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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-Q

**(MARK ONE)**

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

**For the quarterly period ended June 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**

# UNIVERSAL HEALTH SERVICES, INC.
**(Exact name of registrant as specified in its charter)**

| **DELAWARE** | **23-2077891** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**UNIVERSAL CORPORATE CENTER**
**367 SOUTH GULPH ROAD**
**KING OF PRUSSIA, PENNSYLVANIA 19406**
**(Address of principal executive offices) (Zip Code)**

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

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, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 or 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 July 31, 2007:

| | |
|---|---|
| Class A | 3,328,404 |
| Class B | 50,215,997 |
| Class C | 335,800 |
| Class D | 23,530 |

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## PART I. FINANCIAL INFORMATION

## UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES
## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(amounts in thousands, except per share amounts)
(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Net revenues | $1,178,976 | $1,047,673 | $2,376,577 | $2,081,962 |
| Operating charges: | | | | |
| Salaries, wages and benefits | 498,579 | 434,756 | 1,009,572 | 876,988 |
| Other operating expenses | 238,093 | 248,956 | 483,445 | 497,057 |
| Supplies expense | 169,246 | 124,814 | 344,604 | 253,327 |
| Provision for doubtful accounts | 103,039 | 87,182 | 202,132 | 162,189 |
| Depreciation and amortization | 45,406 | 40,369 | 88,869 | 79,399 |
| Lease and rental expense | 16,605 | 15,831 | 32,781 | 32,063 |
| Hurricane related expenses | 1,058 | 3,356 | 625 | 10,260 |
| Hurricane insurance recoveries | — | (3,356) | — | (10,260) |
| | 1,072,026 | 951,908 | 2,162,028 | 1,901,023 |
| Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes | 106,950 | 95,765 | 214,549 | 180,939 |
| Interest expense, net | 13,040 | 8,697 | 25,762 | 17,222 |
| Hurricane insurance recoveries in excess of expenses | — | (21,644) | — | (37,031) |
| Minority interests in earnings of consolidated entities | 8,675 | 11,492 | 22,867 | 22,669 |
| Income before income taxes | 85,235 | 97,220 | 165,920 | 178,079 |
| Provision for income taxes | 33,193 | 36,349 | 64,306 | 66,716 |
| Income from continuing operations | 52,042 | 60,871 | 101,614 | 111,363 |
| Income (loss) from discontinued operations, net of income taxes | 29 | (612) | (35) | (20) |
| Net income | $ 52,071 | $ 60,259 | $ 101,579 | $ 111,343 |
| Basic earnings (loss) per share: | | | | |
| From continuing operations | $ 0.97 | $ 1.13 | $ 1.90 | $ 2.07 |
| From discontinued operations | 0.00 | (0.01) | 0.00 | 0.00 |
| Total basic earnings per share | $ 0.97 | $ 1.12 | $ 1.90 | $ 2.07 |
| Diluted earnings (loss) per share: | | | | |
| From continuing operations | $ 0.97 | $ 1.05 | $ 1.89 | $ 1.93 |
| From discontinued operations | 0.00 | (0.01) | 0.00 | 0.00 |
| Total diluted earnings per share | $ 0.97 | $ 1.04 | $ 1.89 | $ 1.93 |
| Weighted average number of common shares - basic | 53,499 | 53,730 | 53,496 | 53,749 |
| Add: Shares for conversion of convertible debentures | — | 5,999 | — | 6,286 |
| Other share equivalents | 229 | 258 | 211 | 237 |
| Weighted average number of common shares and equivalents - diluted | 53,728 | 59,987 | 53,707 | 60,272 |

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

**UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
(dollar amounts in thousands)
(unaudited)

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 12,663 | $ 14,939 |
| Accounts receivable, net | 647,852 | 595,009 |
| Supplies | 68,562 | 64,532 |
| Other current assets | 28,178 | 19,113 |
| Deferred and prepaid income taxes | 44,528 | 34,913 |
| Total current assets | 801,783 | 728,506 |
| Property and equipment | 2,883,289 | 2,665,209 |
| Less: accumulated depreciation | (1,042,442) | (980,124) |
| | 1,840,847 | 1,685,085 |
| Other assets: | | |
| Goodwill | 745,769 | 719,991 |
| Deferred charges | 7,088 | 7,262 |
| Other | 136,193 | 136,198 |
| | $ 3,531,680 | $3,277,042 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Current maturities of long-term debt | $ 3,014 | $ 1,938 |
| Accounts payable and accrued liabilities | 491,068 | 491,309 |
| Federal and state taxes | 57 | 9,204 |
| Total current liabilities | 494,139 | 502,451 |
| Other noncurrent liabilities | 342,872 | 340,815 |
| Minority interests | 199,773 | 174,061 |
| Long-term debt | 951,060 | 821,363 |
| Deferred income taxes | 29,062 | 35,888 |
| Commitments and contingencies | | |
| Common stockholders' equity | 1,514,774 | 1,402,464 |
| | $ 3,531,680 | $3,277,042 |

See accompanying notes to these condensed consolidated financial statements.

**UNIVERSAL HEALTH SERVICES, INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
(amounts in thousands)
(unaudited)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| **Cash Flows from Operating Activities:** | | |
| Net income | $ 101,579 | $ 111,343 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation & amortization | 88,888 | 79,399 |
| Accretion of discount on convertible debentures | — | 6,364 |
| Gain on sale of assets | (2,200) | — |
| Hurricane insurance recoveries | — | (47,291) |
| Changes in assets & liabilities, net of effects from acquisitions and dispositions: | | |
| Accounts receivable | (36,291) | (46,618) |
| Accrued interest | 9,260 | (488) |
| Accrued and deferred income taxes | (7,368) | 57,195 |
| Other working capital accounts | (125) | (6,702) |
| Other assets and deferred charges | (3,783) | (856) |
| Other | (1,240) | 7,884 |
| Minority interest in earnings of consolidated entities, net of distributions | 9,260 | 10,734 |
| Accrued insurance expense, net of commercial premiums paid | 23,395 | 41,173 |
| Payments made in settlement of self-insurance claims | (22,399) | (23,065) |
| Net cash provided by operating activities | 158,976 | 189,072 |
| **Cash Flows from Investing Activities:** | | |
| Property and equipment additions, net of disposals | (184,587) | (152,673) |
| Acquisition of property and businesses | (81,195) | (14,250) |
| Hurricane insurance recoveries received | — | 53,000 |
| 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 | (275,276) | (113,923) |
| **Cash Flows from Financing Activities:** | | |
| Reduction of long-term debt | — | (140,824) |
| Additional borrowings | 116,271 | 248,645 |
| Issuance of common stock | 1,444 | 2,638 |
| Repurchase of common shares | (3,341) | (71,008) |
| Dividends paid | (8,621) | (8,620) |
| Financing costs | — | (1,625) |
| Net cash received for termination of derivatives | — | 3,393 |
| Capital contributions from minority member | 8,271 | 8,639 |
| Net cash provided by financing activities | 114,024 | 41,238 |
| **(Decrease) Increase in cash and cash equivalents** | (2,276) | 116,387 |
| Cash and cash equivalents, beginning of period | 14,939 | 7,963 |
| **Cash and cash equivalents, end of period** | $ 12,663 | $ 124,350 |
| **Supplemental Disclosures of Cash Flow Information:** | | |
| Interest paid | $ 20,216 | $ 18,019 |
| Income taxes paid, net of refunds | $ 71,410 | $ 9,559 |

See accompanying notes to these condensed consolidated financial statements.

**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 June 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," "predicts," "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. Certain prior year amounts have been reclassified to conform with current year financial statement presentation.

