrative review and audit and our estimates may vary from the final settlements. Such amounts are included in accounts receivable, net, on our Consolidated Balance Sheets. The funding of both federal Medicare and state Medicaid programs are subject to legislative and regulatory changes. As such, we can not make any assurance that future legislation and regulations, if enacted, will not have a material impact on our future Medicare and Medicaid reimbursements.

We provide care to patients who meet certain financial or economic criteria without charge or at amounts substantially less than our established rates. Because we do not pursue collection of amounts determined to qualify as charity care, they are not reported in net revenues or in accounts receivable, net. Our acute care hospitals provided charity care and uninsured discounts, based on charges at established rates, amounting to \$149 million and \$99 million during the three month periods ended September 30, 2007 and 2006, respectively, and \$418 million and \$326 million during the nine month periods ended September 30, 2007 and 2006, respectively.

**Provision for Doubtful Accounts:** Collection of receivables from third-party payors and patients is our primary source of cash and is critical to our operating performance. Our primary collection risks relate to uninsured patients and the portion of the bill which is the patient's responsibility, primarily co-payments and deductibles. We estimate our provisions for doubtful accounts based on general factors such as payor mix, the agings of the receivables and historical collection experience. We routinely review accounts receivable balances in conjunction with these factors and other economic conditions which might ultimately affect the collectibility of the patient accounts and make adjustments to our allowances as warranted. At our acute care hospitals, third party accounts are pursued until all payment and adjustments are posted to the patient account. For those accounts with a patient balance after third party liability is finalized or accounts for uninsured patients, the patient is sent at least two statements followed by a series of collection letters. If the patient is deemed unwilling to pay, the account is written-off as bad debt and transferred to an outside collection agency for additional collection effort. Patients that express an inability to pay are reviewed for write-off as potential charity care. Our accounts receivable are recorded net of established charity care reserves of \$83 million as of September 30, 2007 and \$67 million as of December 31, 2006.

Uninsured patients that do not qualify as charity patients are extended an uninsured discount of at least 20% of total charges. During the collection process the hospital establishes a partial reserve in the allowance for doubtful accounts for self-pay balances outstanding for greater than 60 days from the date of discharge. All self-pay accounts at the hospital level are fully reserved if they have been outstanding for greater than 90 days from the date of discharge. Third party liability accounts are fully reserved in the allowance for doubtful accounts when the balance ages past 180 days from the date of discharge. Potential charity accounts are fully reserved when it is determined the patient may be unable to pay.

On a consolidated basis, we monitor our total self-pay receivables to ensure that the total allowance for doubtful accounts provides adequate coverage based on historical collection experience. At September 30, 2007 and December 31, 2006, accounts receivable are recorded net of allowance for doubtful accounts of \$124 million and \$110 million, respectively.

**Self-Insured Risks:** We provide for self-insured risks, primarily general and professional liability claims and workers' compensation claims, based on estimates of the ultimate costs for both reported claims and claims incurred but not reported. Estimated losses from asserted and incurred but not reported claims are accrued based on our estimates of the ultimate costs of the claims, which includes costs associated with litigating or settling claims, and the relationship of past reported incidents to eventual claims payments. All relevant information, including our own historical experience, the nature and extent of existing asserted claims and reported incidents, and independent actuarial analyses of this information, is used in estimating the expected amount of claims. We also consider amounts that may be recovered from excess insurance carriers, state guaranty funds and other sources in estimating our ultimate net liability for such risk. Our estimated self-insured reserves are reviewed and changed, if necessary, at each reporting date and changes are recognized currently as additional expense or as a reduction of expense.

In addition, we also maintain self-insured employee benefits programs for employee healthcare and dental claims. The ultimate costs related to these programs include expenses for claims incurred and paid in addition to an accrual for the estimated expenses incurred in connection with claims incurred but not yet reported.

**Long-Lived Assets:** We review our long-lived assets, including amortizable intangible assets, for impairment whenever events or circumstances indicate that the carrying value of these assets may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of our asset based on our estimate of its undiscounted future cash flow. If the analysis indicates that the carrying value is not recoverable from future cash flows, the asset is written down to its estimated fair value and an impairment loss is recognized. Fair values are determined based on estimated future cash flows using appropriate discount rates.



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**Goodwill:** Goodwill is reviewed for impairment at the reporting unit level on an annual basis or sooner if the indicators of impairment arise. Our judgments regarding the existence of impairment indicators are based on market conditions and operational performance of each reporting unit. We have designated September 1<sup>st</sup> as our annual impairment assessment date and performed an impairment assessment as of September 1, 2007, which indicated no impairment of goodwill. Future changes in the estimates used to conduct the impairment review, including profitability and market value projections, could indicate impairment in future periods potentially resulting in a write-off of a portion or all of our goodwill.

**Income Taxes:** Deferred tax assets and liabilities are recognized for the amount of taxes payable or deductible in future years as a result of differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. We believe that future income will enable us to realize our deferred tax assets net of recorded valuation allowances relating to state net operating loss carryforwards and other deferred tax assets.

We operate in multiple jurisdictions with varying tax laws. We are subject to audits by any of these taxing authorities. Our tax returns have been examined by the Internal Revenue Service through the year ended December 31, 2002. We believe that adequate accruals have been provided for federal, foreign and state taxes.

**Accounting for Uncertainty in Income Taxes:** We adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes, ( FIN 48 ) effective January 1, 2007. As a result of the implementation of FIN 48, we recognized a \$12 million decrease in the liability for unrecognized tax benefits. This decrease in the liability resulted in an increase to the January 1, 2007 balance of retained earnings of approximately \$12 million. As of January 1, 2007, after implementation of FIN 48, our unrecognized tax benefits were approximately \$6 million. The amount, if recognized, that would affect the effective tax rate is approximately \$4 million.

During the third quarter of 2007, the estimated liabilities for uncertain tax positions (including accrued interest) were reduced due to the lapse of the statute of limitations of various taxing authorities resulting in a net income tax benefit of approximately \$2 million.

We recognize accrued interest and penalties associated with uncertain tax positions as part of the tax provision. As of January 1, 2007, we had approximately \$1 million of accrued interest and penalties. As of September 30, 2007, we have less than \$1 million of accrued interest and penalties. The U.S. federal statute of limitations remains open for the 2004 and subsequent years. Foreign and U.S. state and local jurisdictions have statutes of limitations generally ranging from 3 to 4 years. The statute of limitations on certain jurisdictions could expire within the next twelve months. It is reasonably possible that the amount of unrecognized tax benefits will change during the next 12 months due to the closing of the statute of limitations and that change, if it were to occur, could have a favorable impact on our results of operations.

**Physician Guarantees and Commitments:** On January 1, 2006, we adopted the FASB issued Interpretation No. 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners* ( FIN 45-3 ). Under FIN 45-3, the accounting requirements of FIN 45 are effective for any new revenue guarantees issued or modified on or after January 1, 2006 and the disclosure of all revenue guarantees, regardless of whether they were recognized under FIN 45, is required for all interim and annual periods beginning after January 1, 2006.

Our accrued liabilities and our other assets include \$10 million as of September 30, 2007 and \$9 million as of December 31, 2006, of estimated future payments related to physician-related contractual commitments entered into during 2006 and 2007. Including all potential financial obligations pursuant to contractual guarantees outstanding as of September 30, 2007 (including commitments entered into prior to 2006) we have \$26 million of potential future financial obligations of which \$9 million are potential obligations during 2007, \$11 million are potential obligations during 2008 and \$6 million are potential obligations during 2009 and later.

## **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Management ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The provisions for SFAS 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, except in limited circumstances including certain positions in financial instruments that trade in active markets as well as certain financial and hybrid financial instruments initially measured under SFAS No. 133

Accounting for Derivative Instruments and Hedging Activities ( SFAS No. 133 ) using the transaction price method. In these circumstances, the transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date SFAS No. 157 is initially applied, shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings for the fiscal year in which SFAS No. 157 is initially applied. We do not anticipate that the adoption of SFAS No. 157 will have a material impact on our results of operations or financial position.





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In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115," (SFAS No. 159). SFAS No. 159 permits a company to choose to measure many financial instruments and certain other items at fair value at specified election dates. Most of the provisions in SFAS No. 159 are elective; however, it applies to all companies with available-for-sale and trading securities. A company will report unrealized gains and losses on items for which the fair value option has been reflected in earnings at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs), and; (c) is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective as of the beginning of a company's first fiscal year beginning after November 15, 2007. We are currently evaluating this statement and have not yet determined the impact of such on our results of operations or financial position.

**Results of Operations**

The following table summarizes our results of operations, and is used in the discussion below, for the three months ended September 30, 2007 and 2006:

	Three months ended		Three months ended	
	September 30, 2007		September 30, 2006	
	Amount	% of Revenues	Amount	% of Revenues
Net revenues	\$ 1,180,217	100.0%	\$ 1,043,457	100.0%
Operating charges:				
Salaries, wages and benefits	510,917	43.3%	459,099	44.0%
Other operating expenses	265,534	22.5%	211,875	20.3%
Supplies expense	162,342	13.8%	146,944	14.1%
Provision for doubtful accounts	110,451	9.4%	97,901	9.4%
Depreciation and amortization	46,548	3.9%	40,961	3.9%
Lease and rental expense	17,920	1.5%	16,184	1.6%
Hurricane related expenses, net	82	0.0%	4,172	0.4%
Hurricane insurance recoveries			(4,172)	-0.4%
Subtotal operating expenses	1,113,794	94.4%	972,964	93.2%
Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes	66,423	5.6%	70,493	6.8%
Interest expense, net	12,881	1.1%	6,140	0.6%
Hurricane insurance recoveries in excess of expenses			(130,328)	-12.5%
Minority interests in earnings of consolidated entities	9,784	0.8%	14,948	1.4%
Income before income taxes	43,758	3.7%	179,733	17.2%
Provision for income taxes	14,756	1.3%	65,704	6.3%
Income from continuing operations	29,002	2.4%	114,029	10.9%
Loss from discontinued operations, net of income taxes	(148)	0.0%	(84)	0.0%
Net income	\$ 28,854	2.4%	\$ 113,945	10.9%

Net revenues increased 13% or \$137 million to \$1.18 billion during the three month period ended September 30, 2007 as compared to \$1.04 billion during the comparable prior year quarter. The increase was attributable to:

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a \$78 million or 8% increase in net revenues generated at acute care hospitals and behavioral health care facilities owned during both periods (which we refer to as same facility );

\$38 million of other combined increases in revenues resulting from the acute care facility and behavioral health care facilities acquired during 2006 and 2007, and;

\$21 million of other combined net increases in revenues resulting primarily from the revenues earned during the third quarter of 2007 in connection with a construction management contract pursuant to the terms of which we are building a newly constructed acute care hospital for an unrelated third party.

