EDISON MISSION ENERGY
Form S-4
September 10, 2007

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As filed with the Securities and Exchange Commission on September 10, 2007

Registration No. [ ]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM S-4

**REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933**

Edison Mission Energy

(Exact name of registrant as specified in its charter)

Delaware	**4911**	**95-4031807**
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification No.)

**18101 Von Karman Avenue, Suite 1700
Irvine, California 92612
(949) 752-5588**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

**Steven D. Eisenberg, Esq.
Edison Mission Energy
18101 Von Karman Avenue, Suite 1700
Irvine, California 92612
(949) 752-5588**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

With copies to:

**Robert M. Chilstrom, Esq.
Harold F. Moore, Esq.
Skadden, Arps, Slate, Meagher & Flom LLP
Four Times Square
New York, New York 10036-6522
(212) 735-3000**

Approximate date of commencement of proposed sale to the public: As soon as practicable after this registration statement becomes effective.

If the securities being registered on this Form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price per Security(1)	Proposed Maximum Aggregate Offering Price(1)	Amount of Registration Fee
7.00% Senior Notes due May 15, 2017	$ 1,200,000,000	100%	$ 1,200,000,000	$ 36,840
7.20% Senior Notes due May 15, 2019	$ 800,000,000	100%	$ 800,000,000	$ 24,560
7.625% Senior Notes due May 15, 2027	$ 700,000,000	100%	$ 700,000,000	$ 21,490

(1) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(f) under the Securities Act of 1933.

The Registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, or until the Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to the said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. These securities may not be sold until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and it is not soliciting an offer to buy, these securities in any state where the offer or sale is not permitted.

Subject to completion, dated September 10, 2007.

PROSPECTUS

Edison Mission Energy

Offer to exchange $1,200,000,000 aggregate principal amount of 7.00% Senior Notes due May 15, 2017 (CUSIPs 281023 AS 0, U27811 AE 5 and 281023 AT 8) for $1,200,000,000 7.00% Senior Notes due May 15, 2017 which have been registered under the Securities Act of 1933, as amended, $800,000,000 aggregate principal amount of 7.20% Senior Notes due May 15, 2019 (CUSIPs 281023 AV 3, U27811 AF 2 and 281023 AW 1) for $800,000,000 7.20% Senior Notes due May 15, 2019 which have been registered under the Securities Act of 1933, as amended, and $700,000,000 aggregate principal amount of 7.625% Senior Notes due May 15, 2027 (CUSIPs 281023 AY 7, U27811 AG 0, 281023 AZ 4) for $700,000,000 7.625% Senior Notes due May 15, 2027 which have been registered under the Securities Act of 1933, as amended

The exchange offer will expire at 5:00 p.m., New York City time, on ____________, 2007, unless extended.

Terms of the exchange offer:

- The new notes are being registered with the Securities and Exchange Commission and are being offered in exchange for the old notes that previously were issued in an offering exempt from the Securities and Exchange Commission's registration requirements.
- The terms of the exchange offer are summarized below and more fully described in this prospectus.
- We will exchange the new notes to be issued for all outstanding old notes that are validly tendered and not withdrawn pursuant to the exchange offer.
- You may withdraw tenders of old notes at any time prior to the expiration of the exchange offer.
- The terms of the new notes are substantially identical to those of the old notes, except that the transfer restrictions and registration rights relating to the old notes will not apply to the new notes.
- The exchange of old notes for new notes will not be a taxable transaction for United States federal income tax purposes, but you should see the discussion under the heading "Material U.S. Federal Income Tax Consequences."

We will not receive any cash proceeds from the exchange offer.

We issued the old notes in a transaction not requiring registration under the Securities Act of 1933, as amended, and as a result, their transfer is restricted. We are making the exchange offer to satisfy your registration rights, as a holder of the old notes.

See "Risk Factors" beginning on page 13 for a discussion of certain risks that you should consider prior to tendering your outstanding old notes for exchange.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy of accuracy of this prospectus. Any representation to the contrary is a criminal offense.

Prospectus dated ____________, 2007

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement on Form S-4 under the Securities Act of 1933, as amended, (the "Securities Act") that we filed with the Securities and Exchange Commission (the "SEC"). You should rely only on the information contained in this prospectus or to which we have referred you. We have not authorized anyone to provide you with information that is different. We are not making an offer of these securities in any state where the offer is not permitted. The information in this prospectus may only be accurate on the date of this prospectus.

This prospectus contains summaries, believed to be accurate, of some of the terms of specific documents, but reference is made to the actual documents, copies of which will be made available upon request, for the complete information contained in those documents. All summaries are qualified in their entirety by this reference.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports and other information with the SEC. You may read and copy any document that we file at the public reference rooms of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the public reference rooms by calling the SEC at 1-800-SEC-0330. The SEC also maintains an internet site at http://www.sec.gov, from which you can access our filings. Any statement made in this prospectus concerning any document filed with the SEC is not necessarily complete, and reference is made to the copy of the document filed.

This prospectus incorporates important business and financial information about us from documents that we have filed with the SEC but have not included in or delivered with this prospectus. We will provide you with copies of this information, without charge, upon written or oral request to:

Edison Mission Energy
18101 Von Karman Avenue, Suite 1700
Irvine, California 92612
(949) 752-5588
Attention: General Counsel

To obtain timely delivery of requested documents before the expiration of the exchange offer, you must request them no later than ____________, 2007, which is five business days before the exchange offer expires.

FORWARD-LOOKING STATEMENTS

This prospectus contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements reflect our current expectations and projections about future events based on our knowledge of present facts and circumstances as of the date of this prospectus and assumptions about future events and include any statement that does not directly relate to a historical or current fact. Other information distributed by us that is incorporated in this prospectus, or that refers to or incorporates this prospectus, may also contain forward-looking statements. In this prospectus and elsewhere, the words "expects," "believes," "anticipates," "estimates," "projects," "intends," "plans," "probable," "may," "will," "could," "would," "should," and variations of such words and similar expressions, or discussions of strategy or plans, are intended to identify forward-looking statements. Such statements necessarily involve risks and uncertainties that could cause actual results to differ materially from those anticipated. Some of the risks, uncertainties and other important factors that could cause results to differ, or that otherwise could impact us or our subsidiaries, include but are not limited to:

- supply and demand for electric capacity and energy, and the resulting prices and dispatch volumes, in the wholesale markets to which our generating units have access;
- the cost and availability of coal, natural gas and fuel oil, and associated transportation;
- market volatility and other market conditions that could increase our obligations to post collateral beyond the amounts currently expected, and the potential effect of such conditions on our ability and the ability of our subsidiaries to provide sufficient collateral in support of their hedging activities and purchases of fuel;
- the cost and availability of emission credits or allowances;
- transmission congestion in and to each market area and the resulting differences in prices between delivery points;
- governmental, statutory, regulatory or administrative changes or initiatives affecting us or the electricity industry generally, including the market structure rules applicable to each market;
- environmental regulations that could require additional expenditures or otherwise affect our cost and manner of doing business;

our ability to successfully implement our business strategy, including development projects and future acquisitions;

the extent of additional supplies of capacity, energy and ancillary services from current competitors or new market entrants, including the development of new generation facilities and technologies that may be able to produce electricity at a lower cost than our generating facilities and/or increased access by competitors to our markets as a result of transmission upgrades;

our ability to borrow funds and access capital markets on favorable terms;

the difficulty of predicting wholesale prices, transmission congestion, energy demand, and other aspects of the complex and volatile markets in which we and our subsidiaries participate;

operating risks, including equipment failure, availability, heat rate, output and availability and cost of spare parts and repairs;

project development risks, including those related to siting, financing, construction, permitting, and governmental approvals;

effects of legal proceedings, changes in or interpretations of tax laws, rates or policies, and changes in accounting standards;

general political, economic and business conditions;

weather conditions, natural disasters and other unforeseen events; and

our continued participation and the continued participation by our subsidiaries in tax-allocation and payment agreements with our respective affiliates.

Readers are urged to read this entire prospectus and carefully consider the risks, uncertainties and other factors that affect our business. There may be other factors that may cause our actual results to differ materially from the results referred to in the forward-looking statements. All forward-looking statements attributable to us or persons acting on our behalf apply only as of the date of this prospectus and are expressly qualified in their entirety by the cautionary statements included in this prospectus. We undertake no obligation to publicly update or revise any forward-looking statement whether as a result of new information, future events or otherwise. Readers should review future reports filed by us with the SEC.

INDUSTRY AND MARKET DATA

Industry and market data used throughout this prospectus were obtained through internal company research, surveys and studies conducted by third parties and industry and general publications. Neither we nor the initial purchasers have independently verified, or make any representations about the accuracy of, market and industry data from third-party sources. While we believe internal company estimates are reliable and market definitions are appropriate, they have not been verified by any independent sources, and neither we nor the initial purchasers make any representations about the accuracy of such estimates.

NOTICE TO NEW HAMPSHIRE RESIDENTS

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421-B OF THE NEW HAMPSHIRE UNIFORM SECURITIES ACT ("RSA 421-B"), WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE THAT ANY DOCUMENT FILED UNDER RSA 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY, OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

SUMMARY

This summary highlights information about us and the exchange offer. This summary may not contain all the information that is important to you. Therefore, you should read this summary and the more detailed information appearing elsewhere in this prospectus. We encourage you to read this prospectus in its entirety. In this prospectus, the terms "the Company," "we," "our," "ours" and "us" refer to Edison Mission Energy, or EME, and its direct and indirect subsidiaries unless otherwise stated or the context otherwise requires. You should consider the issues discussed in the "Risk Factors" section beginning on page 13 in evaluating your investment in the New Notes.

Edison Mission Energy

We are an independent power producer engaged in the business of developing, acquiring, owning or leasing, operating and selling energy and capacity from independent power production facilities. We also conduct hedging and energy trading activities in power markets open to competition. We are a wholly owned subsidiary of Mission Energy Holding Company, or MEHC. Edison International is our ultimate parent company. Edison International also owns Southern California Edison Company, one of the largest electric utilities in the United States.

We were formed in 1986 with two domestic operating power plants. As of June 30, 2007, our subsidiaries and affiliates owned or leased interests in 32 operating power plants with an aggregate net physical capacity of 10,670 megawatts (MW), of which our capacity pro rata share was 9,500 MW. At June 30, 2007, six projects totaling 293 MW of generating capacity were under construction.

We operate in one line of business, independent power production, with all our continuing operations located in the United States, except the Doga project in Turkey. Operating revenues are primarily related to the sale of power generated from the fossil fuel plants owned by our indirect subsidiary, Midwest Generation, LLC, located in Illinois, and the Homer City electric generating station, located in Pennsylvania. We have substantially expanded our activities with respect to the development of renewable energy projects, particularly wind. We are headquartered in Irvine, California, with additional offices located in Chicago, Illinois and Boston, Massachusetts.

We are a Delaware corporation. Our principal executive offices are located at 18101 Von Karman Avenue, Suite 1700, Irvine, California 92612 and our telephone number at that address is (949) 752-5588. You can find more information about us posted on the Internet website maintained by our ultimate parent, Edison International, at www.edison.com. The information on Edison International's website is not part of this prospectus.

Overview of Facilities

As of June 30, 2007, our operations consisted of ownership or leasehold interests in the following operating power plants:

Power Plants	Location	Primary Electric Purchaser(2)	Fuel Type	Ownership Interest	Net Physical Capacity (in MW)	EME's Capacity Pro Rata Share (in MW)	Number of Plants
Merchant Power Plants							
Illinois Plants(1)	Illinois	PJM	Coal/Oil/Gas	100%	5,918	5,918	6
Homer City(1)	Pennsylvania	PJM	Coal	100%	1,884	1,884	1
Contracted Power Plants							
Domestic							
Big 4 Projects							
Kern River(1)	California	SCE	Natural Gas	50%	300	150	1
Midway-Sunset(1)	California	SCE	Natural Gas	50%	225	113	1
Sycamore(1)	California	SCE	Natural Gas	50%	300	150	1
Watson	California	SCE	Natural Gas	49%	385	189	1
Westside Projects							
Coalinga(1)	California	PG&E	Natural Gas	50%	38	19	1
Mid-Set(1)	California	PG&E	Natural Gas	50%	38	19	1
Salinas River(1)	California	PG&E	Natural Gas	50%	38	19	1
Sargent Canyon(1)	California	PG&E	Natural Gas	50%	38	19	1
American Bituminous(1)	West Virginia	MPC	Waste Coal	50%	80	40	1
March Point	Washington	PSE	Natural Gas	50%	140	70	1
Sunrise(1)	California	CDWR	Natural Gas	50%	572	286	1
Huntington	New York	LIPA	Biomass	38%	25	9	1
San Juan Mesa(1)	New Mexico	SPS	Wind	75%	120	90	1
Minnesota Wind Projects	Minnesota	NSPC/IPLC	Wind	75-99%	83	75	7
Iowa Wind Projects							
Storm Lake	Iowa	MEC	Wind	100%	109	109	1
Crosswinds	Iowa	CBPC	Wind	99%	21	21	1
Hardin	Iowa	IPLC	Wind	99%	15	15	1
Wildorado	Texas	SPS	Wind	99.9%	161	161	1
International							
Doga(1)	Turkey	TEDAS	Natural Gas	80%	180	144	1
Total					10,670	9,500	32

(1) Plant is operated under contract by an operations and maintenance subsidiary of ours (partially owned plants) or plant is operated directly by a subsidiary of ours (wholly owned plants).

(2) Electric purchaser abbreviations are as follows:

PJM	PJM Interconnection, LLC	SPS	Southwestern Public Service
SCE	Southern California Edison Company	NSPC	Northern States Power Company
PG&E	Pacific Gas & Electric Company	IPLC	Interstate Power and Light Company
MPC	Monongahela Power Company	MEC	Mid-American Energy Company
PSE	Puget Sound Energy, Inc.	CBPC	Corn Belt Power Cooperative
CDWR	California Department of Water Resources	TEDAS	Türkiye Elektrik Dagitim Anonim Sirketi

LIPA	Long Island Power Authority

Refinancing Plans

Tender offers and consent solicitations. On April 17, 2007, we and two of our affiliates launched tender offers as follows:

- We launched a tender offer for any and all $600 million of our outstanding 7.73% senior notes due 2009 (the "EME 2009 Notes").

- Our parent, MEHC, launched a tender offer for any and all $800 million of its outstanding 13.50% senior secured notes due 2008.

- Our subsidiary, Midwest Generation, LLC, launched a tender offer for any and all $1 billion of its outstanding 8.75% second priority senior secured notes due 2034.

Each tender offer was combined with a solicitation of consents from registered holders of the notes to amendments to the indentures pursuant to which the notes were issued, in each case, to eliminate substantially all the restrictive covenants, eliminate or modify certain events of default, eliminate or modify related provisions contained in each indenture and, in the case of the MEHC senior secured notes and the Midwest Generation second priority senior secured notes, to release the collateral securing such notes. In addition, MEHC and Midwest Generation solicited consents to the release of security interests in the collateral securing the notes issued by them. These transactions are referred to as the Tender Offers and Consent Solicitations in this prospectus.

On May 15, 2007, we completed our Tender Offers and Consent Solicitations. The amendments to the indentures pursuant to which these notes were issued, which were proposed in connection with the Tender Offers and Consent Solicitations, became operative. The amendments to the indentures eliminated substantially all the restrictive covenants, eliminated or modified certain events of default and eliminated or modified related provisions contained in each indenture. In addition, the collateral securing each of the MEHC senior secured notes and Midwest Generation second priority senior secured notes was released.

Notes offering. On May 7, 2007, EME completed a private offering of $1.2 billion of its 7.00% senior notes due May 15, 2017, $800 million of its 7.20% senior notes due May 15, 2019 and $700 million of its 7.625% senior notes due May 15, 2027. EME will pay interest on the senior notes on May 15 and November 15 of each year, beginning on November 15, 2007.

The senior notes are EME's senior unsecured obligations, ranking in equal right of payment to all EME's existing and future senior unsecured indebtedness, and will be senior to all EME's future subordinated indebtedness. EME's secured debt and its other secured obligations are effectively senior to the senior notes to the extent of the value of the assets securing such debt or other obligations. None of EME's subsidiaries have guaranteed the senior notes and, as a result, all of the existing and future liabilities of EME's subsidiaries are effectively senior to the senior notes.

EME used the net proceeds of the offering of the senior notes, together with cash on hand, to purchase substantially all of EME's outstanding 7.73% senior notes due 2009, to purchase substantially all of Midwest Generation's 8.75% second priority senior secured notes due 2034, to repay the outstanding amount ($327.8 million) of Midwest Generation's senior secured term loan facility, and to make a dividend payment of $899 million to MEHC which enabled MEHC to purchase substantially all of its 13.5% senior secured notes due 2008. The net proceeds of the offering of the senior notes, together with cash on hand, were also used to pay related tender premiums, consent fees, and accrued

interest. EME recorded a total pre-tax loss of approximately $160 million (approximately $98 million after tax) on early extinguishment of debt during the second quarter of 2007.

Redemption of MEHC Senior Secured Notes. On June 25, 2007, MEHC redeemed in full its senior secured notes. As a result of the redemption, we are no longer subject to financial and investment restrictions that were contained in the indenture pursuant to which the senior secured notes were issued. Following the redemption, MEHC no longer files reports with the U.S. Securities and Exchange Commission.

Credit Agreement Amendments. During the second quarter of 2007, we amended our existing $500 million secured credit facility, increasing the total borrowings available thereunder to $600 million, and Midwest Generation amended and restated its existing $500 million senior secured working capital facility. The changes to the senior secured working capital facility included a reduction in the interest rate, a longer maturity date, and fewer restrictive covenants. Midwest Generation intends to use its secured working capital facility to provide credit support for its hedging activities and for general working capital purposes. Midwest Generation may also support its hedging activities by granting first or second priority liens to eligible hedge counterparties.

The Exchange Offer

As part of our Old Notes offering, which was completed on May 7, 2007, we entered into a registration rights agreement in respect of the Old Notes in which we agreed, among other things, to deliver this prospectus to you and to complete an exchange offer for the Old Notes. Below is a summary of the terms of the exchange offer.

Securities Offered	$2,700,000,000 principal amount of New Notes, consisting of:
	$1,200,000,000 principal amount of 7.00% Senior Notes due May 15, 2017 (the "New Tranche A Notes");
	$800,000,000 principal amount of 7.20% Senior Notes due May 15, 2019 (the "New Tranche B Notes"); and
	$700,000,000 principal amount of 7.625% Senior Notes due May 15, 2027 (the "New Tranche C Notes" and, together with the New Tranche A Notes and the New Tranche B Notes, the "New Notes").
	The form and terms of each tranche of these New Notes are identical in all material respects to those of the corresponding tranche of Old Notes. The New Notes, however, will not contain transfer restrictions and registration rights applicable to the Old Notes.
The Exchange Offer	We are offering to issue up to $2,700,000,000 aggregate principal amount of the New Notes in exchange for a like principal amount of the Old Notes in order to satisfy our obligations under the registration rights agreement that we entered into when the Old Notes were issued.
Expiration Date; Tenders	The exchange offer will expire at 5:00 p.m., New York City time, on ______________, 2007, unless extended in our sole and absolute discretion. By tendering your Old Notes, you represent that:
	you are not our "affiliate," as defined in Rule 405 under the Securities Act;
	any New Notes you receive in the exchange offer are being acquired by you in the ordinary course of your business;
	at the time of commencement of the exchange offer, neither you nor, to your knowledge, anyone receiving New Notes from you, has any arrangement or understanding with any person to participate in the distribution, as defined in the Securities Act, of the Old Notes or the New Notes in violation of the Securities Act;
	if you are not a participating broker-dealer, you are not engaged in, and do not intend to engage in, the distribution, as defined in the Securities Act, of the Old Notes or the New Notes; and

	if you are a broker-dealer, you will receive the New Notes for your own account in exchange for Old Notes that were acquired by you as a result of your market-making or other trading activities and that, you will deliver a prospectus in connection with any resale of the New Notes you receive. For further information regarding resales of the New Notes by participating broker-dealers, see "Plan of Distribution."
	We will extend the duration of the exchange offer as required by applicable law, and may choose to extend if we decide to give holders of Old Notes more time to tender their Old Notes.
Withdrawal; Non-Acceptance	You may withdraw any Old Notes tendered in the exchange offer at any time prior to 5:00 p.m., New York City time, on ____________, 2007. If for any reason the tender of any Old Notes is not accepted for exchange, such withdrawn or unaccepted Old Notes will be credited to the tendering holder's account at The Depository Trust Company, or DTC. For further information regarding the withdrawal of tendered Old Notes, see "The Exchange Offer Terms of the Exchange Offer" and "The Exchange Offer Withdrawal Rights."
Conditions to the Exchange Offer	The exchange offer is subject to certain conditions, which we may waive. See "The Exchange Offer Conditions to the Exchange Offer" for more information regarding the conditions to the exchange offer.
Procedures for Tendering Old Notes	To participate in the exchange offer, you must tender your Old Notes by using the book-entry transfer procedures described below and transmitting an agent's message to the exchange agent on or prior to the expiration or termination of the exchange offer. In order for a book-entry transfer to constitute a valid tender of your Old Notes in the exchange offer, Wells Fargo Bank, National Association, as exchange agent, must receive a confirmation of book-entry transfer of your Old Notes into the exchange agent's account at DTC prior to the expiration or termination of the exchange offer. For more information regarding the use of book-entry transfer procedures, including a description of the required agent's message, see "The Exchange Offer Book-Entry Transfer."
Special Procedures for Beneficial Owners	If you are a beneficial owner whose Old Notes are registered in the name of the broker, dealer, commercial bank, trust company or other nominee and you wish to tender your Old Notes in the exchange offer, you should promptly contact the person in whose name the Old Notes are registered, and instruct that person to tender on your behalf.

Certain U.S. Federal Income Tax Consequences

The exchange of Old Notes for New Notes pursuant to the exchange offer will not be a taxable transaction for U.S. federal income tax purposes. See "Material U.S. Federal Income Tax Consequences" for more information regarding the tax consequences of the exchange offer to you.

Use of Proceeds

We will not receive any cash proceeds from the exchange offer.

Exchange Agent

Wells Fargo Bank, National Association is the exchange agent for the exchange offer. You can find the address and telephone number of the exchange agent below in "The Exchange Offer Exchange Agent."

Resales

Based on interpretations by the staff of the SEC, as set forth in no-action letters issued to third parties, we believe that the New Notes issued in the exchange offer may be offered for resale, resold or otherwise transferred by you without compliance with the registration and prospectus delivery requirements of the Securities Act as long as:

- you are not an affiliate of ours or a broker-dealer that acquired the Old Notes directly from us;
- you are acquiring the New Notes in the ordinary course of your business; and
- you are not participating, do not intend to participate and have no arrangement or understanding with any person to participate, in a distribution of the Old Notes or the New Notes.

If you are an affiliate of ours or are engaged in or intend to engage in or have any arrangement or understanding with any person to participate in the distribution of the Old Notes or the New Notes:

- you cannot rely on the applicable interpretations of the staff of the SEC; and
- you must comply with the registration requirements of the Securities Act in connection with any resale transaction.

Each broker or dealer that receives New Notes for its own account in exchange for Old Notes that were acquired as a result of market-making or other trading activities may be deemed an underwriter and thus must acknowledge that it will comply with the registration and prospectus delivery requirements of the Securities Act in connection with any offer, resale, or other transfer of the New Notes issued in the exchange offer, including the delivery of a prospectus that contains information with respect to any selling holder required by the Securities Act in connection with any resale of the New Notes.

	Furthermore, any broker-dealer that acquired any of its Old Notes directly from us may not rely on the applicable interpretation of the SEC staff contained in no-action letters for Exxon Capital Holdings Corp. (available May 13, 1988), Morgan Stanley & Co. Incorporated (available June 5, 1991) and Shearman & Sterling (available July 2, 1993).
	As a condition to participation in the exchange offer, each holder will be required to represent that it is not our affiliate or a broker-dealer that acquired the Old Notes directly from us.
Broker-Dealers	Each broker-dealer that receives New Notes for its own account in exchange for Old Notes, where such Old Notes were acquired by such broker-dealer as a result of market-making activities or other trading activities, must acknowledge that it will deliver a prospectus in connection with any resale of such New Notes. See "Plan of Distribution."
Consequences of Not Exchanging Old Notes	If you do not exchange your Old Notes in the exchange offer, you will continue to be subject to the restrictions on transfer described in the legend on your Old Notes. In general, you may offer or sell your Old Notes only:
	if they are registered under the Securities Act and applicable state securities laws;
	if they are offered or sold under an exemption from registration under the Securities Act and applicable state securities laws; or
	if they are offered or sold in a transaction not subject to the Securities Act and applicable state securities laws.
	We do not currently intend to register the Old Notes under the Securities Act. Under some circumstances, however, holders of the Old Notes, including holders who are not permitted to participate in the exchange offer or who may not freely sell New Notes received in the exchange offer, may require us to file, and to cause to become effective, a shelf registration statement covering resales of the Old Notes by these holders. For more information regarding the consequences of not tendering your Old Notes and our obligations to file a shelf registration statement, see "The Exchange Offer Consequences of Exchanging or Failing to Exchange Old Notes."
No Prior Market	The New Notes will be a new issue of securities for which there is no existing market. Accordingly, we cannot assure you that a liquid market for the New Notes will develop or be maintained.

Summary of the Terms of the New Notes

The form and the terms of the New Notes and the Old Notes are identical in all material respects, except that the transfer restrictions and registration rights applicable to the Old Notes do not apply to the New Notes. The New Notes will evidence the same debt as the Old Notes and will be governed by the same indenture dated May 7, 2007, the first supplemental indenture dated May 7, 2007, the second supplemental indenture dated May 7, 2007, and the third supplemental indenture dated May 7, 2007 (collectively, the "Indenture").

Issuer	Edison Mission Energy
New Notes Offered	$2,700,000,000 principal amount of New Notes, consisting of:
	$1,200,000,000 principal amount of New Tranche A Notes;
	$800,000,000 principal amount of New Tranche B Notes; and
	$700,000,000 principal amount of New Tranche C Notes.
Maturity Dates	Maturity dates of New Notes, consisting of:
	New Tranche A Notes May 15, 2017
	New Tranche B Notes May 15, 2019
	New Tranche C Notes May 15, 2027
Interest Payment Dates	Interest on the New Notes will accrue from May 7, 2007, and will be paid semi-annually in arrears on May 15 and November 15 of each year, commencing on November 15, 2007.
Ranking	The New Notes will be our senior unsecured obligations, will rank pari passu with all of our existing and future unsecured indebtedness and will rank senior to our future subordinated indebtedness. All existing and future liabilities of our subsidiaries will be effectively senior to the New Notes.
Certain Covenants	The Indenture governing the New Notes contains covenants limiting or prohibiting EME's ability to, among other things:
	create liens,
	incur secured indebtedness, and
	merge or consolidate with other entities.
	These covenants are subject to important qualifications and exceptions. See "Description of the New Notes Certain Covenants."
Repurchase of Notes upon a Change of Control	If a Change of Control Triggering Event (as defined in the Description of the New Notes) occurs, we will be required to offer to repurchase the New Notes at a price equal to 101% of the principal thereof as described under "Description of the New Notes Repurchase of Notes at the Option of the Holder upon a Change of Control."