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

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

At June 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 $350,000 during each of the three month periods ended June 30, 2007 and 2006, and approximately $700,000 during each of the six month periods ended June 30, 2007 and 2006. Our pre-tax share of income from the Trust was $613,000 and $457,000 during the three month periods ended June 30, 2007 and 2006, respectively, and $913,000 and $788,000 during the six month periods ended June 30, 2007 and 2006, respectively. The carrying value of this investment was $10.2 million at June 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 $26.2 million at June 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 $4.1 million and $4.0 million during the three month periods ended June 30, 2007 and 2006, respectively, and $8.1 million and $8.0 million during the six month periods ended June 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 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 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's 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 Minimum Rent | End of Lease Term | Renewal Term (years) |
|---|---|---|---|---|
| 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 potential incremental rent, if any, on the additional real property assets in excess of $11.0 million, being constructed at Inland Valley that were/will be 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. In addition, we along with certain Directors and members of our executive management team owned approximately 6% of the outstanding shares of Broadlane, Inc. Broadlane, Inc. provides contracting and other supply chain services to us and various other healthcare organizations.

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 $6.7 million as of June 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.

As of June 30, 2007 and December 31, 2006, the minority interest liability of $199.8 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 during the fourth quarter of 2007; (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.

At the end of the second quarter of 2007, the operations, assets and liabilities of a surgical hospital, in which we held a 50% ownership interest, were merged into an existing, wholly-owned limited partnership ("LP") which owned and operated a 180-bed acute care facility. Both facilities are located in Laredo, Texas. Based upon fair market valuations as determined by third-party appraisals, after the merger, we hold a 90.35% ownership interest in the LP and the remaining 9.65% ownership interest is held by a physician group which previously held the 50% ownership interest in the surgical hospital. We are the sole general partner of the LP. This non-cash transaction did not have a material impact on our financial statements.

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 June 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 June 30, 2007, we had $471 million of borrowings outstanding under our revolving credit agreement and $50 million of outstanding letters of credit. As of June 30, 2007, we had $279 million of available borrowing capacity pursuant to the terms of our Credit Agreement.

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 June 30, 2007, the total accrual for our professional and general liability claims was $249 million ($246 million net of expected recoveries), of which $32 million is included in other 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 other current liabilities. Included in other assets was $3 million as of June 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.

As of June 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 June 30, 2007 totaled $86 million consisting of: (i) $74 million related to our self-insurance programs; (ii) $7 million consisting primarily of collateral for outstanding bonds of an unaffiliated third party and public utility, and; (iii) $5 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.

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. To the best of our knowledge, we have provided the documents requested in connection with both subpoenas and we continue to cooperate in the investigation. 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, and we are cooperating with this Grand Jury investigation. 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.

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 plaintiffs are seeking to have the matter certified as a class action. The remaining plaintiffs are alleging, among other things, that they are 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. The Hospitals have denied liability and are defending the case, which has not yet been certified as a class action by the court. Although we are unable to definitively determine the extent of the potential financial exposure at this time, we recorded an estimated $10 million pre-tax provision in connection with this matter during 2006 ($2 million and $8 million during the second and fourth quarters of 2006, respectively).

On March 30, 2007, the U.S. Department of Labor filed a claim, in the United States District Court in New Haven, Connecticut, against Stonington Behavioral Health, Inc. ("Stonington"), a wholly-owed subsidiary that owns one of our behavioral health facilities, UHS of Delaware, Inc., and Universal Health Services, Inc., alleging that Stonington failed to pay certain employees (1) the applicable minimum wage, and (2) appropriate pay for overtime, during the period July 1, 2004 to July 1, 2006. The Department of Labor claimed that such violations resulted in underpayments totaling approximately $1.1 million to 143 employees. During the first quarter of 2007, we recorded a $1.1 million pre-tax provision in connection with this claim and in July, 2007, our subsidiaries mentioned above settled this matter by agreeing to pay $1,075,218 in back wages plus $49,000 in penalties.

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. While management believes its policies, procedures and practices comply with governmental regulations, no assurance can be given that we will not be subjected to governmental inquiries or actions.

**(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. Also included in the Other segment column are the combined assets, as of March 31, 2006, of $5.0 million related to the acute care facilities located in the U.S., Puerto Rico and France that are reflected as discontinued operations on our consolidated statements of income. 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 executive for each operating segment also manages 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 June 30, 2007 | | | |
|---|---|---|---|---|
| | Acute Care Hospital Services | Behavioral Health Services | Other | Total Consolidated |
| | (Dollar amounts in thousands) | | | |
| Gross inpatient revenues | $2,092,069 | $452,963 | — | $2,545,032 |
| Gross outpatient revenues | $ 897,359 | $ 59,443 | $ 21,444 | $ 978,246 |
| Total net revenues | $ 853,672 | $286,853 | $ 38,451 | $1,178,976 |
| Income/(loss) before income taxes | $ 66,194 | $ 61,203 | $ (42,162) | $ 85,235 |
| Total assets as of 6/30/07 | $2,273,260 | $914,325 | $344,095 | $3,531,680 |
| Licensed beds | 5,498 | 7,258 | — | 12,756 |
| Available beds | 5,220 | 7,234 | — | 12,454 |
| Patient days | 286,702 | 501,482 | — | 788,184 |
| Admissions | 64,139 | 29,707 | — | 93,846 |
| Average length of stay | 4.5 | 16.9 | — | 8.4 |

| | Six Months Ended June 30, 2007 | | | |
|---|---|---|---|---|
| | Acute Care Hospital Services | Behavioral Health Services | Other | Total Consolidated |
| | (Dollar amounts in thousands) | | | |
| Gross inpatient revenues | $4,363,208 | $886,875 | — | $5,250,083 |
| Gross outpatient revenues | $1,765,490 | $119,088 | $ 40,317 | $1,924,895 |
| Total net revenues | $1,746,537 | $562,565 | $ 67,475 | $2,376,577 |
| Income/(loss) before income taxes | $ 140,733 | $112,333 | $ (87,146) | $ 165,920 |
| Total assets as of 6/30/07 | $2,273,260 | $914,325 | $344,095 | $3,531,680 |
| Licensed beds | 5,498 | 7,158 | — | 12,656 |
| Available beds | 5,220 | 7,114 | — | 12,334 |
| Patient days | 595,876 | 982,835 | — | 1,578,711 |
| Admissions | 132,905 | 59,026 | — | 191,931 |
| Average length of stay | 4.5 | 16.7 | — | 8.2 |

| | Three Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Acute Care Hospital Services | Behavioral Health Services | Other | Total Consolidated |
| | (Dollar amounts in thousands) | | | |
| Gross inpatient revenues | $1,853,383 | $418,824 | — | $2,272,207 |
| Gross outpatient revenues | $ 720,893 | $ 53,522 | $ 20,944 | $ 795,359 |
| Total net revenues | $ 775,976 | $259,618 | $ 12,079 | $1,047,673 |
| Income/(loss) before income taxes | $ 76,574 | $ 55,491 | $ (34,845) | $ 97,220 |
| Total assets as of 6/30/06 | $2,010,365 | $729,201 | $406,055 | $3,145,621 |
| Licensed beds | 5,014 | 6,439 | — | 11,453 |
| Available beds | 4,724 | 6,381 | — | 11,105 |
| Patient days | 267,926 | 466,554 | — | 734,480 |
| Admissions | 60,551 | 27,928 | — | 88,479 |
| Average length of stay | 4.4 | 16.7 | — | 8.3 |

| | Six Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Acute Care Hospital Services | Behavioral Health Services | Other | Total Consolidated |
| | (Dollar amounts in thousands) | | | |
| Gross inpatient revenues | $3,794,538 | $828,224 | — | $4,622,762 |
| Gross outpatient revenues | $1,429,404 | $106,796 | $ 41,665 | $1,577,865 |
| Total net revenues | $1,545,928 | $513,246 | $ 22,788 | $2,081,962 |
| Income/(loss) before income taxes | $ 151,126 | $105,102 | $ (78,149) | $ 178,079 |
| Total assets as of 6/30/06 | $2,010,365 | $729,201 | $406,055 | $3,145,621 |
| Licensed beds | 5,002 | 6,419 | — | 11,421 |
| Available beds | 4,707 | 6,361 | — | 11,068 |
| Patient days | 551,174 | 918,439 | — | 1,469,613 |
| Admissions | 123,718 | 56,000 | — | 179,718 |
| Average length of stay | 4.5 | 16.4 | — | 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.