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Income before income taxes decreased \$136 million to \$44 million during the three months ended September 30, 2007 as compared to \$180 million during the comparable quarter of the prior year. Included in our income before income taxes during the third quarter of 2007, as compared to the comparable prior year quarter, was the following:

a decrease of \$124 million resulting from the hurricane insurance recoveries, in excess of expenses, recorded during the third quarter of 2006 (\$130 million pre-minority interest), as discussed below;

a decrease of \$11 million at our acute care facilities, as discussed below in Acute Care Hospital Services (exclusive of Hurricane related expenses and recoveries);

an increase of \$3 million at our behavioral health care facilities, as discussed below in Behavioral Health Services;

a decrease of \$7 million due to an increase in interest expense, and;

an increase of \$3 million resulting from other combined favorable changes, including the impact of a \$5 million charge incurred during the third quarter of 2006 to record the aggregate present value of the future funding of a portion of a gift from our Chairman of the Board of Directors, Chief Executive Officer and President to The College of William and Mary ( W&M Funding ).

Net income decreased \$85 million to \$29 million during the three month period ended September 30, 2007, as compared to \$114 million during the comparable prior year quarter. The decrease in net income during the third quarter of 2007, as compared to the comparable prior year quarter, resulted from the \$136 million decrease in income before income taxes, as discussed above, partially offset by a \$51 million reduction to our provision for income taxes.

The following table summarizes our results of operations, and is used in the discussion below, for the nine months ended September 30, 2007 and 2006:

	Nine months ended		Nine months ended	
	September 30, 2007		September 30, 2006	
	Amount	Revenues % of	Amount	Revenues % of
Net revenues	\$ 3,556,794	100.0%	\$ 3,125,419	100.0%
Operating charges:				
Salaries, wages and benefits	1,520,489	42.7%	1,336,087	42.7%
Other operating expenses	748,979	21.1%	708,932	22.7%
Supplies expense	506,946	14.3%	400,271	12.8%
Provision for doubtful accounts	312,583	8.8%	260,090	8.3%
Depreciation and amortization	135,417	3.8%	120,360	3.9%
Lease and rental expense	50,701	1.4%	48,247	1.5%
Hurricane related expenses, net	707	0.0%	14,432	0.5%
Hurricane insurance recoveries			(14,432)	-0.5%
Subtotal operating expenses	3,275,822	92.1%	2,873,987	92.0%
Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes	280,972	7.9%	251,432	8.0%

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Interest expense, net	38,643	1.1%	23,362	0.7%
Hurricane insurance recoveries in excess of expenses			(167,359)	-5.4%
Minority interests in earnings of consolidated entities	32,651	0.9%	37,617	1.2%
Income before income taxes	209,678	5.9%	357,812	11.4%
Provision for income taxes	79,062	2.2%	132,420	4.2%
Income from continuing operations	130,616	3.7%	225,392	7.2%
Loss from discontinued operations, net of income taxes	(183)	0.0%	(104)	0.0%
Net income	\$ 130,433	3.7%	\$ 225,288	7.2%

Net revenues increased 14% or \$431 million to \$3.56 billion during the nine month period ended September 30, 2007 as compared to \$3.13 billion during the comparable prior period. The increase was attributable to:

a \$237 million or 8% increase in net revenues generated at our acute care hospitals and behavioral health care facilities, on a same facility basis;

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\$129 million of other combined increases in revenues resulting from the acute care facility and behavioral health care facilities acquired during 2006 and 2007, and;

\$65 million of other combined net increases in revenues resulting primarily from the revenues earned during the first nine months of 2007 in connection with a construction management contract pursuant to the terms of which we are building a newly constructed acute care hospital for an unrelated third party.

Income before income taxes decreased \$148 million to \$210 million during the nine months ended September 30, 2007 as compared to \$358 million during the comparable prior year period. Included in our income before income taxes during the first nine months of 2007, as compared to the comparable prior year period, was the following:

a decrease of \$159 million resulting from the hurricane insurance recoveries, in excess of expenses, recorded during the first nine months of 2006 (\$167 million pre-minority interest), as discussed below;

an increase of \$9 million at our behavioral health care facilities, as discussed below in Behavioral Health Services (exclusive of the \$2 million favorable impact resulting from the reduction to our prior year reserves for professional and general liability self-insured claims, as mentioned below);

an increase of \$16 million (after minority interest) resulting from a reduction to our prior year reserves for professional and general liability self-insured claims, based upon the results of a third-party actuarial analysis;

a decrease of \$15 million due to an increase in interest expense, and;

an increase of \$1 million resulting from other combined favorable changes.

Net income decreased \$95 million to \$130 million during the nine month period ended September 30, 2007, as compared to \$225 million during the comparable prior year period. The decrease in net income during the first nine months of 2007, as compared to the comparable prior year period, resulted from the \$148 million decrease in income before income taxes, as discussed above, partially offset by a \$53 million reduction to our provision for income taxes.

Effective July 1, 2006, the pharmacy services for our acute care facilities were brought in-house from an outsourced vendor. As a result of this change, during the period of January through June of 2007, we experienced an increase to supplies expense of approximately \$56 million, an increase to salaries, wages and benefits expense of approximately \$22 million and a decrease to other operating expense of approximately \$82 million. The transition of our pharmacy services favorably impacted our pre-tax income by approximately \$4 million during the first six months of 2007. As a percentage of our consolidated net revenues for the nine month period ended September 30, 2007, as shown above, the transition of the pharmacy services increased supplies expense by 160 basis points, increased salaries, wages and benefits expense by 60 basis points and decreased other operating expenses by 230 basis points.

**Acute Care Hospital Services**

The following table summarizes the results of operations for our acute care facilities on a same facility basis, and is used in the discussion below for the three and nine months ended September 30, 2007 and 2006 (dollar amounts in thousands):

**Same Facility Acute Care**

**Three Months Ended**

**Nine Months Ended**

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	September 30,				September 30,			
	2007	%	2006	%	2007	%	2006	%
Net revenues	\$ 824,730	100.0	\$ 766,467	100.0	\$ 2,497,094	100.0	\$ 2,311,136	100.0
Salaries, wages and benefits	327,647	39.7	304,643	39.7	971,048	38.9	883,604	38.2
Other operating expenses	160,659	19.5	149,488	19.5	472,776	19.0	522,190	22.6
Supplies expense	137,325	16.7	129,332	16.9	432,935	17.3	348,700	15.1
Provision for doubtful accounts	95,512	11.6	92,912	12.1	278,337	11.1	244,579	10.6
Depreciation and amortization	37,408	4.5	33,614	4.4	108,577	4.3	98,082	4.2
Lease and rental	11,937	1.4	10,977	1.4	33,512	1.3	32,845	1.4
Subtotal operating expenses	770,488	93.4	720,966	94.1	2,297,185	92.0	2,130,000	92.2
Income before interest expense, minority interests and income taxes	54,242	6.6	45,501	5.9	199,909	8.0	181,136	7.8
Interest expense, net	981	0.1	492	0.1	2,350	0.1	985	0.0
Minority interests in earnings of consolidated entities	9,348	1.1	8,156	1.1	29,671	1.2	27,218	1.2
Income before income taxes	\$ 43,913	5.3	\$ 36,853	4.8	\$ 167,888	6.7	\$ 152,933	6.6

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On a same facility basis during the three month period ended September 30, 2007, as compared to the comparable prior year quarter, net revenues at our acute care hospitals increased \$58 million or 8%. Income before income taxes increased \$7 million or 19% to \$44 million or 5.3% of net revenues during the third quarter of 2007 as compared to \$37 million or 4.8% of net revenues during the comparable prior year quarter. On a same facility basis during the nine month period ended September 30, 2007, as compared to the comparable prior year period, net revenues at our acute care hospitals increased \$186 million or 8%. Income before income taxes increased \$15 million or 10% to \$168 million or 6.7% of net revenues during the first nine months of 2007 as compared to \$153 million or 6.6% of net revenues during the comparable prior year period.

Inpatient admissions to these facilities increased 2.5% during the third quarter of 2007, as compared to the comparable 2006 quarter, while patient days increased 2.9%. The average length of patient stay at these facilities was 4.4 days during each of the three month periods ended September 30, 2007 and 2006. The occupancy rate, based on the average available beds at these facilities, was 61% and 60% during the three month periods ended September 30, 2007 and 2006, respectively. Inpatient admissions to these facilities increased 3.1% during the nine months ended September 30, 2007, as compared to the comparable 2006 nine month period, while patient days increased 3.3%. The average length of patient stay at these facilities was 4.5 days and 4.4 days during the nine month periods ended September 30, 2007 and 2006, respectively. The occupancy rate, based on the average available beds at these facilities, was 63% during each of the nine month periods ended September 30, 2007 and 2006.

Our same facility net revenues were favorably impacted by an increase in prices charged to private payors including health maintenance organizations and preferred provider organizations. On a same facility basis, as compared to the comparable periods of the prior years, net revenue per adjusted admission (adjusted for outpatient activity) at these facilities increased 3.0% and 3.1% during the three and nine month periods ended September 30, 2007, respectively, and net revenue per adjusted patient day increased 2.6% and 2.9% during the three and nine month periods ended September 30, 2007, respectively.

Effective July 1, 2006, the pharmacy services for our acute care facilities were brought in-house from an outsourced vendor. As a result of this change, during the period of January through June of 2007, our acute care facilities experienced an increase to supplies expense of approximately \$56 million, an increase to salaries, wages and benefits expense of approximately \$22 million and a decrease to other operating expense of approximately \$82 million. The transition of our pharmacy services favorably impacted our pre-tax income by approximately \$4 million during the period of January through June of 2007. As a percentage of our same facility acute care net revenues for the nine month period ended September 30, 2007, as shown above, the transition of the pharmacy services increased supplies expense by 220 basis points, increased salaries, wages and benefits expense by 90 basis points and decreased other operating expenses by 330 basis points.