Optional Redemption	We may redeem some or all of the New Notes at any time at a price equal to 100% of the principal amount of, plus accrued and unpaid interest on, the New Notes being redeemed plus a "make-whole" premium. See "Description of the New Notes Redemption."
Risk Factors	See "Risk Factors" for a discussion of certain factors that should be considered in evaluating an investment in the New Notes.

Summary Consolidated Financial Data

The following table sets forth a summary of our consolidated financial data for the periods indicated. The historical consolidated operating data for each of the three years ended December 31, 2006 and the financial position data as of December 31, 2006 and 2005 were derived from the audited historical consolidated financial statements included elsewhere in this prospectus. The following selected historical consolidated financial data as of June 30, 2007 and for the six months ended June 30, 2007 and 2006 has been derived from our unaudited consolidated financial statements included elsewhere in this prospectus. Our unaudited consolidated financial statements were prepared on a basis consistent with that used in preparing our audited consolidated financial statements and include all material adjustments, all of which are of a normal recurring nature, that, in the opinion of management, are necessary for a fair statement of our financial position and results of operations for the unaudited periods.

You should read the following information in conjunction with the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the historical consolidated financial statements and the related notes included elsewhere in this prospectus. Historical results are not necessarily indicative of results that may be expected for any future period.

	Years Ended December 31,			Six Months Ended June 30,	
	2004	2005	2006	2006	2007
		(in millions)		(in millions) (unaudited)	
Income Statement Data					
Operating revenues	$ 1,653	$ 2,265	$ 2,239	$ 977	$ 1,243
Operating expenses					
Fuel, plant operations and plant operating lease	1,300	1,287	1,332	658	729
Loss on lease termination, asset impairment and other charges and credits	989	7		(5)	
Depreciation and amortization	152	134	144	71	76
Administrative and general	149	154	140	64	84
Total Operating Expenses	2,590	1,582	1,616	788	889
Operating income (loss)	(937)	683	623	189	354
Equity in income from unconsolidated affiliates	218	229	186	71	80
Impairment loss on equity method investment		(55)			
Interest and other income	52	69	120	61	57
Interest expense	(298)	(300)	(279)	(145)	(129)
Loss on early extinguishment of debt		(4)	(146)	(143)	(160)
Income (loss) from continuing operations before income taxes and minority interest	(965)	622	504	33	202
Provision (benefit) for income taxes	(406)	208	189	1	68
Minority interest	(1)		1		
Income (loss) from continuing operations	(560)	414	316	32	134
Income from operations of discontinued subsidiaries (including gain on disposal of $533 million in 2004), net of tax	690	29	98	77	5
Income before accounting change	130	443	414	109	139
Cumulative effect of change in accounting, net of tax(1)		(1)			
Net income	$ 130	$ 442	$ 414	$ 109	$ 139

(1) The 2005 loss from a change in accounting principle resulted from the adoption of a new accounting standard for conditional asset retirements.

	As of December 31,			As of June 30, 2007
	2004	2005	2006	
	(in millions)			(in millions) (unaudited)
Balance Sheet Data				
Assets	$ 7,087	$ 7,023	$ 7,250	$ 7,114
Current liabilities	994	846	646	504
Long-term obligations	3,530	3,330	3,035	3,845
Shareholder's equity	1,745	1,910	2,582	1,681

	Years Ended December 31,			Six Months Ended June 30,	
	2004	2005	2006	2006	2007
	(in millions)			(in millions) (unaudited)	
Other Data					
Ratio of earnings to fixed charges(2)(3)		2.23x	2.01x	1.20x	1.71x

(2) For purposes of computing the ratio of earnings to fixed charges, earnings are divided by fixed charges. "Earnings" represent the aggregate of income (loss) for continuing operations before income taxes and minority interest. "Fixed charges" represent interest (whether expensed or capitalized), amortization of debt discount and the interest component of rental expense.

(3) For the year ended December 31, 2004, there was a fixed charge deficiency of $953 million.

RISK FACTORS

Your investment in the New Notes involves a high degree of risk. You should carefully consider the risks described below as well as other information and data included in this prospectus, before making an investment decision. Additional risks and uncertainties not presently known to us or that we currently believe are immaterial may also adversely impact our business operations. If any of the events described in the risk factors below occurs, our business, financial condition, operating results and prospects could be materially adversely affected, which in turn could adversely affect our ability to pay interest and/or principal on the New Notes.

Risks Relating to Exchange Offer

You may have difficulty selling the Old Notes which you do not exchange, since Old Notes will continue to have restrictions on transfer and cannot be sold without registration under securities laws or exemptions from registration.

If a large number of Old Notes are exchanged for New Notes issued in the exchange offer, it may be difficult for holders of Old Notes that are not exchanged in the exchange offer to sell the Old Notes, since those Old Notes may not be offered or sold unless they are registered or there are exemptions from registration requirements under the Securities Act or state laws that apply to them. In addition, if there are only a small number of Old Notes outstanding, there may not be a very liquid market in those Old Notes. There may be few investors that will purchase unregistered securities in which there is not a liquid market. See "The Exchange Offer Consequences of Exchanging or Failing to Exchange Old Notes."

In addition, if you do not tender your Old Notes or if we do not accept some Old Notes, those notes will continue to be subject to the transfer and exchange provisions of the Indenture and the existing transfer restrictions of the Old Notes that are described in the legend on such notes and in the offering memorandum relating to the Old Notes.

Late deliveries of Old Notes or any other failure to comply with the exchange offer procedures could prevent a holder from exchanging its Old Notes.

Noteholders are responsible for complying with all exchange offer procedures. The issuance of New Notes in exchange for Old Notes will only occur upon completion of the procedures described in this prospectus under "The Exchange Offer." Therefore, holders of Old Notes who wish to exchange them for New Notes should allow sufficient time for timely completion of the exchange procedure. Neither we nor the exchange agent are obligated to extend the offer or notify you of any failure to follow the proper procedure.

If you do not exchange your Old Notes in the exchange offer, you will no longer be entitled to an increase in interest payments on Old Notes that the Indenture provides for if we fail to complete the exchange offer.

Once the exchange offer has been completed, holders of outstanding Old Notes will not be entitled to any increase in the interest rate on their notes, which the Indenture provides for if we fail to complete the exchange offer. Holders of Old Notes will not have any further rights to have their Old Notes registered, except in limited circumstances, once the exchange offer is completed.

If you exchange your Old Notes, you may not be able to resell the New Notes you receive in the exchange offer without registering them and delivering a prospectus.

If you exchange your Old Notes in the exchange offer for the purpose of participating in a distribution of the New Notes, you may be deemed to have received restricted securities and, if so, you will be required to comply with the registration and prospectus delivery requirements of the Securities Act in connection with any resale transaction.

Based on interpretations by the SEC in no-action letters, we believe, with respect to New Notes issued in the exchange offer, that:

- holders who are not "affiliates" of ours within the meaning of Rule 405 of the Securities Act,
- holders who acquire their notes in the ordinary course of business and
- holders who do not engage in, intend to engage in, or have arrangements to participate in a distribution (within the meaning of the Securities Act) of the notes do not have to comply with the registration and prospectus delivery requirements of the Securities Act.

Holders described in the preceding sentence must tell us in writing at our request that they meet these criteria. Holders that do not meet these criteria could not rely on interpretations of the SEC in no-action letters, and would have to register the New Notes they receive in the exchange offer and deliver a prospectus for them. In addition, holders that are broker-dealers may be deemed "underwriters" within the meaning of the Securities Act in connection with any resale of New Notes acquired in the exchange offer. Holders that are broker-dealers must acknowledge that they acquired their Old Notes in market-making activities or other trading activities and must deliver a prospectus when they resell the New Notes they acquire in the exchange offer in order not to be deemed an underwriter. Our obligation to make this prospectus available to broker-dealers is limited. We cannot guarantee that a proper prospectus will be available to broker-dealers wishing to resell their New Notes.

You should review the more detailed discussion in "The Exchange Offer Procedures for Tendering Old Notes" and "The Exchange Offer Consequences of Exchanging or Failing to Exchange Old Notes."

Risks Relating to Our Business

We have substantial interests in merchant energy power plants which are subject to market risks related to wholesale energy prices.

Our merchant energy power plants do not have long-term power purchase agreements. Because the output of these power plants is not committed to be sold under long-term contracts, these projects are subject to market forces which determine the amount and price of energy, capacity and ancillary services sold from the power plants. The factors that influence the market price for energy, capacity and ancillary services include:

- prevailing market prices for coal, natural gas and fuel oil, and associated transportation;
- the extent of additional supplies of capacity, energy and ancillary services from current competitors or new market entrants, including the development of new generation facilities or

- technologies that may be able to produce electricity at a lower cost than our generating facilities and /or increased access by competitors to our markets as a result of transmission upgrades;
- transmission congestion in and to each market area and the resulting differences in prices between delivery points;
- the market structure rules established for each market area and regulatory developments affecting the market areas, including any price limitations and other mechanisms adopted to address volatility or illiquidity in these markets or the physical stability of the system;
- the cost and availability of emission credits or allowances;
- the availability, reliability and operation of competing power generation facilities, including nuclear generating plants where applicable, and the extended operation of such facilities beyond their presently expected dates of decommissioning;
- weather conditions prevailing in surrounding areas from time to time; and
- changes in the demand for electricity or in patterns of electricity usage as a result of factors such as regional economic conditions and the implementation of conservation programs.

In addition, unlike most other commodities, electric power can only be stored on a very limited basis and generally must be produced concurrently with its use. As a result, the wholesale power markets are subject to significant and unpredictable price fluctuations over relatively short periods of time. There is no assurance that our merchant energy power plants will be successful in selling power into their markets or that the prices received for their power will generate positive cash flows. If our merchant energy power plants do not meet these objectives, they may not be able to generate enough cash to service their own debt and lease obligations, which could have a material adverse effect on us.

Our financial results can be affected by changes in fuel prices, fuel transportation cost increases, and interruptions in fuel supply.

Our business is subject to changes in fuel costs, which may negatively affect our financial results and financial position by increasing the cost of producing power. The fuel markets can be volatile, and actual fuel prices can differ from our expectations.

Although we attempt to purchase fuel based on our known fuel requirements, we are still subject to the risks of supply interruptions, transportation cost increases, and fuel price volatility. In addition, fuel deliveries may not exactly match energy sales, due in part to the need to purchase fuel inventories in advance for reliability and dispatch requirements. The price at which we can sell our energy may not rise or fall at the same rate as a corresponding rise or fall in fuel costs.

We may not be able to hedge market risks effectively.

We are exposed to market risks through our ownership and operation of merchant energy power plants and through our power marketing business. These market risks include, among others, volatility arising from the timing differences associated with buying fuel, converting fuel into energy and delivering energy to a buyer. We use forward contracts and derivative financial instruments, such as futures contracts and options, to manage market risks and exposure to fluctuating electricity and fuel prices. We cannot provide assurance that these strategies will successfully mitigate market risks, or that they will not result in net losses.

We may not cover the entire exposure of our assets or positions to market price volatility, and the level of coverage will vary over time. Fluctuating commodity prices may negatively affect our financial results to the extent that assets and positions have not been hedged.

The effectiveness of our hedging activities may depend on the amount of working capital available to post as collateral in support of these transactions, either in support of performance guarantees or as a cash margin. The amount of credit support that must be provided typically is based on the difference between the price of the commodity in a given contract and the market price of the commodity. Significant movements in market prices can result in a requirement to provide cash collateral and letters of credit in very large amounts. Without adequate liquidity to meet margin and collateral requirements, we could be exposed to the following:

- a reduction in the number of counterparties willing to enter into bilateral contracts, which would result in increased reliance on short-term and spot markets instead of bilateral contracts, increasing our exposure to market volatility; and

- a failure to meet a margining requirement, which could permit the counterparty to terminate the related bilateral contract early and demand immediate payment for the replacement value of the contract.

As a result of these and other factors, we cannot predict with precision the effect that risk management decisions may have on our business, operating results or financial position.

We are exposed to credit and performance risk from third parties under supply and transportation contracts.

We rely on contracts for the supply and transportation of fuel and other services required for the operation of our generation facilities. Our operations are exposed to the risk that counterparties will not perform their obligations. If a counterparty failed to perform under a contract, we would need to obtain alternate suppliers or alternate means of transportation for our requirements of fuel or other services, which could result in higher costs or disruptions in our operations. Furthermore, we are exposed to credit risk because damages related to a breach of contract may not be recoverable. Accordingly, the failure of a supplier to fulfill our contractual obligations could have a material adverse effect on our financial results.

We are subject to extensive energy industry regulation.

Our operations are subject to extensive regulation by governmental agencies. Our projects are subject to federal laws and regulations that govern, among other things, transactions by and with purchasers of power, including utility companies, the development and construction of generation facilities, the ownership and operations of generation facilities, and access to transmission. Under limited circumstances where exclusive federal jurisdiction is not applicable or specific exemptions or waivers from state or federal laws or regulations are otherwise unavailable, federal and/or state utility regulatory commissions may have broad jurisdiction over non-utility owned electric power plants. Generation facilities are also subject to federal, state and local laws and regulations that govern, among other things, the geographical location, zoning, land use and operation of a project.

The Federal Energy Regulatory Commission may impose various forms of market mitigation measures, including price caps and operating restrictions, where it determines that potential market power might exist and that the public interest requires mitigation. In addition, many of our facilities are subject to rules, restrictions and terms of participation imposed and administered by various regional transmission organizations and independent system operators. For example, independent system

operators, also known as ISOs, and regional transmission organizations, also known as RTOs, may impose bidding and scheduling rules, both to curb the potential exercise of market power and to facilitate market functions. Such actions may materially affect our results of operations.

There is no assurance that the introduction of new laws or other future regulatory developments will not have a material adverse effect on our business, results of operations or financial condition, nor is there any assurance that we will be able to obtain and comply with all necessary licenses, permits and approvals for our projects. If projects cannot comply with all applicable regulations, our business, results of operations and financial condition could be adversely affected.

We are subject to extensive environmental regulation and permitting requirements that may involve significant and increasing costs.

Our operations are subject to extensive environmental regulation with respect to, among other things, air quality, water quality, waste disposal, and noise. We are required to obtain and comply with conditions established by licenses, permits and other approvals in order to construct, operate or modify our facilities. Failure to comply with these requirements could subject us to civil or criminal liability, the imposition of liens or fines, or actions by regulatory agencies seeking to curtail our operations.

We devote significant resources to environmental monitoring, pollution control equipment and emission allowances to comply with environmental regulatory requirements. We believe that we are currently in substantial compliance with environmental regulatory requirements. However, the United States Environmental Protection Agency (US EPA) has issued a notice of violation (NOV) to Midwest Generation and Commonwealth Edison Company (Commonwealth Edison), the former owner of Midwest Generation's coal-fired power plants, alleging violations of the Clean Air Act and certain opacity and particulate matter standards. The current trend is toward more stringent standards, stricter regulation, and more expansive application of environmental regulations. Environmental advocacy groups and regulatory agencies in the United States have been focusing considerable attention on carbon dioxide emissions from coal-fired power plants and their potential role in climate change. The adoption of laws and regulations to implement carbon dioxide controls could adversely affect our coal-fired plants. Also, coal plant emissions of nitrogen oxides and sulfur oxides, mercury and particulates are subject to increased controls and mitigation expenses. Additionally, certain of the states in which we operate are contemplating air pollution control regulations that are more stringent than existing and proposed federal regulations. The continued operation of our facilities, particularly our coal-fired facilities, will require substantial capital expenditures for environmental controls.

For example, in December 2006, Midwest Generation entered into an agreement with the Illinois Environmental Protection Agency (Illinois EPA) to reduce mercury, nitrogen oxide and sulfur dioxide emissions at Midwest Generation's Illinois coal-fired power plants. Capital expenditures relating to controls contemplated by the agreement are expected (in 2006 dollars) to be in the range of approximately $2.7 billion to $3.4 billion through 2018. There is no assurance that these capital expenditures will not exceed the above estimates.

In addition, future environmental laws and regulations, and future enforcement proceedings that may be taken by environmental authorities, could affect the costs and the manner in which we conduct our business. There is no assurance that we would be able to recover these increased costs from our customers or that our business, financial position and results of operations would not be materially adversely affected. Furthermore, changing environmental regulations could make some units uneconomical to maintain or operate. If we cannot comply with all applicable regulations, we could be required to retire or suspend operations at our facilities, or restrict or modify the operations of our facilities, and our business, results of operations and financial condition could be adversely affected.

Typically, environmental laws require a lengthy and complex process for obtaining licenses, permits and approvals prior to construction, operation or modification of a project or generating facility. Meeting all the necessary requirements can delay or sometimes prevent the completion of a proposed project as well as require extensive modifications to existing projects, which may involve significant capital expenditures. We cannot provide assurance that we will be able to obtain and comply with all necessary licenses, permits and approvals for our plants. If there is a delay in obtaining required approvals or permits or if we fail to obtain and comply with such permits, the operation of our facilities may be interrupted or become subject to additional costs.

Our development projects or future acquisitions may not be successful.

Our future financial condition, results of operations and cash flows will depend in large part upon our ability to successfully implement our long-term strategy, which includes the development and acquisition of electric power generation facilities, with an emphasis on renewable energy (primarily wind), integrated gasification combined cycle, and gas-fired power plants. We may be unable to identify attractive acquisition or development opportunities and/or to complete and integrate them on a successful and timely basis. Furthermore, implementation of this strategy may be affected by factors beyond our control, such as increased competition, legal and regulatory developments, price volatility in electric or fuel markets, and general economic conditions.

In support of our development activities, we have entered into commitments to purchase wind turbines for future projects and plan to make substantial additional commitments in the future. In addition, we expend significant amounts for preliminary engineering, permitting, legal and other expenses before we can determine whether we will win a competitive bid, or whether a project is feasible or economically attractive.

Our development activities are subject to risks including, without limitation, risks related to project siting, financing, construction, permitting, and governmental approvals. We may not be successful in developing new projects or the timing of such development may be delayed beyond the date such turbines are ready for installation. Furthermore, we may not be able to obtain financing for new projects that are developed and may not be able to obtain sufficient equity capital or additional borrowings to enable us to fund equity commitments for future projects. Recent disruptions in the credit markets have impacted the availability of credit, cost of borrowing, and terms and conditions of new borrowings. It is uncertain whether these market conditions will affect our ability to obtain financing for new projects or the terms and conditions of future financings. If a project under development is abandoned, we would expense all capitalized costs incurred in connection with that project, and could incur additional losses associated with any related contingent liabilities. If we are not successful in developing new projects, we may be required to sell turbines that were purchased and such sales may result in substantial losses.

Finally, we cannot provide assurance that our development projects or acquired assets will generate sufficient cash flow to support the indebtedness incurred to acquire them or the capital expenditures needed to develop them, or that we will ultimately realize a satisfactory rate of return.

Competition could adversely affect our business.

The independent power industry is characterized by numerous capable competitors, some of whom may have more extensive operating experience in the acquisition and development of power projects, larger staffs, and greater financial resources than we do. Several participants in the wholesale markets, including many regulated utilities, have a lower cost of capital than most merchant generators and often are able to recover fixed costs through rate base mechanisms, allowing them to build, buy and

upgrade generation assets without relying exclusively on market clearing prices to recover their investments. This could affect our ability to compete effectively in the markets in which those entities operate.

Newer plants owned by our competitors are often more efficient than our facilities. This may put some of our facilities at a competitive disadvantage to the extent that our competitors are able to produce more power from each increment of fuel than our facilities are capable of producing. Over time, some of our facilities may become obsolete in their markets, or be unable to compete, because of the construction of newer, more efficient power plants.

In addition to the competition already existing in the markets in which we presently operate or may consider operating in the future, we are likely to encounter significant competition as a result of further consolidation of the power industry by mergers and asset reallocations, which could create powerful new competitors, and new market entrants such as investment companies. In addition, the Energy Policy Act of 2005 (EPAct 2005) and other regulatory initiatives may result in changes in the power industry to which we may not be able to respond in as timely and effective manner as our competitors.

We may not be able to raise capital on favorable terms, to refinance our or our subsidiaries' existing indebtedness, or to fund operations, capital expenditures, and future acquisitions and development activities, which could adversely affect our results of operations.

The factors that influence our ability to arrange for financing and our costs of capital include:

- general economic and capital market conditions;
- the availability of bank credit;
- investor confidence;
- the financial condition, performance, prospects, and credit ratings of us and/or the subsidiary requiring the financing; and
- changes in tax and securities laws.

Recent disruptions in the credit markets have impacted the availability of credit, cost of borrowing, and terms and conditions of new borrowings. We cannot provide assurance that our projected sources of capital will be available when needed or that our actual cash requirements will not be greater than expected.

Restrictions in the instruments governing our indebtedness and the indebtedness of our subsidiaries limit our and our subsidiaries' ability to enter into specified transactions that we otherwise may enter into.

The instruments governing our indebtedness and the indebtedness of our subsidiaries contain financial and investment covenants. Restrictions contained in these documents or documents we or our subsidiaries enter in the future could affect, and in some cases significantly limit or prohibit, our ability and the ability of our subsidiaries to, among other things, incur, refinance, and prepay debt, make capital expenditures, pay dividends and make other distributions, make investments, create liens, sell assets, enter into sale and leaseback transactions, issue equity interests, enter into transactions with affiliates, create restrictions on the ability to pay dividends or make other distributions and engage in mergers and consolidations. These restrictions may significantly impede our ability and the ability of

our subsidiaries to take advantage of business opportunities as they arise, to grow our business or to compete effectively. In addition, these restrictions may significantly impede the ability of our subsidiaries to make distributions to us.

Our projects may be affected by general operating risks and hazards customary in the power generation industry. We may not have adequate insurance to cover all these hazards.

The operation of power generation facilities involves many operating risks, including:

- performance below expected levels of output or efficiency;
- interruptions in fuel supply;
- disruptions in the transmission of electricity;
- curtailment of operations due to transmission constraints;
- breakdown or failure of equipment or processes;
- imposition of new regulatory, permitting, or environmental requirements, or violations of existing requirements;
- employee work force factors, including strikes, work stoppages or labor disputes;
- operator/contractor error; and
- catastrophic events such as terrorist activities, fires, tornadoes, earthquakes, explosions, floods or other similar occurrences affecting power generation facilities or the transmission and distribution infrastructure over which power is transported.

These and other hazards can cause significant personal injury or loss of life, severe damage to and destruction of property, plant and equipment, contamination of or damage to the environment, and suspension of operations. The occurrence of one or more of the events listed above could decrease or eliminate revenues generated by our projects or significantly increase the costs of operating them, and could also result in our being named as a defendant in lawsuits asserting claims for substantial damages, potentially including environmental cleanup costs, personal injury, property damage, fines and penalties. Equipment and plant warranties and insurance may not be sufficient or effective under all circumstances to cover lost revenues or increased expenses. A decrease or elimination in revenues generated by the facilities or an increase in the costs of operating them could decrease or eliminate funds available to meet our obligations as they become due and could have a material adverse effect on us. A default under a financing obligation of a project entity could result in a loss of our interest in the project.

The accounting for our hedging and proprietary trading activities may increase the volatility of our quarterly and annual financial results.

We engage in hedging activities in order to mitigate our exposure to market risk with respect to electricity sales from our generation facilities, fuel utilized by those facilities and emissions allowances. We generally attempt to balance our fixed-price physical and financial purchases and sales commitments in terms of contract volumes and the timing of performance and delivery obligations through the use of financial and physical derivative contracts. We also use derivative contracts with

respect to our limited proprietary trading activities, through which we attempt to achieve incremental returns by transacting where we have specific market expertise. These derivative contracts are recorded on our balance sheet at fair value pursuant to SFAS No. 133. Some of these derivative contracts do not qualify under SFAS No. 133 for hedge accounting, and changes in their fair value are therefore recognized currently in earnings as unrealized gains or losses. As a result, our financial results, including gross margin, operating income and balance sheet ratios, will at times be volatile and subject to fluctuations in value primarily due to changes in electricity and fuel prices.

Risks Relating to the New Notes

We are primarily a holding company. Our only material source of cash is and will be distributions from our subsidiaries, and the New Notes will be effectively subordinated to the claims of our direct and indirect subsidiaries.

We are primarily a holding company with no material business operations of our own. Our most significant assets are the capital stock of our subsidiaries. We conduct virtually all of our business operations through those subsidiaries. Accordingly, our only material source of cash, including cash to make payments on or redeem the New Notes or our other indebtedness, is and will be dividends and distributions with respect to our ownership interests in our subsidiaries that are derived from the earnings and cash flow generated by our subsidiaries. We cannot assure you that our subsidiaries will generate sufficient earnings and cash flow to pay dividends or distributions to us or that applicable state law and contractual restrictions binding on our subsidiaries will permit dividends or distributions in the future. See " Restrictions in the instruments governing our indebtedness and the indebtedness of our subsidiaries limit our and our subsidiaries' ability to enter into specified transactions that we otherwise may enter into." In addition, our direct and indirect subsidiaries will not guarantee the New Notes and will have no legal obligations to make payments on the New Notes or make funds available for those payments, whether by dividends, loans or other payments. Accordingly, we may not be able to pay interest on the New Notes or principal when due at maturity or otherwise.

In the event of a bankruptcy, liquidation, dissolution, reorganization or similar proceeding involving us, the New Notes will be effectively subordinated to the claims of the creditors of all of our direct and indirect subsidiaries, including trade creditors and holders of indebtedness of those subsidiaries. Accordingly, there might only be a limited amount of assets available to satisfy your claims as a holder of the New Notes upon an acceleration of the maturity of the New Notes.

We have a substantial amount of indebtedness, including long-term lease obligations.

As of June 30, 2007, our consolidated debt was $4.0 billion. In addition, our subsidiaries had $4.0 billion of long-term power plant lease obligations due over a period ranging up to 28 years. Subject to certain exceptions, the indenture governing the New Notes limits our ability to incur secured debt to 15% of our consolidated net tangible assets, but will not impose limitations on our ability to incur additional unsecured indebtedness. See "Description of the New Notes Certain covenants; restrictions on liens." All existing and future liabilities of our subsidiaries will be effectively senior to the New Notes. In addition, our $600 million secured credit facility is secured by the stock of certain of our subsidiaries. The New Notes will be junior to borrowings under this facility and any secured indebtedness we may incur in the future to the extent of the collateral securing such indebtedness.

The substantial amount of consolidated debt and financial obligations presents the risk that we might not have sufficient cash to service our indebtedness, including the New Notes, or long-term lease obligations and that the existing corporate debt, project debt and lease obligations could limit our ability to grow our business, to compete effectively or operate successfully under adverse economic

conditions, or to plan for and react to business and industry changes. If our or our subsidiaries' cash flows and capital resources were insufficient to allow us to make scheduled payments on our debt, we might have to reduce or delay capital expenditures, sell assets, seek additional capital, or restructure or refinance the debt. The terms of our or our subsidiaries' debt may not allow these alternative measures, the debt or equity may not be available on acceptable terms, and these alternative measures may not satisfy all scheduled debt service obligations.