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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | (amounts in thousands) | | | |
| | 2007 | 2006 | 2007 | 2006 |
| Basic: | | | | |
| Income from continuing operations | $52,042 | $60,871 | $101,614 | $111,363 |
| Less: Dividends on unvested restricted stock, net of taxes | (19) | (21) | (44) | (43) |
| Income from continuing operations – basic | $52,023 | $60,850 | $101,570 | $111,320 |
| Income (loss) from discontinued operations | 29 | (612) | (35) | (20) |
| Net income – basic | $52,052 | $60,238 | $101,535 | $111,300 |
| Diluted: | | | | |
| Income from continuing operations | $52,042 | $60,871 | $101,614 | $111,363 |
| Less: Dividends on unvested restricted stock, net of taxes | (19) | (21) | (44) | (43) |
| Add: Debenture interest, net of taxes | — | 2,445 | — | 4,902 |
| Income from continuing operations-diluted | $52,023 | $63,295 | $101,570 | $116,222 |
| Income (loss) from discontinued operations | 29 | (612) | (35) | (20) |
| Net income – diluted | $52,052 | $62,683 | $101,535 | $116,202 |
| Weighted average number of common shares | 53,499 | 53,730 | 53,496 | 53,749 |
| Net effect of dilutive stock options and grants based on the treasury stock method | 229 | 258 | 211 | 237 |
| Assumed conversion of discounted convertible debentures | — | 5,999 | — | 6,286 |
| Weighted average number of common shares and equivalents | 53,728 | 59,987 | 53,707 | 60,272 |
| Earnings (Loss) Per Basic Share: | | | | |
| From continuing operations | $ 0.97 | $ 1.13 | $ 1.90 | $ 2.07 |
| From discontinued operations | 0.00 | (0.01) | 0.00 | 0.00 |
| Total earnings per basic share | $ 0.97 | $ 1.12 | $ 1.90 | $ 2.07 |
| Earnings (Loss) Per Diluted Share: | | | | |
| From continuing operations | $ 0.97 | $ 1.05 | $ 1.89 | $ 1.93 |
| From discontinued operations | 0.00 | (0.01) | 0.00 | 0.00 |
| Total earnings per diluted share | $ 0.97 | $ 1.04 | $ 1.89 | $ 1.93 |

**Stock-Based Compensation:** During the three months ending June 30, 2007 and 2006, compensation cost of $2.1 million ($1.3 million after-tax) and $1.5 million ($1.0 million after-tax), respectively, was recognized related to outstanding stock options. During the six months ending June 30, 2007 and 2006, compensation costs of $4.5 million ($2.8 million after-tax) and $3.2 million ($2.0 million after-tax), respectively, was recognized related to outstanding stock options. In addition, during the three months ended June 30, 2007 and 2006, compensation costs of $1.9 million ($1.2 million after-tax) and $1.7 million ($1.1 million after-tax), respectively, was recognized related to restricted stock, and during the six months ended June 30, 2007 and 2006, compensation costs of $4.1 million ($2.5 million after taxes) and $2.8 million ($1.8 million after taxes) was recognized related to restricted stock. As of June 30, 2007 there was $29.9 million of unrecognized compensation cost related to unvested options and restricted stock which is expected to be recognized over the remaining weighted average vesting period of 2.7 years. During the second quarter of 2007, there were 12,500 stock options, net of cancellations, granted under this plan with a weighted-average grant-date fair value of $13.64 per option and 8,000 restricted stock shares granted with a weighted-average grant date fair value of $59.78 per share. During the six months of 2007, there were 25,000 stock options, net of cancellations, granted under this plan with a weighted-average grant-date fair value of $13.61 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.

| (amounts in thousands) | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Net income | $52,071 | $60,259 | $101,579 | $111,343 |
| Other comprehensive income (loss): | | | | |
| Unrealized derivative gains on cash flow hedges, net of taxes of $1.3 million | — | 2,135 | — | 2,135 |
| Recognition of derivative gains on cash flow hedges, net of taxes | (84) | — | (168) | — |
| Comprehensive income | $51,987 | $62,394 | $101,411 | $113,478 |

**(9) Dispositions and Acquisitions of assets and businesses**

***Acquisitions and divestitures during the six months ended June 30, 2007:***

During the first six months of 2007, we paid $81 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);
- the previously leased, real property assets of a behavioral health facility located in Ohio (acquired during the first quarter of 2007), and;
- the acquisition of a 52-bed behavioral health facility located in Dover, Delaware (acquired during the second 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 six months ended June 30, 2007.

***Acquisitions during the six months ended June 30, 2006:***

- We paid $14 million to acquire the assets of closed behavioral health care facilities located in Florida and Georgia.

**(10) Dividends**

A dividend of $.08 per share or $4.3 million in the aggregate was declared by the Board of Directors on May 17, 2007 and was paid on June 15, 2007 to shareholders of record as of June 1, 2007.

**(11) Pension Plan**

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

| | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Service cost | $ 336 | $ 348 | $ 672 | $ 696 |
| Interest cost | 1,091 | 1,100 | 2,182 | 2,200 |
| Expected return on assets | (1,193) | (935) | (2,386) | (1,870) |
| Recognized actuarial loss | 280 | 444 | 560 | 888 |
| Net periodic pension cost | $ 514 | $ 957 | $ 1,028 | $ 1,914 |

During the six months ended June 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 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.

We recognize accrued interest and penalties associated with uncertain tax positions as part of the tax provision. As of June 30, 2007, we had approximately $1.2 million of accrued interest and penalties. The U.S. federal statute of limitations remains open for the 2003 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.

## 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 June 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 111 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 73% and 75% of our consolidated net revenues during the three month periods ended June 30, 2007 and 2006, respectively, and 74% and 75% during the six month periods ended June 30, 2007 and 2006, respectively. Net revenues from our behavioral health care facilities accounted for 24% and 25% of our consolidated net revenues during the three month periods ended June 30, 2007 and 2006, respectively, and 24% and 25% during the six month periods ended June 30, 2007 and 2006, respectively. Approximately 2% of our consolidated net revenues during each of the three and six month period ended June 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," "believes," "estimates," "appears," "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;
- the outcome of known and unknown litigation, government investigations, and liabilities and other claims asserted against us, including the government's investigation of our South Texas Health Systems affiliates;
- national, regional and local economic and business conditions;

- 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;
- 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**

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 37% and 38% of our net patient revenues during the three month periods ended June 30, 2007 and 2006, respectively, and 36% and 37% during the six month periods ended June 30, 2007 and 2006, respectively. Revenues from managed care entities, including health maintenance organizations and managed Medicare and Medicaid programs accounted for 45% and 42% of our net patient revenues during the three month periods ended June 30, 2007 and 2006, respectively, and 44% and 42% during the six month periods ended June 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 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 $143 million and $109 million during the three month periods ended June 30, 2007 and 2006, respectively, and $270 million and $227 million during the six month periods ended June 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 $82 million as of June 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 June 30, 2007 and December 31, 2006, accounts receivable are recorded net of allowance for doubtful accounts of $119 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.

**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 1st as our annual impairment assessment date and performed an impairment assessment as of September 1, 2006, 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 and a reduction in income tax payable for the same amount. 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**.**

We recognize accrued interest and penalties associated with uncertain tax positions as part of the tax provision. As of June 30, 2007, we had approximately $1.2 million of accrued interest and penalties. The U.S. federal statute of limitations remains open for the 2003 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 significant 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-other and our other assets include $8 million as of June 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 June 30, 2007 (including commitments entered into prior to 2006) we have $26 million of potential future financial obligations of which $11 million are potential obligations during 2007, $10 million are potential obligations during 2008 and $5 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.