We continue to experience an increase in uninsured patients throughout our portfolio of acute care hospitals which in part, has resulted from an increase in the number of patients who are employed but do not have health insurance. We provide care to patients who meet certain financial or economic criteria without charge or at amounts substantially less than our established rates. Because we do not pursue collection of amounts determined to qualify as charity care, they are not reported in net revenues or in accounts receivable, net. Our acute care hospitals provided charity care and uninsured discounts, based on charges at established rates, amounting to \$149 million and \$99 million during the three month periods ended September 30, 2007 and 2006, respectively, and \$418 million and \$326 million during the nine month periods ended September 30, 2007 and 2006, respectively.

During the past several years, the operating results of our acute care facilities located in the McAllen/Edinburg, Texas market have been pressured by continued intense hospital and physician competition as a physician-owned hospital in the market has eroded a portion of our higher margin business, including cardiac procedures. In response to these competitive pressures, we have undertaken significant capital investment in the market, including Edinburg Children's Hospital, a new dedicated 120-bed children's facility, which was completed and opened in March, 2006, as well as South Texas Behavioral Health Center, a 134-bed replacement behavioral facility, which was completed and opened in late June, 2006. The financial results for the Edinburg Children's Hospital and South Texas Behavioral Health Center are included in the same facility financial results presented above. Although we experienced significant declines in inpatient volumes in this market during 2005 and 2004, patient volumes at these facilities stabilized during 2006 and during the first nine months of 2007 as we experienced a 2.5% and 5.5% increase in combined inpatient admissions during the three and nine months periods ended September 30, 2007,



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respectively. Combined patient days at these facilities decreased 0.9% during the three months ended September 30, 2007 and increased 5.8% during the nine months ended September 30, 2007 as compared to the comparable prior year periods. The increase in the combined inpatient admissions during the three and nine month periods of 2007 resulted primarily from the opening of the Children's Hospital and Behavioral Health Center during 2006.

Combined income before income taxes at the facilities in this market decreased \$1 million during the third quarter of 2007, as compared to the comparable quarter of the prior year, and decreased \$6 million during the first nine months of 2007 as compared to the comparable prior year nine month period. Unfavorably impacting the results of these facilities during the three and nine months ended September 30, 2007 were charges of \$4 million and \$8 million, respectively, representing the reserving of the prior year portion of Texas Medicaid supplemental payments. As part of CMS routine retroactive review of new Medicaid state plan amendment (SPA) that pertains to the Medicaid supplemental payment programs for this county, CMS has indicated that certain Inter-Governmental Transfers (IGTs) related to this retroactive SPA approval may be ineligible for federal matching dollars which were used to fund the programs. In the anticipation of a possible CMS retroactive IGT ineligibility determination, the above-mentioned reserves were established to reserve for potential CMS action related to 2005 and 2006 Medicaid supplemental payments.

A continuation of increased provider competition in this market, as well as additional capacity under construction by us and others (including newly constructed capacity at the physician owned hospital that opened during October, 2007), could result in additional erosion of the net revenues and financial operating results of our acute care facilities in this market. We expect the competitive pressures in the market to continue and potentially intensify when additional capacity is added to the market in future periods by our competitors.

The operating factors mentioned above have resulted in a certain degree of volatility in our income from continuing operations. Although we have undertaken actions with respect to physician recruitment and other measures as mentioned above in the McAllen/Edinburg market, the ultimate impact and timing of potential improvements in the operating results of the facilities in the market are beyond our ability to predict. A continuation of the unfavorable operating results experienced in this market and/or a continuation of the increased level of uninsured patients to our facilities and the resulting adverse trends in the provision for doubtful accounts and charity care provided, could have a material unfavorable impact on our future operating results.

The following table summarizes the results of operations for all our acute care operations during the three and nine months ended September 30, 2007 and 2006. Included in these results, in addition to the same facility results shown above, is: (i) the financial results for the three and nine months ended September 30, 2007 for the Texoma Healthcare System that was acquired as of January 1, 2007; (ii) the prior period effect of a favorable adjustment to reduce our reserves for professional and general liability self-insured claims (as discussed below); (iii) the net hurricane related expenses and insurance recoveries; (iv) the prior year portion of recording or reserving of Medicaid supplemental payments and cost reports settlements, and; (v) the write-down of the carrying-value of an investment in a joint-venture (dollar amounts in thousands).

**All Acute Care Facilities**

	Three Months Ended				Nine Months Ended			
	2007	September 30, %	2006	%	2007	September 30, %	2006	%
Net revenues	\$ 863,206	100.0	\$ 777,632	100.0	\$ 2,609,743	100.0	\$ 2,323,560	100.0
Salaries, wages and benefits	347,082	40.2	304,643	39.2	1,027,169	39.3	883,604	38.0
Other operating expenses	172,042	19.9	149,488	19.2	482,278	18.5	522,220	22.5
Supplies expense	143,093	16.6	129,332	16.6	450,600	17.3	348,700	15.0
Provision for doubtful accounts	102,764	11.9	92,912	11.9	291,584	11.2	244,579	10.5
Depreciation and amortization	38,633	4.5	33,614	4.3	111,850	4.3	98,082	4.2
Lease and rental	12,654	1.5	11,073	1.4	35,490	1.4	33,769	1.5
Hurricane related expenses	(209)	0.0	4,172	0.5	(48)	0.0	14,432	0.6
Hurricane insurance recoveries			(4,172)	-0.5			(14,432)	-0.6
Subtotal operating expenses	816,059	94.5	721,062	92.7	2,398,923	91.9	2,130,954	91.7
Income before interest expense, hurricane recoveries in excess of expenses, minority interest and income taxes	47,147	5.5	56,570	7.3	210,820	8.1	192,606	8.3

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Interest expense, net	1,056	0.1	492	0.1	2,583	0.1	985	0.0
Minority interests in earnings of consolidated entities	9,051	1.0	14,712	1.9	30,464	1.2	36,160	1.6
Hurricane recoveries in excess of expenses			(130,328)	-16.8			(167,359)	-7.2
Income before income taxes	\$ 37,040	4.3	\$ 171,694	22.1	\$ 177,773	6.8	\$ 322,820	13.9

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During the three months ended September 30, 2007, as compared to the comparable prior year quarter, net revenues at our acute care hospitals increased 11% or \$86 million. The increase in net revenues was primarily attributable to:

a \$58 million increase at same facility revenues, as discussed above, and;

\$28 million of other combined net increases, including \$44 million of revenues generated during the third quarter of 2007 by the Texoma Healthcare System which was acquired as of January 1, 2007.

Income before income taxes decreased \$135 million during the third quarter of 2007 as compared to the comparable quarter of 2006. Included in income before income taxes at our acute care hospitals during the third quarter of 2007, as compared to the comparable prior year quarter, was the following:

an increase of \$7 million at our acute care facilities on a same facility basis, as discussed above;

a decrease of \$124 million from the change in hurricane insurance recoveries in excess of expenses recorded during each quarter due to the insurance recoveries, in excess of expenses, recorded during the third quarter of 2006 (\$130 million pre-minority interest), as discussed below in Impact of Hurricane Katrina;

a \$17 million decrease resulting from the unfavorable change in the prior period effect of the recording or reserving of Medicaid supplemental payments and cost report settlements;

a \$3 million decrease due to the write-down of the carrying-value of an investment in a joint-venture, and;

\$2 million of other combined favorable changes resulting primarily from the pre-tax income generated during the third quarter of 2007 by the Texoma Healthcare System.

During the nine months ended September 30, 2007, as compared to the comparable prior year period, net revenues at our acute care hospitals increased 12% or \$286 million. The increase in net revenues was primarily attributable to:

a \$186 million increase at same facility revenues, as discussed above, and;

a \$100 million of other combined net increases, including \$119 million of revenues generated during the nine months of 2007 by the Texoma Healthcare System.

Income before income taxes decreased \$145 million during the first nine months of 2007 as compared to the comparable nine month period of 2006. Included in income before income taxes at our acute care hospitals during the first nine months of 2007, as compared to the comparable prior year period, was the following:

an increase of \$15 million at our acute care facilities on a same facility basis, as discussed above;

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a decrease of \$159 million from the change in hurricane insurance recoveries, in excess of expenses, recorded during each period due to \$158 million of insurance recoveries, in excess of expenses, recorded during the nine months ended September 30, 2006 (\$167 million pre-minority interest), as discussed below in Impact of Hurricane Katrina;

an increase of \$15 million (after minority interest) representing the portion of the reduction to our prior year reserves for professional and general liability self-insured claims, as discussed below, attributable to our acute care facilities;

a \$19 million decrease resulting from the unfavorable change in the prior period effect of the recording or reserving of Medicaid supplemental payments and cost report settlements;

a \$3 million decrease due to the write-down of the carrying-value of an investment in a joint-venture, and;

\$6 million of other combined favorable changes resulting primarily from the pre-tax income generated during the first nine months of 2007 by the Texoma Healthcare System.

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During the second quarter of 2007, based upon the results of a third-party actuarial analysis, we recorded an \$18 million (pre-minority interest) reduction to our prior year reserves for professional and general liability self-insured claims. This favorable change in our estimated future claims payments was partially due to the favorable impact of medical malpractice tort reform experienced in several states in which we operate as well as a decrease in obstetrical-related claims due to a company-wide patient safety initiative in this high-risk specialty.

**Behavioral Health Services**

The following table summarizes the results of operations for our behavioral health care facilities, on a same facility basis, and is used in the discussion below for the three and nine months ended September 30, 2007 and 2006 (dollar amounts in thousands):

**Same Facility Behavioral Health**

	Three Months Ended				Nine Months Ended			
	September 30,		%		September 30,		%	
	2007	2006	2007	2006	2007	2006	2007	2006
Net revenues	\$ 274,370	\$ 254,170	100.0	100.0	\$ 818,774	\$ 767,412	100.0	100.0
Salaries, wages and benefits	137,078	128,094	50.0	50.4	404,919	381,799	49.5	49.8
Other operating expenses	52,662	48,120	19.2	18.9	153,244	143,307	18.7	18.7
Supplies expense	16,218	15,447	5.9	6.1	47,399	45,193	5.8	5.9
Provision for doubtful accounts	6,935	5,061	2.5	2.0	19,096	15,180	2.3	2.0
Depreciation and amortization	6,607	5,570	2.4	2.2	18,267	16,851	2.2	2.2
Lease and rental	4,047	4,293	1.5	1.7	12,058	11,877	1.5	1.5
Subtotal operating expenses	223,547	206,585	81.5	81.3	654,983	614,207	80.0	80.0
Income before interest expense, minority interests and income taxes	50,823	47,585	18.5	18.7	163,791	153,205	20.0	20.0
Interest expense, net	45	51	0.0	0.0	154	198	0.0	0.0
Minority interests in earnings of consolidated entities	(1,256)	(208)	-0.5	-0.1	(935)	(529)	-0.1	0.0
Income before income taxes	\$ 52,034	\$ 47,742	19.0	18.8	\$ 164,572	\$ 153,536	20.1	20.0

On a same facility basis during the third quarter of 2007, as compared to the comparable 2006 quarter, net revenues at our behavioral health care facilities increased 8% or \$20 million. Income before income taxes increased \$4 million or 9% to \$52 million or 19.0% of net revenues during the three months ended September 30, 2007, as compared to \$48 million or 18.8% of net revenues during the comparable prior year quarter. On a same facility basis during the first nine months of 2007, as compared to the comparable 2006 nine month period, net revenues at our behavioral health care facilities increased 7% or \$51 million. Income before income taxes increased \$11 million or 7% to \$165 million or 20.1% of net revenues during the nine months ended September 30, 2007, as compared to \$154 million or 20.0% of net revenues during the comparable prior year period.