In addition, in connection with the entry into new financings or amendments to existing financing arrangements, our financial and operational flexibility may be further reduced as a result of more restrictive covenants, requirements for security and other terms that are often imposed on sub-investment grade entities.

You may find it difficult to sell your notes because there is no existing trading market for the New Notes.

You may find it difficult to sell your notes because an active trading market for the notes may not develop. The New Notes are being offered to the holders of the Old Notes. The Old Notes were issued on May 7, 2007, primarily to a small number of institutional investors. After the exchange offer, the trading market for the remaining untendered Old Notes could be adversely affected. There is no existing trading market for the New Notes. Future trading prices of the New Notes will depend on many factors, including prevailing interest rates, our operating results, and the market for similar securities. We do not intend to apply for listing or quotation of the New Notes on any exchange, and so we do not know the extent to which investor interest will lead to the development of a trading market or how liquid that market might be. Although the initial purchasers in the private offering of the Old Notes have informed us that they intend to make a market in the New Notes, they are not obligated to do so. The initial purchasers may cease their market-making at any time. As a result, the market price of the New Notes could be adversely affected.

Historically, the market for non-investment grade debt has been subject to disruptions that have caused substantial volatility in the prices of securities similar to the New Notes offered by this prospectus. The market for the New Notes, if any, may be subject to similar disruptions. These disruptions may adversely affect the value of the New Notes.

THE EXCHANGE OFFER

Purpose of the Exchange Offer

When we sold the Old Notes on May 7, 2007, or the "closing date," we entered into a registration rights agreement with the initial purchasers of the Old Notes. Under the registration rights agreement, we agreed to file a registration statement regarding the exchange of the Old Notes for New Notes which are registered under the Securities Act. We also agreed to use our reasonable best efforts to cause the registration statement to become effective with the SEC and to conduct this exchange offer after the registration statement is declared effective. The registration rights agreement provides that we will be required to pay additional interest to the holders of the Old Notes if:

- we do not file the exchange offer registration statement with the SEC on or prior to the 180th calendar day following the closing date;
- the exchange offer registration statement has not been declared effective on or prior to the 240th calendar day following the closing date; or
- the exchange offer is not consummated on or prior to 30 business days after the 240th calendar day following the closing date.

The exchange offer is not being made to holders of Old Notes in any jurisdiction where the exchange would not comply with the securities or blue sky laws of such jurisdiction. A copy of the registration rights agreement is filed as an exhibit to the registration statement of which this prospectus forms a part.

Each broker-dealer that receives New Notes for its own account in exchange for Old Notes, where such New Notes were acquired by such broker-dealer as a result of market-making activities or other trading activities, will acknowledge that it will deliver a prospectus in connection with any resale of the New Notes. See "Plan of Distribution."

Terms of the Exchange Offer

Upon the terms and conditions described in this prospectus, we will accept for exchange Old Notes that are properly tendered on or before the expiration date and not withdrawn as permitted below. As used in this prospectus, the term "expiration date" means 5:00 p.m., New York City time, on ____________, 2007. However, if we, in our sole discretion, have extended the period of time for which the exchange offer is open, the term "expiration date" means the latest time and date to which we extend the exchange offer.

As of the date of this prospectus, $2,700,000,000 aggregate principal amount at maturity of the Old Notes is outstanding. The Old Notes were offered under the Indenture. This prospectus is first being sent on or about ____________, 2007 to all holders of Old Notes known to us. Our obligation to accept Old Notes for exchange in the exchange offer is subject to the conditions described below under " Conditions to the Exchange Offer." We reserve the right to extend the period of time during which the exchange offer is open. We would then delay acceptance for exchange of any Old Notes by giving oral or written notice of an extension to the holders of Old Notes as described below. During any extension period, all Old Notes previously tendered will remain subject to the exchange offer and may be accepted for exchange by us. Any Old Notes not accepted for exchange will be returned to the tendering holder after the expiration or termination of the exchange offer. Holders of Old Notes do not have dissenters' rights of appraisal in connection with the exchange offer.

Old Notes tendered in the exchange offer must be in denominations of principal amount of $2,000 and any integral multiple of $1,000.

We reserve the right to amend or terminate the exchange offer, and not to accept for exchange any Old Notes not previously accepted for exchange, upon the occurrence of any of the conditions of the exchange offer specified below under " Conditions to the Exchange Offer." We will give oral or written notice of any extension, amendment, non-acceptance or termination to the holders of the Old Notes as promptly as practicable. We will notify you of any extension by means of a press release or other public announcement no later than 9:00 a.m., New York City time on that date.

Our acceptance of the tender of Old Notes by a tendering holder will form a binding agreement upon the terms and subject to the conditions provided in this prospectus.

Procedures for Tendering

A tendering holder must, on or prior to the expiration date, transmit an agent's message to the exchange agent at the address listed below under the heading " Exchange Agent."

In addition, the exchange agent must receive, on or before the expiration date, a timely confirmation of book-entry transfer of the Old Notes into the exchange agent's account at the DTC, the book-entry transfer facility, along with an agent's message.

The term "agent's message" means a message, transmitted to DTC and received by the exchange agent and forming a part of a book-entry transfer, that states that DTC has received an express acknowledgment that the tendering holder agrees to appoint the exchange agent as the tendering holder's true and lawful agent and attorney-in-fact with respect to such tendered Old Notes, with full power of substitution, among other things, to cause the Old Notes to be assigned, transferred and exchanged.

If you are a beneficial owner whose Old Notes are registered in the name of a broker, dealer, commercial bank, trust company or other nominee, and wish to tender, you should promptly instruct the registered holder to tender on your behalf.

We will determine in our sole discretion all questions as to the validity, form and eligibility of Old Notes tendered for exchange. This discretion extends to the determination of all questions concerning the timing of receipts and acceptance of tenders. These determinations will be final and binding.

We reserve the right to reject any amount of Old Notes not properly tendered, or any acceptance that might, in our judgment or our counsel's judgment, be unlawful. We also reserve the right to waive any conditions of the exchange offer as applicable to all Old Notes prior to the expiration date. We also reserve the right to waive any defects or irregularities or conditions of the exchange offer as to any amount of Old Notes prior to the expiration date. Our interpretation of the terms and conditions of the exchange offer as to any amount of Old Notes either before or after the expiration date shall be final and binding on all parties. Unless waived, any defects or irregularities in connection with tenders of Old Notes must be cured within a reasonable period of time. None of we, the exchange agent or any other person will be under any duty to give notification of any defect or irregularity in any tender of Old Notes. Nor will we, the exchange agent or any other person incur any liability for failing to give notification of any defect or irregularity.

By tendering, each holder will represent to us that, among other things:

- the holder is not an affiliate of ours (as defined in Rule 405 under the Securities Act) or a broker-dealer tendering notes acquired directly from us for its own account;
- the New Notes are being acquired in the ordinary course of business of the person receiving the New Notes, whether or not that person is the holder;
- neither the holder nor the other person has any arrangement or understanding with any person to participate in the distribution (within the meaning of the Securities Act) of the New Notes; and
- the holder is not engaged in, and does not intend to engage in, a distribution of the New Notes.

However, any purchaser of Old Notes who is our "affiliate" (within the meaning of the Securities Act) who intends to participate in the exchange offer for the purpose of distributing the New Notes or a broker-dealer (within the meaning of the Securities Act) that acquired Old Notes in a transaction other than as part of its trading or market-making activities and who has arranged or has an understanding with any person to participate in the distribution of the New Notes:

- will not be able to rely on the applicable interpretation by the staff of the SEC set forth in the applicable no-action letters;
- will not be able to tender its Old Notes in the exchange offer; and
- must comply with the registration and prospectus delivery requirements of the Securities Act in connection with any sale or transfer of the notes unless such sale or transfer is made pursuant to an exemption from such requirements.

By tendering, each broker-dealer that receives New Notes for its own account in exchange for Old Notes, where the Old Notes were acquired by it for its own account as a result of market-making activities or other trading activities, will acknowledge that it will deliver a prospectus that meets the requirements of the Securities Act in connection with any resale of the New Notes. By so acknowledging and by delivering a prospectus, a broker-dealer will not be deemed to admit that it is an "underwriter" within the meaning of the Securities Act. However, a broker-dealer may be a statutory underwriter. See "Plan of Distribution."

Furthermore, any broker-dealer that acquired any of its Old Notes directly from us:

- may not rely on the applicable interpretation of the staff of the SEC's position contained in *Exxon Capital Holdings Corp.*, SEC no-action letter (April 13, 1988), *Morgan, Stanley & Co. Inc.*, SEC no-action letter (June 5, 1991), and *Shearman & Sterling*, SEC no-action letter (July 2, 1993); and
- must also be named as a selling holder in connection with the registration and prospectus delivery requirements of the Securities Act relating to any resale transaction.

Acceptance of Old Notes for Exchange; Delivery of New Notes

Upon satisfaction or waiver of all of the conditions to the exchange offer, we will accept, promptly after the expiration date, all Old Notes properly tendered, unless we terminate the exchange offer

because of the non-satisfaction of conditions. We will issue the New Notes as soon as practicable after acceptance of the Old Notes. See "Conditions to the Exchange Offer" below. For purposes of the exchange offer, we will be deemed to have accepted properly tendered Old Notes for exchange when, as and if we have given oral or written notice to the exchange agent, with prompt written confirmation of any oral notice.

For each Old Note accepted for exchange, the holder of the Old Note will receive a New Note having a principal amount equal to that of the surrendered Old Note. The New Notes will bear interest from the most recent date to which interest has been paid on the Old Notes. Accordingly, registered holders of New Notes on the relevant record date for the first interest payment date following the completion of the exchange offer will receive interest accruing from the most recent date to which interest has been paid. The accreted value of the New Notes will be the same as the accreted value of the Old Notes. Old Notes accepted for exchange will cease to accrue interest from and after the date of completion of the exchange offer. Holders of Old Notes whose Old Notes are accepted for exchange will not receive any payment for accrued interest on the Old Notes otherwise payable on any interest payment date, the record date for which occurs on or after completion of the exchange offer and will be deemed to have waived their rights to receive the accrued interest on the Old Notes.

In all cases, issuance of New Notes for Old Notes will be made only after timely receipt by the exchange agent of a timely book-entry confirmation of the Old Notes into the exchange agent's account at the book-entry transfer facility.

Unaccepted or non-exchanged Old Notes will be returned without expense to the tendering holder of the Old Notes. In the case of Old Notes tendered by book-entry transfer in accordance with the book-entry procedures described below, the non-exchanged Old Notes will be returned or recredited promptly.

Book-Entry Transfer

The exchange agent will make a request to establish an account for the Old Notes at DTC for purposes of the exchange offer within two business days after the date of this prospectus. A holder of the Old Notes must make book-entry delivery of Old Notes by causing DTC to transfer those Old Notes into the exchange agent's account at DTC in accordance with DTC's procedure for transfer. This holder should transmit its acceptance to DTC on or prior to the expiration date. DTC will verify this acceptance, execute a book-entry transfer of the tendered Old Notes into the exchange agent's account at DTC and then send to the exchange agent confirmation of this book-entry transfer. The confirmation of this book-entry transfer will include an agent's message confirming that DTC has received an express acknowledgment from this holder that this holder agrees to be bound by the assignment, transfer and exchange of the Old Notes. Delivery of New Notes issued in the exchange offer may be effected through book-entry transfer at DTC. However, an agent's message must be transmitted to and received by the exchange agent at the address listed below under "Exchange Agent" on or prior to the expiration date.

Exchanging Book-Entry Notes

The exchange agent and DTC have confirmed that any financial institution that is a participant in DTC may utilize DTC Automated Tender Offer Program, or ATOP, procedures to tender Old Notes. Any participant in the DTC may make book-entry delivery of Old Notes by causing the DTC to transfer such Old Notes into the exchange agent's account in accordance with the DTC's ATOP procedures for transfer. However, the exchange for the Old Notes so tendered will only be made after

a book-entry confirmation of the book-entry transfer of Old Notes into the exchange agent's account, and timely receipt by the exchange agent of an agent's message.

Withdrawal Rights

Tenders of Old Notes may be withdrawn at any time before 5:00 p.m., New York City time, on the expiration date.

For a withdrawal to be effective, the exchange agent must receive a written notice of withdrawal at the address or at the facsimile number, indicated below under " Exchange Agent" before 5:00 p.m., New York City time, on the expiration date. Any notice of withdrawal must specify the number of the account at the DTC from which the Old Notes were tendered and specify the name and number of the account at the DTC to be credited with the withdrawn Old Notes and otherwise comply with the procedures of DTC.

We will determine all questions as to the validity, form and eligibility, including time of receipt, or notices of withdrawal. Any Old Notes so withdrawn will be deemed not to have been validly tendered for exchange. No New Notes will be issued unless the Old Notes so withdrawn are validly re-tendered. Any Old Notes that have been tendered for exchange, but which are not exchanged for any reason, will be credited to an account maintained with the DTC. Properly withdrawn Old Notes may be re-tendered by following the procedures described under " Procedures for Tendering" above at any time on or before 5:00 p.m., New York City time, on the expiration date.

Conditions to the Exchange Offer

Notwithstanding any other provision of the exchange offer, we shall not be required to accept for exchange, or to issue New Notes in exchange for, any Old Notes, and may terminate or amend the exchange offer, if at any time prior to the expiration date any of the following events occurs:

- there is threatened, instituted or pending any action or proceeding before, or any injunction, order or decree issued by, any court or governmental agency or other governmental regulatory or administrative agency or commission;

- a change in applicable law prohibits the consummation of such exchange offer; or

- any change, or any development involving a prospective change, has occurred or been threatened in our business, financial condition, operations or prospects and those of our subsidiaries taken as a whole that is or may be adverse to us, or we have become aware of facts that have or may have an adverse impact on the value of the Old Notes or the New Notes, which in our reasonable judgment in any case makes it inadvisable to proceed with the exchange offer and about which change or development we make a public announcement.

All conditions will be deemed satisfied or waived prior to the expiration date, unless we assert them prior to the expiration date. The foregoing conditions to the exchange offer are for our sole benefit and we may prior to the expiration date assert them regardless of the circumstances giving rise to any of these conditions, or we may prior to the expiration date waive them in whole or in part in our reasonable discretion. Our failure at any time to exercise any of the foregoing rights will not be deemed a waiver of any right.

In addition, we will not accept for exchange any Old Notes tendered, and no New Notes will be issued in exchange for any Old Notes, if at this time any stop order is threatened or in effect relating

to the registration statement of which this prospectus constitutes a part. We are required to make every reasonable effort to obtain the withdrawal of any order suspending the effectiveness of a Registration Statement at the earliest possible moment.

Exchange Agent

We have appointed The Wells Fargo Bank, National Association as the exchange agent for the exchange offer. You should direct all executed letters, questions and requests for assistance, or requests for additional copies of this prospectus to the exchange agent addressed as follows:

Delivery To:
The Wells Fargo Bank, National Association
By Hand, Registered or Certified Mail, or Overnight Courier:
Wells Fargo Bank, National Association
707 Wilshire Boulevard, 17th Floor
Los Angeles, California 90017
Attn: Maddy Hall
For Information Call: (213) 614-2588
By Facsimile: (213) 614-3355
Confirm By Telephone: (213) 614-2588

All other questions should be addressed to Edison Mission Energy, 18101 Von Karman Avenue, Suite 1700, Irvine, California 92612, Attention: Steven D. Eisenberg. If you deliver the transmit instructions via facsimile other than to any facsimile number indicated above, then your delivery or transmission will not constitute a valid delivery or transmission.

Fees and Expenses

We will not make any payment to brokers, dealers or others soliciting acceptances of the exchange offer. We have agreed to pay all expenses incidental to the exchange offer other than commissions and concessions of any broker or dealer and certain transfer taxes and will indemnify holders of the notes, including any broker-dealers, against certain liabilities, including liabilities under the Securities Act. The estimated cash expenses to be incurred in connection with the exchange offer will be paid by us and will include fees and expenses of the exchange agent, accounting, legal, printing and related fees and expenses.

Accounting Treatment

We will not recognize any gain or loss for accounting purposes upon the consummation of the exchange offer. We will amortize the expense of the exchange offer over the term of the New Notes in accordance with accounting principles generally accepted in the United States of America.

Transfer Taxes

We will pay any transfer taxes in connection with the exchange of Old Notes for New Notes in the exchange offer unless you instruct us to register New Notes in the name of, or request any Old Notes not tendered or not accepted in the exchange offer be returned to, a person other than the registered tendering holder. In those cases, you will be responsible for the payment of any applicable transfer tax.

Consequences of Exchanging or Failing to Exchange the Old Notes

Holders of Old Notes who do not exchange their Old Notes for New Notes in the exchange offer will continue to be subject to the provisions in the Indenture regarding transfer and exchange of the Old Notes and the restrictions on transfer of the Old Notes as described in the legend on the Old Notes as a consequence of the issuance of the Old Notes under exemptions from, or in transactions not subject to, the registration requirements of the Securities Act and applicable state securities laws. In general, the Old Notes may not be offered or sold, unless registered under the Securities Act, except under an exemption from, or in a transaction not subject to, the Securities Act and applicable state securities laws. Old Notes holders that do not exchange Old Notes for New Notes in the exchange offer will no longer have any registration rights with respect to such notes.

Based on existing interpretations of the Securities Act by the SEC's staff contained in several no-action letters to third parties, and subject to the immediately following sentence, we believe that the New Notes would generally be freely transferable by holders after the exchange offer without further registration under the Securities Act, subject to certain representations required to be made by each holder of New Notes, as set forth below. However, any purchaser of New Notes who is one of our "affiliates" (as defined in Rule 405 under the Securities Act) or who intends to participate in the exchange offer for the purpose of distributing the New Notes:

- will not be able to rely on the applicable interpretation of the staff of the SEC;
- will not be able to tender its Old Notes in the exchange offer; and
- must comply with the registration and prospectus delivery requirements of the Securities Act in connection with any sale or transfer of the notes unless such sale or transfer is made pursuant to an exemption from such requirements. See "Plan of Distribution."

We do not intend to seek our own interpretation regarding the exchange offer and there can be no assurance that the SEC's staff would make a similar determination with respect to the notes as it has in other interpretations to other parties, although we have no reason to believe otherwise.

USE OF PROCEEDS

We will not receive any proceeds from the exchange offer. In consideration for issuing the New Notes, we will receive in exchange the Old Notes of like principal amount, the terms of which are identical in all material respects to the New Notes. The Old Notes surrendered in exchange for New Notes will be retired and canceled and cannot be reissued. Accordingly, issuance of the New Notes will not result in any increase in our indebtedness. We have agreed to bear the expenses of the exchange offer. No underwriter is being used in connection with the exchange offer.

CAPITALIZATION

The following table sets forth our consolidated capitalization as of June 30, 2007. This table should be read in conjunction with "Use of Proceeds," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and related notes included in this prospectus.

	As of June 30, 2007
Short- and long-term obligations(1)(2):	
Old Notes	$ 2,700
7.73% senior notes due 2009	13
7.50% senior notes due 2013	500
7.75% senior notes due 2016	500
Obligations to affiliates	78
EME recourse debt	3,791
Subsidiary debt obligations	166
Total consolidated debt	3,957
Shareholder's equity(3)	1,681
Total capitalization	$ 5,638

(1) Although not included in the table above, we are obligated under an intercompany loan with our subsidiary Midwest Generation to repay $1.4 billion of intercompany loans resulting from the Powerton and Joliet sale-leaseback transaction.

(2) As of June 30, 2007, we had $522 million available under our secured credit facility and our subsidiary, Midwest Generation, had $467 million available under its $500 million senior secured working capital facility.

(3) In connection with the early repayment of the 7.73% senior notes due 2009 and Midwest Generation's 8.75% second priority senior secured notes due 2034, tender premiums of $137 million, together with remaining deferred financing costs related to the debt repaid were expensed. The after-tax impact was approximately $98 million. In addition, we made a dividend payment of $899 million to our parent, MEHC, from the proceeds of the Old Notes enabling MEHC to repay its 13.50% senior secured notes due 2008, accrued interest and tender premiums related thereto.

SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth a summary of our consolidated financial data for the periods indicated. In April 2006, EME received, as a capital contribution, ownership interests in a portfolio of wind projects located in Iowa and Minnesota and a small biomass project. These projects were previously owned by EME's affiliate, Edison Capital. EME accounted for this acquisition at Edison Capital's historical cost as a transaction between entities under common control for a net book value of approximately $76 million. The historical consolidated financial and operating results data reflects the acquisition as though EME had always owned the projects for all periods presented. The historical consolidated operating data for each of the three years ended December 31, 2006 and the financial position data as of December 31, 2006 and 2005 were derived from the audited historical consolidated financial statements included elsewhere in this prospectus. We derived the historical consolidated operating results data for the year ended December 31, 2003 and the financial position data as of December 31, 2004 from audited historical consolidated financial statements. We derived the historical consolidated operating results data for the year ended December 31, 2002 and the financial position data as of December 31, 2003 and 2002 from our accounting records. The following selected historical consolidated financial data as of June 30, 2007 and for the six months ended June 30, 2007 and 2006 has been derived from our unaudited consolidated financial statements included elsewhere in this prospectus. Our unaudited consolidated financial statements were prepared on a basis consistent with that used in preparing our audited consolidated financial statements and include all material adjustments, all of which are of a normal recurring nature, that, in the opinion of management, are necessary for a fair statement of our financial position and results of operations for the unaudited periods.

You should read the following information in conjunction with the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the historical consolidated financial statements and the related notes included elsewhere in this prospectus. Historical results are not necessarily indicative of results that may be expected for any future period.

	Years Ended December 31,					Six Months Ended June 30,	
	2002	**2003**	**2004**	**2005**	**2006**	**2006**	**2007**
	(in millions)					(in millions) (unaudited)	
Income Statement Data							
Operating revenues	$ 1,713	$ 1,779	$ 1,653	$ 2,265	$ 2,239	$ 977	$ 1,243
Operating expenses							
Fuel, plant operations and plant operating lease	1,292	1,334	1,300	1,287	1,332	658	729
Loss on lease termination, asset impairment and other charges and credits	60	304	989	7		(5)	
Depreciation and amortization	147	156	152	134	144	71	76
Administrative and general	118	138	149	154	140	64	84
Total operating expenses	1,617	1,932	2,590	1,582	1,616	788	889
Operating income (loss)	96	(153)	(937)	683	623	189	354
Equity in income from unconsolidated affiliates	196	239	218	229	186	71	80
Impairment loss on equity method investment				(55)			
Interest and other income	15	2	52	69	120	61	57
Interest expense	(313)	(303)	(298)	(300)	(279)	(145)	(129)
Loss on early extinguishment of debt				(4)	(146)	(143)	(160)

	Years Ended December 31,					Six Months Ended June 30,	
	2002	2003	2004	2005	2006	2006	2007
	(in millions)					(in millions) (unaudited)	
Income (loss) from continuing operations before income taxes and minority interest	(6)	(215)	(965)	622	504	33	202
Provision (benefit) for income taxes	(28)	(121)	(406)	208	189	1	68
Minority interest	(2)	(2)	(1)		1		
Income (loss) from continuing operations	20	(96)	(560)	414	316	32	134
Income (loss) from operations of discontinued subsidiaries (including gain on disposal of $533 million in 2004), net of tax	22	124	690	29	98	77	5
Income before accounting change	42	28	130	443	414	109	139
Cumulative effect of change in accounting, net of tax(1)	(14)	(9)		(1)			
Net income	$ 28	$ 19	$ 130	$ 442	$ 414	$ 109	$ 139

(1) Our 2005 loss from a change in accounting principle resulted from the adoption of a new accounting standard for conditional asset retirements. Our 2003 loss from a change in accounting principle resulted from adoption of a new accounting standard for asset retirement obligations. Our 2002 loss from a change in accounting principle resulted from adoption of a new accounting standard for goodwill and other intangible assets.

	As of December 31,					As of June 30, 2007
	2002	2003(2)	2004(3)	2005	2006	
	(in millions)					(in millions) (unaudited)
Balance Sheet Data						
Assets	$ 11,220	$ 12,299	$ 7,087	$ 7,023	$ 7,250	$ 7,114
Current liabilities	1,356	1,203	994	846	646	504
Long-term obligations	3,022	2,919	3,530	3,330	3,035	3,845
Preferred securities	281					
Shareholder's equity	1,751	1,954	1,745	1,910	2,582	1,681

(2) In the fourth quarter of 2003, we adopted FIN No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," which required us to reflect the junior subordinated deferrable debentures as a liability, which under the prior accounting treatment would have been eliminated in consolidation, instead of the Monthly Income Preferred Securities.

(3) Assets decreased in 2004 compared to 2003 due to completion of the sale of substantially all of our international assets.

	Years Ended December 31,					Six Months Ended June 30,	
	2002	2003	2004	2005	2006	2006	2007
	(in millions)					(in millions) (unaudited)	
Other Data							
Ratio of earnings to fixed charges(4)(5)	1.18x			2.23x	2.01x	1.20x	1.71x

(4) For purposes of computing the ratio of earnings to fixed charges, earnings are divided by fixed charges. "Earnings" represent the aggregate of income (loss) for continuing operations before income taxes and minority interest. "Fixed charges" represent interest (whether expensed or capitalized), dividends on preferred securities for continuing operations, amortization of debt discount and the interest component of rental expense.

(5) For the years ended December 31, 2004 and 2003, there was a fixed charge deficiency of $953 million and $85 million, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations is presented in four sections:

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MANAGEMENT'S OVERVIEW; CRITICAL ACCOUNTING POLICIES

Management's Overview

Introduction

EME is a holding company which operates primarily through its subsidiaries and affiliates which are engaged in the business of developing, acquiring, owning or leasing, operating and selling energy and capacity from independent power production facilities. EME's subsidiaries or affiliates have typically been formed to own all or an interest in one or more power plants and ancillary facilities, with each plant or group of related plants being individually referred to by EME as a project. As of June 30, 2007, EME's subsidiaries and affiliates owned or leased interests in 32 operating power plants and 6 projects under construction.

EME's subsidiaries and affiliates have financed the development and construction or acquisition of its projects by capital contributions from EME and the incurrence of debt obligations by its subsidiaries and affiliates owning the operating facilities. These project level debt obligations are generally structured as non-recourse to EME, with several exceptions, including EME's guarantee of the Powerton and Joliet leases as part of a refinancing of indebtedness incurred by its project subsidiary to purchase the Illinois Plants. As a result, these project level debt obligations have structural priority with respect to revenues, cash flows and assets of the project companies over debt obligations incurred by EME itself. In this regard, EME has, itself, borrowed funds to make the equity contributions required of it for its projects and for general corporate purposes. Since EME does not, itself, directly own any revenue producing generation facilities, it depends for the most part on cash distributions from its projects to meet its debt service obligations, and to pay for general and administrative expenses. Distributions to EME from projects are generally only available after all current debt service obligations at the project level have been paid and are further restricted by contractual restrictions on distributions included in the documentation evidencing the project level debt obligations.