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 elected in earnings (or another performance indicator if the company does not report 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 June 30, 2007 and 2006:

| | Three months ended June 30, 2007 | | Three months ended June 30, 2006 | |
|---|---|---|---|---|
| | Amount | % of Revenues | Amount | % of Revenues |
| Net revenues | $1,178,976 | 100.0% | $1,047,673 | 100.0% |
| Operating charges: | | | | |
| Salaries, wages and benefits | 498,579 | 42.3% | 434,756 | 41.5% |
| Other operating expenses | 238,093 | 20.2% | 248,956 | 23.8% |
| Supplies expense | 169,246 | 14.4% | 124,814 | 11.9% |
| Provision for doubtful accounts | 103,039 | 8.7% | 87,182 | 8.3% |
| Depreciation and amortization | 45,406 | 3.9% | 40,369 | 3.9% |
| Lease and rental expense | 16,605 | 1.4% | 15,831 | 1.5% |
| Hurricane related expenses, net | 1,058 | 0.1% | 3,356 | 0.3% |
| Hurricane insurance recoveries | — | — | (3,356) | -0.3% |
| Subtotal operating expenses | 1,072,026 | 90.9% | 951,908 | 90.9% |
| Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes | 106,950 | 9.1% | 95,765 | 9.1% |
| Interest expense, net | 13,040 | 1.1% | 8,697 | 0.8% |
| Hurricane insurance recoveries in excess of expenses | — | — | (21,644) | -2.1% |
| Minority interests in earnings of consolidated entities | 8,675 | 0.8% | 11,492 | 1.1% |
| Income before income taxes | 85,235 | 7.2% | 97,220 | 9.3% |
| Provision for income taxes | 33,193 | 2.8% | 36,349 | 3.5% |
| Income from continuing operations | 52,042 | 4.4% | 60,871 | 5.8% |
| Income (loss) from discontinued operations, net of income taxes | 29 | 0.0% | (612) | 0.0% |
| Net income | $ 52,071 | 4.4% | $ 60,259 | 5.8% |

Net revenues increased 13% or $131 million to $1.18 billion during the three month period ended June 30, 2007 as compared to $1.05 billion during the comparable prior year quarter. The increase was attributable to:

- a $61 million or 6% 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");
- $43 million of other combined increases in revenues resulting from the acute care facility and behavioral health care facilities acquired during 2006 and 2007, and;
- $27 million of other combined net increases in revenues resulting primarily from the revenues earned during the second 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.

Income before income taxes decreased $12 million to $85 million during the three months ended June 30, 2007 as compared to $97 million during the comparable quarter of the prior year. Included in our income before income taxes during the second quarter of 2007, as compared to the comparable prior year quarter, was the following:

- a decrease of $21 million resulting from the hurricane insurance recoveries in excess of expenses recorded during the second quarter of 2006 ($23 million pre-minority interest), as discussed below;
- a decrease of $4 million at our acute care facilities, as discussed below in Acute Care Hospital Services (exclusive of Hurricane related expenses and recoveries and the 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 $4 million at our behavioral health care facilities, as discussed below in Behavioral Health Services (exclusive of the 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 $4 million due to an increase in interest expense, and;
- a decrease of $3 million resulting from other combined unfavorable changes.

Net income decreased $8 million to $52 million during the three month period ended June 30, 2007, as compared to $60 million during the comparable prior year quarter. The decrease in net income during the second quarter of 2007, as compared to the comparable prior year quarter, resulted from the $12 million decrease in income before income taxes, as discussed above, partially offset by a $4 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 second quarter of 2007, we experienced an increase to supplies expense of approximately $27 million or 230 basis points (calculated as a percentage of our consolidated net revenues shown above), an increase to salaries, wages and benefits expense of approximately $11 million or 90 basis points and a decrease to other operating expenses of approximately $40 million or 340 basis points. The transition of our pharmacy services favorably impacted our pre-tax income by approximately $2 million during the second quarter of 2007.

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

| | Six months ended June 30, 2007 | | Six months ended June 30, 2006 | |
|---|---|---|---|---|
| | Amount | % of Revenues | Amount | % of Revenues |
| Net revenues | $2,376,577 | 100.0% | $2,081,962 | 100.0% |
| Operating charges: | | | | |
| Salaries, wages and benefits | 1,009,572 | 42.5% | 876,988 | 42.1% |
| Other operating expenses | 483,445 | 20.3% | 497,057 | 23.9% |
| Supplies expense | 344,604 | 14.5% | 253,327 | 12.2% |
| Provision for doubtful accounts | 202,132 | 8.5% | 162,189 | 7.8% |
| Depreciation and amortization | 88,869 | 3.7% | 79,399 | 3.8% |
| Lease and rental expense | 32,781 | 1.4% | 32,063 | 1.5% |
| Hurricane related expenses, net | 625 | 0.0% | 10,260 | 0.5% |
| Hurricane insurance recoveries | — | — | (10,260) | -0.5% |
| Subtotal operating expenses | 2,162,028 | 91.0% | 1,901,023 | 91.3% |
| Income before interest expense, hurricane insurance recoveries in excess of expenses, minority interests and income taxes | 214,549 | 9.0% | 180,939 | 8.7% |
| Interest expense, net | 25,762 | 1.0% | 17,222 | 0.8% |
| Hurricane insurance recoveries in excess of expenses | — | — | (37,031) | -1.8% |
| Minority interests in earnings of consolidated entities | 22,867 | 1.0% | 22,669 | 1.1% |
| Income before income taxes | 165,920 | 7.0% | 178,079 | 8.6% |
| Provision for income taxes | 64,306 | 2.7% | 66,716 | 3.3% |
| Income from continuing operations | 101,614 | 4.3% | 111,363 | 5.3% |
| (Loss) income from discontinued operations, net of income taxes | (35) | 0.0% | (20) | 0.0% |
| Net income | $ 101,579 | 4.3% | $ 111,343 | 5.3% |

Net revenues increased 14% or $295 million to $2.38 billion during the six month period ended June 30, 2007 as compared to $2.08 billion during the comparable prior period. The increase was attributable to:

- a $163 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”);
- $87 million of other combined increases in revenues resulting from the acute care facility and behavioral health care facilities acquired during 2006 and 2007, and;
- $45 million of other combined net increases in revenues resulting primarily from the revenues earned during the first six 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 $12 million to $166 million during the six months ended June 30, 2007 as compared to $178 million during the comparable prior year period. Included in our income before income taxes during the first six months of 2007, as compared to the comparable prior year period, was the following:

- a decrease of $35 million resulting from the hurricane insurance recoveries in excess of expenses recorded during the first six months of 2006 ($37 million pre-minority interest), as discussed below;
- an increase of $10 million at our acute care facilities, as discussed below in Acute Care Hospital Services (exclusive of Hurricane related expenses and recoveries and the 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 $5 million at our behavioral health care facilities, as discussed below in Behavioral Health Services (exclusive of the 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 $9 million due to an increase in interest expense, and;
- an increase of $1 million resulting from other combined unfavorable changes.

Net income decreased $10 million to $102 million during the six month period ended June 30, 2007, as compared to $111 million during the comparable prior year period. The decrease in net income during the first six months of 2007, as compared to the comparable prior year period, resulted from the $12 million decrease in income before income taxes, as discussed above, partially offset by a $2 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 first six months of 2007, we experienced an increase to supplies expense of approximately $56 million or 240 basis points (calculated as a percentage of our consolidated net revenues shown above), an increase to salaries, wages and benefits expense of approximately $22 million or 90 basis points and a decrease to other operating expenses of approximately $82 million or 350 basis points. The transition of our pharmacy services favorably impacted our pre-tax income by approximately $4 million during the first six months of 2007.