Inpatient admissions to these facilities increased 3.4% during the third quarter of 2007, as compared to the comparable 2006 quarter, while patient days increased 4.7%. The average length of patient stay at these facilities was 16.8 days and 16.6 days during the quarters ended September 30, 2007 and 2006, respectively. The occupancy rate, based on the average available beds at these facilities, was 76% and 77% during the three months ended September 30, 2007 and 2006, respectively. Inpatient admissions to these facilities increased 3.3% during the nine months ended September 30, 2007, as compared to the comparable 2006 nine month period, while patient days increased 3.9%. The average length of patient stay at these facilities was 16.6 days and 16.5 days during the nine months ended September 30, 2007 and 2006, respectively. The occupancy rate, based on the average available beds at these facilities, was 77% and 79% during the nine months ended September 30, 2007 and 2006, respectively.

On a same facility basis, as compared to the comparable prior year periods, net revenue per adjusted admission at these facilities increased 5.1% and 3.3% during the three and nine months ended September 30, 2007, respectively, and net revenue per adjusted patient day increased 3.7% and 2.7% during the three and nine months ended September 30, 2007, respectively.



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The following table summarizes the results of operations for our behavioral health care facilities, including newly acquired or recently opened facilities, for the three and nine months ended September 30, 2007 and 2006 (dollar amounts in thousands):

**All Behavioral Health Care Facilities**

	Three Months Ended				Nine Months Ended			
	September 30,		September 30,		September 30,		September 30,	
	2007	%	2006	%	2007	%	2006	%
Net revenues	\$ 285,013	100.0	\$ 254,170	100.0	\$ 847,578	100.0	\$ 767,416	100.0
Salaries, wages and benefits	143,734	50.4	128,205	50.4	423,477	50.0	382,153	49.8
Other operating expenses	55,920	19.6	48,273	19.0	159,100	18.8	143,752	18.7
Supplies expense	17,053	6.0	15,450	6.1	49,891	5.9	45,352	5.9
Provision for doubtful accounts	7,320	2.6	5,061	2.0	20,083	2.4	15,180	2.0
Depreciation and amortization	7,314	2.6	5,570	2.2	20,372	2.4	16,851	2.2
Lease and rental	4,160	1.5	4,293	1.7	12,272	1.4	11,882	1.5
Subtotal operating expenses	235,501	82.6	206,852	81.4	685,195	80.8	615,170	80.2
Income before interest expense, minority interests and income taxes	49,512	17.4	47,318	18.6	162,383	19.2	152,246	19.8
Interest expense, net	98	0.0	51	0.0	315	0.0	198	0.0
Minority interests in earnings of consolidated entities	(1,256)	-0.4	(208)	-0.1	(935)	-0.1	(529)	-0.1
Income before income taxes	\$ 50,670	17.8	\$ 47,475	18.7	\$ 163,003	19.2	\$ 152,577	19.9

During the third quarter of 2007, as compared to the comparable prior year quarter, net revenues at our behavioral health care facilities (including newly acquired or recently opened facilities), increased 12% or \$31 million. The increase in net revenues was attributable to

a \$20 million increase in same facility revenues, as discussed above, and;

\$11 million of revenues generated at facilities recently acquired or opened.

Income before income taxes increased \$3 million or 7% to \$51 million or 17.8% of net revenues during the third quarter of 2007, as compared to \$48 million or 18.7% of net revenues during the third quarter of 2006. The increase in income before income taxes at our behavioral health facilities was attributable to:

a \$4 million increase at our behavioral health facilities owned for more than a year, as discussed above, and;

a decrease of \$1 million resulting from the combined losses, net of income, generated at recently acquired or opened facilities.

During the nine months ended September 30, 2007, as compared to the comparable prior year nine month period, net revenues at our behavioral health care facilities (including newly acquired or recently opened facilities), increased 10% or \$80 million. The increase in net revenues was attributable to

a \$51 million increase in same facility revenues, as discussed above, and;

\$29 million of revenues generated at facilities recently acquired or opened.

Income before income taxes increased \$10 million or 7% to \$163 million or 19.2% of net revenues during the first nine months of 2007, as compared to \$153 million or 19.9% of net revenues during the nine months ended September 30, 2006. The increase in income before income taxes at our behavioral health facilities was attributable to:

a \$11 million increase at our behavioral health facilities owned for more than a year, as discussed above;

an increase of \$2 million representing the portion of the reduction to our prior year reserves for professional and general liability self-insured claims, as discussed above, attributable to our behavioral health facilities, and;

a decrease of \$3 million resulting from the combined losses, net of income, generated at facilities recently acquired or opened.



**Table of Contents****Sources of Revenue**

**Overview:** We receive payments for services rendered from private insurers, including managed care plans, the federal government under the Medicare program, state governments under their respective Medicaid programs and directly from patients.

Hospital revenues depend upon inpatient occupancy levels, the medical and ancillary services and therapy programs ordered by physicians and provided to patients, the volume of outpatient procedures and the charges or negotiated payment rates for such services. Charges and reimbursement rates for inpatient routine services vary depending on the type of services provided (e.g., medical/surgical, intensive care or behavioral health) and the geographic location of the hospital. Inpatient occupancy levels fluctuate for various reasons, many of which are beyond our control. The percentage of patient service revenue attributable to outpatient services has generally increased in recent years, primarily as a result of advances in medical technology that allow more services to be provided on an outpatient basis, as well as increased pressure from Medicare, Medicaid and private insurers to reduce hospital stays and provide services, where possible, on a less expensive outpatient basis. We believe that our experience with respect to our increased outpatient levels mirrors the general trend occurring in the health care industry and we are unable to predict the rate of growth and resulting impact on our future revenues. Patients are generally not responsible for any difference between customary hospital charges and amounts reimbursed for such services under Medicare, Medicaid, some private insurance plans, and managed care plans, but are responsible for services not covered by such plans, exclusions, deductibles or co-insurance features of their coverage. The amount of such exclusions, deductibles and co-insurance has generally been increasing each year. Indications from recent federal and state legislation are that this trend will continue. Collection of amounts due from individuals is typically more difficult than from governmental or business payers and we continue to experience an increase in uninsured and self-pay patients which unfavorably impacts the collectibility of our patient accounts thereby increasing our provision for doubtful accounts and charity care provided.

The following table shows the approximate percentages of net patient revenue on a combined basis for our acute care and behavioral health facilities during the three month and nine month periods ended September 30, 2007 and 2006 (excludes sources of revenues for all periods presented for divested facilities which reflected as discontinued operations in our Consolidated Financial Statements). Net patient revenue is defined as revenue from all sources after deducting contractual allowances and discounts from established billing rates, which we derived from various sources of payment for the years indicated. The tables below exclude sources of revenue for all periods presented for divested facilities, which are reflected as discontinued operations in our Consolidated Financial Statements.

**Acute Care and Behavioral Health Facilities Combined**

	Percentage of Net Patient Revenues Three Months Ended		Percentage of Net Patient Revenues Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Third Party Payors:				
Medicare	24%	25%	24%	25%
Medicaid	15%	14%	13%	12%
Managed Care (HMO and PPOs)	44%	41%	44%	42%
Other Sources	17%	20%	19%	21%
Total	100%	100%	100%	100%

The following table shows the approximate percentages of net patient revenue for our acute care facilities:

**Acute Care Facilities**

	Percentage of Net Patient Revenues Three Months Ended		Percentage of Net Patient Revenues Nine Months Ended	

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	September 30,		September 30,	
	2007	2006	2007	2006
<b>Third Party Payors:</b>				
Medicare	26%	27%	27%	29%
Medicaid	11%	11%	8%	8%
Managed Care (HMO and PPOs)	45%	41%	45%	41%
Other Sources	18%	21%	20%	22%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

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The following table shows the approximate percentages of net patient revenue for our behavioral health facilities:

**Behavioral Health Facilities**

	Percentage of Net Patient Revenues Three Months Ended		Percentage of Net Patient Revenues Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Third Party Payors:				
Medicare	16%	16%	15%	15%
Medicaid	26%	25%	25%	24%
Managed Care (HMO and PPOs)	40%	42%	41%	43%
Other Sources	18%	17%	19%	18%
Total	100%	100%	100%	100%

**Medicare:** Medicare is a federal program that provides certain hospital and medical insurance benefits to persons aged 65 and over, some disabled persons and persons with end-stage renal disease. All of our acute care hospitals and many of our behavioral health centers are certified as providers of Medicare services by the appropriate governmental authorities. Amounts received under the Medicare program are generally significantly less than a hospital's customary charges for services provided.

Under the Medicare program, for inpatient services, our general acute care hospitals receive reimbursement under a prospective payment system ( PPS ). Under inpatient PPS, hospitals are paid a predetermined fixed payment amount for each hospital discharge. The fixed payment amount is based upon each patient's diagnosis related group ( DRG ). Every DRG is assigned a payment rate based upon the estimated intensity of hospital resources necessary to treat the average patient with that particular diagnosis. The DRG payment rates are based upon historical national average costs and do not consider the actual costs incurred by a hospital in providing care. This DRG assignment also affects the predetermined capital rate paid with each DRG. The DRG and capital payment rates are adjusted annually by the predetermined geographic adjustment factor for the geographic region in which a particular hospital is located and are weighted based upon a statistically normal distribution of severity.