Business Strategy

EME's business strategy includes the following core elements:

- Optimizing the value of its existing generation assets through:
  - operational excellence focused on long-term cost effective maintenance;
  - integration of commercial marketing and trading activities with plant operations to enhance gross margin; and

- effective participation in regulatory rule-making in markets where EME operates.

Diversifying the fuel type of its generation assets through:

- developing and acquiring new renewable energy projects, primarily wind;
- developing and acquiring natural gas-fired power projects in locations where existing or projected capacity for generation is constrained; and
- developing new clean coal generation projects, such as integrated gasification combined cycle projects.

Entering into more mid- to long-term power sales contracts in order to complement its merchant sales activities.

Reducing cash flow volatility from merchant power plants through asset-based commodity hedging activities.

Leveraging the knowledge and expertise in trading to enhance financial performance within a disciplined risk management structure.

Business Development

EME has undertaken a number of activities in 2006 and 2007 with respect to wind projects, including the following:

Jointly completed development and commenced construction of six new wind projects with third parties, including:

- the 95 MW Sleeping Bear wind project located in Oklahoma,
- the 61 MW Mountain Wind I project located in Wyoming,
- the 50 MW Jeffers wind project located in Minnesota,
- the 38 MW Lookout wind project located in Pennsylvania,
- the 29 MW Forward wind project also located in Pennsylvania, and
- the 20 MW Odin wind project located in Minnesota.

Completed construction and commenced operations of the 161 MW Wildorado wind project located in Texas, the 15 MW Hardin wind project located in Iowa and the 21 MW Crosswinds wind project also located in Iowa.

During 2007, EME purchased 1,028 MW of turbines for delivery in 2008 and 2009 from Mitsubishi Power Systems Americas, Inc. and Suzlon Wind Energy Corporation with an aggregate purchase price of approximately $1.2 billion.

In April 2007, EME acquired six projects in development in Texas and Oklahoma totaling 700 MW. These projects are in various stages of development with target completion dates of 2008

through 2010. The purchase price for these projects is comprised of an initial payment and subsequent payments tied to milestones and adjustments based on EME's projected internal rate of return in individual projects. Completion of development of these projects is dependent on a number of items, including, among other things, obtaining power sales agreements, and in certain cases, permits and interconnection agreements.

In August 2007, EME acquired a 99.9% interest in a 150 MW wind project under development in Texas. The project consists of two phases. Construction of Phase I of this project (80 MW) commenced in August 2007 with completion scheduled during the first quarter of 2008. Phase II of this project (70 MW) is scheduled for completion during the fourth quarter of 2008. The total estimated capital cost, excluding capitalized interest, is approximately $266 million. The project plans to sell electricity into the Electric Reliability Council of Texas (ERCOT) market as a merchant wind generator.

As of June 30, 2007, EME had a development pipeline of potential wind projects with an installed capacity of approximately 3,100 MW (the development pipeline represents potential projects with respect to which EME either owns the project rights or has exclusive negotiation rights).

PJM Reliability Pricing Model

In April 2007, PJM Interconnection, LLC (PJM) completed the first capacity auction under the PJM Reliability Pricing Model. EME participated in the auction for the period June 1, 2007 through May 31, 2008. After accounting for previous forward sales of capacity, EME's subsidiary Edison Mission Marketing & Trading, Inc. (EMMT) sold net 2,628 MW of capacity from its fossil fuel plants located in Illinois (the Illinois Plants) and net 786 MW of capacity from the Homer City electric generating station in Pennsylvania (the Homer City facilities). The Illinois Plants and the Homer City facilities are located in the "Rest of Market" area which had a clearing price of $40.80 per MW-day.

In July 2007, EME participated in the auction for the period June 1, 2008 through May 31, 2009. After accounting for previous forward sales of capacity, EMMT sold net 3,283 MW of capacity from the Illinois Plants and net 820 MW of capacity from the Homer City facilities. The Illinois Plants and the Homer City facilities are located in the "Rest of Market" area which had a clearing price of $111.92 per MW-day.

For further discussion regarding the PJM and recent auctions, see "Market Risk Exposures Commodity Price Risk Capacity Price Risk."

Illinois Auction

In September 2006, the first Illinois power procurement auction was held by Commonwealth Edison according to the rules approved by the Illinois Commerce Commission. Through the auction, EMMT entered into two load requirements services contracts. Under the terms of these agreements, Midwest Generation expects to deliver, through EMMT, electricity, capacity and specified ancillary, transmission and load following services necessary to serve a portion of Commonwealth Edison's residential and small commercial customer load. The estimated megawatt-hours for the remainder of 2007, 2008 and 2009 under these energy supply agreements are 4.1 million, 5.6 million and 1.6 million, respectively. The amount of power sold under these agreements can vary significantly with variations in load. See "Market Risk Exposures Commodity Price Risk Energy Price Risk Affecting Sales from the Illinois Plants" for further discussion of Midwest Generation's hedge position.

Illinois Settlement

On July 24, 2007, Midwest Generation and EMMT, along with other power generation companies and utilities, entered into a settlement agreement with the Illinois Attorney General. The settlement was subject to the passage of legislation which will, among other things, establish a new Illinois Power Agency to manage future power procurement for Commonwealth Edison and Ameren Corporation (Ameren) (beginning with the planning year June 1, 2009 through May 31, 2010). The settlement legislation was passed by the Illinois legislature on July 26, 2007, and was signed by the Governor of Illinois on August 28, 2007.

As part of the settlement, Midwest Generation has agreed to pay $25 million over three years toward approximately $1 billion in utility customer rate relief and startup costs of the new Illinois Power Agency. The remainder is to be funded by subsidiaries of Exelon Corporation, subsidiaries of Ameren, Dynegy Holdings Inc., and Mid-American Energy Company. Also as part of the settlement, the Illinois Attorney General has agreed to file motions to dismiss auction-related complaints filed at the Federal Energy Regulatory Commission (the FERC), the Illinois Commerce Commission and in the Illinois courts.

Subject to the foregoing, Midwest Generation plans to make a payment of $7.5 million within ten business days after the settlement becomes effective (or on such later date as the Illinois Attorney General may specify in writing), followed by monthly payments of $750,000 beginning in January 2008 and continuing until the total commitment has been funded. These payments are non-refundable; however, Midwest Generation's obligations to make the monthly payments will cease if, at any time prior to December 2009, as further described in the rate relief package and related agreements, Illinois imposes an electric rate freeze or an additional tax on generators.

Environmental Developments Regarding Emissions

On December 11, 2006, Midwest Generation entered into an agreement with the Illinois EPA to reduce mercury, nitrogen oxide (NOx) and sulfur dioxide (SO2) emissions at Midwest Generation's Illinois coal-fired power plants, which Midwest Generation believes will provide reasonable certainty of the timing and amount of emissions reductions which will be required of the Illinois Plants for these pollutants through 2018. The agreement requires Midwest Generation to achieve specified emissions reductions through a combination of environmental retrofits or unit shutdowns. Capital expenditures are estimated (in 2006 dollars) between $2.7 billion and $3.4 billion. See "Liquidity and Capital Resources Environmental Matters and Regulations Air Quality Regulation Clean Air Act Illinois" for further discussion.

Refinancing

Senior Notes Offering

On June 6, 2006, EME completed a private offering of $500 million of its 7.50% senior notes due 2013 and $500 million of its 7.75% senior notes due 2016. The proceeds of the offering were used, together with cash on hand, to purchase substantially all of EME's outstanding 10% senior notes due 2008 and 9.875% senior notes due 2011. On December 6, 2006, EME redeemed all of its remaining 10% senior notes and 9.875% senior notes outstanding. In connection with the purchase of these notes, EME recorded a $146 million loss on early extinguishment of debt in 2006.

On May 7, 2007, EME completed a private offering of $1.2 billion of its 7.00% senior notes due May 15, 2017, $800 million of its 7.20% senior notes due May 15, 2019 and $700 million of its 7.625%

senior notes due May 15, 2027. EME will pay interest on the senior notes on May 15 and November 15 of each year, beginning on November 15, 2007. The net proceeds were used, together with cash on hand, to:

- purchase substantially all of EME's outstanding 7.73% senior notes due 2009,
- purchase substantially all of Midwest Generation's 8.75% second priority senior secured notes due 2034,
- repay the outstanding balance of Midwest Generation's senior secured term loan facility ($327.8 million), and
- make a dividend payment of $899 million to MEHC which enabled MEHC to purchase substantially all of its 13.5% senior secured notes due 2008.

Redemption of MEHC Senior Secured Notes

On June 25, 2007, MEHC redeemed in full its senior secured notes. As a result of the redemption, EME is no longer subject to financial and investment restrictions that were contained in the indenture pursuant to which the senior secured notes were issued. Following the redemption, MEHC no longer files reports with the SEC.

The refinancing activities improved EME's overall liquidity, operating flexibility and ability to capitalize on growth opportunities. EME recorded a total pre-tax loss of approximately $160 million (approximately $98 million after tax) on early extinguishment of debt during the second quarter of 2007.

Credit Agreement Amendments

During the second quarter of 2007, EME amended its existing $500 million secured credit facility, increasing the total borrowings available thereunder to $600 million, and Midwest Generation amended and restated its existing $500 million senior secured working capital facility. The changes to the senior secured working capital facility included a reduction in the interest rate, a longer maturity date, and fewer restrictive covenants. Midwest Generation intends to use its secured working capital facility to provide credit support for its hedging activities and for general working capital purposes. Midwest Generation may also support its hedging activities by granting first or second priority liens to eligible hedge counterparties.

ERP Initiative

During 2006, EME commenced a new initiative as part of an Edison International enterprise-wide project to implement an integrated enterprise resource planning (ERP) application from SAP during the next two years. The implementation of this application will replace EME's existing financial, human resources, materials management, and fuel management information systems with SAP's integrated ERP application. The procurement and material management systems were implemented for three of the Illinois Plants in July 2007, as well as the EME financial systems. Implementation of these applications at the remaining Illinois Plants and Homer City facilities began on September 1, 2007, and implementation of the human resources systems is scheduled for the second quarter of 2008 as part of an Edison International enterprise-wide project.

Critical Accounting Policies

Introduction

The accounting policies described below are viewed by management as "critical" because their correct application requires the use of material judgments and estimates, and they have a material impact on EME's results of operations and financial position.

Derivative Financial Instruments and Hedging Activities

EME uses derivative financial instruments for hedging activities and trading purposes. Derivative financial instruments are mainly utilized to manage exposure from changes in electricity and fuel prices and interest rates. EME follows Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133), which requires derivative financial instruments to be recorded at their fair value unless an exception applies. SFAS No. 133 also requires that changes in a derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. For derivatives that qualify for hedge accounting, depending on the nature of the hedge, changes in fair value are either offset by changes in the fair value of the hedged assets, liabilities or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings. For further discussion, see "Market Risk Exposures Accounting for Energy Contracts."

Management's judgment is required to determine if a transaction meets the definition of a derivative and, if it does, whether the normal sales and purchases exception applies or whether individual transactions qualify for hedge accounting treatment. The majority of EME's long-term power sales and fuel supply agreements related to its generation activities either: (1) do not meet the definition of a derivative because they are not readily convertible to cash, or (2) qualify as normal purchases and sales and are, therefore, recorded on an accrual basis.

Derivative financial instruments used for trading purposes include forwards, futures, options, swaps and other financial instruments with third parties. EME records derivative financial instruments used for trading at fair value. The majority of EME's derivative financial instruments with a short-term duration (less than one year) are valued using quoted market prices. In the absence of quoted market prices, derivative financial instruments are valued considering the time value of money, volatility of the underlying commodity, and other factors as determined by EME. Resulting gains and losses are recognized in operating revenues in the accompanying consolidated income statements in the period of change. Derivative assets include open financial positions related to derivative financial instruments recorded at fair value, including cash flow hedges, that are "in-the-money" and the present value of net amounts receivable from structured transactions. Derivative liabilities include open financial positions related to derivative financial instruments, including cash flow hedges, that are "out-of-the-money."

Determining the fair value of derivatives under SFAS No. 133 is a critical accounting policy because the fair value of a derivative is susceptible to significant change resulting from a number of factors, including: volatility of energy prices, credit risks, market liquidity and discount rates. See "Market Risk Exposures," for a description of risk management activities and sensitivities to change in market prices.

EME enters into master agreements and other arrangements in conducting hedging and trading activities with a right of setoff in the event of bankruptcy or default by the counterparty. These types of transactions are reported net in the balance sheet in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 39, "Offsetting Amounts Related to Certain Contracts."

Impairment of Long-Lived Assets

EME follows SFAS No. 144. EME evaluates long-lived assets whenever indicators of impairment exist. This accounting standard requires that if the undiscounted expected future cash flow from a company's assets or group of assets (without interest charges) is less than its carrying value, asset impairment must be recognized in the financial statements. The amount of impairment is determined by the difference between the carrying amount and fair value of the asset.

The assessment of impairment is a critical accounting policy because significant management judgment is required to determine: (1) if an indicator of impairment has occurred, (2) how assets

should be grouped, (3) the forecast of undiscounted expected future cash flow over the asset's estimated useful life to determine if an impairment exists, and (4) if an impairment exists, the fair value of the asset or asset group. Factors that EME considers important, which could trigger an impairment, include operating losses from a project, projected future operating losses, the financial condition of counterparties, or significant negative industry or economic trends. During 2005 and 2004, EME recorded impairment charges of $55 million and $35 million, respectively, related to specific assets included in continuing operations. See "Results of Operations Annual Results of Continuing Operations for 2006, 2005 and 2004 Earnings from Consolidated Operations Illinois Plants" and " Earnings from Unconsolidated Affiliates Impairment Loss on Equity Method Investment."

Off-Balance Sheet Financing

EME has entered into sale-leaseback transactions related to the Powerton and Joliet plants in Illinois and the Homer City facilities in Pennsylvania. See "Liquidity and Capital Resources Contractual Obligations, Commitments and Contingencies Contractual Obligations at December 31, 2006 Operating Lease Obligations." Each of these transactions was completed and accounted for by EME as an operating lease in its consolidated financial statements in accordance with SFAS No. 98, which requires, among other things, that all the risk and rewards of ownership of assets be transferred to a new owner without continuing involvement in the assets by the former owner other than as normal for a lessee. The sale-leaseback transactions of these power plants were complex matters that involved management judgment to determine compliance with SFAS No. 98, including the transfer of all the risk and rewards of ownership of the power plants to the new owner without EME's continuing involvement other than as normal for a lessee. These transactions were entered into to provide a source of capital either to fund the original acquisition of the assets or to repay indebtedness previously incurred for the acquisition. Each of these leases uses special purpose entities.

Based on existing accounting guidance, EME does not record these lease obligations in its consolidated balance sheet. If these transactions were required to be consolidated as a result of future changes in accounting guidance, it would: (1) increase property, plant and equipment and long-term obligations in the consolidated financial position, and (2) impact the pattern of expense recognition related to these obligations because EME would likely change from its current straight-line recognition of rental expense to an annual recognition of the straight-line depreciation on the leased assets as well as the interest component of the financings which is weighted more heavily toward the early years of the obligations. The difference in expense recognition would not affect EME's cash flows under these transactions. See "Liquidity and Capital Resources Off-Balance Sheet Transactions Sale-Leaseback Transactions."

Contract Indemnities

During 2004, EME sold a majority of its international operations. The asset sale agreements contain indemnities from EME to the purchasers, including indemnification for pre-closing environmental liabilities and for pre-closing foreign taxes imposed with respect to operations of the assets prior to the sale. At June 30, 2007, EME had recorded an estimated liability of $94 million related to these matters.

In addition, Midwest Generation agreed to reimburse Commonwealth Edison and Exelon Generation Company, LLC (Exelon Generation) for 50% of specific asbestos claims pending as of February 2003 and related expenses less recovery of insurance costs, and agreed to a sharing arrangement for liabilities and expenses associated with future asbestos-related claims as specified in a supplemental agreement. See "Liquidity and Capital Resources Contractual Obligations, Commitments and Contingencies Commercial Commitments." Midwest Generation engaged an independent actuary during 2004 with extensive experience in performing asbestos studies to estimate future losses based on its claims experience and other available information. In calculating future

losses, the actuary made various assumptions, including, but not limited to, the settlement of future claims under the supplemental agreement with Commonwealth Edison as described above, the distribution of exposure sites, and that the filing date of asbestos claims will not be after 2045. At June 30, 2007, Midwest Generation had recorded a liability of $64 million related to this contract indemnity.

Income Taxes

SFAS No. 109, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. EME uses the asset and liability method of accounting for deferred income taxes and provides deferred income taxes for all significant income tax temporary differences. See "Audited Consolidated Financial Statements of Edison Mission Energy Notes to Consolidated Financial Statements Note 10. Income Taxes" for additional details.

As part of the process of preparing its consolidated financial statements, EME is required to estimate its income taxes in each jurisdiction in which it operates. This process involves estimating actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as depreciation, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within EME's consolidated balance sheet. In addition, estimated taxes for uncertain tax positions are accrued and included in other long-term liabilities in the consolidated balance sheet.

For additional information regarding EME's accounting policies, see "Audited Consolidated Financial Statements of Edison Mission Energy Notes to Consolidated Financial Statements Note 1. Summary of Significant Accounting Policies."

RESULTS OF OPERATIONS

EME operates in one line of business, independent power production. Operating revenues are primarily derived from the sale of power generated from the Illinois Plants and the Homer City facilities. Intercompany interest expense and income between EME and its consolidated subsidiaries have been eliminated in the following project results, except as described below with respect to loans provided to EME from a wholly owned subsidiary, Midwest Generation, and loans from Midwest Generation to EMMT for margining. Equity in income from unconsolidated affiliates relates to energy projects accounted for under the equity method. EME recognizes its proportional share of the income or loss of such entities.

On April 1, 2006, EME received, as a capital contribution, ownership interests in a portfolio of wind projects located in Iowa and Minnesota and a small biomass project. These projects were previously owned by EME's affiliate, Edison Capital. Both MEHC and Edison Capital are wholly owned subsidiaries of Edison Mission Group, which is a subsidiary of Edison International. EME accounted for this acquisition at Edison Capital's historical cost as a transaction between entities under common control. Therefore, these consolidated financial statements include the results of operations, financial position and cash flows of the acquired projects as though EME had such ownership throughout the periods presented.

EME uses the words "earnings" or "losses" in this section to describe income or loss from continuing operations before income taxes.

Interim Results of Continuing Operations

The following section provides a summary of the operating results for the second quarters of 2007 and 2006 and six months ended June 30, 2007 and 2006 together with discussions of the contributions by specific projects and of other significant factors affecting these results.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Project Earnings (Losses) Before Income Taxes(1)				
Consolidated operations				
Illinois Plants	$ 88	$ 25	$ 277	$ 152
Homer City	38	35	102	33
Energy Trading(2)	36	26	62	55
San Juan Mesa	1	1	3	5
Gain on sale of assets				4
Storm Lake	2	3	4	3
Wildorado	2		2	
Other	1	(1)	3	
Unconsolidated affiliates				
Big 4 projects	45	32	63	55
Sunrise	6	5	4	3
Doga	10	5	14	4
Other	4	2	9	3
	233	133	543	317
Corporate interest income	18	20	38	37
Corporate interest expense	(81)	(64)	(136)	(130)
Corporate administrative and general	(36)	(25)	(68)	(49)
Loss on early extinguishment of debt	(160)	(143)	(160)	(143)
Other income (expense), net	(2)		(3)	10
	$ (28)	$ (79)	$ 214	$ 42

(1) Project earnings are equal to income from continuing operations before income taxes, except with respect to wind projects, which also include production tax credits. Wind project earnings, including the production tax credits set forth in the table below, were $6 million and $4 million for the second quarters of 2007 and 2006, respectively, and $11 million and $9 million for the six months ended June 30, 2007 and 2006, respectively. The project earnings for the wind projects include $7 million and $4 million of production tax credits for the second quarters of 2007 and 2006, respectively, and $12 million and $9 million for the six months ended June 30, 2007 and 2006, respectively. Production tax credits are recognized as wind energy is generated based upon a per kilowatt-hour rate prescribed in applicable federal and state statutes. Under generally accepted accounting principles (GAAP), production tax credits generated by the wind projects are recorded as a reduction in income taxes. Accordingly, project earnings (losses) represent a non-GAAP performance measure which may not be comparable to those of other companies. Management believes that inclusion of production tax credits in project earnings for wind projects is more meaningful for investors as federal and state subsidies are an integral part of the economics of these projects. The following table reconciles the total project earnings as shown above with income from continuing operations before income taxes under GAAP:

	Three Months Ended June 30,		Six Months Ended June 30	
	2007	2006	2007	2006

	Three Months Ended June 30,		Six Months Ended June 30	
	(in millions)			
Project earnings (losses)	$ (28)	$ (79)	$ 214	$ 42
Less: Production tax credits	(7)	(4)	(12)	(9)
Income (loss) from continuing operations before income taxes	$ (35)	$ (83)	$ 202	$ 33

(2) Income from energy trading represents the gains recognized from price changes related to contracts for electricity, fuels and transmission congestion. The overhead cost of energy trading is included in administrative and general expenses.

Earnings from Consolidated Operations

Illinois Plants

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Operating Revenues	$ 334	$ 266	$ 765	$ 612
Operating Expenses				
Fuel	85	72	194	166
Gain on sale of emission allowances(1)			(4)	(6)
Plant operations	127	115	216	196
Plant operating leases	18	18	37	37
Depreciation and amortization	25	25	50	50
Loss from disposal of assets	1		1	
Administrative and general	6	7	11	12
Total operating expenses	262	237	505	455
Operating Income	72	29	260	157
Other Income (Expense)				
Interest income on note receivable from EME	28	28	56	56
Interest expense and other	(12)	(32)	(39)	(61)
Total other income (expense)	16	(4)	17	(5)
Income Before Taxes	$ 88	$ 25	$ 277	$ 152
Statistics				
Generation (in GWh)				
Energy only contracts	4,445	5,493	11,143	12,738
Load requirements services contracts(2)	1,681		3,613	
Total	6,126	5,493	14,756	12,738
Aggregate plant performance				
Equivalent availability(3)	61.5%	66.0%	74.7%	76.4%
Capacity factor(4)	50.0%	44.8%	60.5%	52.3%
Load factor(5)	81.3%	67.9%	81.1%	68.4%
Forced outage rate(6)	6.0%	7.7%	6.0%	5.0%
Average realized price/MWh				
Energy only contracts(7)	$ 49.04	$ 46.70	$ 49.06	$ 45.85
Load requirements services contracts(8)	$ 62.58	$	$ 62.21	$
Capacity revenue only (in millions)	$ 4	$ 7	$ 6	$ 13
Average fuel costs/MWh	$ 13.82	$ 13.42	$ 13.13	$ 13.14

(1) The Illinois Plants sold excess SO2 emission allowances to the Homer City facilities at fair market value. Sales to the Homer City facilities were $10 million for both the quarter ended and six months ended June 30, 2007. These sales reduced operating expenses. EME eliminated $8 million of intercompany profit during the second quarter of 2007 on emission allowances sold but not yet used by the Homer City facilities at June 30, 2007. In addition, EME recorded $4 million and $6 million of intercompany profit during the first quarters of 2007 and 2006, respectively, on emission allowances sold by the Illinois Plants to the Homer City facilities in the fourth quarters of 2006 and 2005, respectively, but not used by the Homer City facilities until the first quarters of 2007 and 2006, respectively.

(2) Represents two load requirements services contracts, awarded as part of an Illinois auction, with Commonwealth Edison that commenced on January 1, 2007.

(3) The equivalent availability factor is defined as the number of MWh the coal units are available to generate electricity divided by the product of the capacity of the coal units (in MW) and the number of hours in the period. Equivalent availability reflects the impact of the unit's inability to achieve full load, referred to as derating, as well as outages which result in a complete unit shutdown. The coal units are not available during periods of planned and unplanned maintenance.

(4) The capacity factor is defined as the actual number of MWh generated by the coal plants divided by the product of the capacity of the coal plants (in MW) and the number of hours in the period.

(5) The load factor is determined by dividing capacity factor by the equivalent availability factor.

(6) Midwest Generation refers to unplanned maintenance as a forced outage.

(7) The average realized energy price reflects the average price at which energy is sold into the market including the effects of hedges, real-time and day-ahead sales and PJM fees and ancillary services. It is determined by dividing (i) operating revenue less unrealized SFAS No. 133 gains (losses) and other non-energy related revenue by (ii) generation. Revenue related to capacity sales are excluded from the calculation of average realized energy price.

(8) The average realized price reflects the contract price for sales to Commonwealth Edison under load requirements services contracts that include energy, capacity and ancillary services. It is determined by dividing (i) contract revenue less PJM operating and ancillary charges by (ii) generation.

Earnings from the Illinois Plants increased $63 million and $125 million for the second quarter of 2007 and six months ended June 30, 2007, respectively, compared to the corresponding periods of 2006. The increases in earnings were primarily due to higher energy revenues resulting from higher generation and average realized energy prices as compared to 2006 and lower interest expense due to the repayment of debt in May 2007. Partially offsetting these increases were higher planned maintenance costs. Earnings for the six months ended June 30, 2007 were also adversely affected by an increase in unrealized losses in 2007 related to hedge contracts described below.

Included in operating revenues were unrealized gains (losses) of $4 million and $1 million for the second quarters of 2007 and 2006, respectively, and $(18) million and $11 million for the six months ended June 30, 2007 and 2006, respectively. Unrealized gains (losses) are primarily due to power contracts that did not qualify for hedge accounting under SFAS No. 133 (sometimes referred to as economic hedges). These energy contracts were entered into to hedge the price risk related to projected sales of power. During 2007, power prices increased, resulting in mark-to-market losses on economic hedges. At June 30, 2007, unrealized losses of $11 million were recognized primarily from economic hedges related to subsequent periods. See "Market Risk Exposures Commodity Price Risk" for more information regarding forward market prices.

The earnings of the Illinois Plants included interest income of $28 million for both the second quarters of 2007 and 2006 and $56 million for both the six months ended June 30, 2007 and 2006 related to loans to EME. In August 2000, Midwest Generation, which owns or leases the Illinois Plants, entered into a sale-leaseback transaction of the Powerton-Joliet facilities. The proceeds from the sale of these facilities were loaned to EME, which also provided a guarantee of the related lease obligations of Midwest Generation. The Powerton-Joliet sale-leaseback is recorded as an operating lease for accounting purposes.