**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 six months ended June 30, 2007 and 2006 (dollar amounts in thousands):

**Same Facility – Acute Care**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | % | 2006 | % | 2007 | % | 2006 | % |
| Net revenues | $ 814,761 | 100.0 | $ 770,265 | 100.0 | $ 1,672,364 | 100.0 | $ 1,540,217 | 100.0 |
| Salaries, wages and benefits | 316,572 | 38.9 | 287,815 | 37.4 | 643,401 | 38.5 | 578,961 | 37.6 |
| Other operating expenses | 154,689 | 19.0 | 188,559 | 24.5 | 312,117 | 18.7 | 372,702 | 24.2 |
| Supplies expense | 144,242 | 17.7 | 107,719 | 14.0 | 295,610 | 17.7 | 219,368 | 14.2 |
| Provision for doubtful accounts | 93,708 | 11.5 | 81,922 | 10.6 | 182,825 | 10.9 | 151,667 | 9.8 |
| Depreciation and amortization | 36,337 | 4.5 | 32,944 | 4.3 | 71,169 | 4.3 | 64,468 | 4.2 |
| Lease and rental | 10,913 | 1.3 | 10,796 | 1.4 | 21,575 | 1.3 | 21,868 | 1.4 |
| Subtotal operating expenses | 756,461 | 92.8 | 709,755 | 92.1 | 1,526,697 | 91.3 | 1,409,034 | 91.5 |
| Income before interest expense, minority interests and income taxes | 58,300 | 7.2 | 60,510 | 7.9 | 145,667 | 8.7 | 131,183 | 8.5 |
| Interest expense, net | 702 | 0.1 | 246 | 0.1 | 1,369 | 0.1 | 493 | 0.0 |
| Minority interests in earnings of consolidated entities | 7,397 | 0.9 | 9,234 | 1.2 | 20,323 | 1.2 | 19,062 | 1.3 |
| Income before income taxes | $ 50,201 | 6.2 | $ 51,030 | 6.6 | $ 123,975 | 7.4 | $ 111,628 | 7.2 |

On a same facility basis during the three month period ended June 30, 2007, as compared to the comparable prior year quarter, net revenues at our acute care hospitals increased $44 million or 6%. Income before income taxes decreased $1 million or 2% to $50 million or 6.2% of net revenues during the second quarter of 2007 as compared to $51 million or 6.6% of net revenues during the comparable prior year quarter. On a same facility basis during the six month period ended June 30, 2007, as compared to the comparable prior year period, net revenues at our acute care hospitals increased $132 million or 9%. Income before income taxes increased $12 million or 11% to $124 million or 7.4% of net revenues during the first six months of 2007 as compared to $112 million or 7.2% of net revenues during the comparable prior year period.

Inpatient admissions to these facilities increased 1.9% during the second quarter of 2007, as compared to the comparable 2006 quarter, while patient days increased 2.3%. The average length of patient stay at these facilities was 4.4 days during each of the three month periods ended June 30, 2007 and 2006. The occupancy rate, based on the average available beds at these facilities, was 61% and 62% during the three month periods ended June 30, 2007 and 2006, respectively. Inpatient admissions to these facilities increased 3.4% during the six months ended June 30, 2007, as compared to the comparable 2006 six month period, while patient days increased 3.5%. The average length of patient stay at these facilities was 4.5 days during each of the six month periods ended June 30, 2007 and 2006. The occupancy rate, based on the average available beds at these facilities, was 64% and 65% during the six month periods ended June 30, 2007 and 2006, respectively.

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 1.7% and 3.7% during the three and six month periods ended June 30, 2007, respectively, and net revenue per adjusted patient day increased 1.3% and 3.6% during the three and six month periods ended June 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 second quarter of 2007, we experienced an increase to supplies expense of approximately $27 million or 330 basis points (calculated as a percentage of our same facility acute care net revenues shown above), an increase to salaries, wages and benefits expense of approximately $11 million or 140 basis points and a decrease to other operating expenses of approximately $40 million or 490 basis points. The transition of our pharmacy services favorably impacted our pre-tax income by approximately $2 million during the second quarter of 2007. During the six months ended June 30, 2007, our acute care facilities experienced an increase to supplies expense of approximately $56 million or 340 basis points, an increase to salaries, wages and benefits expense of approximately $22 million or 130 basis points and a decrease to other operating expenses of approximately $82 million or 490 basis points. The transition of our pharmacy services favorably impacted our pre-tax income by approximately $4 million during the first six months of 2007.

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 $143 million and $109 million during the three month periods ended June 30, 2007 and 2006, respectively, and $270 million and $227 million during the six month periods ended June 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 six months of 2007 as we experienced a 6.0% and 7.0% increase in combined inpatient admissions during the three and six months periods ended June 30, 2007, respectively. Combined patient days at these facilities increased 7.3% and 9.2% during the three and six month periods ended June 30, 2007, respectively, as compared to the comparable prior year periods. The increase in the combined inpatient admissions during the three and six month periods of 2007 resulted primarily from the opening of the Children's Hospital and Behavioral Health Center during 2006. Despite the increase in inpatient volumes, combined income before income taxes at the facilities in this market remained unchanged during the second quarter of 2007, as compared to the comparable quarter of the prior year and decreased $3 million during the first six months of 2007 as compared to the comparable prior year six month period. 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), 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 in regards 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 six months ended June 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 six months ended June 30, 2007 for the Texoma Healthcare System that was acquired as of January 1, 2007; (ii) the favorable impact of a reduction to our prior year reserves for professional and general liability self-insured claims (as discussed below), and; (iii) the net hurricane related expenses and insurance recoveries recorded during the three and six months ended June 30, 2007 and 2006 (dollar amounts in thousands).

**All Acute Care Facilities**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | % | 2006 | % | 2007 | % | 2006 | % |
| Net revenues | $ 853,672 | 100.0 | $ 775,976 | 100.0 | $ 1,746,537 | 100.0 | $ 1,545,928 | 100.0 |
| Salaries, wages and benefits | 335,393 | 39.3 | 287,815 | 37.1 | 680,087 | 38.9 | 578,961 | 37.5 |
| Other operating expenses | 146,306 | 17.1 | 188,559 | 24.3 | 310,236 | 17.8 | 372,732 | 24.1 |
| Supplies expense | 150,438 | 17.6 | 107,719 | 13.9 | 307,507 | 17.6 | 219,368 | 14.2 |
| Provision for doubtful accounts | 96,290 | 11.3 | 81,922 | 10.6 | 188,820 | 10.8 | 151,667 | 9.8 |
| Depreciation and amortization | 37,299 | 4.4 | 32,944 | 4.2 | 73,217 | 4.2 | 64,468 | 4.2 |
| Lease and rental | 11,558 | 1.4 | 11,210 | 1.4 | 22,836 | 1.3 | 22,696 | 1.5 |
| Hurricane related expenses | 871 | 0.1 | 3,356 | 0.4 | 161 | 0.0 | 10,260 | 0.7 |
| Hurricane insurance recoveries | | — | (3,356) | -0.4 | — | — | (10,260) | -0.7 |
| Subtotal operating expenses | 778,155 | 91.2 | 710,169 | 91.5 | 1,582,864 | 90.6 | 1,409,892 | 91.2 |
| Income before interest expense, hurricane recoveries in excess of expenses, minority interest and income taxes | 75,517 | 8.8 | 65,807 | 8.5 | 163,673 | 9.4 | 136,036 | 8.8 |
| Interest expense, net | 778 | 0.1 | 246 | 0.0 | 1,527 | 0.1 | 493 | 0.0 |
| Minority interests in earnings of consolidated entities | 8,545 | 0.9 | 10,631 | 1.4 | 21,413 | 1.2 | 21,448 | 1.4 |
| Hurricane recoveries in excess of expenses | — | — | (21,644) | -2.8 | — | — | (37,031) | -2.4 |
| Income before income taxes | $ 66,194 | 7.8 | $ 76,574 | 9.9 | $ 140,733 | 8.1 | $ 151,126 | 9.8 |

During the three months ended June 30, 2007, as compared to the comparable prior year quarter, net revenues at our acute care hospitals increased 10% or $78 million. The increase in net revenues was primarily attributable to:

- a $44 million increase at same facility revenues, as discussed above, and;
- a $34 million increase consisting primarily of the revenues generated during the second quarter of 2007 by the Texoma Healthcare System which was acquired as of January 1, 2007.