DRG rates are adjusted by an update factor each federal fiscal year, which begins on October 1. The index used to adjust the DRG rates, known as the hospital market basket index, gives consideration to the inflation experienced by hospitals in purchasing goods and services. Generally, however, the percentage increases in the DRG payments have been lower than the projected increase in the cost of goods and services purchased by hospitals. For federal fiscal years 2007, 2006, 2005 and 2004, the update factors were 3.4%, 3.7%, 3.3% and 3.4%, respectively. For 2008, the update factor is 3.3%. Hospitals are allowed to receive the full basket update if they provide the Centers for Medicare and Medicaid Services ( CMS ) with specific data relating to the quality of services provided. We have complied fully with this requirement and intend to comply fully in future periods. CMS has also restructured the inpatient PPS DRGs to account more fully for the severity of patient illness. As a result, payments are expected to increase for hospitals serving more severely ill patients and decrease for those serving patients who are less severely ill. The new severity-adjusted DRGs will be phased-in over 2008 and 2009.

In August 2006, CMS finalized new provisions for the hospital inpatient PPS for the upcoming federal fiscal year, which included a significant change in the manner in which it determines the underlying relative weights used to calculate the DRG payment amount. For federal fiscal year 2007, CMS began to phase-in the use of hospital costs rather than hospital charges for the DRG relative weight determination. This change is to phase-in ratably over three years with full phase-in to be completed in federal fiscal year 2009.

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On August 1, 2007, CMS issued a final rule revising Medicare payment and policy under the hospital inpatient PPS for federal fiscal year 2008. These changes, which were first proposed in April 2007, will restructure the inpatient DRGs to account more fully for the severity of patient illness. Specifically, the final rule creates 745 new severity-adjusted DRGs to replace the current 538 DRGs. As a result, payments are expected to increase for hospitals serving more severely ill patients and decrease for those serving patients who are less severely ill. Based on public comments, the new severity-adjusted DRGs will be phased in over two years, rather than the one year suggested in the April 2007 proposed rule.

The August 2007 final rule also includes important provisions to ensure that Medicare no longer pays for the additional costs of certain preventable conditions (including certain infections) acquired in the hospital.

The rule also expands the list of publicly reported quality measures that hospitals would need to report in calendar year 2008 in order to qualify for the full market basket update in federal fiscal year 2009, and reduces Medicare's payment when a hospital replaces a device that is supplied to the hospital at no or reduced cost.

Generally, CMS expects that payments to all hospitals will increase by approximately 3.5% for federal fiscal year 2008, primarily as a result of the 3.3% market basket increase. Payments to specific hospitals may increase more or less than this amount depending on the patients they serve. For example, urban hospitals that generally treat more severely ill patients are expected to receive a 3.8% increase in payments.

In September, 2007, the TMA, Abstinence Education, and QI Programs Extension Act of 2007 legislation took effect and will scale back cuts in hospital reimbursement that CMS was set to impose under the final rule for the inpatient hospital prospective payment system (IPPS) for federal fiscal year (FFY) 2008. CMS planned on reducing the standardized amount by 1.2% in FFY2008 and 1.8% in FFY2009 to account for expected changes in coding practices by hospitals as CMS implemented a new Medicare-Severity Diagnosis Related Group (MS-DRG) system for inpatient hospitals. The new law cuts these reductions by 0.6% in FFY2008 and 0.9% in FFY2009.

We continue to evaluate this final rule and are therefore not yet able to determine the ultimate impact on our acute care hospitals' Medicare reimbursements. However, we estimate that, including the wage index changes and outlier impact, our overall Medicare rate increase will be approximately 2.5% to 3.0%.

For the majority of outpatient hospital services, both general acute and behavioral health hospitals are paid under an outpatient PPS according to ambulatory procedure codes (APC) that group together services that are clinically related and use similar resources. Depending on the service rendered during an encounter, a patient may be assigned to a single or multiple groups. Medicare pays a set price or rate for each group, regardless of the actual costs incurred in providing care. Medicare sets the payment rate for each APC based on historical median cost data, subject to geographic modification. The APC payment rates are updated each federal fiscal year. For 2007, 2006, 2005 and 2004, the payment rate update factors were 3.4%, 3.7%, 3.3% and 3.4%, respectively. In July, 2007, CMS published a proposed update factor of 3.3% for 2008.

We operate inpatient rehabilitation hospital units that treat Medicare patients with specific medical conditions which are excluded from the Medicare inpatient PPS DRG payment methodology. Inpatient rehabilitation facilities (IRFs) must meet a certain volume threshold each year for the number patients with these specific medical conditions, often referred to as the 75 Percent Rule. Medicare payment for IRF patients is based on a prospective case rate based on a CMS determined Case-Mix Group classification and is updated annually by CMS. The IRF qualifying thresholds are 65% in 2007 and 75% in 2008.

Psychiatric hospitals have traditionally been excluded from the inpatient services PPS. However, on January 1, 2005, CMS implemented a new PPS (Psych PPS) for inpatient services furnished by psychiatric hospitals under the Medicare program. This system replaced the cost-based reimbursement guidelines with a per diem PPS with adjustments to account for certain facility and patient characteristics. Psych PPS also contains provisions for Outlier Payments and an adjustment to a psychiatric hospital's base payment if it maintains a full-service emergency department. The new system is being phased-in over a three-year period. Also, CMS has included a stop-loss provision to ensure that hospitals avoid significant losses during the transition. In May 2006, CMS published its annual increase to the federal component of the Psych PPS per diem rate. This increase includes the effects of market basket updates resulting in a 4.5% increase in total payments for Rate Year 2007, covering the period of July 1, 2006 to June 30, 2007. According to the May, 2007 CMS notice, the market basket increase is 3.2% for the period of July 1, 2007 through June 30, 2008. We believe the continued phase-in of Psych PPS will have a favorable effect on our future results of operations, however, due to the three-year phase-in period, we do not believe the favorable effect will have a material impact on our 2007 results of operations.

**Medicaid:** Medicaid is a joint federal-state funded health care benefit program that is administered by the states to provide benefits to qualifying individuals who are unable to afford care. Most state Medicaid payments are made under a PPS-like system, or under programs that negotiate payment levels with individual hospitals. Amounts received under the Medicaid program are generally significantly less than a hospital's customary charges for services provided. In addition to revenues



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received pursuant to the Medicare program, we receive a large portion of our revenues either directly from Medicaid programs or from managed care companies managing Medicaid. All of our acute care hospitals and most of our behavioral health centers are certified as providers of Medicaid services by the appropriate governmental authorities.

We receive a large concentration of our Medicaid revenues from Texas and significant amounts from Pennsylvania, Washington, DC and Illinois. We can provide no assurance that reductions to Medicaid revenues, particularly in the above-mentioned states, will not have a material adverse effect on our future results of operations. Furthermore, the federal government and many states are currently working to effectuate significant reductions in the level of Medicaid funding, which could adversely affect future levels of Medicaid reimbursement received by our hospitals.

In February, 2005, a Texas Medicaid State Plan Amendment went into effect for Potter County that expands the supplemental inpatient reimbursement methodology for the state's Medicaid program. This state plan amendment was approved retroactively to March, 2004. In connection with this program, we earned revenues of \$4 million and \$8 million during the three months ended September 30, 2007 and 2006, respectively, and \$14 million during each of the nine months ended September 30, 2007 and 2006. During the remainder of 2007, covering a portion of the SFY2008 (covering the period of October 1, 2007 to December 31, 2007), our estimated revenues earned pursuant to this program may be approximately \$4 million, which is contingent on the ability of the local hospital district to make Inter-Governmental transfers (IGTs) to the state of Texas. At this time, we believe the hospital district will fund the IGTs at a level in SFY2008 that is comparable to the SFY2007 funding.

On July 27, 2006, CMS retroactively approved to June 11, 2005, an amendment to the Texas Medicaid State Plan which permits the state of Texas to make supplemental payments to certain hospitals located in Hidalgo, Maverick and Webb counties. Our four acute care hospital facilities located in these counties are eligible to receive these supplemental Medicaid payments. This program was subject to final state rule making procedures and the local governmental agencies providing the necessary funds on an ongoing basis through inter-governmental transfers to the state of Texas. In connection with this program, we earned revenues of \$4 million and \$1 million during the three months ended September 30, 2007 and 2006, respectively, and \$9 million and \$1 million during the nine months ended September 30, 2007 and 2006, respectively.

As part of CMS routine retroactive review of new Medicaid state plan amendment (SPA) that pertains to the Medicaid supplemental payment programs for Hidalgo and Webb counties, CMS has indicated that certain IGTs related to this retroactive SPA approval may be ineligible for federal matching dollars which were used to fund the programs. In the anticipation of a possible CMS retroactive IGT ineligibility determination, we established a reserve for potential CMS action related to 2005 and 2006 Medicaid supplemental payments (\$6 million reserved during the three months ended September 30, 2007 and \$10 million during the nine months ended September 30, 2007).

In October, 2007, we were notified by the Texas Health and Human Services Commission (HHSC) that CMS deferred approximately 25% of the federal financial participation (FFP) on Medicaid supplemental payments made to private hospitals during the second calendar quarter of 2007 pursuant to two SPAs approved by CMS in July and September of 2006. This deferral applies to our acute care hospitals that operate in Hidalgo, Maverick and Webb counties. During this deferral period, the HHSC will provide information to CMS in response to their concerns that a certain amount of the state's expenditures claimed for FFP were not allowable according to federal regulations. We are unable to predict the CMS final decision regarding whether any state expenditures will be deemed allowable for FFP. The CMS decision on this FFP will likely occur in late 2007 or early 2008. Should the current programs remain in effect, we estimate that our hospitals in these counties will be entitled to reimbursements of approximately \$7 million annually.

In September 2005, legislation in Texas went into effect that ensures that some form of Medicaid managed care will exist in every Texas county. In addition, the Texas STAR+PLUS program, which provides an integrated acute and long-term care Medicaid managed care delivery system to elderly and disabled Medicaid beneficiaries in the Harris County service area will be expanded to seven additional service areas. Such actions could have a material unfavorable impact on the reimbursement our Texas hospitals receive.

We operate two freestanding psychiatric hospitals in the Dallas, Texas region that operated under the Lone Star Select II prospective per diem payment program. We were notified by the Commission that this per diem payment program terminated on August 31, 2006. These affected facilities were paid on a TEFRA cost based payment system for September and October of 2006. Effective November 1, 2006, the Commission's payment for these hospitals is based on a prospective per diem rate based on a prior year cost report.