Homer City

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in millions)			
Operating Revenues	$ 176	$ 151	$ 374	$ 274
Operating Expenses				
Fuel(1)	68	68	140	129
Gain on sale of emission allowances(2)				
Plant operations	41	28	75	63
Plant operating leases	26	26	51	51
Depreciation and amortization	4	4	7	8
Administrative and general	1	1	2	2

	2004	2005	2006	2007	2008
Net income (loss)	$ 12.1	$ 21.0	$ 12.8	$ (24.1)	$ 5.0
Add:					
Interest expense, net			(0.1)	7.2	14.2
Integration, merger related costs and other charges			2.9	57.7	26.7
Provision (benefit) for income taxes	7.6	13.3	8.4	(13.4)	3.3
Effect of change in estimate on cost of goods sold				(3.1)	
Impairment of intangible assets					14.8
Depreciation and amortization expense	2.4	5.8	8.8	20.2	28.5
Adjusted EBITDA	$ 22.1	$ 40.1	$ 32.8	$ 44.5	$ 92.5
Adjusted EBITDA Margin	6.1%	7.7%	5.0%	3.7%	4.8%

Reconciliation of Adjusted EBITDA to Net Operating Cash Flows

	Years Ended December 31,				
	2004	**2005**	**2006**	**2007**	**2008**
Adjusted EDITDA	$ 22.1	$ 40.1	$ 32.8	$ 44.5	$ 92.5
Interest expense, net			0.1	(7.2)	(14.2)
(Provision) benefit for income taxes	(7.6)	(13.3)	(8.4)	13.4	(3.3)
Effect of change in estimate on cost of goods sold				3.1	
Integration, merger related costs and other charges			(2.9)	(22.6)	(22.2)
Provision for bad debt	1.8	(1.1)	7.3	16.2	24.7
Stock-based compensation		0.8	0.9	1.5	4.9
Amortization of deferred financing fees				0.2	0.4
Loss on disposition of equipment			0.5	0.1	0.2
Deferred income taxes	0.3	(2.0)	(1.6)	(13.4)	2.8
Other	0.8	(1.1)	(3.5)	(0.9)	(0.5)
Changes in assets and liabilities	(9.0)	(18.1)	(15.2)	1.4	(19.6)
Net Cash Flows from Operating Activities	$ 8.4	$ 5.3	$ 10.0	$ 36.3	$ 65.7

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Report on Form 10-K contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which reflect the Corporation s current estimates, expectations and projections about the Corporation s future results, performance, prospects and opportunities. Forward-looking statements include, among other things, the information concerning the Corporation s possible future results of operations including revenue, costs of goods sold, and gross margin, business and growth strategies, financing plans, the Corporation s competitive position and the effects of competition, the projected growth of the industries in which we operate, and the benefits and synergies to be obtained from the Pharmacy Transaction and the Corporation s ability to consummate strategic acquisitions. Forward-looking statements include statements that are not historical facts and can be identified by forward-looking words such as anticipate , believe , could , estimate , expect , intend , plan , may , should , will , would, projec expressions. These forward-looking statements are based upon information currently available to us and are subject to a number of risks, uncertainties and other factors that could cause the Corporation s actual results, performance, prospects or opportunities to differ materially from those expressed in, or implied by, these forward-looking statements. Important factors that could cause the Corporation s actual results to differ materially from the results referred to in the forward-looking statements we make in this report include:

- changes in or the failure to achieve the underlying assumptions and expectations related to the Pharmacy Transaction;
- availability of financial and other resources to us after the Pharmacy Transaction, including our expectations regarding liquidity and capital resources;
- the Corporation s access to capital, credit ratings, indebtedness and ability to raise additional financings and operate under the terms of the Corporation s debt obligations;
- a determination by the IRS that the Pharmacy Transaction should be treated as a taxable transaction, in whole or in part, and any tax liabilities and indemnification obligations related thereto;
- the Corporation s ability to operate under the terms of the Tax Matters Agreement, including the covenants and restrictions which limit the Corporation s discretion in the operation of the Corporation s business;
- certain restrictions resulting from continuing relationships with the Corporation s former parent companies;
- the effects of intense competition in the markets in which we operate;
- the effects of retaining existing customers and service contracts and ability to attract new customers for growth of the Corporation s business;
- the effects of renegotiating contract pricing relating to significant customers;

the effects of the loss or bankruptcy of or default by a significant customer or customers, supplier or other entity relevant to the Corporation s operations;

the Corporation s ability to implement its business strategy, including, without limitation, the Corporation s ability to integrate the formerly separate institutional pharmacy businesses of the Corporation s former parent companies, including costs associated with such integration, and resolve any inefficiencies in connection with the Pharmacy Transaction;

the Corporation s ability to successfully pursue the Corporation s development activities and successfully integrate new operations and systems, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations;

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the Corporation s ability to control costs, particularly labor and employee benefit costs, rising pharmaceutical costs and regulatory compliance costs;

the effects of healthcare reform and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare and institutional pharmacy services industries;

changes in the reimbursement rates or methods of payment from Medicare and Medicaid and other third party payors, or the implementation of other measures to reduce the reimbursement for the Corporation s services or the services of the Corporation s customers and the impact of Medicare Part D;

the Corporation s ability, and the ability of the Corporation s customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;

the ability to obtain financing for acquisitions from the various lenders in the senior secured credit facility;

further consolidation of managed care organizations and other third party payors;

political and economic conditions nationally, regionally and in the markets in which we operate;

natural disasters, war, civil unrest, terrorism, fire, floods, earthquakes, hurricanes or other matters beyond the Corporation s control;

the increases in energy costs and the impact on the costs of delivery expense and utility expense;

elimination of, changes in or the Corporation s failure to satisfy pharmaceutical manufacturers rebate programs;

the Corporation s ability to obtain goods and services provided by the Corporation s former parent companies under the Transition Services Agreements, IT Services Agreement and Prime Vendor Agreement at comparable prices and on terms as favorable as those obtained under such agreements;

the Corporation s ability to attract and retain key executives, pharmacists and other healthcare personnel;

the Corporation s ability to comply with the terms of its Corporate Integrity Agreement entered into between the Office of Inspector General of the Department of Health and Human Services and PharMerica LTC on March 29, 2005;

the Corporation s risk of loss not covered by insurance;

the outcome of litigation to which the Corporation is a party from time to time;

changes in accounting rules and standards, audits, compliance with the Sarbanes-Oxley Act and regulatory investigations;

the effects on the Corporation s results of operations related to the accounting for the costs of acquisitions as a result of new accounting rules;

changes in market conditions that would result in the impairment of goodwill or other assets of the Corporation;

changes in market conditions in which we operate that would influence the value of the Corporation s stock;

changes in volatility of the Corporation s stock price and the risk of litigation following a decline in the price of the Corporation s stock price;

the adequacy of our facilities to accommodate our anticipated needs;

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- the Corporation s ability to anticipate a shift in demand for generic drug equivalents;

- adverse results in material litigation matters or governmental inquiries;

- the effects of changes to critical accounting estimates; and

- other factors, risks and uncertainties referenced in the Corporation s filings with the Commission, including the Risk Factors set forth in this Report on Form 10-K.

YOU ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON ANY FORWARD-LOOKING STATEMENTS, ALL OF WHICH SPEAK ONLY AS OF THE DATE OF THIS ANNUAL REPORT. EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT ANY EVENTS OR CIRCUMSTANCES AFTER THE DATE OF THIS ANNUAL REPORT OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS. ALL SUBSEQUENT WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS ATTRIBUTABLE TO US OR ANY PERSON ACTING ON THE CORPORATION S BEHALF ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THE CAUTIONARY STATEMENTS CONTAINED OR REFERRED TO IN THIS SECTION AND IN OUR RISK FACTORS SET FORTH IN PART I, ITEM 1A OF THIS REPORT ON FORM 10-K AND IN THE SECTION CAPTIONED RISK FACTORS IN THE FORM S-4/S-1, AND IN OTHER REPORTS FILED WITH THE SEC BY THE CORPORATION.

General

Pharmacy Transaction

The Corporation was formed on October 23, 2006 by Kindred and AmerisourceBergen for the purpose of consummating the transactions contemplated by the Master Agreement dated October 25, 2006, as amended. Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through the Pharmacy Transaction, combined their respective institutional pharmacy businesses, KPS and PharMerica LTC, into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007.

Under the terms of the Pharmacy Transaction, on the Closing Date, each of KPS and PharMerica LTC borrowed $125.0 million as mutually agreed upon by Kindred and AmerisourceBergen and used such proceeds to fund a one-time, tax-free cash distribution in that amount to their respective parent companies. Following the cash distributions, Kindred spun off to its stockholders all of the outstanding stock of KPS and AmerisourceBergen spun off to its stockholders all of the outstanding stock of PharMerica LTC. Immediately thereafter, separate wholly owned subsidiaries of the Corporation were merged with and into KPS and PharMerica LTC with KPS and PharMerica LTC as the surviving entities of the mergers, and, as a result, KPS and PharMerica LTC became wholly owned subsidiaries of the Corporation. The Corporation issued 30 million shares of its common stock in the mergers (see Note 2 to the Corporation s consolidated financial statements). Immediately following such spin-offs and mergers, the stockholders of Kindred and AmerisourceBergen each owned 50% of the outstanding common stock of the Corporation. The shares of the Corporation s common stock held by Kindred and AmerisourceBergen prior to the Pharmacy Transaction were cancelled, and neither retained any ownership of the outstanding shares of common stock of the Corporation.

The Pharmacy Transaction was accounted for using the purchase method of accounting under accounting principles generally accepted in the United States, with KPS treated as the accounting acquirer. Under the purchase method of accounting, the deemed purchase price was allocated to the underlying tangible and identifiable intangible assets and liabilities acquired based upon their respective fair values with any excess deemed purchase price allocated to goodwill. See Note 2 to the Corporation s consolidated financial statements for additional information.

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Prior to the closing of the Pharmacy Transaction, the Corporation had no assets or liabilities and conducted no business activity. Prior to the closing of the Pharmacy Transaction, the Corporation s business was operated as separate businesses of two different public companies, Kindred and AmerisourceBergen.

Reporting Entity

The consolidated financial statements included in this Annual Report on Form 10-K as of December 31, 2007 and 2008 and for the years ended December 31, 2006, 2007 and 2008 reflect the financial position, results of operations and cash flows of the Corporation, which during the 2006 periods covered by this Annual Report and the first seven months of 2007, KPS was a wholly owned subsidiary of Kindred. As discussed above, the Pharmacy Transaction was accounted for as an acquisition by KPS of PharMerica LTC. As a result, the historical financial statements of KPS have become the historical financial statements of the Corporation. The results of PharMerica LTC are included in the results of operations of the Corporation beginning August 1, 2007. Accordingly, except as otherwise discussed below, this Management s Discussion and Analysis reflects the financial condition, results of operations and cash flows of the Corporation at December 31, 2008 and historically of KPS on a stand-alone basis for all periods prior to August 1, 2007. The financial condition, results of operations and cash flows of the Corporation as of and for the years ended December 31, 2006 and 2007 may not be indicative of the Corporation s future performance or reflect what the Corporation s financial conditions, results of operations and cash flows would have been had the Pharmacy Transaction been consummated as of January 1 of each respective year had the Corporation operated as a separate, stand-alone entity during the periods presented.

The Corporation s Business and Industry Trends

The Corporation is an institutional pharmacy services company, which services healthcare facilities and provides management pharmacy services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States. The Corporation operates over 100 institutional pharmacies in 40 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 84 hospitals in the United States.

The institutional pharmacy services business is highly competitive. Competition is a significant factor that can impact the Corporation s financial results. In each geographic market, there are national, regional and local institutional pharmacies that provide services comparable to those offered by the Corporation s pharmacies. These pharmacies may have greater financial and other resources than we do and may be more established in the markets they serve than we are. The Corporation also competes against regional and local pharmacies that specialize in the highly-fragmented long-term care markets. In the future some of the Corporation s customers may seek to in-source the provision of pharmaceuticals to patients in their facilities by establishing an internal pharmacy.

A variety of factors are affecting the institutional pharmacy industry. With an aging population and the extension of drug coverage to a greater number of individuals through Medicare Part D, the consumption of pharmaceuticals by residents of long-term care facilities is likely to increase in the future. In addition, individuals are expected to enter assisted living facilities, independent living facilities and continuing care retirement communities at increasing rates. The implementation of Medicare Part D on January 1, 2006, significantly affected the delivery of pharmaceutical care to the elderly. Under Medicare Part D, eligible individuals may choose to enroll in various Medicare Part D Plans to receive prescription drug coverage. Each Medicare Part D Plan determines the formulary for the long-term care residents enrolled in its plan. Accordingly, institutional pharmacies must follow each Part D Plan s formulary, reimbursement and administrative processes for the long-term care residents they serve. Institutional pharmacies have expanded their formularies to accommodate various formularies of key Part D Plans. Institutional pharmacies may experience increased administrative burdens and

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costs owing to the greater complexity of the requirements for drug reimbursement. Medicare Part D also requires increased choices for patients with respect to complex drug categories and therapeutic interchange opportunities. Institutional pharmacies may realize increased revenue by providing long-term care residents with specialized services in these areas. Continued industry consolidation may also impact the dynamics of the institutional pharmacy market.

In addition, our continued success depends on our ability to attract and retain pharmacists and other pharmacy professionals. Competition for qualified pharmacists and other pharmacy professionals is strong. The loss of pharmacy personnel or the inability to attract, retain or motivate sufficient numbers of qualified pharmacy professionals could adversely affect our business. Although we generally have been able to meet our staffing requirements for pharmacists and other pharmacy professionals in the past, our inability to do so in the future could have a material adverse impact on us.

Critical Accounting Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect reported amounts and related disclosures. Management considers an accounting estimate to be critical if:

It requires assumptions to be made that were uncertain at the time the estimate was made; and

Change in the estimate or different estimates that could have been made could have a material impact on our consolidated results of operations or financial condition.

The Corporation s management has discussed the development and selection of these critical accounting estimates with the audit committee of the Board of Directors and with the Corporation s independent registered public accounting firm, and they both have reviewed the disclosure presented below relating to critical accounting estimates.

The table of critical accounting estimates is not intended to be a comprehensive list of all of the Corporation s accounting policies that require estimates. Management believes that of the significant accounting policies, as discussed in Note 1 of the consolidated financial statements included elsewhere in this report, the estimates discussed below involve a higher degree of judgment and complexity. Management believes the current assumptions and other considerations used to estimate amounts reflected in the consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts reflected in the consolidated financial statements, the resulting changes could have a material adverse effect on the consolidated results of operations and financial condition of the Corporation.

The table that follows presents information about our critical accounting estimates, as well as the effects of hypothetical changes in the material assumptions used to develop each estimate:

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Nature of Critical Estimate Item

Allowance for doubtful accounts and provision for doubtful accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDP s) under Medicaid Part D, the respective state Medicaid programs, long-term care institutions, third party insurance companies and private payors. Our ability to collect outstanding receivables is critical to our results of operations and cash flow. We establish an allowance for doubtful accounts to reduce the carrying value of our receivables to their estimated net realizable value. The primary uncertainties lie with the private payors, which include co-payments and deductibles from individual patients, dual eligible co-payments that are due from PDP s, and payments due from some long-term care institutions. In addition, certain drugs dispensed are subject to being returned and the responsible paying party is due back a credit for such returns.

Our allowances for doubtful accounts, included in our balance sheet at December 31, 2007 and 2008, were $43.4 million and $46.5 million, respectively.

Our quarterly provision for doubtful accounts included in our statements of operations excluding the impact of the third quarter 2007 change in estimate was as follow (in millions):

	Amount	% of Revenues
2006		
March 31	$ 2.0	1.3%
June 30	2.8	1.8
September 30	1.9	1.1
December 31	0.6	0.4
2007		
March 31	$ 1.1	0.6%
June 30	3.3	1.9
September 30	6.3	1.7
December 31	5.5	1.1
2008		
March 31	$ 5.2	1.1%
June 30	5.5	1.1
September 30	7.2	1.5
December 31	6.8	1.4

Under Medicare Part D, co-payments related to institutional residents who are both Medicare and Medicaid eligible (dual eligible) are due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility subsequent to which the PDPs are responsible for reimbursement.

Assumptions/Approach Used

The largest components of bad debts in our accounts receivable relate to the accounts for which private payors are responsible, (which we refer to as private and other), dual eligible co-payments from PDP s which are included in Medicare Part D receivables, and accounts for which our customers from long-term care institutions are responsible for under Medicare Part A and owe us for the drug component of their patients stay at their respective institution.

We attempt to collect the private and other accounts through various efforts for which the patient is the responsible party. We attempt to collect the dual eligible co-payments from PDP s by obtaining the appropriate documentation from the responsible party of the patient or from the documentation located at the long term care institution. This is known as Best Available Evidence or BAE. We attempt to collect payments due from long-term care institutions through billing and collecting in accordance with the terms of the contracts. In all cases, the drugs have been dispensed.

In general, we perform the following steps in collecting accounts receivable:

- if possible, perform up front adjudication prior to dispensing the product;
- billing and follow-up with third party payors;
- billing and follow-up with long-term care institutions;
- utilization of collection agencies;
- other legal processes; and
- if all collection efforts are unsuccessful, write off of the accounts.

We determine the allowance for doubtful accounts utilizing a number of analytical tools and benchmarks. No single statistic or measurement alone determines the allowance for doubtful accounts.

We monitor and review trends by payor classification along with the composition of our aging accounts receivable. This review is focused primarily on trends in private and other payor, dual eligible co-payments, historic payment patterns of long-term care institutions, and monitoring respective credit risks.

In addition, we analyze other factors such as revenue days in accounts receivables, denial trends by payor types, subsequent cash collections, and current events that may impact payment patterns of our long-term care institution customers.

The following table shows our institutional pharmacy revenue days outstanding reflected in our institutional pharmacy net accounts receivable as of the dates indicated:

	2007	**2008**
March 31	41.5	39.7
June 30	44.4	40.7
September 30	45.4	41.1
December 31	40.1	42.0

Sensitivity Analysis

If our provision as a percent of institutional revenue increases 0.10%, our after tax income would change by approximately $1.1 million or $0.04 per diluted share.

This is only one example of reasonably possible sensitivity scenarios. The process of determining the allowance requires us to estimate uncollectible accounts that are highly uncertain and requires a high degree of judgment. Our estimates may be impacted by economic conditions, success in collections at the regional business offices, payor mix and trends in federal and state regulations.

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Nature of Critical Estimate Item

Allowance for doubtful accounts and provision for doubtful accounts -(continued)

The following table shows our allowance for doubtful accounts as a percent of gross accounts receivable:

	Allowance	Gross Accounts Receivable	% of Gross Accounts Receivable
2007			
March 31	NM	NM	NM
June 30	NM	NM	NM
September 30	$ 64.6	$ 282.1	22.9%
December 31	43.4	256.4	16.9
2008			
March 31	$ 44.3	$ 261.6	16.9%
June 30	45.2	262.0	17.3
September 30	45.8	266.6	17.2
December 31	46.5	265.8	17.5

Please refer to Note 1 to our consolidated financial statements included elsewhere in this report for a detailed rollforward of our allowance for doubtful accounts.

Assumptions/Approach Used

The following table shows our summarized aging categories by quarter:

	0 to 60 days	61 to 120 days	Over 120 Days
2007			
March 31	NM	NM	NM
June 30	NM	NM	NM
September 30	60.6%	16.5%	22.9%
December 31	64.8%	17.4%	17.8%
2008			
March 31	68.7%	14.2%	17.1%

June 30	63.2%	19.7%	17.1%
September 30	62.0%	19.1%	18.9%
December 31	64.1%	18.1%	17.8%

On a monthly basis, the Corporation performs a comprehensive assessment of its reserve levels in light of its expectations around the ultimate collection of its accounts receivable balances. The Corporation considers recent industry trends, changes in reimbursement sources and procedures, age of receivables and recent collection history.

In September 2007 as part of the analysis described above, the Corporation recorded in integration, merger related costs and other charges a change in accounting estimate to increase the allowance for doubtful accounts by $27.9 million, resulting in loss per share impact of $0.84.

Sensitivity Analysis

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Nature of Critical Estimate Item

Revenue recognition/Allowance for contractual discounts

We recognize revenues at the time services are provided or products are delivered.

Our sources of revenues for the years ended December 31, 2006, 2007, and 2008 are as follows:

	2006	2007	2008
Medicare Part D	38.6%	45.2%	45.5%
Institutional healthcare providers	37.1	30.3	29.7
Medicaid	8.6	8.9	9.3
Private and other	3.6	6.4	6.8
Insured	3.2	3.8	5.2
Medicare	1.2	0.9	0.5
Hospital Management fees	7.7	4.5	3.0
Total	100%	100%	100%

Our sources of revenues for the quarters ended March 31, June 30, September 30, and December 31, 2007 and 2008 are as follows:

	Three Months Ended March 31,		Three Months Ended June 30,	
	2007	2008	2007	2008
Medicare Part D	43.9%	46.2%	41.2%	44.7%
Institutional healthcare providers	33.9	29.6	34.0	30.1
Medicaid	7.8	9.6	7.9	9.2
Private and other	4.8	6.2	5.2	7.0
Insured	0.7	4.8	2.5	5.4
Medicare	1.2	0.6	1.3	0.5
Hospital management fees	7.7	3.0	7.9	3.1
Total	100.0%	100.0%	100.0%	100.0%

	Three Months Ended September 30,		Three Months Ended December 31,	
	2007	2008	2007	2008
Medicare Part D	45.9%	45.1%	46.5%	45.9%
Institutional healthcare providers	29.1	29.2	28.7	29.7
Medicaid	9.1	9.5	9.6	8.9
Private and other	7.1	7.3	6.9	6.9
Insured	4.5	5.3	4.9	5.3
Medicare	0.7	0.6	0.6	0.4
Hospital management fees	3.6	3.0	2.8	2.9

Total	100.0%	100.0%	100.0%	100.0%

Please refer to Note 7 to our consolidated financial statements included elsewhere in this report for a detailed discussion of our revenue recognition policies.

Assumptions/Approach Used

A significant portion of our revenues are billed to PDPs under Medicare Part D, the state Medicaid programs, long-term care institutions, third party insurance companies, and private payors. Some claims are electronically adjudicated through online processing at the point the prescription is dispensed such that our operating system is automatically updated with the actual amount to be reimbursed. As a result, our revenues and the associated receivables are based upon the actual reimbursement to be received. For claims that are adjudicated on-line and are rejected or otherwise denied upon submission, the Corporation provides contractual allowances based upon historical trends, contractual reimbursement terms and other factors which may impact ultimate reimbursement. Amounts are adjusted to actual reimbursed amounts based upon cash receipts.

Co-payments for our services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payors and are typically not collected at the time products are delivered or services are provided. Co-payments under the Medicaid programs and third party plans are generally billed to the responsible party as part of our normal billing procedures which are subject to normal collection procedures.

Under Medicare Part D, co-payments related to institutional residents who are both Medicare and Medicaid eligible (dual eligible) are due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility subsequent to which the PDP s are responsible for reimbursement.

Under certain circumstances, including state-mandated return policies under various Medicaid programs, we accept returns of medications and issue credit memorandums to the applicable payor. Product returns are processed in the period returned. We estimate an amount for expected returns based on historical trends.

Our hospital pharmacy management revenues represent contractually defined management fees and the reimbursement of costs associated with the direct operations of hospital pharmacies, and are primarily comprised of personnel costs.

Sensitivity Analysis

Due to the large number of contractual customers within our institutional pharmacy business, if our reimbursement declined or was negatively impacted 0.25%, the negative impact on net income would be $2.8 million or $0.09 per diluted share.

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Nature of Critical Estimate Item

Inventory and cost of drugs dispensed

We have inventory located at each of our institutional pharmacy locations. The inventory consists of prescription drugs, over the counter products and intravenous solutions. Our inventory relating to controlled substances is maintained on a manually prepared perpetual system to the extent required by the Drug Enforcement Agency. All other inventory is maintained on a periodic system, through the performance of monthly physical inventories.

At December 31, 2007 and 2008, our inventory on our consolidated balance sheets was as follows (in millions):

2007	$77.9
2008	$73.4

Our annualized inventory turns were as follows:

	2007	2008
March 31	15.8	16.4
June 30	16.1	16.1
September 30	15.9	16.5
December 31	16.7	16.5

We receive rebates on purchases from various vendors and suppliers.

Rebates included in our statements of operations were as follows (in millions):

	2006	2007	2008
March 31	$ 3.1	$ 4.0	$ 12.7
June 30	3.3	3.8	13.9
September 30	3.9	11.5	12.1
December 31	3.6	12.4	11.9
Total	$ 13.9	$ 31.7	$ 50.6

Please refer to Note 1 to our consolidated financial statements included elsewhere in this report for a detailed discussion of our inventory.

Assumptions/Approach Used

Our inventory is maintained on a first-in, first-out (FIFO) lower of cost or market basis. Our controlled prescription drugs are maintained on a perpetual inventory basis to the extent required by the Drug Enforcement Agency. All other inventory is maintained on a periodic basis. We perform inventory counts at all locations with the use of our personnel and the use of third party inventory count teams under our supervision. Effective in the first quarter of 2009, we will only perform quarterly inventory counts and these will be performed on the third month of each quarter.

All inventory counts are reconciled to the balance sheet account and differences are adjusted through cost of goods sold. In addition, we record an amount of potential returns of prescription drugs based on historical rates of returns.

We account for rebates and other incentives received from vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory, in accordance with Emerging Issues Task Force Issue No. 02-16, Accounting by a Customer for Certain Consideration Received from a Vendor. We consider these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory.

Sensitivity Analysis

Actual inventory counts may include estimates based on amounts that may be dispensed from an open container. In addition, items are reviewed for potential obsolescence.

A 1.0% error rate in the count of prescription drugs in inventory would negatively impact net income $0.4 million, or $0.01 per diluted share.

If our rebates received were to be reduced by 1.0%, the effect on net income for the year ended December 31, 2008 would have been a decrease of $0.3 million, or $0.01 per diluted share.

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Nature of Critical Estimate Item

Goodwill, other intangible assets and accounting for business combinations

Goodwill represents the excess of the purchase price over the fair value of the net assets of acquired companies. Our intangible assets are comprised primarily of tradenames, customer relationship assets, and non-compete agreements.

Our goodwill included in our consolidated balance sheets as of December 31, 2007 and 2008 was as follows (in millions):

2007	$111.3
2008	$113.7

The increase in our goodwill during 2007 was primarily the result of the acquisition of PharMerica LTC. This acquisition resulted in $64.5 million of goodwill.

Our net intangible assets, included in our consolidated balance sheets as of December 31, 2007 and December 31, 2008 were as follows (in millions):

	2007	2008
Customer relationships	$ 57.4	$ 53.1
Tradenames	27.9	27.9
Non-competition agreements	2.4	2.4
	87.7	83.4
Accumulated Amortization	(10.2)	(10.0)
	$ 77.5	$ 73.4

Please refer to Note 4 to our consolidated financial statements included elsewhere in this report for a detailed rollforward of our goodwill and intangible assets.

Assumptions/Approach Used

We follow the guidance in Statement of Financial Accounting Standard No. 142, *Goodwill and Other Intangible Assets*, and test goodwill for impairment using a fair value approach. We are required to test for impairment annually, absent some triggering event that would accelerate an impairment test. We determine fair

value using widely accepted valuation techniques, including discounted cash flow and market multiple analyses. These types of analyses require us to make assumptions and estimates regarding future cash flows, industry economic factors and the profitability of future business strategies.