Income before income taxes decreased $10 million during the second quarter of 2007 as compared to the comparable quarter of 2006. Included in income before income taxes at our acute care hospitals during the second quarter of 2007, as compared to the comparable prior year quarter, was the following:

- an decrease of $1 million at our acute care facilities on a same facility basis, as discussed above;
- a decrease of $21 million from the change in hurricane insurance recoveries in excess of expenses recorded during each quarter due primarily to $20 million of insurance recoveries in excess of expenses recorded during the second quarter of 2006 ($22 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 $6 million decrease resulting from the second quarter of 2006 including the favorable impact of the settlement of prior year Medicaid cost reports, and;
- $3 million of other combined favorable changes resulting primarily from the pre-tax income generated during the second quarter of 2007 by the Texoma Healthcare System.

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.

During the six months ended June 30, 2007, as compared to the comparable prior year period, net revenues at our acute care hospitals increased 13% or $201 million. The increase in net revenues was primarily attributable to:

- a $132 million increase at same facility revenues, as discussed above, and;
- a $69 million increase consisting primarily of the revenues generated during the second quarter of 2007 by the Texoma Healthcare System which was acquired as of January 1, 2007.

Income before income taxes decreased $10 million during the first six months of 2007 as compared to the comparable six month period of 2006. Included in income before income taxes at our acute care hospitals during the first six months of 2007, as compared to the comparable prior year period, was the following:

- an increase of $12 million at our acute care facilities on a same facility basis, as discussed above;

- a decrease of $34 million from the change in hurricane insurance recoveries in excess of expenses recorded during each quarter due primarily to $35 million of insurance recoveries in excess of expenses recorded during the six months ended June 30, 2006 ($37 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 $6 million decrease resulting from the six months of 2006 including the favorable impact of the settlement of prior year Medicaid cost reports, and;
- $3 million of other combined favorable changes resulting primarily from the pre-tax income generated during the first six months of 2007 by the Texoma Healthcare System.

**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 six months ended June 30, 2007 and 2006 (dollar amounts in thousands):

**Same Facility – Behavioral Health**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | % | 2006 | % | 2007 | % | 2006 | % |
| Net revenues | $ 276,526 | 100.0 | $ 259,614 | 100.0 | $ 544,404 | 100.0 | $ 513,242 | 100.0 |
| Salaries, wages and benefits | 134,114 | 48.5 | 126,586 | 48.8 | 267,841 | 49.2 | 253,705 | 49.4 |
| Other operating expenses | 50,183 | 18.1 | 47,684 | 18.4 | 100,582 | 18.5 | 95,187 | 18.5 |
| Supplies expense | 15,800 | 5.7 | 15,166 | 5.8 | 31,181 | 5.7 | 29,746 | 5.8 |
| Provision for doubtful accounts | 5,964 | 2.2 | 4,830 | 1.9 | 12,161 | 2.2 | 10,119 | 2.0 |
| Depreciation and amortization | 5,938 | 2.1 | 5,621 | 2.2 | 11,660 | 2.1 | 11,281 | 2.2 |
| Lease and rental | 4,030 | 1.5 | 3,730 | 1.4 | 8,011 | 1.5 | 7,584 | 1.5 |
| Subtotal operating expenses | 216,029 | 78.1 | 203,617 | 78.4 | 431,436 | 79.2 | 407,622 | 79.4 |
| Income before interest expense, minority interests and income taxes | 60,497 | 21.9 | 55,997 | 21.6 | 112,968 | 20.8 | 105,620 | 20.6 |
| Interest expense, net | 55 | 0.0 | 46 | 0.0 | 109 | 0.0 | 147 | 0.0 |
| Minority interests in earnings of consolidated entities | 20 | 0.0 | (11) | 0.0 | 321 | 0.1 | (321) | 0.0 |
| Income before income taxes | $ 60,422 | 21.9 | $ 55,962 | 21.6 | $ 112,538 | 20.7 | $ 105,794 | 20.6 |

On a same facility basis during the second quarter of 2007, as compared to the comparable 2006 quarter, net revenues at our behavioral health care facilities increased 7% or $17 million. Income before income taxes increased $4 million or 8% to $60 million or 21.9% of net revenues during the three months ended June 30, 2007, as compared to $56 million or 21.6% of net revenues during the comparable prior year quarter. On a same facility basis during the first six months of 2007, as compared to the comparable 2006 six month period, net revenues at our behavioral health care facilities increased 6% or $31 million. Income before income taxes increased $7 million or 6% to $113 million or 20.7% of net revenues during the six months ended June 30, 2007, as compared to $106 million or 20.6% of net revenues during the comparable prior year period.

Inpatient admissions to these facilities increased 3.5% during the second quarter of 2007, as compared to the comparable 2006 quarter, while patient days increased 3.6%. The average length of patient stay at these facilities was 16.7 days during each of the quarters ended June 30, 2007 and 2006. The occupancy rate, based on the average available beds at these facilities, was 78% and 80% during the three months ended June 30, 2007 and 2006, respectively. Inpatient admissions to these facilities increased 3.3% during the six months ended June 30, 2007, as compared to the comparable 2006 six month period, while patient days increased 3.5%. The average length of patient stay at these facilities was 16.4 days during each of the six months ended June 30, 2007 and 2006. The occupancy rate, based on the average available beds at these facilities, was 78% and 80% during the six months ended June 30, 2007 and 2006, respectively.

On a same facility basis, as compared to the comparable prior year periods, net revenue per adjusted admission (adjusted for outpatient activity) at these facilities increased 3.3% and 2.5% during the three and six months ended June 30, 2007, respectively, and net revenue per adjusted patient day increased 3.1% and 2.3% during the three and six months ended June 30, 2007, respectively.

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

**All Behavioral Health Care Facilities**

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | % | 2006 | % | 2007 | % | 2006 | % |
| Net revenues | $ 286,853 | 100.0 | $ 259,618 | 100.0 | $ 562,565 | 100.0 | $ 513,246 | 100.0 |
| Salaries, wages and benefits | 140,677 | 49.0 | 126,765 | 48.8 | 279,743 | 49.7 | 253,948 | 49.5 |
| Other operating expenses | 50,868 | 17.7 | 47,862 | 18.4 | 103,180 | 18.3 | 95,479 | 18.6 |
| Supplies expense | 16,692 | 5.8 | 15,280 | 5.9 | 32,838 | 5.8 | 29,902 | 5.8 |
| Provision for doubtful accounts | 6,458 | 2.3 | 4,830 | 1.9 | 12,763 | 2.3 | 10,119 | 2.0 |
| Depreciation and amortization | 6,739 | 2.3 | 5,621 | 2.2 | 13,058 | 2.3 | 11,281 | 2.2 |
| Lease and rental | 4,088 | 1.4 | 3,734 | 1.4 | 8,112 | 1.4 | 7,589 | 1.5 |
| Subtotal operating expenses | 225,522 | 78.6 | 204,092 | 78.6 | 449,694 | 79.9 | 408,318 | 79.6 |
| Income before interest expense, minority interests and income taxes | 61,331 | 21.4 | 55,526 | 21.4 | 112,871 | 20.1 | 104,928 | 20.4 |
| Interest expense, net | 108 | 0.1 | 46 | 0.0 | 217 | 0.0 | 147 | 0.0 |
| Minority interests in earnings of consolidated entities | 20 | 0.0 | (11) | 0.0 | 321 | 0.1 | (321) | -0.1 |
| Income before income taxes | $ 61,203 | 21.3 | $ 55,491 | 21.4 | $ 112,333 | 20.0 | $ 105,102 | 20.5 |

During the second 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 11% or $27 million. The increase in net revenues was attributable to

- a $17 million increase in same facility revenues, as discussed above, and;
- $10 million of revenues generated at facilities recently acquired or opened.

Income before income taxes increased $6 million or 10% to $61 million or 21.3% of net revenues during the second quarter of 2007, as compared to $55 million or 21.4% of net revenues during the second 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;
- 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.

During the six months ended June 30, 2007, as compared to the comparable prior year six month period, net revenues at our behavioral health care facilities (including newly acquired or recently opened facilities), increased 10% or $49 million. The increase in net revenues was attributable to

- a $31 million increase in same facility revenues, as discussed above, and;
- $18 million of revenues generated at facilities recently acquired or opened.