**Managed Care:** A significant portion of our net patient revenues are generated from managed care companies, which include health maintenance organizations, preferred provider organizations and managed Medicare and Medicaid programs (referred to as Medicare Part C or Medicare Advantage). In general, we expect the percentage of our business from managed care programs to continue to grow. The consequent growth in managed care networks and the resulting impact of these



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networks on the operating results of our facilities vary among the markets in which we operate. Typically, we receive lower payments per patient from managed care payors than we do from traditional indemnity insurers, however, during the past few years we have secured price increases from many of our commercial payors including managed care companies.

**Commercial Insurance:** Our hospitals also provide services to individuals covered by private health care insurance. Private insurance carriers typically make direct payments to hospitals or, in some cases, reimburse their policy holders, based upon the particular hospital's established charges and the particular coverage provided in the insurance policy. Private insurance reimbursement varies among payors and states and is generally based on contracts negotiated between the hospital and the payor.

Commercial insurers are continuing efforts to limit the payments for hospital services by adopting discounted payment mechanisms, including predetermined payment or DRG-based payment systems, for more inpatient and outpatient services. To the extent that such efforts are successful and reduce the insurers' reimbursement to hospitals and the costs of providing services to their beneficiaries, such reduced levels of reimbursement may have a negative impact on the operating results of our hospitals.

**Other Sources:** Our hospitals provide services to individuals that do not have any form of health care coverage. Such patients are evaluated, at the time of service or shortly thereafter, for their ability to pay based upon federal and state poverty guidelines, qualifications for Medicaid or other state assistance programs, as well as our local hospital's indigent and charity care policy. Patients without health care coverage who do not qualify for Medicaid or indigent care write-offs are offered substantial discounts in an effort to settle their outstanding account balances. In addition, effective January 1, 2006, we implemented a formal uninsured discount policy for our acute care hospitals which had the effect of lowering both our provision for doubtful accounts and net revenues but did not materially impact net income.

**State Medicaid Disproportionate Share Hospital Payments:** Hospitals that have an unusually large number of low-income patients (i.e., those with a Medicaid utilization rate of at least one standard deviation above the mean Medicaid utilization, or having a low income patient utilization rate exceeding 25%) are eligible to receive a disproportionate share hospital (DSH) adjustment. Congress established a national limit on DSH adjustments. Although this legislation and the resulting state broad-based provider taxes have affected the payments we receive under the Medicaid program, to date the net impact has not been materially adverse.

Upon meeting certain conditions and serving a disproportionately high share of Texas' and South Carolina's low income patients, five of our facilities located in Texas and one facility located in South Carolina received additional reimbursement from each state's DSH fund. The Texas and South Carolina programs have been renewed for each state's 2008 fiscal years (covering the period of September 1, 2007 through August 31, 2008 for Texas and October 1, 2007 through September 30, 2008 for South Carolina). Included in our financial results was an aggregate of \$13 million and \$16 million during the three months ended September 30, 2007 and 2006, respectively, and \$38 million and \$36 million during the nine months ended September 30, 2007 and 2006, respectively. Failure to renew these DSH programs beyond their scheduled termination dates, failure of our hospitals that currently receive DSH payments to qualify for future DSH funds under these programs, or reductions in reimbursements, could have a material adverse effect on our future results of operations.

In February 2003, the United States Department of Health and Human Services (HHS) Office of Inspector General (OIG) published a report indicating that Texas Medicaid may have overpaid Texas hospitals for DSH payments. To date, no actions to follow up on this report have had any material impact on our Texas hospitals.

**Sources of Revenues and Health Care Reform:** Given increasing budget deficits, the federal government and many states are currently considering additional ways to limit increases in levels of Medicare and Medicaid funding, which could also adversely affect future payments received by our hospitals. In addition, the uncertainty and fiscal pressures placed upon the federal government as a result of, among other things, the ongoing military engagement in Iraq, the War on Terrorism, economic recovery stimulus packages, responses to natural disasters, such as Hurricane Katrina, the continuing expansion of a Medicare drug benefit and the federal budget deficit in general may affect the availability of federal funds to provide additional relief in the future. We are unable to predict the effect of future policy changes on our operations.

In addition to statutory and regulatory changes to the Medicare and each of the state Medicaid programs, our operations and reimbursement may be affected by administrative rulings, new or novel interpretations and determinations of existing laws and regulations, post-payment audits, requirements for utilization review and new governmental funding restrictions, all of which may materially increase or decrease program payments as well as affect the cost of providing services and the timing of payments to our facilities. The final determination of amounts we receive under the Medicare and Medicaid programs often takes many years, because of audits by the program representatives, providers' rights of appeal and the application of numerous technical reimbursement provisions. We believe that we have made adequate provisions for such potential adjustments. Nevertheless, until final adjustments are made, certain issues remain unresolved and previously determined allowances could become either inadequate or more than ultimately required.





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Finally, we expect continued third-party efforts to aggressively manage reimbursement levels and cost controls. Reductions in reimbursement amounts received from third-party payors could have a material adverse effect on our financial position and our results of operations.

**Other Operating Results**

Combined net revenues from our surgical hospitals, ambulatory surgery centers and radiation oncology centers were \$9 million during each of the three month periods ended September 30, 2007 and 2006 and \$26 million and \$25 million during the nine month periods ended September 30, 2007 and 2006, respectively. During the three and nine month periods ended September 30, 2007, we earned revenues of \$21 million and \$66 million, respectively, in connection with a construction management contract pursuant to the terms of which we are building a newly constructed acute care hospital for an unrelated third party. Combined income before income taxes earned in connection with the revenues mentioned above was \$2 million and \$1 million during the three months ended September 30, 2007 and 2006, respectively, and \$7 million and \$4 million during the nine months ended September 30, 2007 and 2006, respectively.

Interest expense was \$13 million and \$6 million during the three months ended September 30, 2007 and 2006, respectively, and \$39 million and \$23 million during the nine months ended September 30, 2007 and 2006, respectively. The increase in interest expense during the three and nine month periods of 2007, as compared to the comparable prior year periods, was primarily due to an increase in the average outstanding borrowings.

The effective tax rate was 33.7% and 36.6% during the three month periods ended September 30, 2007 and 2006, respectively, and 37.7% and 37.0% during the nine month periods ended September 30, 2007 and 2006, respectively. The effective tax rates during the three and nine months ended September 30, 2007 and 2006 were favorably impacted by favorable adjustments of \$2 million during the 2007 periods and \$3 million during the 2006 period resulting from the reductions to reserves due to the expiration of statute of limitations in various tax jurisdictions. The effective tax rates for the 2007 periods were unfavorably impacted by an increase in the effective state income tax rate. The effective tax rate during the three and nine months ended September 30, 2006 were unfavorably impacted by the non-deductible \$5 million charge incurred during the third quarter of 2006 in connection with the W&M Funding.

**Discontinued Operations**

The following table shows the combined results of operations for the facilities reflected as discontinued operations on our consolidated statements of income for the three and nine month periods ended September 30, 2007 and 2006 (amounts in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
<b>Income (loss) from discontinued operations, net of income taxes</b>				
Net revenues	\$ 9	\$ 31	\$ 32	192
Loss from operations	(240)	(133)	(296)	(165)
Income tax benefit	92	49	113	61
Loss from discontinued operations, net of income taxes	\$ (148)	\$ (84)	\$ (183)	\$ (104)

**Impact of Hurricane Katrina**

In August, 2005, our facilities listed below were severely damaged from Hurricane Katrina. Since the Hurricane, all facilities remain closed and non-operational as we continue to evaluate the likely recovery period for the surrounding communities.

**Methodist Hospital** located in New Orleans, Louisiana consisting of Methodist Hospital ( Methodist ), a six-story, 306-bed acute-care facility and Lakeland Medical Pavilion ( Lakeland ), a two-story, 54-bed acute-care facility.

**Chalmette Medical Center** located in Chalmette, Louisiana consisting Chalmette Medical Center ( Chalmette ), a two-story, 138-bed acute-care facility, which has been razed, and Virtue Street Pavilion, a one-story, 57-bed facility providing physical rehabilitation, skilled nursing and inpatient behavioral health services.

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Since these facilities have been closed since Hurricane Katrina, no revenues are reflected in our consolidated statements of income for the post-hurricane period.

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Prior to December, 2006, Methodist and Lakeland were owned by a limited liability company ( LLC ) in which we held a 90% ownership interest while the remaining 10% interest was held by an unaffiliated third-party. Pursuant to the terms of the LLC agreement, the third-party, minority member had certain put rights which they elected to exercise in December, 2006. The exercise of this put right required us to purchase the minority member's interest for \$14.8 million which was paid during the first quarter of 2007 and, as stipulated in the LLC agreement, consisted of the minority member's initial contribution in each facility. The gain resulting from this transaction, which was recorded during the fourth quarter of 2006, did not have a material impact on our 2006 results of operations.

Included in our financial results for the three and nine months ended September 30, 2007, were pre-tax hurricane related expenses of \$82,000 and \$707,000, respectively.

Included in our financial results was a pre-tax charge of \$4 million during the three months ended September 30, 2006 and \$13 million (\$14 million pre-minority interest) during the nine months ended September 30, 2006, consisting primarily of expenses incurred in connection with remediation of the hurricane-damaged properties including removal of damaged property and debris and sealing of the buildings to prevent further weather-related deterioration. Also included in our 2006 financial results were pre-tax hurricane related insurance recoveries of \$127 million (\$135 million pre-minority interest) during the three months ended September 30, 2006 and \$171 million (\$182 pre-minority interest) during the nine months ended September 30, 2006.

**Professional and General Liability Claims and Property Insurance**

As of September 30, 2007, the total accrual for our professional and general liability claims was \$259 million (\$257 million net of expected recoveries), of which \$32 million is included in current liabilities. As of December 31, 2006, the total accrual for our professional and general liability claims was \$248 million (\$245 million net of expected recoveries), of which \$32 million is included in current liabilities. Included in other assets was \$2 million as of September 30, 2007 and \$3 million as of December 31, 2006, related to estimated expected recoveries from various state guaranty funds in connection with professional and general liability claims payments related to a former commercial insurer which was placed in receivership during 2002. During the second quarter of 2007, based upon the results of a third-party actuarial analysis, we recorded an \$18 million reduction to our prior year reserves for professional and general liability self-insured claims. This favorable change in our estimated future claims payments was partially due to the favorable impact of medical malpractice tort reform experienced in several states in which we operate as well as a decrease in obstetrical-related claims due to a company-wide patient safety initiative in this high-risk specialty.