The purchase prices of acquisitions are allocated to the assets acquired and liabilities assumed based upon their respective fair values. We engage independent third-party valuation firms to assist us in determining the fair values of assets acquired and liabilities assumed. Such valuations require us to make significant estimates and assumptions, including projections of future events and operating performance.

Fair value estimates are derived from management with the assistance of independent third-party firms, established market values of comparable assets, or internal calculations of estimated future net cash flows. Our estimate of future cash flows is based on assumptions and projections we believe to be currently reasonable and supportable. The ultimate decision of allocations are that of management.

We follow the guidance in Statement of Financial Accounting Standard No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*, for assessing the potential impairment of tangible assets and long-lived assets recorded on the Corporation s balance sheet. We review our assets whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

For the year ended December 31, 2008, we recognized an impairment charge of $14.8 million related to finite lived intangible assets resulting in a loss per dilutive share impact of $0.30. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. See Note 4 to our financial statements for further disclosures of the impairment charge.

Sensitivity Analysis

We performed our annual testing for goodwill impairment as of December 31, 2007 and 2008 using the methodology described here, and determined that no goodwill impairment existed. If actual future results are not consistent with our assumptions and estimates, we may be required to record goodwill impairment charges in the future. Our estimate of fair value of acquired assets and assumed liabilities are based upon assumptions believed to be reasonable based upon current facts and circumstances.

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Nature of Critical Estimate Item

Accounting for income taxes

The provision for income taxes is based upon the Corporation s annual taxable income or loss for each respective accounting period. The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets generally represent items that will result in a tax deduction in future years for which we have already recorded the tax benefit in our income statement. The Corporation also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards.

We assess the likelihood that deferred tax assets will be recovered from future taxable income. A valuation allowance is provided for deferred tax assets if it is more-likely-than-not that some portion or all of the net deferred tax assets will not be realized. Our deferred tax asset balances in our consolidated balance sheets as of December 31, 2007 and 2008 were as follows (in millions), including the impact of valuation allowances:

2007	$ 85.9
2008	$ 84.3

Our valuation allowances for deferred tax assets in our consolidated balance sheets as of December 31, 2007 and 2008 were as follows (in millions):

2007	$6.0
2008	$10.3

Significant judgment is required in determining and assessing the impact of uncertain tax positions. For an identified uncertain tax position to qualify for benefit recognition, the position must have at least a more-likely-than-not chance of being sustained on its technical merits if challenged by relevant taxing authorities and taken by management to the court of last resort. If an uncertain position does not meet this recognition threshold based on our analysis of applicable tax law, we establish a FIN 48 liability for the realized, but unrecognized tax benefit. As of December 31, 2008, the Corporation has a $2.4 million liability recorded for unrecognized tax benefits for U.S. Federal and State tax jurisdictions. The Corporation records accrued interest and penalties associated with uncertain tax positions as income tax expense in the consolidated statement of operations. We recognize the benefit for an uncertain tax position we have taken upon any one of the following conditions: 1) the recognition threshold is met due to changes in facts, circumstances and information available at the reporting date; 2) the tax position is effectively settled through examination, negotiation or litigation; or 3) the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Please refer to Note 10 to our consolidated financial statements included elsewhere in this report for a detailed discussion of our accounting for income taxes.

Assumptions/Approach Used

The first step in determining the deferred tax asset valuation allowance is identifying reporting jurisdictions where we have a history of tax and operating losses or are projected to have losses in future periods as a result of changes in operational performance. We then determine if a valuation allowance should be established against the deferred tax assets for that reporting jurisdiction. The second step is to determine the amount of valuation allowance. We will generally establish a valuation allowance equal to the net deferred tax asset (deferred tax assets less deferred tax liabilities) related to the jurisdiction identified in step one of the analysis. In certain cases, we may not reduce the valuation allowance by the amount of the deferred tax liabilities depending on the nature and timing of future taxable income attributable to deferred tax liabilities.

Tax benefits from uncertain tax positions are recognized in the Corporation s financial statements if it is more-likely-than-not that the position is sustainable based on the technical merits of the position. In evaluating whether the position has met this recognition threshold, the Corporation assumes that the appropriate taxing authority has full knowledge of all relevant information. The amount of benefit recognized in the Corporation s financial statements for a tax position meeting the recognition threshold is determined by a measurement of the largest amount of benefit that is more than 50 percent likely to be realized upon ultimate settlement.

Subsequent recognition, derecognition and measurement of uncertain tax positions is based on management s best judgment given the facts, circumstances, and information available at the reporting date.

With respect to the net operating loss carryforwards, the Corporation considers all available positive and negative evidence to determine whether a valuation allowance is needed. This includes an analysis of the statutory carryforward available under law, anticipated future income or loss, as well as tax planning strategies. If the cumulative weight of evidence suggests that it is more-likely-than-not that all or some portion of the net operating losses will not be realized, a full or partial valuation allowance will be recognized based upon the qualitative and quantitative evidence examined.

Sensitivity Analysis

Our deferred tax assets exceeded our deferred tax liabilities by $84.3 million as of December 31, 2008, including the impact of valuation allowances. Historically, we have produced federal taxable income and we expect to generate taxable income in future years. Therefore, we believe that the likelihood of our not realizing the federal tax benefit of our deferred tax assets is remote.

However, we do have subsidiaries with a history of tax losses in certain state jurisdictions and, based upon those historical tax losses and current expected results, we assumed that the subsidiaries would not be profitable in the future for those states tax purposes unless a strong earnings history existed apart from an identifiable operational condition no longer present. If our assertion regarding the future profitability of those subsidiaries was incorrect, then our deferred tax assets would be understated by the amount of the valuation allowance of $6.0 million and $10.3 million at December 31, 2007 and 2008, respectively.

The IRS may propose adjustments for items we have failed to identify as tax contingencies. If the IRS were to propose and sustain assessments we would incur additional tax payments for 2008 plus the applicable penalties and interest.

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Income Statement Caption/

Nature of Critical Estimate Item

Accounting for stock-based compensation

On July 12, 2007, the Corporation adopted the PharMerica Corporation Omnibus Plan under which the Corporation is able to grant equity-based and other awards to its employees, directors and consultants. The Corporation has initially reserved up to 3,800,000 shares of its common stock for awards to be granted under the plan plus 534,642 shares issued for converted equity awards held by employees of KPS and PharMerica LTC upon the consummation of the Pharmacy Transaction. The Compensation Committee has granted stock based compensation awards with respect to 1,903,913 common shares under the Omnibus Plan. After consideration of forfeitures, 2,252,406 shares remain available for grant at December 31, 2008. The Corporation s Compensation Committee administers the Omnibus Plan and has the authority to determine the recipient of the awards, the types of awards, the number of shares covered and the terms and conditions of the awards. The Omnibus Plan allows for grants of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, deferred shares, performance awards, including cash bonus awards, and other stock-based awards. On July 24, 2008, the Corporation s stockholders approved an amendment to the Omnibus Plan to provide the Compensation Committee with increased flexibility to use non-GAAP measures to measure performance, including the ability to exclude from the performance measures certain items or charges related to an event or occurrence which the Compensation Committee determines should be excluded, in accordance with the performance criteria of performance awards granted pursuant to the Omnibus Incentive Plan. In 2007 and 2008, the Compensation Committee established long-term and short-term incentive programs under the Omnibus Plan.

Unvested stock options and restricted shares of Kindred and AmerisourceBergen common stock held by our employees who were formerly PharMerica LTC or KPS employees were replaced with stock based awards of the Corporation s common stock, which will have the same terms and conditions as applied to the forfeited Kindred or AmerisourceBergen stock based awards.

Our stock-based compensation for the years ended December 31, 2006, 2007 and 2008 included in our results of operations was as follows (in millions):

2006: $0.9

2007: $1.5

2008: $4.9

Please refer to Note 9 to our consolidated financial statements included elsewhere in this report for a detailed discussion of our accounting for stock-based compensation.

Assumptions/Approach Used

In connection with the granting of shares under the Omnibus plan, each option is to vest in four equal annual installments and to have a term of seven years. The restricted shares/restricted share units will generally vest, in full, upon the three year anniversary of the date of grant, thus stressing the retentive aspect of these awards. The full vesting of performance share units is based upon the Corporation s earnings before interest, income taxes, depreciation and amortization, or Adjusted EBITDA performance, which will reinforce the importance of achieving the Corporation s profitability objectives. The performance period for the

performance share units is a three-year period.

We estimated the fair value of stock options granted during 2007 and 2008 using the Black Scholes Merton option valuation model (BSM). We are amortizing the fair value on a straight-line basis over the requisite service periods of the awards, which are the vesting periods of three to four years. The stock options that were granted under the Omnibus Plan vest 25% on each grant anniversary date over four years of continued employment. Restricted stock awards vest 100% at the third anniversary.

The weighted average fair value per share of stock options granted by us during 2007 and 2008 were $5.82 and $4.67, respectively. The following table shows the weighted average assumptions we used to develop the fair value estimates under our stock options valuation model for 2007 and 2008 and the paragraphs below this table summarizes each assumption:

	2007	2008
Expected volatility	33.3 - 45.0%	33.3 - 41.7%
Risk free interest rate (range)	4.55 - 4.98%	1.53 - 2.45%
Expected dividends		
Average expected term (years)	0.3 - 5.0	2.0 - 5.0
Fair value per share of stock options granted based on the Black-Sholes-Merton model	$5.82	$4.67

Population stratification under SFAS No. 123(R), provides that a company should aggregate individual awards into relatively homogeneous groups with respect to exercise and post-vesting employment behaviors for the purpose of refining the expected term assumption, regardless of the valuation technique used to estimate the fair value. In addition, SAB 107 clarifies that a company may generally make a reasonable fair value estimate with as few as one or two groupings. We have stratified our employee population into two groups: (i) insiders, who are the Section 16 filers under SEC rules; and (ii) non-insiders, who are the rest of the employee population.

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. As the Corporation has no history prior to July 31, 2007, we have used historical peer-group volatility. Historical volatility is an appropriate starting point for setting this assumption under SFAS No. 123(R). According to SFAS No. 123(R), companies should also consider how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of twelve companies in the same or similar industries as the Corporation. SFAS No. 123(R) and SAB 107 acknowledge that there is likely to be a range of reasonable estimates for volatility.

Sensitivity Analysis

The fair value calculations of our stock option grants are affected by assumptions that are believed to be reasonable based upon the facts and circumstances at the time of grant. Changes in our volatility estimates can materially affect the fair values of our stock option grants. If our stock based compensation expense during 2008 was 10% higher, our 2008 after-tax income from continuing operations would decrease by approximately $ 0.3 million, or $0.01 per diluted share.

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Nature of Critical Estimate Item

Assumptions/Approach Used

In addition, SFAS No. 123(R) requires that if a best estimate cannot be made, management should use the mid-point in the range of reasonable estimates for volatility.

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option.

We have never paid cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. Consequently, we use an expected dividend yield of zero.

Pre-vesting forfeitures do not affect the fair value calculation, but they affect the expense calculation. SFAS No. 123(R) requires us to estimate pre-vesting forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We have estimated pre-vesting option forfeitures and recorded share-based compensation expense only for those awards that are expected to vest.

Post-vesting cancellations include vested options that are cancelled, exercised or expire unexercised.

The Corporation calculated an expected term using management s estimate of option exercises. The majority of the Corporation s stock options are on a graded-vesting schedule. Statement 123(R) permits companies to estimate the value of awards with graded vesting by treating each vesting tranche as a separate award. Alternatively, the award may be valued as a single award. Management has determined to value each tranche of the awards separately utilizing a multiple fair value method.

Sensitivity Analysis

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Impact of Recent Accounting Pronouncements

On March 19, 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an Amendment of FASB Statement No. 133. Statement No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ; and (c) derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. Specifically, Statement No. 161 requires:

Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation;

Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format;

Disclosure of information about credit-risk-related contingent features; and

Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

Statement No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged, however, at the current time the Corporation does not plan to early adopt the standard. The adoption of SFAS No. 161 is not expected to have a material impact on the Corporation s financial position, results of operations or liquidity.

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations.* This statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: 1) the formation of a joint venture; 2) the acquisition of an asset or a group of assets that does not constitute a business; 3) a combination between entities or businesses under common control; or 4) a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The adoption of SFAS No. 141(R) will have a material effect on the Corporation s results of operations and financial position, to the extent the Corporation has acquisitions, as costs that have historically been capitalized as a part of the purchase price will now be expensed, such as accounting, legal and other professional fees.

In December 2007, the FASB issued SFAS No. 160. *Non-controlling Interests in Consolidated Financial Statements, an Amendment to ARB No. 51*. This statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The effective date of this statement is the same as that of the related Statement No. 141(R). The adoption of SFAS No. 160 will not have a material effect on the Corporation s results of operations, cash flows or financial position.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The intent of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected

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cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles. FSP FAS 142-3 requires an entity to disclose information for a recognized intangible asset that enables users of the financial statements to assess the extent to which the expected future cash flows associated with the asset are affected by the entity s intent and/or ability to renew or extend the arrangement. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The requirements for determining the useful life of intangible assets apply to intangible assets acquired after January 1, 2009. The disclosure requirements will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The adoption of FSP FAS 142-3 will have a material effect on the Corporation s results of operations and financial position, to the extent the Corporation has acquisitions.

Key Financial Statement Components

Consolidated Statements of Operations

Our revenues are comprised primarily of product revenues and are derived from the sale of prescription drugs through our institutional pharmacies. The majority of our product revenues are derived on a fee-for-service basis. Hospital pharmacy revenues represent management fees and pass through costs associated with managing the clients hospital pharmacy.

Cost of goods sold is comprised primarily of the cost of product and is principally attributable to the dispensing of prescription drugs. Our cost of product relating to drugs dispensed by our institutional pharmacies consists primarily of the cost of inventory dispensed and our costs incurred to process and dispense the prescriptions, including the associated fixed asset depreciation. In addition, cost of product includes a credit for rebates earned from brand-name pharmaceutical manufacturers whose drugs are included in our formularies. These rebates generally take the form of formulary rebates, which are earned based on the volume of a specific drug dispensed, or market share rebates, which are earned based on the achievement of contractually specified market share levels. Cost of goods also includes direct labor, delivery costs, rent, utilities, depreciation, travel costs, professional fees and other costs attributable to the dispensing of medications. The Corporation also receives rebates on generic drugs dispensed and administrative rebates.

Selling, general and administrative expenses reflect the costs of operations dedicated to executive management, the generation of new sales, maintenance of existing client relationships, management of clinical programs, enhancement of technology capabilities, direction of pharmacy operations, human resources and performance of reimbursement activities, in addition to finance, legal and other staff activities.

Integration, merger related costs and other charges represents the costs associated with the spin-offs of Kindred Pharmacy Services and PharMerica LTC from Kindred Healthcare and AmerisourceBergen and their respective mergers. The definition also represents costs of integrating information systems, duplicative costs associated with merging overall corporate functions and the consolidation of pharmacies within a similar location.

Interest expense (income), net, primarily includes interest expense relating to our senior secured credit facility and our swap agreement, partially offset by interest income generated by cash and cash equivalents.

Consolidated Balance Sheets

Our assets include cash and cash equivalent investments, accounts receivable, inventory, fixed assets, deferred tax assets, goodwill and intangibles.

Cash reflects the accumulation of positive cash flows from our operations and financing activities, and primarily includes deposits with banks or other financial institutions.

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Accounts receivable primarily consist of amounts due from Prescription Drug Plans under Medicare Part D, the respective state Medicaid programs, long-term care institutions, third party insurance companies, and private payors, net of allowances for doubtful accounts, as well as contractual allowances.

Inventory reflects the cost of prescription products held for dispensing by our institutional pharmacies and are recorded on a first-in, first-out basis. We perform monthly inventory counts and record our inventory and cost of goods sold based on such monthly inventories. We also include an estimate for returns on inventory.

Deferred tax assets primarily represent temporary differences between the financial statement basis and the tax basis of certain accrued expenses and stock-based compensation. Fixed assets include investments in our institutional pharmacies and information technology, including capitalized software development. Goodwill and intangible assets are comprised primarily of goodwill and intangibles related to our previous acquisitions.

Our primary liabilities include accounts payable, accrued salaries and wages, other current liabilities, debt and deferred tax liabilities. Accounts payable primarily consist of amounts payable for prescription inventory purchases and other purchases made in the normal course of business. Accrued expenses and other current liabilities primarily consist of employee and facility-related cost accruals incurred in the normal course of business, as well as income taxes payable. Our debt is primarily comprised of a loan under our senior secured credit facility. We do not have any off-balance sheet arrangements, other than purchase commitments and lease obligations.

Consolidated Statements of Cash Flows

An important element of our operating cash flows is the timing of billing cycles and subsequent cash collections. We pay for our prescription drug inventory in accordance with payment terms offered under our Prime Vendor Agreement. The Corporation receives rebates from its prime vendor and suppliers each period; rebates earned are recorded as a reduction to inventory and cost of goods sold in the period earned. Outgoing cashflows include inventory purchases, employee payroll and benefits, facility operating expenses, capital expenditures including technology investments, interest and principal payments on our outstanding debt, and income taxes. The cost of acquisitions will also result in cash outflows.

Definitions

Listed below are definitions of terms used by the Corporation in managing the business. The definitions are necessary to the understanding of the Management s Discussion and Analysis section of this document.

Assisted Living Facilities (ALF): Represents assisted living facility. Its units or beds will represent the number of apartment type units within the facility.

Bps: Represents basis points. Basis points are based on percentages. For example, 100 bps represents a change of 1%.

DNA: Represents data not available.

NA: Represents not applicable.

NM: Represents not meaningful.

Prescriptions Dispensed: Represents a prescription filled for an individual patient. A prescription will usually be for a 15 or 30 day period and will include only one drug type.

Revenues per prescription dispensed: Represents the revenues from the institutional pharmacy segment divided by the total prescriptions dispensed.

Skilled Nursing Facilities (SNF): Represents skilled nursing facilities. Its licensed beds will represent the customer licensed beds and this may not be indicative of its census.

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Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information (dollars in millions, except per prescription and per patient amounts, and prescriptions in thousands):

	Years Ended December 31,									
	2006		Increase (Decrease)		2007		Increase (Decrease)		2008	
	Amount	% of Revenues			Amount	% of Revenues			Amount	% of Revenues
Net revenues:										
Institutional Pharmacy	$ 602.2	92.3%	$ 560.8	93.1%	$ 1,163.0	95.5%	$ 725.8	62.4%	$ 1,888.8	97.0%
Hospital Management	50.4	7.7	4.4	8.7	54.8	4.5	3.7	6.8	58.5	3.0
Total net revenues	652.6	100.0	565.2	86.6	1,217.8	100.0	729.5	59.9	1,947.3	100.0
Cost of goods sold:										
Institutional Pharmacy	518.1	79.4	482.2	93.1	1,000.3	82.1	615.0	61.5	1,615.3	83.0
Hospital Management	39.8	6.1	3.9	9.8	43.7	3.6	3.7	8.5	47.4	2.4
Total cost of goods sold	557.9	85.5	486.1	87.1	1,044.0	85.7	618.7	59.3	1,662.7	85.4
Gross profit:										
Institutional Pharmacy	84.1	12.9	78.6	93.5	162.7	13.4	110.8	68.1	273.5	14.0
Hospital Management	10.6	1.6	0.5	4.7	11.1	0.9		0.0	11.1	0.6
Total gross profit	$ 94.7	14.5%	$ 79.1	83.5%	$ 173.8	14.3%	$ 110.8	63.8%	$ 284.6	14.6%
Institutional Pharmacy										
Volume information										
Prescriptions dispensed	12,644		12,107	95.8%	24,751		15,568	62.9%	40,319	
Revenue per prescription dispensed	$ 47.63		$ (0.64)	(1.3)%	$ 46.99		$ (0.14)	(0.3)%	$ 46.85	
Gross Profit per prescription dispensed	$ 6.65		$ (0.08)	(1.2)%	$ 6.57		$ 0.21	3.2%	$ 6.78	
Customer licensed beds under contract										
Beginning of period	93,282		9,289	10.0%	102,571		234,472	228.6%	337,043	
Additions	19,567		240,809	NM	260,376		(238,978)	(91.8)	21,398	
Losses	(10,056)		(15,927)	158.4	(25,983)		(10,082)	38.8	(36,065)	
Other	(222)		301	135.6	79		(79)	(100.0)		
End of period	102,571		234,472	228.6%	337,043		(14,667)	(4.4)%	322,376	
Hospital Management										
Volume information										
Hospital management contracts serviced	81		5.0	6.2 %	86		(2)	(2.3)%	84	

Revenues

The increase in institutional pharmacy revenues of $725.8 million for the year ended December 31, 2008, compared to the year ended December 31, 2007 was primarily the result of the acquisition of PharMerica LTC on July 31, 2007. This resulted in a significant increase in patients serviced. The acquisition of an institutional pharmacy business in the fourth quarter of 2008 accounted for $4.5 million of revenues for the year ended December 31, 2008.

The $3.7 million increase in hospital management revenues for the year ended December 31, 2008, compared to the year ended December 31, 2007 resulted from an increase in direct reimbursable costs as well as certain contractually provided management fee increases, partially offset by a decline in the number of hospitals served.

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The increase in institutional pharmacy revenues of $560.8 million for the year ended December 31, 2007, compared to the year ended December 31, 2006 was primarily the result of the acquisition of PharMerica LTC which accounted for $528.8 million or 94% of the total increase. Revenues from three pharmacies acquired in 2006 accounted for $14.2 million or 3% while the opening of five new locations contributed $16.5 million of the increase. The remaining increase of $1.3 million was a result of same pharmacy volume and rate changes. The decrease in revenue per prescription dispensed was primarily the result of declines in customer pricing mix. Revenues were also impacted by net customer losses during the year.

The $4.4 million increase in hospital management revenues for the year ended December 31, 2007, compared to the year ended December 31, 2006 resulted from an increase in the number hospitals serviced as well as certain contractually provided management fee increases.

Cost of Goods Sold

Institutional pharmacy cost of goods sold increased $615.0 million for the year ended December 31, 2008 compared to the same period in 2007 due primarily to the acquisition of PharMerica LTC on July 31, 2007.

The $3.7 million increase in hospital management cost of goods sold for the year ended December 31, 2008, compared to the year ended December 31, 2007 was the result of an increase in the direct costs of the hospital pharmacies which was a pass-through to our customers. These increases were primarily related to labor and related expenses.

Institutional pharmacy cost of goods sold increased $482.2 million for the year ended December 31, 2007 compared to the same period in 2006. The acquisition of PharMerica LTC accounted for $450.5 million or 93% of the increase and a change in estimate associated with the accounting for rebates reduced cost of goods sold by $3.1 million for the period ended December 31, 2007. The 2006 acquisitions contributed an estimated $12.7 million to the increase and the 2006 new store openings contributed an estimated $14.3 million, both representing approximately 3% of the increase. The remaining increase of $7.8 million was due to the same pharmacy increase in non-drug costs.

The Hospital Management cost of goods sold increased $3.9 million for the year ended December 31, 2007, over the comparable prior year period. Cost of goods sold for the Hospital Management segment is primarily related to labor costs, and increased as a result of the provision of management services to additional hospitals served, combined with the impact of wage inflation.

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Gross Profit and Operating Expenses

Gross profit and other operating expenses for the periods presented were as follows (dollars in millions):

	Years Ended December 31,									
	2006		Increase (Decrease)		2007		Increase (Decrease)		2008	
	Amount	% of Revenues			Amount	% of Revenues			Amount	% of Revenues
Gross profit and operating expenses:										
Institutional Pharmacy	$ 84.1	12.9%	$ 78.6	93.5%	$ 162.7	13.4%	$ 110.8	68.1%	$ 273.5	14.0%
Hospital Management	10.6	1.6	0.5	4.7	11.1	0.9			11.1	0.6
Total gross margin	94.7	14.5	79.1	83.5	173.8	14.3	110.8	63.8	284.6	14.6
Selling, general and administrative expenses	67.3	10.3	74.1	110.1	141.4	11.6	72.7	51.4	214.1	11.0
Amortization expense	3.4	0.5	1.6	47.1	5.0	0.4	1.5	30.0	6.5	0.3
Impairment of intangible assets							14.8	100.0	14.8	0.8
Integration, merger related costs and other charges	2.9	0.4	54.8	NM	57.7	4.8	(31.0)	(53.7)	26.7	1.4
Interest expense, net	(0.1)		7.3	NM	7.2	0.6	7.0	97.2	14.2	0.7
Income (loss) before provision for income taxes	21.2	3.3	(58.7)	(276.9)	(37.5)	(3.1)	45.8	(122.1)	8.3	0.4
Provision (benefit) for income taxes	8.4	1.3	(21.8)	(259.5)	(13.4)	(1.1)	16.7	(124.6)	3.3	0.1
Net income (loss)	$ 12.8	2.0%	$ (36.9)	(288.3)%	$ (24.1)	(2.0)%	$ 29.1	(120.7)%	$ 5.0	0.3%

Institutional pharmacy gross profit for the year ended December 31, 2008 was $273.5 million or $6.78 per prescription dispensed. Institutional gross profit margin for the year ended December 31, 2008 was 14.5% of institutional revenue. This compares to an institutional gross profit for the year ended December 31, 2007 of $162.7 million or $6.57 per prescription dispensed. Institutional gross profit margin for the year ended December 31, 2007 was 14.0% of institutional revenue. The institutional gross profit for 2008 compared to 2007 was favorably impacted by a reduction in expenses as a result of the consolidation of pharmacy locations during the period as institutional cost of goods as a percent of institutional revenue declined 50 bps.

Institutional pharmacy gross profit for the year ended December 31, 2007 was $162.7 million or $6.57 per prescription dispensed. This compares to institutional gross profit of $84.1 million or $6.65 per prescription dispensed for the year ended December 31, 2006. As a percent of institutional revenue, gross profit margin was 14.0% for the year ended December 31, 2006. Institutional gross profit per prescription decreased $0.08 or 1.2% primarily as a result of competitive pricing issues, which resulted in a decline in revenue per prescription dispensed by $0.64 per prescription.