Income before income taxes increased $7 million or 7% to $112 million or 20.0% of net revenues during the first six months of 2007, as compared to $105 million or 20.5% of net revenues during the six months ended June 30, 2006. The increase in income before income taxes at our behavioral health facilities was attributable to:

- a $7 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;
- $2 million of combined losses, net of income, generated at facilities recently acquired or opened.

**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 six month periods ended June 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 June 30, | | Percentage of Net Patient Revenues Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Third Party Payors: | | | | |
| Medicare | 24% | 25% | 25% | 26% |
| Medicaid | 13% | 13% | 11% | 11% |
| Managed Care (HMO and PPOs) | 45% | 42% | 44% | 42% |
| Other Sources | 18% | 20% | 20% | 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 June 30, | | Percentage of Net Patient Revenues Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Third Party Payors: | | | | |
| Medicare | 28% | 29% | 28% | 29% |
| Medicaid | 9% | 10% | 7% | 7% |
| Managed Care (HMO and PPOs) | 47% | 41% | 45% | 41% |
| Other Sources | 16% | 20% | 20% | 23% |
| Total | 100% | 100% | 100% | 100% |

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 June 30, | | Percentage of Net Patient Revenues Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Third Party Payors: | | | | |
| Medicare | 15% | 14% | 15% | 14% |
| Medicaid | 25% | 24% | 24% | 24% |
| Managed Care (HMO and PPOs) | 41% | 44% | 42% | 43% |
| Other Sources | 19% | 18% | 19% | 19% |
| 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 fort he 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.

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.

We are in the process of evaluating 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. CMS has temporarily reduced the IRF qualifying threshold from 75% to 50% in 2005, 60% in 2006 and 65% in 2007 before returning to the 75% threshold 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 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 $3 million during the three months ended June 30, 2007 and 2006, respectively, and $9 million and $6 million during the six months ended June 30, 2007 and 2006, respectively. For the remainder of the state fiscal year ("SFY") 2007 (covering the period of July 1, 2007 through August 31, 2007), our total supplemental payments pursuant to the provisions of this program are estimated to be approximately $3 million. During the remainder of 2007, covering a portion of the SFY2008 (covering the period of September 1, 2007 to December 31, 2007), our estimated revenues earned pursuant to this program could range from zero to $9 million depending on the ability of the local hospital district to make Inter-Governmental Transfers ("IGTs") to the state of Texas. We are unable to predict whether the hospital district will fund the IGTs at a level in SFY2008 above the minimum range.

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 is 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 $2.2 million and $400,000 during the three months ended June 30, 2007 and 2006, respectively, and $4.0 million and $900,000 during the six months ended June 30, 2007 and 2006, respectively. We estimate that our hospitals will be entitled to reimbursements of approximately $7 million annually pursuant to the terms of this program.

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, during the second quarter of 2007, we established a reserve, which did not have a material impact on our financial statements, for this potential CMS action related to 2005 Medicaid supplemental payments.

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 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 2007 fiscal years (covering the period of September 1, 2006 through August 31, 2007 for Texas and October 1, 2006 through September 30, 2007 for South Carolina). Although neither state has definitively quantified the amount of DSH funding our facilities will receive during the SFY2007, both states have indicated the allocation criteria will be similar to the methodology used in previous years. Included in our financial results was an aggregate of $12 million and $9 million during the three months ended June 30, 2007 and 2006, respectively, and $25 million and $20 million during the six months ended June 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.

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 June 30, 2007 and 2006 and $17 million during each of the six month periods ended June 30, 2007 and 2006. During the three and six month periods ended June 30, 2007, we earned revenues of $27 million and $46 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 $3 million and $1 million during the three months ended June 30, 2007 and 2006, respectively, and $5 million and $3 million during the six months ended June 30, 2007 and 2006, respectively.

Interest expense was $13 million and $9 million during the three months ended June 30, 2007 and 2006, respectively, and $26 million and $17 million during the six months ended June 30, 2007 and 2006, respectively. The increase in interest expense during the three and six 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 38.9% and 37.4% during the three month periods ended June 30, 2007 and 2006, respectively, and 38.8% and 37.5% during the six month periods ended June 30, 2007 and 2006, respectively. The increase in the effective tax rate during the 2007 three and six month periods, as compared to the comparable prior year periods, was primarily due to an increase in the effective state income tax rate.

**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 six month periods ended June 30, 2007 and 2006 (amounts in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| Income (loss) from discontinued operations, net of income taxes | 2007 | 2006 | 2007 | 2006 |
| Net revenues | $ 23 | $ (43) | $ 23 | 161 |
| Income (loss) from operations | 46 | (972) | (56) | (32) |
| Income tax benefit (provision) | (17) | 360 | 21 | 12 |
| Income (loss) from discontinued operations, net of income taxes | $ 29 | $ (612) | $ (35) | $ (20) |

**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 and Virtue Street Pavilion, a one-story, 57-bed facility providing physical rehabilitation, skilled nursing and inpatient behavioral health services.

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

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 six months ended June 30, 2007, were pre-tax hurricane related expenses of $1.1 million and $600,000, respectively.

Included in our financial results was a pre-tax charge of $3 million during the three months ended June 30, 2006 and $9 million ($10 million pre-minority interest) during the six months ended June 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 $23 million ($25 million pre-minority interest) during the three months ended June 30, 2006 and $44 million ($47 pre-minority interest) during the six months ended June 30, 2006.

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

As of June 30, 2007, the total accrual for our professional and general liability claims was $249 million ($246 million net of expected recoveries), of which $32 million is included in other 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 other current liabilities. Included in other assets was $3 million as of June 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 $159 million during the six months ended June 30, 2007 and $189 million during the six month period of the prior year. The $30 million net decrease was primarily attributable to the following:

- a favorable net change of $20 million due to: (i) a favorable $38 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 and hurricane insurance recoveries), 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;
- a favorable change of $11 million in accounts receivable, which includes: (i) the favorable change resulting from the collection of $45 million of Texas upper payment limit and disproportionate share hospital receivables outstanding as of December 31, 2006; (ii) an $18 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; (iii) a $15 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 six months of 2007, as compared to the comparable period in 2006, and; (iv) $1 million of other combined favorable changes;
- an unfavorable change of $65 million in accrued and deferred income taxes due primarily to 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 approximately $50 million of income taxes originally scheduled to be paid during the first six months of 2006, to the second half of the year, and;

- $4 million of other combined net favorable changes.

Our days sales outstanding ("DSO"), are calculated by dividing our quarterly net revenue by the number of days in the six month period. The result is divided into the accounts receivable balance at June 30th of each year to obtain the DSO. Our DSO were 49 days at June 30, 2007 and 47 days at June 30, 2006.

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

During the six month period ended June 30, 2007, we used $275 million of net cash in investing activities as compared to $114 million of net cash used in investing activities during the six months ended June 30, 2006.

During the first six months of 2007, we used $275 million of net cash in investing activities as follows:

- spent $184 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 during the fourth quarter of 2007, 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 during the second quarter of 2007 and a major renovation to our 319-bed acute care facility located in Bradenton, Florida that was completed during the second quarter of 2007;
- spent $81 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, and; (iii) the acquisition of a 52-bed behavioral health facility located in Dover, Delaware.
- 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 six months of 2006, we used $114 million of net cash in investing activities as follows:

- spent $153 million to finance capital expenditures at our facilities, including construction costs related to a new 170-bed acute care hospital in Las Vegas, Nevada scheduled to be completed and opened during the third quarter of 2007, 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 completed and opened and a new 134-bed replacement behavioral health care facility in McAllen, Texas that has been completed and opened;
- spent $14 million to acquire the assets of two closed behavioral health care facilities located in Florida and Georgia, and;
- received $53 million of commercial insurance proceeds in connection with damage sustained from Hurricane Katrina.