Effective April 1, 2007, we have commercial property insurance policies covering catastrophic losses resulting from windstorm damage up to \$100 million per occurrence. Losses resulting from non-named windstorms are subject to a \$250,000 deductible. Losses resulting from named windstorms are subject to a 5% deductible based upon the declared value of the property. In addition, we have commercial property insurance policies covering catastrophic losses resulting from earthquake and flood damage, each subject to annual aggregate limitations of \$100 million. Earthquake losses are subject to a \$250,000 deductible for our facilities located in all states except California, Alaska and Puerto Rico. Earthquake losses sustained at facilities located in California, Alaska and Puerto Rico are subject to a 5% deductible based upon the declared value of the property. Flood losses have a \$250,000 deductible except in FEMA designated flood zones A and V (which are located in certain sections of Florida, Oklahoma and Texas) in which case the losses are subject to a \$500,000 deductible. Due to a sharp increase in property losses experienced nationwide in recent years, the cost of commercial property insurance has increased significantly. As a result, catastrophic coverage for earthquake and flood has been limited to annual aggregate losses (as opposed to per occurrence losses). Given these insurance market conditions, there can be no assurance that a continuation of these unfavorable trends, or a sharp increase in uninsured property losses sustained by us, will not have a material adverse effect on our future results of operations.

**Liquidity****Net cash provided by operating activities**

Net cash provided by operating activities was \$323 million during the nine months ended September 30, 2007 and \$250 million during the nine month period of the prior year. The \$73 million net increase was primarily attributable to the following:

a favorable net change of \$27 million due to: (i) a favorable \$45 million change due to an increase in net income plus or minus the adjustments to reconcile net income to net cash provided by operating activities (depreciation and amortization, accretion of discount on convertible debentures, gains on sales of assets, hurricane insurance recoveries and hurricane related expenses), and; (ii) an unfavorable \$18 million change in accrued insurance expense, net of commercial premiums paid, resulting primarily from the previously mentioned \$18 million reduction to our prior year reserves for professional and

general liability self-insured claims recorded during the second quarter of 2007;

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a favorable change of \$68 million in accounts receivable, which includes: (i) the favorable change resulting from the collection during 2007 of \$45 million of Texas upper payment limit and disproportionate share hospital receivables outstanding as of December 31, 2006; (ii) the favorable change resulting from \$39 million of receivables outstanding as of September 30, 2006, which were collected during the fourth quarter of 2006, in connection with Medicare payments that were temporarily suspended by CMS in late September, 2006 and \$16 million related to Texas supplemental Medicaid reimbursements; (iii) a \$14 million unfavorable change in the combined accounts receivable at our four acute care hospitals located in Las Vegas, Nevada due primarily to an increase in patient volumes and net revenues during the first nine months of 2007, as compared to the comparable period in 2006; (iv) a \$4 million unfavorable change due to the increase in construction contract receivables recorded in connection with our management of a newly constructed acute care facility for an unaffiliated third-party, and; (v) \$2 million of other combined favorable changes;

an unfavorable change of \$43 million in accrued and deferred income taxes due primarily to the nine months of 2006 being favorably impacted by postponement payment relief granted by the Internal Revenue Service for companies that owned Hurricane Katrina-affected businesses in the most severely damaged parishes of Louisiana. This IRS granted postponement resulted in the deferral of income taxes originally scheduled to be paid during the first nine months of 2006, to October of 2006;

a favorable change of \$39 million in other working capital accounts due primarily to the timing of certain accrued payroll and accounts payable disbursements that were funded in October of 2007, and;

\$18 million of other combined net unfavorable changes.

Our days sales outstanding ( DSO ), are calculated by dividing our quarterly net revenue by the number of days in the nine month period. The result is divided into the accounts receivable balance at September 30th of each year to obtain the DSO. Our DSO were 48 days at September 30, 2007 and 51 days at September 30, 2006.

**Net cash provided by/used in investing activities**

During the nine month period ended September 30, 2007, we used \$376 million of net cash in investing activities as compared to \$134 million of net cash used in investing activities during the nine months ended September 30, 2006.

During the first nine months of 2007, we used \$376 million of net cash in investing activities as follows:

spent \$263 million to finance capital expenditures at our facilities, including construction costs related to a new 170-bed acute care hospital in Las Vegas, Nevada that is scheduled to be completed and opened in early 2008, a new 171-bed acute care hospital located in Palmdale, California that is scheduled to be completed and opened in 2009, a newly constructed replacement behavioral health care facility located in Chicago, Illinois that was completed and opened during the third quarter of 2007 and a major renovation to our 319-bed acute care facility located in Bradenton, Florida that was completed and opened during the second quarter of 2007;

spent \$103 million to acquire: (i) certain assets of Texoma Healthcare System located in Texas, including a 234-bed acute-care hospital, a 60-bed behavioral health hospital, a 21-bed freestanding rehabilitation hospital and TexomaCare, a 34-physician group practice structured as a 501A corporation; (ii) the previously leased, real property assets of a behavioral health facility located in Ohio; (iii) the acquisition of a 52-bed behavioral health facility located in Dover, Delaware; (iv) a 97-bed behavioral health facility located in Pennsylvania, and; (v) a 78-bed behavioral health facility located in Utah;

spent \$15 million to acquire the remaining 10% minority ownership interest in a limited liability company ( LLC ) that owns Methodist Hospital and Lakeland Medical Pavilion located in Louisiana that were severely damaged and closed as a result of Hurricane Katrina. Pursuant to the terms of the LLC agreement, the third-party, minority member had certain put rights which they elected to exercise in December, 2006 requiring us to purchase their ownership interest at the minority member's initial contribution

in each facility, and;

received \$5 million in connection with the sale of vacant real property located in McAllen, Texas. During the first nine months of 2006, we used \$134 million of net cash in investing activities as follows:

spent \$233 million to finance capital expenditures at our facilities, including construction costs related to a new 170-bed acute care hospital in Las Vegas, Nevada, a new 104-bed replacement acute care hospital in Eagle Pass, Texas that has been completed and opened, a new 120-bed children's hospital in Edinburg, Texas that has been

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completed and opened, a new 134-bed replacement behavioral health care facility in McAllen, Texas that has been completed and opened and a major renovation to our 319-bed acute care facility located in Bradenton, Florida that was completed and opened during the second quarter of 2007;

spent \$46 million to acquire the: (i) assets of two closed behavioral health care facilities located in Florida and Georgia which are being renovated and are scheduled to open during 2007; (ii) acquire a 128-bed behavioral health facility in Utah; (iii) acquire the assets of an 86-bed behavioral health facility in Colorado which is being renovated and is expected to open in 2007, and; (iv) acquire a medical office building in Nevada, and;

received \$189 million of hurricane related insurance proceeds from damaged sustained from Hurricane Katrina of which \$145 million is included in net cash provided by (used in) investing activities and the remaining \$44 million is included in net cash provided by operating activities.

***2007 Expected Capital Expenditures:***

During the fourth quarter of 2007, we expect to spend approximately \$100 million to \$110 million on capital expenditures, including expenditures for capital equipment, renovations, new projects at existing hospitals and completion of major construction projects in progress. We believe that our capital expenditure program is adequate to expand, improve and equip our existing hospitals. We expect to finance all capital expenditures and acquisitions with internally generated funds and/or additional funds, as discussed below

**Net cash provided by/used in financing activities**

During the nine month period ended September 30, 2007, we generated \$52 million of net cash provided by financing activities as compared to \$109 million of net cash used in financing activities during the comparable nine month period of 2006.

During the first nine months of 2007, we generated \$52 million of net cash provided by financing activities as follows:

generated \$170 million of proceeds generated from borrowings pursuant to our \$200 million accounts receivable securitization program that we entered into during the third quarter of 2007;

spent \$104 million for net debt repayments consisting primarily of repayments pursuant to our \$800 million revolving credit facility;

spent approximately \$14 million to repurchase 279,611 shares of our Class B Common Stock;

spent \$13 million to pay quarterly cash dividends of \$.08 per share;

received \$12 million of capital contributions from minority members consisting primarily of capital contributions received from a third-party for their share of costs related to an acute care facility currently under construction in Las Vegas, and;

generated \$1 million from the issuance of shares of our Class B Common Stock pursuant to the terms of employee stock purchase plans.

During the first nine months of 2006, we used \$109 million of net cash from financing activities as follows:



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generated \$249 million of net proceeds (net of underwriting discount) from the issuance of \$250 million of senior notes which have a 7.125% coupon rate and will mature on June 30, 2016;

spent \$142 million of net debt repayments consisting primarily of \$100 million of repayments under our revolving credit facility and \$31 million of repayments resulting from the redemption of a portion of our outstanding convertible debentures that were due in 2020 prior to our exercise of our call option in June of 2006;

spent approximately \$220 million to repurchase approximately 4.2 million shares of our Class B Common Stock;

spent \$13 million to pay quarterly cash dividends of \$.08 per share;

received \$12 million of capital contributions from a third-party minority member for their share of costs related to an acute care facility currently under construction in Las Vegas, and;

generated \$5 million of net cash from other financing activities.

### **Capital Resources**

#### **Credit Facilities and Outstanding Debt Securities**

We have an \$800 million, unsecured non-amortizing revolving credit agreement, as amended, ( Credit Agreement ) which is scheduled to expire on July 28, 2011. In April, 2007, the Credit Agreement was amended to increase commitments from

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\$650 million to \$800 million. The Credit Agreement includes a \$100 million sub-limit for letters of credit. The interest rate on the borrowings is determined, at our option, as either: (i) the one, two, three or six month London Inter-Bank Offer Rate ( LIBOR ) plus a spread of 0.33% to 0.575%; (ii) at the higher of the Agent s prime rate or the federal funds rate plus 0.50%, or; (iii) a competitive bid rate. A facility fee ranging from 0.07% to 0.175% is required on the total commitment. The applicable margins over LIBOR and the facility fee are based upon our credit ratings from Standard & Poor s Ratings Services and Moody s Investors Service, Inc. At September 30, 2007, the applicable margin over the LIBOR rate was .50% and the commitment fee was .125%. There are no compensating balance requirements. As of September 30, 2007, we had \$253 million of borrowings outstanding under our revolving credit agreement and \$47 million of outstanding letters of credit. As of September 30, 2007, we had \$500 million of available borrowing capacity pursuant to the terms of our Credit Agreement.