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Selling, general and administrative expenses

Selling, general and administrative expenses represent the following costs for the periods, excluding integration, merger related costs and other charges (dollars in millions):

	Years Ended December 31,									
	2006		Increase (Decrease)		2007		Increase (Decrease)		2008	
	Amount	% of Revenues			Amount	% of Revenues			Amount	% of Revenues
Selling, general and administrative expenses										
Total wages, benefits and contract labor	$ 33.3	5.1%	$ 35.6	106.9%	$ 68.9	5.7%	$ 38.6	56.0%	$ 107.5	5.5%
Provision for doubtful accounts	7.3	1.1	8.9	121.9	16.2	1.3	8.5	52.5	24.7	1.3
Contracted services	0.1		9.5	NM	9.6	0.8	7.6	79.2	17.2	0.9
Supplies	2.6	0.4	1.1	42.3	3.7	0.3	3.8	102.7	7.5	0.4
Travel expenses	3.0	0.5	1.7	56.7	4.7	0.4	1.2	25.5	5.9	0.3
Professional fees	1.8	0.3	3.8	211.1	5.6	0.5	4.0	71.4	9.6	0.5
Stock-based compensation	0.9	0.1	0.6	66.7	1.5	0.1	3.4	226.7	4.9	0.3
Management fee	11.5	1.8	(3.1)	(27.0)	8.4	0.7	(8.4)	(100.0)		
Depreciation	0.9	0.1	5.5	611.1	6.4	0.5	4.3	67.2	10.7	0.5
Rent	0.8	0.1	4.5	562.5	5.3	0.4	3.6	67.9	8.9	0.4
Maintenance	0.3	0.1	1.7	566.7	2.0	0.2	1.1	55.0	3.1	0.2
Other costs	4.8	0.7	4.3	89.6	9.1	0.7	5.0	54.9	14.1	0.7
Total selling general and administrative expenses	$ 67.3	10.3%	$ 74.1	110.1%	$ 141.4	11.6%	$ 72.7	51.4%	$ 214.1	11.0%

The increase of $72.7 million in selling, general and administrative expenses for the year ended December 31, 2008 compared to December 31, 2007, was primarily attributable to a full year of operating results from the acquisition of PharMerica LTC, the legal and accounting fees associated with becoming compliant under the Sarbanes Oxley Act and the additional costs associated with being a public company. Stock based compensation increased $3.4 million for the year ended December 31, 2008 compared to December 31, 2007, due to the Corporation incurring a full year of compensation expense. Prior year stock based compensation primarily represented only stock based compensation for the period from the date of the Pharmacy Transaction, July 31, 2007 to December 31, 2007. Total selling general and administrative expenses declined as a percentage of total revenues due primarily to the elimination of the management fee with Kindred and the elimination of duplicative positions.

The increase of $74.1 million in selling, general and administrative expenses for the year ended December 31, 2007 compared to December 31, 2006, was primarily attributable to the acquisition of PharMerica LTC which accounted for $64.3 million or 87% of the increase. The remaining increase of $9.8 million, of which $7.2 million was labor related costs, was a result of increased overhead in anticipation of the Pharmacy Transaction as well as increases in personnel to service additional pharmacies from acquisitions and new pharmacy openings.

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Depreciation and Amortization

Depreciation expense for the periods presented was as follows (dollars in millions):

	Years Ended December 31,					
	2006		2007		2008	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Leasehold improvements	$ 0.6	0.1%	$ 2.7	0.2%	$ 2.3	0.1%
Equipment and software	4.8	0.7	12.7	1.1	19.3	1.0
Leased equipment			0.2		0.4	NM
Total depreciation expense	$ 5.4	0.8%	$ 15.6	1.3%	$ 22.0	1.1%
Depreciation expense recorded in cost of goods sold	$ 4.5	0.7%	$ 8.8	0.7%	$ 11.3	0.6%
Depreciation expense recorded in selling, general & administrative expenses	0.9	0.1	6.4	0.6	10.7	0.5
Depreciation expense recorded in integration, merger related costs and other charges			0.4			
Total depreciation expense	$ 5.4	0.8%	$ 15.6	1.3%	$ 22.0	1.1%
Total capital expenditures	$ 9.9	1.5%	$ 16.7	1.4%	$ 22.1	1.1%

The increase of $6.4 million in depreciation expense for the year ended December 31, 2008 over the prior year amount of $15.6 million is primarily related to a full year of operating results from the PharMerica LTC acquisition as well as assets acquired for the Corporation to establish its own systems infrastructure.

The increase of $10.2 million in depreciation expense for the year ended December 31, 2007 over the prior year amount of $5.4 million is primarily related to the PharMerica LTC acquisition as well as assets acquired for the Corporation to establish its own systems infrastructure. For the year ended December 31, 2007, the Corporation recognized approximately $6.3 million in depreciation expense from assets acquired in the Pharmacy Transaction.

Amortization expense related to certain identifiable intangibles for the periods presented were as follows (dollars in millions):

	Years Ended December 31,					
	2006		2007		2008	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Amortization of intangibles:						
Trade names	$	%	$ 0.6	%	$ 1.3	0.1%
Non-compete agreements	0.4		0.4		0.4	NM
Noncontractual customer relationships	3.0	0.5	4.0	0.4	4.8	0.2
Total amortization expense	$ 3.4	0.5%	$ 5.0	0.4%	$ 6.5	0.3%

The increase in amortization expense in 2008 and 2007 of $1.5 million and $1.6 million, respectively, was the result of amortization of the intangibles acquired in connection with the PharMerica LTC acquisition.

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Impairment of intangible assets

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million, related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. Using a discounted cash flow analysis, the Corporation determined that a pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value, resulting in a loss per diluted share impact of $0.30.

Integration, merger related costs and other charges

Integration, merger related costs and other charges incurred by the Corporation for the periods presented were as follows (dollars in millions, except per share amounts):

	Years Ended December 31,		
	2006	2007	2008
Integration costs and other charges:			
Allowance for doubtful accounts	$	$ 27.9	$
Professional and advisory fees		1.1	1.7
General and administrative		0.6	3.2
Employee costs		0.6	7.2
Severance costs		1.1	5.3
Facility costs		2.6	9.3
		33.9	26.7
Merger related costs:			
Professional and advisory fees	2.9	8.0	
General and administrative		5.4	
Employee costs		7.6	
Severance costs		2.0	
Facility costs		0.7	
Other costs		0.1	
	2.9	23.8	
Total integration, merger related costs and other charges	$ 2.9	$ 57.7	$ 26.7
Negative effect on diluted earnings per share	NM	$ (1.74)	$ (0.53)

Integration, merger related costs and other charges decreased $31.0 million for the year ended December 31, 2008 compared to the prior year. The decrease is due primarily to the $27.9 million adjustment of the Corporation s allowance for doubtful accounts estimation methodologies recognized during the year ended December 31, 2007. Integration costs and other charges of $26.7 million increased approximately $20.7 million compared to the prior year equivalent amount of $6.0 million due to the increased number of pharmacy consolidations during the year ended December 31, 2008 and costs incurred to integrate the Corporation s system infrastructure. During the year ended December 31, 2008, there were twenty-one pharmacy locations impacted by consolidation. As of December 31, 2008, substantially all pharmacy consolidations have been completed. In fiscal year 2009 we will complete our pharmacy consolidations and begin the integration of our pharmacy system platforms, which will result in additional integration related costs.

During the year ended December 31, 2007, the Corporation performed a comprehensive assessment of allowance for doubtful accounts estimation methodologies and reserve levels in light of its expectations around the ultimate collection of its accounts receivable balances. The Corporation considered recent industry trends,

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changes in reimbursement sources and procedures, age of receivables and recent collection history. In connection with that comprehensive assessment of allowance for doubtful accounts, included in amounts charged to integration, merger related costs and other charges was a change in accounting estimate to increase the allowance for doubtful accounts by $27.9 million, resulting in loss per share impact of $0.84.

The Corporation also incurred integration, merger related costs and other charges through December 31, 2007 related to the consolidation of pharmacies within similar locations, costs associated with the Pharmacy Transaction, costs associated with the integration of our information systems, and duplicate costs associated with merging the overall corporate function of KPS and PharMerica LTC.

During the year ended December 31, 2007, there were four pharmacy locations impacted by consolidation which we completed during the fourth quarter of 2007.

Interest Expense

Interest expense for the periods presented was as follows (dollars in millions):

	Years Ended December 31,		
	2006	**2007**	**2008**
Interest expense:			
Term Debt	$	$ 7.4	$ 14.5
Revolving Credit Facility (including commitment fees and letters of credit fees)		0.2	
Subtotal		7.6	14.5
Other:			
Interest income	(0.1)	(0.6)	(0.7)
Amortization of deferred financing fees		0.2	0.4
Total interest expense	$ (0.1)	$ 7.2	$ 14.2
Interest rate (excluding applicable margin):			
Average interest rate on variable term debt	%	6.32%	3.05%
LIBOR 1month, at beginning of period	%	5.32%	4.60%
LIBOR 1month, at end of period	%	4.60%	0.44%
LIBOR 3 months, at beginning of period	%	5.36%	4.70%
LIBOR 3 months, at end of period	%	4.70%	1.43%

Interest expense increased $7.0 for the year ended December 31, 2008 compared to the prior year period as a result of a full year of incurring interest on the Corporation s debt instruments in 2008.

Interest expense increased during 2007 as a result of the Corporation closing on, and borrowing under, the Credit Agreement on July 31, 2007 versus historically utilizing cash flows from operations and from Kindred to finance the operations of the business. During 2007 and 2008 the Corporation paid down $25.0 and $10.0 million, respectively, in borrowings under the Credit Agreement. The current margin over the LIBOR is 1.0% at December 31, 2008.

Tax Provision (Benefit)

The tax provision (benefit) for the periods presented was as follows (dollars in millions):

	Years Ended December 31,		
	2006	**2007**	**2008**
Provision (benefit) for income taxes	$ 8.4	$ (13.4)	$ 3.3

Effective tax rate	39.6%	(35.7)%	39.7%

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Our effective tax rate for the year ended December 31, 2008 was 39.7% comprised of the 35.0% federal rate and 4.7% for state rate and permanent differences. The effective tax rate for the year ended December 31, 2007 was a benefit of 35.7% comprised of the 35.0% federal rate and net benefit rate of 0.7% for the state rate and permanent differences. The effective tax rate for the year ended December 31, 2006 was 39.6% comprised of the 35.0% federal rate and 4.6% for state rate and permanent differences.

Liquidity and Capital Resources

The primary source of liquidity for the Corporation is cash flows from operations and the available borrowings under the Credit Agreement. Based upon our existing cash levels, expected operating cash flows, capital spending, potential future acquisitions and the availability of borrowings under our revolving credit facility, we believe that we have the necessary financial resources to satisfy our expected short-term and long-term liquidity needs.

The Corporation continues to achieve certain cost savings resulting from operating efficiencies, synergies and other restructuring activities that resulted from the Pharmacy Transaction. Notwithstanding other anticipated savings, we will experience some increased costs associated with the continuation of information systems integration and enhancements. The Corporation currently plans to complete the consolidation of its pharmacies by March 31, 2009. As of December 31, 2008, substantially all pharmacy consolidations have been completed.

Cash Flows. The following table presents selected data from our consolidated statements of cash flows (dollars in millions):

	Years Ended December 31,		
	2006	**2007**	**2008**
Net cash provided by operating activities	$ 10.0	$ 36.3	$ 65.7
Net cash used in investing activities	(25.0)	(22.0)	(47.4)
Net cash provided by (used in) financing activities	17.3	14.0	(9.0)
Net increase in cash and cash equivalents	2.3	28.3	9.3
Cash and cash equivalents at beginning of period	1.4	3.7	32.0
Cash and cash equivalents at end of period	$ 3.7	$ 32.0	$ 41.3

Operating Activities Cash flows provided by operations aggregated $65.7 million for the year ended December 31, 2008 compared to $36.3 million for the year ended December 31, 2007. Operating cash flows for the year ended December 31, 2008 was positively impacted by an improvement in the results of operations following the Pharmacy Transaction and the consolidation of pharmacies during the year. The timing of the end of fiscal year 2008 compared to the end of fiscal year 2007 also added approximately $7.0 million in cash flows due to the timing of payments and collections between periods.

Investing Activities Cash flows used in investing activities aggregated $47.4 million for the year ended December 31, 2008 compared to $22.0 million for the year ended December 31, 2007. Approximately $25.9 million of cash flows used in investing activities were used for the acquisition of an institutional pharmacy business in the fourth quarter of 2008 and the purchase of the 49.0% minority interest held by a third-party in the Corporation s joint ventures. Cash paid for capital expenditures was $22.1 million for the year ended December 31, 2008 compared to $16.7 million for the year ended December 31, 2007.

Financing Activities Cash flows used in financing activities aggregated $9.0 million for the year ended December 31, 2008 compared to cash provided by financing activities of $14.0 million for the year ended December 31, 2007. Cash flows used in financing activities primarily related to the payment of $10.0 million on the Corporation s long-term debt. The Corporation received cash provided by financing activities for the year ended December 31, 2007 due primarily to the proceeds from the Pharmacy Transaction.

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Cash and cash equivalents totaled $41.3 million at December 31, 2008 compared to $32.0 million at December 31, 2007.

Credit Agreement

On the Closing Date, the Corporation entered into a Credit Agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent. The Credit Agreement consists of a $275.0 million term loan facility and a $150.0 million revolving credit facility. The Corporation borrowed $275.0 million under the term loan portion of the Credit Agreement and an additional $20.0 million under the revolving credit portion of the Credit Agreement on the Closing Date to refinance the loans made to KPS and PharMerica LTC to finance their respective cash distributions, to pay fees and expenses incurred in connection with the Pharmacy Transaction and for working capital and other general corporate purposes. Indebtedness under the Credit Agreement matures on July 31, 2012. There is no scheduled amortization under the term loan facility but the term loan is subject to certain prepayment obligations relating to certain asset sales, certain casualty losses and the incurrence by the Corporation of certain indebtedness.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted LIBO rate plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625%, and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation. As of December 31, 2007, borrowings under the Credit Agreement bore at a blended rate of 6.57%, including the applicable margin of 1.25%, per annum based upon the one month and three month adjusted LIBO Rate (without giving effect to the interest rate swap transaction discussed below) and the Corporation had approximately $149.3 million available under the revolving credit facility. As of December 31, 2008, borrowings under the Credit Agreement bore interest at a blended rate of 3.9%, including the applicable margin of 1.0%, per annum based upon the one month and three month adjusted LIBO Rate (without giving effect to the interest rate swap transaction discussed below) and the Corporation had approximately $147.3 million available under the revolving credit facility. We have been informed by one of the lenders that they will not fund any of their commitments under the revolving credit facility in the amount of $8.3 million, thus decreasing the availability under the revolving credit facility to $139.0 million.

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation s wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and non-financial affirmative and negative covenants, representations, warranties, affirmative covenants and events of default that are customary to facilities of this nature.

The Corporation had a total of $240.0 million outstanding of Term Debt as of December 31, 2008 under the Credit Agreement. The Corporation had no borrowings under the revolving portion of its Credit Agreement as of December 31, 2008. The Credit Agreement provides for the issuance of letters of credit which, when issued, constitute usage and reduce availability on the revolving portion of the Credit Agreement. The aggregate amount of letters of credit outstanding as of December 31, 2007 and 2008 was $0.7 million and $2.7 million, respectively. After giving effect to the letters of credit, total availability under the revolving credit facility was $149.3 million and $147.3 million as of December 31, 2007 and 2008, respectively. The total availability of the revolving credit facility is limited by the ability of the lenders in the Credit Agreement to fund any future requested borrowings. We have been informed by one of the lenders that they will not fund any of their

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commitments under the revolving credit facility up to the amount of $8.3 million, thus decreasing the availability under the revolving credit facility to $139.0 million. The Corporation is actively pursuing a replacement lendor to fulfill the commitment.

Covenants

The Credit Agreement requires the Corporation to satisfy a minimum fixed charge coverage ratio and a maximum leverage ratio. The fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than 2.00:1.00 during the period from the Closing Date through December 31, 2008; 2.25:1.00 during the period January 1, 2009 through December 31, 2009; and 2.50:1.00 thereafter. The maximum leverage ratio, which also is tested quarterly, cannot exceed 4.50:1.00 during the period July 1, 2008 through December 31, 2008; 3.50:1.00 during the period January 1, 2009 through December 31, 2009; and 3.00:1.00 thereafter (the leverage ratio is not tested when at any time it is less than 2.00:1.00 or both S&P and Moody s shall have in effect corporate credit ratings for the Corporation that are investment grade). The Credit Agreement provides for the Corporation to use an adjusted EBITDA number in conjunction with the calculation of the leverage ratio. This adjusted EBITDA used in connection with the leverage ratio calculation pursuant to the Credit Agreement is not the same calculation the Corporation uses to determine the Adjusted EBITDA. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.00% of revenues, subject to certain carry over rights in regards to unused portions commencing with the fiscal year ended December 31, 2008.

The financial covenant ratio and requirements are as follows:

	Minimum Fixed Charge Coverage Ratio	Maximum Total Leverage Coverage Ratio	Capital Expenditure
Requirement	>=2.00 to1.00	<=4.50 to1.00	<=3.00%
December 31, 2007	2.57	2.99	1.40%
March 31, 2008	2.76	2.62	**
June 30, 2008	3.00	2.38	**
September 30, 2008	3.30	2.15	**
December 31, 2008	3.67	1.99	1.13%

** Not applicable as Capital Expenditures Covenant is an annual requirement under the terms of the Credit Agreement.

In addition, the Credit Agreement contains customary affirmative and negative covenants, which among other things, limit the Corporation s ability to incur additional debt, create liens, pay dividends, effect transactions with the Corporation s affiliates, sell assets, pay subordinated debt, merge, consolidate, enter into acquisitions, and effect sale leaseback transactions.

Interest Rate Swap

On the Closing Date, the Corporation entered into an interest rate swap agreement with JPMorgan as the counterparty. The interest rate swap agreement was effective as of the Closing Date and has a maturity date of July 31, 2009. The Corporation entered into the interest rate swap agreement to mitigate the floating interest rate risk on $200.0 million of its outstanding variable rate borrowings. The interest rate swap agreement requires the Corporation to make quarterly fixed rate payments to JPMorgan calculated on a notional amount at an annual fixed rate of 5.123% plus applicable margin (1.0%). JPMorgan will be obligated to make quarterly floating payments to the Corporation based on the three-month LIBO rate plus applicable margin (1.0%) on the same referenced notional amount.

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Notwithstanding the terms of the interest rate swap transaction, the Corporation is ultimately obligated for all amounts due and payable under the Credit Agreement. The notional value of the swap is $200.0 million as of December 31, 2008.

The fair value of the interest rate swap agreement is the amount at which it could be settled. The Corporation has designated the interest rate swap as a cash flow hedge instrument, which is recorded in the Corporation s accompanying consolidated balance sheet at its fair value.

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen, the Corporation s former 50% stockholder. Pursuant to this agreement, the Corporation agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years.

If the Corporation fails to reach this minimum purchase volume, ABDC may adjust the price of goods the Corporation purchases from it to reflect the lower than expected purchase volume. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. For the year ended December 31, 2008 the Corporation purchased a total of $1.3 billion under the terms of the Prime Vendor Agreement. As of December 31, 2008 the Corporation had an amount payable to AmerisourceBergen under the terms of the Prime Vendor Agreement of $34.0 million, which is included in accounts payable in the accompanying consolidated balance sheets.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred, the Corporation s former 50% stockholder (the IT Services Agreement). Pursuant to this IT Services Agreement, KHOI will be the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years. The services provided by KHOI will include business services necessary to operate, manage and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services will include, among other matters, functions for financial management and systems and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support and general business systems. The Corporation incurred approximately $17.3 million to Kindred under the terms of the IT Services Agreement for the year ended December 31, 2008. As of December 31, 2008, the Corporation had approximately $2.3 million in accounts payable related to the IT Services Agreement.

Except for certain services that will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The IT Services Agreement shall automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination, KHOI must provide termination and expiration assistance for up to 180 days.

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Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, other than purchase commitments and lease obligations. See Contractual Obligations below.

Contractual Obligations

The Corporation is obligated to make future payments under various contracts such as long-term purchase obligations, debt agreements, and lease agreements, and has certain commitments such as guarantees. The Corporation has grouped these contractual obligations and off-balance sheet arrangements into operating activities, financing activities, and investing activities in the same manner as they are classified in the Consolidated Statements of Cash Flows in order to provide a better understanding of the nature of the obligations and arrangements and to provide a basis for comparison to historical information.

The table below provides a summary of contractual obligations and off-balance sheet arrangements as of December 31, 2008 (in millions):

	2009	2010	2011	2012	2013	Thereafter
Operating activities:						
Prime Vendor Agreement (1)	$	$	$	$	$	$
Non-cancelable operating leases	16.4	14.2	10.1	6.5	4.4	10.2
Technology service agreement	14.4	14.4	14.4	8.4		
Financing activities:						
Total debt and estimated interest	12.4	10.1	10.1	245.9		
Totals	$ 43.2	$ 38.7	$ 34.6	$ 260.8	4.4	$ 10.2

(1) Under the Prime Vendor Agreement the Corporation is required to purchase 95% of its drug purchases through AmerisourceBergen.

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Supplemental Quarterly Information

The following tables represent the results of the Corporation s quarterly operations for the years ended December 31, 2007 and 2008 (in millions, except where indicated)

	2007 Quarters				2008 Quarters			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Net revenues:								
Institutional pharmacy revenues	$ 161.2	$ 159.7	$ 364.0	$ 478.0	$ 480.2	$ 471.3	$ 471.6	$ 465.7
Hospital management revenues	13.5	13.7	13.5	14.2	14.9	15.0	14.6	14.0
Total revenues	174.7	173.4	377.5	492.2	495.1	486.3	486.2	479.7
Cost of goods sold:								
Institutional pharmacy	142.0	142.0	310.3	406.0	410.5	403.4	404.1	397.3
Hospital management	10.8	11.0	10.8	11.1	12.1	12.1	11.8	11.4
Total cost of goods sold	152.8	153.0	321.1	417.1	422.6	415.5	415.9	408.7
Gross profit:								
Institutional pharmacy	19.2	17.7	53.7	72.0	69.7	67.9	67.5	68.4
Hospital management	2.7	2.7	2.7	3.1	2.8	2.9	2.8	2.6
Total gross profit	21.9	20.4	56.4	75.1	72.5	70.8	70.3	71.0
Selling, general and administrative	16.7	17.7	46.8	60.2	57.3	54.0	50.5	52.3
Amortization expense	1.0	1.0	1.4	1.6	1.6	1.6	1.6	1.7
Impairment of intangible assets								14.8
Integration, merger related costs and other charges	3.3	2.4	46.8	5.2	4.1	6.6	7.1	8.9
Operating income (loss)	0.9	(0.7)	(38.6)	8.1	9.5	8.6	11.1	(6.7)
Interest expense, net			3.1	4.1	3.7	3.5	3.4	3.6
Income (loss) before income taxes	0.9	(0.7)	(41.7)	4.0	5.8	5.1	7.7	(10.3)
Provision (benefit) for income taxes	0.4	(0.3)	(14.7)	1.2	2.5	2.2	3.4	(4.8)
Net income (loss)	$ 0.5	$ (0.4)	$ (27.0)	$ 2.8	$ 3.3	$ 2.9	$ 4.3	$ (5.5)
Earnings (loss) per common share (1):								
Basic	NM	NM	$ (1.07)	$ 0.09	$ 0.11	$ 0.10	$ 0.14	$ (0.18)
Diluted	NM	NM	$ (1.07)	$ 0.09	$ 0.11	$ 0.10	$ 0.14	$ (0.18)
Shares used in computing earnings (loss) per common share:								
Basic	NM	NM	25.1	30.0	30.1	30.1	30.1	30.1
Diluted	NM	NM	25.1	30.0	30.1	30.2	30.4	30.1
Balance sheet data:								
Working capital	$ 68.5	$ 84.6	$ 288.2	$ 268.6	$ 263.5	$ 277.1	$ 281.1	$ 272.3
Goodwill	$ 45.8	$ 45.8	$ 158.4	$ 111.3	$ 109.9	$ 109.9	$ 110.7	$ 113.7
Intangible assets, net	$ 36.9	$ 36.0	$ 79.1	$ 77.5	$ 75.9	$ 74.3	$ 72.7	$ 73.4
Total assets	$ 238.4	$ 258.3	$ 701.9	$ 680.1	$ 675.4	$ 673.2	$ 684.1	$ 679.2
Long-term debt	$	$	$ 265.0	$ 250.0	$ 240.0	$ 240.0	$ 240.0	$ 240.0
Total stockholder s equity	$ 190.4	$ 207.8	$ 306.9	$ 309.2	$ 311.2	$ 317.4	$ 324.3	$ 319.8
Supplemental information:								
Adjusted EBITDA (2)	$ 7.0	$ 4.4	$ 11.0	$ 22.1	$ 21.1	$ 22.4	$ 25.1	$ 23.9

Adjusted EBITDA Margin (2)	4.0%	2.5%	2.9%	4.5%	4.3%	4.6%	5.2%	5.0%
Net cash provided by (used in) operating activities	$ 8.9	$ (15.9)	$ 20.1	$ 23.2	$ 11.2	$ 13.0	$ 17.5	$ 24.0
Net cash used in investing activities	$ (2.2)	$ (1.7)	$ (15.1)	$ (3.0)	$ (8.1)	$ (3.5)	$ (10.3)	$ (25.5)
Net cash provided by (used in) financing activities	$ (7.8)	$ 18.3	$ 21.5	$ (17.9)	$ (9.9)	$ 0.2	$ 0.5	$ 0.2
Statistical information (in whole numbers except where indicated)								
Institutional Pharmacy								
Volume information:								
Prescriptions dispensed (in thousands)	3,440	3,470	7,779	10,062	10,212	10,067	10,044	9,996
Revenue per prescription dispensed	$ 46.86	$ 46.02	$ 46.79	$ 47.51	$ 47.02	$ 46.82	$ 46.95	$ 46.59
Gross profit per prescription dispensed	$ 5.58	$ 5.10	$ 6.90	$ 7.16	$ 6.83	$ 6.74	$ 6.72	$ 6.84
Customer licensed beds under contract:								
Beginning of period	102,571	103,326	102,471	342,177	337,043	334,226	331,299	325,613
Additions	4,137	3,322	246,597	6,029	5,157	6,335	4,901	5,005
Losses	(2,867)	(4,186)	(8,567)	(10,383)	(7,974)	(9,262)	(10,587)	(8,242)
Other	(515)	9	1,676	(780)				
End of period	103,326	102,471	342,177	337,043	334,226	331,299	325,613	322,376
Hospital management contracts serviced	83	84	85	86	88	86	85	84

(1) The Corporation has never declared a cash dividend. Earnings (loss) per common share in whole dollars.

(2) See Use of Non GAAP Measures For Measuring Quarterly Results for a definition and reconciliation of Adjusted EBITDA to net income.

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Use of Non-GAAP Measures For Measuring Quarterly Results

The Corporation calculates Adjusted EBITDA as provided in the reconciliation below and calculates Adjusted EBITDA Margin by taking Adjusted EBITDA and dividing it by revenues. The Corporation calculates and uses Adjusted EBITDA as an indicator of its ability to generate cash from reported operating results. The measurement is used in concert with net income and cash flows from operations, which measure actual cash generated in the period. In addition, the Corporation believes that Adjusted EBITDA and Adjusted EBITDA Margin is a supplemental measurement tool used by analysts and investors to help evaluate overall operating performance and the ability to incur and service debt and make capital expenditures. In addition, Adjusted EBITDA, as defined in the Credit Agreement, is used in conjunction with the Corporation s debt leverage ratio and this calculation sets the applicable margin for the quarterly interest charge. Adjusted EBITDA, as defined in the Credit Agreement, is not the same calculation as this Adjusted EBITDA table. Adjusted EBITDA does not represent funds available for the Corporation s discretionary use and is not intended to represent or to be used as a substitute for net income or cash flows from operations data as measured under U.S. generally accepted accounting principles (GAAP). The items excluded from Adjusted EBITDA but included in the calculation of the Corporation s reported net income are significant components of the accompanying consolidated statements of operations, and must be considered in performing a comprehensive assessment of overall financial performance. The Corporation s calculation of Adjusted EBITDA may not be consistent with calculations of EBITDA used by other companies. The following is a reconciliation of the Corporation s net income, net operating cash flows and diluted earnings (loss) per common share for the periods presented.