***2007 Expected Capital Expenditures:***

During the remaining six months of 2007, we expect to spend approximately $200 to $225 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 six month period ended June 30, 2007, we generated $114 million of net cash provided by financing activities as compared to $41 million of net cash used in financing activities during the comparable six month period of 2006.

During the first six months of 2007, we generated $114 million of net cash provided by financing activities as follows:

- generated $116 million of net proceeds from additional borrowings pursuant to our $800 million revolving credit facility;
- spent approximately $3 million to repurchase approximately 58,000 shares of our Class B Common Stock;
- spent $8 million to pay quarterly cash dividends of $.08 per share;
- received $8 million of capital contributions from a third-party minority member for their share of costs related to an acute care facility currently under construction, 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 six months of 2006, we generated $41 million of net cash from financing activities as follows:

- 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 are scheduled to mature on June 30, 2016;
- spent $141 million of net debt repayments consisting primarily of $100 million of repayments under our $500 million unsecured non-amortizing revolving credit agreement (“Revolver”) 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 $71 million to repurchase approximately 1.4 million shares of our Class B Common Stock on the open market;
- spent $9 million to pay an $.08 per share quarterly cash dividend;
- received $9 million of capital contributions from a third-party minority member for their share of costs related to an acute care facility currently under construction, and;
- $4 million of other net cash generated resulting primarily from $3 million of cash received during the second quarter of 2006 from the unwind of Treasury Lock agreements entered into during the quarter in connection with the issuance of the 7.125%, $250 million Senior Notes.

## 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 $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 June 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 June 30, 2007, we had $471 million of borrowings outstanding under our revolving credit agreement and $50 million of outstanding letters of credit. As of June 30, 2007, we had $279 million of available borrowing capacity pursuant to the terms of our Credit Agreement.

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 38% at June 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 June 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 June 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 June 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 June 30, 2007 totaled $86 million consisting of: (i) $74 million related to our self-insurance programs; (ii) $7 million consisting primarily of collateral for outstanding bonds of an unaffiliated third party and public utility, and; (iii) $5 million of debt guarantees related to entities in which we own a minority interest.

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

There have been no material changes in the quantitative and qualitative disclosures during the three months ended June 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.

**Item 4. Controls and Procedures**

As of June 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 second 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.

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. To the best of our knowledge, we have provided the documents requested in connection with both subpoenas and we continue to cooperate in the investigation. 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, and we are cooperating with this Grand Jury investigation. 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.

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 plaintiffs are seeking to have the matter certified as a class action. The remaining plaintiffs are alleging, among other things, that they are 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. The Hospitals have denied liability and are defending the case, which has not yet been certified as a class action by the court. Although we are unable to definitively determine the extent of the potential financial exposure at this time, we recorded an estimated $10 million pre-tax provision in connection with this matter during 2006 ($2 million and $8 million during the second and fourth quarters of 2006, respectively).

On March 30, 2007, the U.S. Department of Labor filed a claim, in the United States District Court in New Haven, Connecticut, against Stonington Behavioral Health, Inc. ("Stonington"), a wholly-owed subsidiary that owns one of our behavioral health facilities, UHS of Delaware, Inc., and Universal Health Services, Inc., alleging that Stonington failed to pay certain employees (1) the applicable minimum wage, and (2) appropriate pay for overtime, during the period July 1, 2004 to July 1, 2006. The Department of Labor claimed that such violations resulted in underpayments totaling approximately $1.1 million to 143 employees. During the first quarter of 2007, we recorded a $1.1 million pre-tax provision in connection with this claim and in July, 2007, our subsidiaries mentioned above settled this matter by agreeing to pay $1,075,218 in back wages plus $49,000 in penalties.

## 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 811 shares at an average price of $62.85 per share or $51,000 in the aggregate during the second quarter of 2007, and 58,065 shares at an average price of $57.53 or $3.3 million in the aggregate during the six month period ended June 30, 2007. As of June 30, 2007, the number of shares available for purchase was 2,018,100 shares. There is no expiration date for our stock repurchase program.

| 2007 period | 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 |
|---|---|---|---|---|---|---|
| April, 2007 | — | — | — | — | — | 2,018,911 |
| May, 2007 | 7,500 | $ 0.01 | 61 | $ 60.99 | $ 4 | 2,018,850 |
| June, 2007 | 750 | — | 750 | $ 63.00 | $ 47 | 2,018,100 |
| Total April through June | 8,250 | $ 0.01 | 811 | $ 62.85 | $ 51 | 2,018,100 |

(a.) Includes 7,439 restricted shares that were forfeited by former employees (including 7,000 shares by a former executive officer) pursuant to the terms of the restricted stock purchase plan.

**Dividends**

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

**Item 4. Submission of Matters to a Vote of Security Holders**

The following information relates to matters submitted to a vote of our stockholders at the Annual Meeting of Stockholders held on May 16, 2007.

At the meeting, the following proposals, as described in the proxy statement delivered to all of our stockholders, were approved by the votes indicated:

Election by Class A & Class C stockholders of two Class II Directors:

| | Anthony Pantaleoni | Rick Santorum |
|---|---|---|
| Votes cast in favor | 3,664,204 | 3,664,204 |
| Votes withheld | 0 | 0 |

Election by Class B & Class D stockholders of a Class II Director, Robert H. Hotz:

| | |
|---|---|
| Votes cast in favor | 40,336,091 |
| Votes withheld | 3,730,003 |

**Item 6. Exhibits**

(a) Exhibits:

10.1 Amendment No. 2 to the Credit Agreement, dated as of April 13, 2007 by and among the Company, JP Morgan Chase Bank, N.A., as Administrative Agent, Bank of America, N.A., as Syndication Agent and ABN Amro Bank, N.V., Sun Trust Bank and Wachovia Bank, National Association, as Co-Documentation Agents and other lenders named therein, previously filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated April 13, 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.

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.

**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: August 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)

## EXHIBIT INDEX

| Exhibit No. | Description |
|---|---|
| 10.1 | Amendment No. 2 to the Credit Agreement, dated as of April 13, 2007 by and among the Company, JP Morgan Chase Bank, N.A., as Administrative Agent, Bank of America, N.A., as Syndication Agent and ABN Amro Bank, N.V., Sun Trust Bank and Wachovia Bank, National Association, as Co-Documentation Agents and other lenders named therein, previously filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated April 13, 2007, is incorporated herein by reference. |
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| 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 |

**Exhibit 31.1**

**CERTIFICATION - Chief Executive Officer**

I, Alan B. Miller, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Universal Health Services, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal controls over financial reporting, or caused such internal controls over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principals;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2007

/s/ Alan B. Miller

President and Chief Executive Officer

**Exhibit 31.2**

**CERTIFICATION-Chief Financial Officer**

I, Steve Filton, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Universal Health Services, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal controls over financial reporting, or caused such internal controls over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principals;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2007

/s/ Steve Filton

Senior Vice President and Chief Financial Officer

**EXHIBIT 32.1**

**CERTIFICATION PURSUANT TO**
**18 U.S.C. SECTION 1350,**
**AS ADOPTED PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Universal Health Services, Inc. (the "Company") on Form 10-Q for the quarter ended June 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Alan B. Miller, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, and to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the end of, and for the period covered by, the Report.

/s/ Alan B. Miller
President and Chief Executive Officer
August 8, 2007

A signed original of this written statement required by Section 906 has been provided to Universal Health Services, Inc. and will be retained and furnished to the Securities and Exchange Commission or its staff upon request.

**EXHIBIT 32.2**

**CERTIFICATION PURSUANT TO**
**18 U.S.C. SECTION 1350,**
**AS ADOPTED PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Universal Health Services, Inc. (the "Company") on Form 10-Q for the quarter ended June 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Steve Filton, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, and to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the end of, and for the period covered by, the Report.

/s/ Steve Filton
Senior Vice President and Chief Financial Officer
August 8, 2007

A signed original of this written statement required by Section 906 has been provided to Universal Health Services, Inc. and will be retained and furnished to the Securities and Exchange Commission or its staff upon request.