In August of 2007, we entered into a \$200 million accounts receivable securitization program ( Securitization ) with a group of conduit lenders and liquidity banks. The patient accounts receivable for substantially all of our acute care hospitals serve as collateral for the outstanding borrowings. The interest rate on the borrowings is based on the commercial paper rate plus a spread of .25%. The initial term of this Securitization is 364 days and the term can be extended for incremental 364 day periods upon mutual agreement of the parties. The Securitization has a term-out feature that can be exercised by us if the banks do not extend the Securitization which would extend the maturity date to June 30, 2010. Under the terms of the term-out provision, the borrowing rate would be the same as our Credit Agreement rate. Outstanding borrowings which can be refinanced through available borrowings under the terms of our Credit Agreement are classified as long-term on our condensed consolidated balance sheet. As of September 30, 2007, there were \$170 million of borrowings outstanding pursuant to this program.

On June 30, 2006, we issued \$250 million of senior notes (the Notes ) which have a 7.125% coupon rate and mature on June 30, 2016. Interest on the Notes is payable semiannually in arrears on June 30 and December 30 of each year.

During 2001, we issued \$200 million of senior notes which have a 6.75% coupon rate and which mature on November 15, 2011. The interest on the senior notes is paid semiannually in arrears on May 15 and November 15 of each year. The senior notes can be redeemed in whole at any time and in part from time to time.

Our total debt as a percentage of total capitalization was 37% at September 30, 2007 and 37% at December 31, 2006. Covenants relating to long-term debt require maintenance of a minimum net worth, specified debt to total capital and fixed charge coverage ratios. We are in compliance with all required covenants as of September 30, 2007.

We expect to finance all capital expenditures and acquisitions, pay dividends and potentially repurchase shares of our common stock utilizing internally generated and additional funds. Additional funds may be obtained through: (i) the issuance of equity; (ii) borrowings under our existing revolving credit facility or through refinancing the existing revolving credit agreement, and/or; (iii) the issuance of other long-term debt. There can be no assurance that such additional funds will be available in the preferred amounts or from the preferred sources.

**Off-Balance Sheet Arrangements**

During the three months ended September 30, 2007, there have been no material changes in the off-balance sheet arrangements consisting of operating leases and standby letters of credit and surety bonds. Reference is made to Item 7. Management s Discussion and Analysis of Operations and Financial Condition Contractual Obligations and Off-Balance Sheet Arrangements, in our Annual Report on Form 10-K for the year ended December 31, 2006.

We have various obligations under operating leases or master leases for real property and under operating leases for equipment. The real property master leases are leases for buildings on or near hospital property for which we guarantee a certain level of rental income. We sublease space in these buildings and any amounts received from these subleases are offset against the expense. In addition, we lease four hospital facilities from the Trust with terms scheduled to expire in 2011 and 2014. These leases contain up to four, 5-year renewal options.

As of September 30, 2007, we were party to certain off balance sheet arrangements consisting of standby letters of credit and surety bonds. Our outstanding letters of credit and surety bonds as of September 30, 2007 totaled \$79 million consisting of: (i) \$74 million related to our self-insurance programs; (ii) \$4 million consisting primarily of collateral for outstanding bonds of an unaffiliated third-party and public utility, and; (iii) \$1 million of debt guarantees related to entities in which we own a minority interest.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

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There have been no material changes in the quantitative and qualitative disclosures during the three months ended September 30, 2007. Reference is made to Item 7A. Quantitative and Qualitative Disclosures about Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2006.

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**Item 4. Controls and Procedures**

As of September 30, 2007, under the supervision and with the participation of our management, including our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), we performed an evaluation of the effectiveness of our disclosure controls and procedures, as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the 1934 Act ). Based on this evaluation, the CEO and CFO have concluded that our disclosure controls and procedures are effective to ensure that material information is recorded, processed, summarized and reported by management on a timely basis in order to comply with our disclosure obligations under the 1934 Act and the SEC rules thereunder.

**Changes in Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting or in other factors during the third quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are subject to claims and suits in the ordinary course of business, including those arising from care and treatment afforded by our hospitals and are party to various other litigation, as outlined below.

*Investigation of South Texas Health System affiliates:*

We and our South Texas Health System affiliates, which operate McAllen Medical Center, McAllen Heart Hospital, Edinburg Regional Medical Center and certain other affiliates, were served with a subpoena dated November 21, 2005, issued by the Office of Inspector General of the Department of Health and Human Services ( OIG ). At that time, the Civil Division of the U.S. Attorney 's office in Houston, Texas indicated that the subpoena was part of an investigation under the False Claims Act of compliance with Medicare and Medicaid rules and regulations pertaining to the employment of physicians and the solicitation of patient referrals from physicians from January 1, 1999 to the date of the subpoena related to the South Texas Health System. On March 9, 2007, an additional subpoena was served upon us by the OIG requesting documents concerning the Medicare cost reports for the South Texas Health System affiliates. On February 16, 2007, our South Texas Health System affiliates were served with a search warrant in connection with what we have been advised is a related criminal Grand Jury investigation concerning the production of documents. At that time, the government obtained various documents and other property related to the facilities. Follow-up Grand Jury subpoenas for documents and witnesses and other requests for information were subsequently served on South Texas Health System facilities and certain employees.

Over the last several weeks, at our request, our legal representatives have met with representatives of the civil and criminal divisions of the United States Attorney 's Office for the Southern District of Texas to discuss the status of these matters. Our representatives have been advised that the government is continuing its investigations. We believe that, based on those discussions and its investigations to date, the government is focused on certain arrangements entered into by the South Texas Health System affiliates which, the government believes may have violated Medicare and Medicaid rules and regulations pertaining to payments to physicians and the solicitation of patient referrals from physicians and other matters relating to payments to various individuals which may have constituted improper or illegal payments. We believe that the government is also focusing its investigation to determine whether the South Texas Health System affiliates and certain individuals illegally failed to fully comply with the original OIG subpoena. We are in the process of investigating these matters and are cooperating with the investigations and intend to respond to the matters raised with us. We are unable to evaluate the existence or extent of any potential financial exposure in connection with this matter at this time.

We monitor all aspects of our business and have developed a comprehensive ethics and compliance program that is designed to meet or exceed applicable federal guidelines and industry standards. Because the law in this area is complex and constantly evolving, governmental investigation or litigation may result in interpretations that are inconsistent with industry practices, including ours. Although we believe our policies, procedures and practices comply with governmental regulations, no assurance can be given that we will not be subjected to further inquiries or actions, or that we will not be faced with sanctions, fines or penalties in connection with the investigation of our South Texas Health System affiliates. Even if we were to ultimately prevail, the government 's inquiry and/or action in connection with this matter could have a material adverse effect on our future operating results.

*Lasko-Hoellinger, et al, v. UHS of Delaware, Inc. et al, and other related matter:*

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On November 1, 2005, our management company and several of our facilities located in California, including Inland Valley Medical Center, Rancho Springs Medical Center, Del Amo Hospital and Corona Regional Medical Center ( Hospitals ) were named as defendants in a wage and hour lawsuit filed in Los Angeles Superior Court under the caption *Lasko-Hoellinger, et*

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*al v. UHS of Delaware, Inc., et al.* Del Amo Hospital was subsequently dismissed from the case. While two of the four original plaintiffs in that case voluntarily requested that they be dismissed as plaintiffs from that lawsuit, the remaining two plaintiffs sought to have the matter certified as a class action. The remaining plaintiffs alleged, among other things, that they were entitled to recover damages from the Hospitals for missed breaks and other alleged violations of various California Labor Code sections and applicable wage orders for a period of at least one year prior to the filing of the case. During 2006, we recorded an estimated \$10 million pre-tax provision in connection with this and another related matter (\$2 million during the first quarter of 2006 and \$8 million during the fourth quarter of 2006). During the third quarter of 2007, this case and the related matter were settled for a combined total of \$10.4 million.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 2. Unregistered sales of Equity Securities and Use of Proceeds**

On July 20, 2006, we announced that our Board of Directors authorized us to repurchase an additional 5 million shares on the open market under our stock repurchase program. Pursuant to the terms of our program, we purchased 221,546 shares at an average price of \$49.95 per share or \$11.1 million in the aggregate during the third quarter of 2007, and 222,357 shares at an average price of \$50.00 or \$11.1 million in the aggregate during the nine month period ended September 30, 2007. As of September 30, 2007, the number of shares available for purchase was 1,796,554 shares. There is no expiration date for our stock repurchase program.

	Total number of shares purchased(a)	Average price paid per share for forfeited restricted shares	Total number of shares purchased as part of publicly announced programs	Average price paid per share for shares purchased as part of publicly announced program	Aggregate purchase price paid (in thousands)	Maximum number of shares that may yet be purchased under the program
<b>2007 period</b>						
July, 2007	1,802	\$ 0.01	120	\$ 57.85	\$ 7	2,017,980
August, 2007	207,086	\$ 0.01	205,743	\$ 49.61	\$ 10,206	1,812,237
September, 2007	15,683		15,683	\$ 54.42	\$ 853	1,796,554
Total July through September	224,571	\$ 0.01	221,546	\$ 49.95	\$ 11,066	1,796,554

(a.) Includes 3,025 restricted shares that were forfeited by former employees pursuant to the terms of the restricted stock purchase plan.

**Dividends**

During the quarter ended September 30, 2007, we declared and paid dividends of \$.08 per share.

**Item 6. Exhibits**

(a) Exhibits:

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Credit and Security Agreement, dated as of August 31, 2007, previously filed as Exhibit 10.1 to our Current Report on Form 8-K dated September 6, 2007, is incorporated herein by reference.

- 10.2 Form of Receivables Sale Agreement, dated as of August 31, 2007, previously filed as Exhibit 10.2 to our Current Report on Form 8-K dated September 6, 2007, is incorporated herein by reference.
- 10.3 Form of Performance Undertaking, dated as of August 31, 2007, previously filed as Exhibit 10.3 to our Current Report on Form 8-K dated September 6, 2007 is incorporated herein by reference.
- 11. Statement re computation of per share earnings is set forth in Note 7 of the Notes to Condensed Consolidated Financial Statements.

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- 31.1 Certification of the Company's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934.
- 31.2 Certification of the Company's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934.
- 32.1 Certification of the Company's 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 the Company's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



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**UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES**

**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.

Universal Health Services, Inc.  
(Registrant)

Date: November 8, 2007

/s/ Alan B. Miller  
Alan B. Miller, Chairman of the Board,  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Steve Filton  
Steve Filton, Senior Vice President,  
Chief Financial Officer  
(Principal Financial Officer)

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**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
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