Unaudited Reconciliation of Net Income to Adjusted EBITDA

	2007 Quarters				2008 Quarters			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Net income (loss)	$ 0.5	$ (0.4)	$ (27.0)	$ 2.8	$ 3.3	$ 2.9	$ 4.3	$ (5.5)
Add:								
Interest expense, net			3.1	4.1	3.7	3.5	3.4	3.6
Integration, merger related costs and other charges	3.3	2.4	46.8	5.2	4.1	6.6	7.1	8.9
Provision (benefit) for income taxes	0.4	(0.3)	(14.7)	1.2	2.5	2.2	3.4	(4.8)
Effect of change in estimate on cost of goods sold			(3.1)					
Impairment of intagible assets								14.8
Depreciation and amortization expense	2.8	2.7	5.9	8.8	7.5	7.2	6.9	6.9
Adjusted EBITDA	$ 7.0	$ 4.4	$ 11.0	$ 22.1	$ 21.1	$ 22.4	$ 25.1	$ 23.9
Adjusted EBITDA Margin	4.0%	2.5%	2.9%	4.5%	4.3%	4.6%	5.2%	5.0%

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Use of Non-GAAP Measures For Measuring Quarterly Results (Continued)

Unaudited Reconciliation of Adjusted EBITDA to Net Operating Cash Flows

	2007 Quarters				2008 Quarters			
	First	**Second**	**Third**	**Fourth**	**First**	**Second**	**Third**	**Fourth**
Adjusted EDITDA	$ 7.0	$ 4.4	$ 11.0	$ 22.1	$ 21.1	$ 22.4	$ 25.1	$ 23.9
Interest expense, net			(3.1)	(4.1)	(3.7)	(3.5)	(3.4)	(3.6)
(Provision) benefit for income taxes	(0.4)	0.3	14.7	(1.2)	(2.5)	(2.2)	(3.4)	4.8
Effect of change in estimate on cost of goods sold			3.1					
Integration, merger related costs and other charges	(3.3)	(2.4)	(12.1)	(4.8)	(3.6)	(6.2)	(6.5)	(5.9)
Provision for bad debt	1.1	3.3	6.3	5.5	5.2	5.5	7.2	6.8
Stock-based compensation		0.1	0.4	0.9	1.0	1.1	1.4	1.4
Amortization of deferred financing fees			0.1	0.1	0.1	0.1	0.1	0.1
Deferred income taxes	0.2	(3.3)	(19.6)	9.3	2.5	1.6	2.8	(4.1)
(Gain) loss on disposition of equipment		(0.1)	0.8	(0.8)		0.6	0.2	(0.6)
Other	(0.3)	(0.2)	0.4	(0.5)	(0.3)	0.3	(0.3)	(0.2)
Changes in assets and liabilities	4.6	(18.0)	18.1	(3.3)	(8.6)	(6.7)	(5.7)	1.4
Net Cash Flows from Operating Activities	$ 8.9	$ (15.9)	$ 20.1	$ 23.2	$ 11.2	$ 13.0	$ 17.5	$ 24.0

The Corporation calculates and uses diluted earnings per share, exclusive of integration, merger related costs and other charges, impairment on intangible assets and favorable impact on tax ruling as an indicator of its core operating results. The measurement is used in concert with net income and diluted earnings per share, which measure actual earnings per share generated in the period. The Corporation believes the exclusion of these charges in expressing earnings per share provides management with a useful measure to assess period to period comparability and is useful to investors in evaluating the Corporation s operating results from period to period. Diluted earnings per share, exclusive of integration, merger related costs and other charges, impairment on intangible assets and favorable impact on tax ruling does not represent the amount that effectively accrues directly to stockholders (i.e., such costs are a reduction in earnings and stockholders equity) and is not intended to represent or to be used as a substitute for diluted earnings per share as measured under GAAP. The integration, merger related costs and other charges, impairment on intangible assets and favorable impact on tax ruling excluded from the diluted earnings per share are significant components of the accompanying condensed consolidated statements of operations, and must be considered in performing a comprehensive assessment of overall financial performance.

Unaudited Reconciliation of Diluted Earnings (Loss) Per Share to Adjusted Diluted Earnings Per Share

	2007	2008				
	Fourth Quarter	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**Year**
Diluted Earnings (loss) per common share	$ 0.09	$ 0.11	$ 0.10	$ 0.14	$ (0.18)	$ 0.17
Add:						
Diluted earnings per common share impact of:						
Impairment of intangible assets					0.30	0.30
Integration, merger related costs and other charges	0.12	0.08	0.12	0.13	0.20	0.53
Impact of tax rate differential (Fourth Quarter only)					(0.06)	
Adjusted diluted earnings per common share after impact of above items	$ 0.21	$ 0.19	$ 0.22	$ 0.27	$ 0.26	$ 1.00

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Following Represents the Fourth Quarter 2008 Results compared to the Fourth Quarter 2007

Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information (dollars in millions):

	Quarter Ended					
	December 31, 2007		Increase (Decrease)		December 31, 2008	
	Amount	% of Revenues			Amount	% of Revenues
Net revenues:						
Institutional Pharmacy	$ 478.0	97.1%	$ (12.3)	(2.6)%	$ 465.7	97.1%
Hospital Management	14.2	2.9	(0.2)	(1.4)	14.0	2.9
Total net revenues	492.2	100.0	(12.5)	(2.5)	479.7	100.0
Cost of goods sold:						
Institutional Pharmacy	406.0	82.5	(8.7)	(2.1)	397.3	82.8
Hospital Management	11.1	2.2	0.3	2.7	11.4	2.4
Total cost of goods sold	417.1	84.7	(8.4)	(2.0)	408.7	85.2
Gross profit:						
Institutional Pharmacy	72.0	14.7	(3.6)	(5.0)	68.4	14.3
Hospital Management	3.1	0.6	(0.5)	(16.1)	2.6	0.5
Total gross profit	$ 75.1	15.3%	$ (4.1)	(5.5)%	$ 71.0	14.8%
Institutional Pharmacy (in whole numbers except where indicated)						
Volume information						
Prescriptions dispensed (in thousands)	10,062		(66)	(0.7)%	9,996	
Revenue per prescription dispensed	$ 47.51		$ (0.92)	(1.9)%	$ 46.59	
Gross profit per prescription dispensed	$ 7.16		$ (0.32)	(4.5)%	$ 6.84	
Customer licensed beds under contract						
Beginning of period	342,177		(16,564)	(4.8)%	325,613	
Additions	6,029		(1,024)	(17.0)	5,005	
Losses	(10,383)		2,141	(20.6)	(8,242)	
Other	(780)		780	(100.0)		
End of period	337,043		(14,667)	(4.4)%	322,376	
Hospital Management						
Volume information						
Hospital management contracts serviced	86		(2.0)	(2.3)%	84	

Revenues

The decrease in institutional pharmacy revenues of $12.3 million for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 was the result of a decline in rate variance of $9.2 million and an unfavorable volume variance of $3.1 million. The decline in rate variance is due primarily to the shift in product mix from the conversion of brand named drugs to generic drugs during the year as well as price concessions. During 2008 a significant amount of brand named drugs converted to generic, including well known products such as Fosamax® and Risperdal®. The acquisition of an institutional pharmacy business in the fourth quarter of 2008 accounted for $4.5 million of revenues for the three months ended December 31, 2008.

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The $0.2 million decrease in hospital management revenues for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 resulted from a decrease in the number of hospitals serviced during the period offset by contractually provided management fee increases and increases in direct cost pass-throughs.

Cost of Goods Sold

Institutional pharmacy cost of goods sold decreased $8.7 million for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 due primarily to a reduction in drug purchases as a result of less prescriptions being dispensed. Also contributing to the reduction was a decline in salary, wages and benefits due to a lower number of employees as a result of the pharmacy consolidations.

The $0.3 million increase in hospital management cost of goods sold for the year ended December 31, 2008, compared to the three months ended December 31, 2007 was the direct result of an increase in direct costs partially offset by a decrease in the number of hospitals served.

Gross Profit and Operating Expenses

Gross profit and other operating expenses were the following for the periods presented (dollars in millions):

	Quarter Ended					
	December 31, 2007		Increase (Decrease)		December 31, 2008	
	Amount	% of Revenue			Amount	% of Revenue
Gross profit and operating expenses:						
Institutional Pharmacy	$ 72.0	14.7%	$ (3.6)	(5.0)%	$ 68.4	14.3%
Hospital Management	3.1	0.6	(0.5)	(16.1)	2.6	0.5
Total gross profit	75.1	15.3	(4.1)	(5.5)	71.0	14.8
Selling, general and administrative expenses	60.2	12.2	(7.9)	(13.1)	52.3	10.9
Amortization expense	1.6	0.3	0.1	6.2	1.7	0.4
Impairment of intangible assets			14.8	100.0	14.8	3.0
Integration, merger related costs and other charges	5.2	1.1	3.7	71.2	8.9	1.9
Interest expense, net	4.1	0.9	(0.5)	(12.2)	3.6	0.7
Income before provision for income taxes	4.0	0.8	(14.3)	(357.5)	(10.3)	(2.1)
Provision for income taxes	1.2	0.2	(6.0)	(500.0)	(4.8)	(1.0)
Net income	$ 2.8	0.6%	$ (8.3)	(296.4)%	$ (5.5)	(1.1)%

Institutional pharmacy gross profit for the three months ended December 31, 2008 was $68.4 million or $6.84 per prescription dispensed compared to $72.0 million or $7.16 per prescription dispensed. Institutional gross profit margin for the three months ended December 31, 2008 was 14.7% compared to 15.1% for the three months ended December 31, 2007. The decline in institutional gross profit margin as a percent of institutional pharmacy revenues is due primarily to a decline in rebates of $0.5 million, costs associated with the consolidation of pharmacies, and price concessions.

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Selling, general and administrative expenses

Selling, general and administrative expenses represent the following costs for the periods, excluding integration, merger related costs and other charges (dollars in millions):

	Quarter Ended					
	December 31, 2007		Increase (Decrease)		December 31, 2008	
	Amount	% of Revenue			Amount	% of Revenue
Selling, general and administrative expenses:						
Total wages, benefits and contract labor	$ 30.4	6.2%	$ (4.3)	(14.1)%	$ 26.1	5.4%
Contracted services	5.6	1.1	(1.5)	(26.8)	4.1	0.9
Provision for doubtful accounts	5.5	1.1	1.3	23.6	6.8	1.4
Supplies	1.4	0.3	0.6	42.9	2.0	0.4
Travel expenses	1.5	0.3	(0.1)	(6.7)	1.4	0.3
Professional fees	2.7	0.5	(0.1)	(3.7)	2.6	0.5
Stock-based compensation	0.9	0.2	0.5	55.6	1.4	0.3
Depreciation	4.1	0.8	(1.5)	(36.6)	2.6	0.5
Rent	3.2	0.7	(1.8)	(56.3)	1.4	0.3
Maintenance	1.0	0.2	(0.3)	(30.0)	0.7	0.2
Other costs	3.9	0.8	(0.7)	(17.9)	3.2	0.7
Total selling general and administrative expenses	$ 60.2	12.2%	$ (7.9)	(13.1)%	$ 52.3	10.9%

Total labor costs decreased $4.3 million for the three months ended December 31, 2008, over the comparable period in the prior year as a result of management s effort to eliminate duplicate overhead positions within the pharmacy locations and reduce certain corporate overhead functions. The provision for doubtful accounts increased as a result of current economic trends. Contracted services declined $1.5 million for the three months ended December 31, 2008, over the comparable period in the prior year due to lower costs incurred under the Kindred IT TSA, due primarily to management s efforts to reduce costs incurred and take on certain information technology functions. Stock based compensation increased as a result of the additional awards in March 2008. Depreciation, rental and maintenance expenses declined $3.6 million due to the elimination of equipment and facility related costs associated with overhead functions at the pharmacy locations.

Depreciation and Amortization

Depreciation expense represents the following costs for the periods as follows (dollars in millions):

	Quarter Ended			
	December 31, 2007		December 31, 2008	
	Amount	% of Revenues	Amount	% of Revenues
Leasehold improvements	$ 1.3	0.3%	$ 0.5	0.1%
Equipment and software	5.8	1.2	4.7	0.9
Leased equipment	0.1			
Total depreciation expense	$ 7.2	1.5%	$ 5.2	1.0%
Depreciation expense recorded in cost of goods sold	$ 3.1	0.6%	$ 2.6	0.5%
Depreciation expense recorded in selling, general & administrative expenses	4.1	0.9	2.6	0.5

Total depreciation expense	$ 7.2	1.5%	$ 5.2	1.0%
Total capital expenditures	$ 2.2	0.4%	$ 4.3	0.9%

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Depreciation expense decreased for the three months ended December 31, 2008, compared to the three months ended December 31, 2007 primarily due to certain assets acquired with the Pharmacy Transaction becoming fully depreciated in the first six months of 2008 and the disposal of equipment as a result of pharmacy consolidations during the year.

Amortization expenses represents the following (dollars in millions):

	Quarter Ended			
	December 31, 2007		December 31, 2008	
	Amount	% of Revenues	Amount	% of Revenues
Amortization of intangibles:				
Trade names	$ 0.4	0.1%	$ 0.3	0.1%
Non-compete agreements	0.1		0.1	NM
Customer relationships	1.1	0.2	1.3	0.3
Total amortization expense	$ 1.6	0.3%	$ 1.7	0.4%

Amortization expense increased by $0.1 million for the three months ended December 31, 2008 as compared to the three months ended December 31, 2007 as a result of the acquisition of an institutional pharmacy business in the fourth quarter of 2008.

Impairment of intangible assets

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million, related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. Using a discounted cash flow analysis, the Corporation determined that a pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value, resulting in a loss per share impact of $0.30.

Integration, merger related costs and other charges

The following is a summary of integration, merger related costs and other charges incurred by the Corporation as follows (dollars in millions, except per share amounts):

	Quarter Ended	
	December 31, 2007	December 31, 2008
Integration costs and other charges:		
Professional and advisory fees	$ 1.1	$ 0.2
General and administrative	0.6	0.6
Employee costs	0.5	0.9
Severance costs	0.6	1.6
Facility costs	2.6	5.6
	5.4	8.9
Merger related costs:		
Severance costs	(0.2)	

		(0.2)		
Total integration, merger related costs and other charges	$	5.2	$	8.9
Negative effect on diluted earnings per share	$	(0.12)	$	(0.20)

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For the three months ended December 31, 2007 and 2008, respectively, the Corporation expensed approximately $5.2 million and $8.9 million of integration, merger related costs and other charges related to the consolidation of pharmacies within a similar location, and costs to integrate system platforms. Facility costs increased from $2.6 million to $5.6 million due primarily to fixed assets disposals and rental expenses as a result of increased pharmacy consolidations during the quarter ended December 31, 2008 compared to the quarter ended December 31, 2007.

As of December 31, 2008, substantially all pharmacy consolidations have been completed. In fiscal year 2009 we will complete our pharmacy consolidations and begin the integration of our pharmacy system platforms, which will result in additional integration related costs.

Interest Expense

Interest expense represents the following costs for the periods (dollars in millions):

	Quarter Ended	
	December 31, 2007	**December 31, 2008**
Interest expense, net:		
Term Debt	$ 4.2	$ 3.5
Revolving credit facility (including commitment fees and letters of credit fees)	0.1	
Subtotal	4.3	3.5
Other:		
Interest expense (income)	(0.3)	
Amortization of deferred financing fees	0.1	0.1
Total interest expense, net	$ 4.1	$ 3.6
Interest rate (excluding applicable margin):		
Average interest rate on term debt	6.32%	2.95%
LIBOR 1month, at beginning of period	5.12%	3.93%
LIBOR 1month, at end of period	4.60%	0.44%
LIBOR 3 months, at beginning of period	5.23%	4.05%
LIBOR 3 months, at end of period	4.70%	1.43%

The overall decrease in interest expense was the result of a lower LIBOR and lower debt outstanding in the fourth quarter of 2008. The current margin over the LIBOR is at 1.0%. Total debt outstanding as of December 31, 2007 and 2008 was $250.0 million and $240.0 million, respectively.

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Tax Provision (Benefit)

The tax provision (benefit) for the periods presented was as follows (dollars in million):

	Quarter Ended	
	December 31, 2007	**December 31, 2008**
Tax provision (benefit)	$ 1.2	$ (4.8)
Total provision (benefit) as a percentage of income	30.0%	(46.0)%

The effective tax rate for the three months ended December 31, 2008 was a benefit of 46.0% comprised of the 35.0% federal rate and 11.0% for the state rate and permanent differences. Our effective tax rate for the three months ended December 31, 2007 was 30.0% comprised of the 35.0% federal rate and a net 5.0% benefit for the state rate and permanent differences.

The state rate for the period ended December 31, 2008 was impacted by the need for valuation allowances on losses generated by the impairments of certain finite lived intangible assets in the period. The benefit for the period was favorably impacted by a ruling obtained from the Internal Revenue Service during the period on a specific permanent item.

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Liquidity and Capital Resources

The following compares the Corporation s Statement of Cash Flows for the quarters ended December 31, 2007 and 2008 (in millions):

	Quarter Ended	
	December 31, 2007	December 31, 2008
Statement of Cash Flows		
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 2.8	$ (5.5)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	7.2	5.2
Amortization	1.6	1.7
Impairment charge		14.8
Integration, merger related costs and other charges	0.4	3.0
Stock-based compensation	0.9	1.4
Amortization of deferred financing fees	0.1	0.1
Deferred income taxes	9.3	(4.1)
Loss (gain) on disposition of equipment	(0.8)	(0.6)
Other	(0.5)	(0.2)
Change in operating assets and liabilities:		
Accounts receivable, net	3.7	4.3
Inventory and other assets	1.5	4.2
Prepaids and other assets	4.9	(1.2)
Accounts payable	(4.2)	(0.8)
Salaries, wages and other compensation	1.8	(0.7)
Other accrued liabilities	(5.5)	2.4
Net cash provided by operating activities	23.2	24.0
Cash flows provided by (used in) investing activities:		
Purchase of equipment and leasehold improvements	(2.2)	(4.3)
Acquisitions, net of cash acquired	(0.8)	(21.5)
Cash proceeds from sale of assets		0.3
Net cash used in investing activities	(3.0)	(25.5)
Cash flows provided by (used in) financing activities:		
Net contributions from (to) Former Parent	(3.3)	
Repayments of long-term debt	(15.0)	
Cash contributions received from minority shareholders	0.4	
Issuance of common stock		0.2
Net cash provided by (used in) financing activities	(17.9)	0.2
Change in cash and cash equivalents	2.3	(1.3)
Cash and cash equivalents at beginning of period	29.7	42.6
Cash and cash equivalents at end of period	$ 32.0	$ 41.3
Supplemental information:		
Cash paid for interest	$ 4.5	$ 3.5

Cash paid for taxes	$ 0.7	$ 0.1

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Following Represents the Fourth Quarter 2008 Results compared to the Third Quarter 2008

Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information (in millions, except where indicated):

	Quarter Ended			
	September 30, 2008 Amount	Increase (Decrease)		December 31, 2008 Amount
Net revenues:				
Institutional Pharmacy	$ 471.6	$ (5.9)	(1.3)%	$ 465.7
Hospital Management	14.6	(0.6)	(4.1)	14.0
Total net revenues	486.2	(6.5)	(1.3)	479.7
Cost of goods sold:				
Institutional Pharmacy	404.1	(6.8)	(1.7)	397.3
Hospital Management	11.8	(0.4)	(3.4)	11.4
Total cost of goods sold	415.9	(7.2)	(1.7)	408.7
Gross profit:				
Institutional Pharmacy	67.5	0.9	1.3	68.4
Hospital Management	2.8	(0.2)	(7.1)	2.6
Total gross profit	$ 70.3	$ 0.7	1.0%	$ 71.0
Institutional Pharmacy (in whole numbers, except where indicated)				
Volume information:				
Prescriptions dispensed (in thousands)	10,044	(48)	(0.5)%	9,996
Revenue per prescription dispensed	$ 46.95	$ (0.36)	(0.8)%	$46.59
Gross Profit per prescription dispensed	$ 6.72	$ 0.12	1.8%	$ 6.84
Customer licensed beds under contract:				
Beginning of period	331,299	(5,686)	(1.7)%	325,613
Additions	4,901	104	2.1	5,005
Losses	(10,587)	2,345	(22.1)	(8,242)
End of period	325,613	(3,237)	(1.0)%	322,376
Hospital Management				
Hospital management contracts serviced	85	(1.0)	(1.2)%	84

Revenues

The decrease in institutional pharmacy revenues of $5.9 million for the three months ended December 31, 2008, compared to the three months ended September 30, 2008 was due to an unfavorable volume variance of $2.3 million and a decline in revenue per prescription dispensed which represented $3.6 million. The decline in revenue per prescription dispensed is due primarily to the mix of drugs dispensed in the period as well as the impact of the renegotiation of certain customer contracts. The acquisition in the fourth quarter of 2008 accounted for $4.5 million of revenues for the three months ended December 31, 2008.

The $0.6 million decrease in hospital management revenues for the three months ended December 31, 2008, compared to the three months ended September 30, 2008 is due primarily to the loss of one hospital management contract in the fourth quarter 2008. The loss of the contract in the period was the result of a hospital facility being sold.

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Cost of Goods Sold

The decrease in institutional pharmacy cost of goods sold of $6.8 million for the three months ended December 31, 2008, compared to the three months ended September 30, 2008 was due to reduced drug purchases resulting from a decline in the number of prescriptions dispensed in the period. Also contributing to the decline in cost of goods sold was a reduction in salary, wages and employee benefits of $2.9 million.

The decrease in hospital management cost of goods sold of $0.4 million for the three months ended December 31, 2008, compared to the three months ended September 30, 2008 was directly related to the loss of one hospital management contract in the period. The loss of the contract in the period was the result of a hospital facility being sold.

Gross Profit and Operating Expenses

Gross profit and other operating expenses were the following for the periods presented (in millions):

	Quarter Ended					
	September 30, 2008		Increase (Decrease)		December 31, 2008	
	Amount	% of Revenue			Amount	% of Revenue
Gross profit and operating expenses:						
Institutional Pharmacy	$ 67.5	13.9%	$ 0.9	1.3%	$ 68.4	14.3%
Hospital Management	2.8	0.6	(0.2)	(7.1)	2.6	0.5
Total gross profit	70.3	14.5	0.7	1.0	71.0	14.8
Selling, general and administrative expenses	50.5	10.4	1.8	3.6	52.3	10.9
Amortization expense	1.6	0.3	0.1	6.2	1.7	0.4
Impairment of intangible assets			14.8	100.0	14.8	3.0
Integration, merger related costs and other charges	7.1	1.5	1.8	25.4	8.9	1.9
Interest expense, net	3.4	0.7	0.2	5.9	3.6	0.7
Income before provision for income taxes	7.7	1.6	(18.0)	(233.8)	(10.3)	(2.1)
Provision for income taxes	3.4	0.7	(8.2)	(241.2)	(4.8)	(1.0)
Net income	$ 4.3	0.9%	$ (9.8)	(227.9)%	$ (5.5)	(1.1)%

Institutional pharmacy gross profit for the three months ended December 31, 2008 was $68.4 million or $6.84 per prescription dispensed. This compares to institutional pharmacy gross profit of $67.5 million or $6.72 per prescription dispensed for the three months ended September 30, 2008. As a percent of institutional pharmacy revenue, gross profit margin was 14.7% for the three months ended December 31, 2008 compared to 14.3% for the three months ended September 30, 2008. The improvement in gross margin between periods is due primarily to management s efforts to control costs and eliminate duplicative functions.

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Selling, general and administrative expenses

Selling, general and administrative expenses represent the following costs for the periods (in millions):

	Quarter Ended					
	September 30, 2008		Increase (Decrease)		December 31, 2008	
	Amount	% of Revenue			Amount	% of Revenue
Selling, general and administrative expenses:						
Total wages, benefits and contract labor	$ 23.7	4.9%	$ 2.4	10.1%	$ 26.1	5.4%
Contracted services	4.0	0.8	0.1	2.5	4.1	0.9
Provision for doubtful accounts	7.2	1.5	(0.4)	(5.6)	6.8	1.4
Supplies	1.8	0.4	0.2	11.1	2.0	0.4
Travel expenses	1.4	0.3			1.4	0.3
Professional fees	2.1	0.4	0.5	23.8	2.6	0.5
Stock-based compensation	1.4	0.3			1.4	0.3
Depreciation	2.6	0.5			2.6	0.5
Rent	2.1	0.4	(0.7)	(33.3)	1.4	0.3
Maintenance	0.8	0.2	(0.1)	(12.5)	0.7	0.2
Other costs	3.4	0.7	(0.2)	(5.9)	3.2	0.7
Total selling general and administrative expenses	$ 50.5	10.4%	$ 1.8	3.6%	$ 52.3	10.9%

The increase of $1.8 million in selling, general and administrative expenses for the three months ended December 31, 2008, compared to the three months ended September 30, 2008, was primarily related to health self-insurance expense not being impacted by the third quarter non-recurring refund. For the three months ended September 30, 2008, the Corporation received a refund related to over charges on healthcare claims processed in the period of $2.1 million, of which approximately $0.6 million was recorded as selling, general and administrative expenses. The provision for doubtful accounts in the fourth quarter decreased $0.4 million due to an improvement in cash collections during the quarter. Rental, maintenance and other costs decreased $1.0 during the fourth quarter due primarily to reduced costs as a result of the pharmacy consolidations in the period. Professional fees increased due to legal and outsourced professional services.

Depreciation and Amortization

Depreciation expense represents the following costs for the periods (in millions):

	Quarter Ended			
	September 30, 2008		December 31, 2008	
	Amount	% of Revenues	Amount	% of Revenues
Leasehold improvements	$ 0.4	0.1%	$ 0.5	0.1%
Equipment and software	4.8	1.0	4.7	0.9
Leased equipment	0.1	NM		
Total depreciation expense	$ 5.3	1.1%	$ 5.2	1.0%
Depreciation expense recorded in cost of goods sold	$ 2.7	0.6%	$ 2.6	0.5%
Depreciation expense recorded in selling, general & administrative expenses	2.6	0.5	2.6	0.5

Total depreciation expense	$ 5.3	1.1%	$ 5.2	1.0%
Total capital expenditures	$ 6.0	1.2%	$ 4.3	0.9%

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The decrease of $0.1 million in depreciation expense for the three months ended December 31, 2008 compared to the three months ended September 30, 2008 is due to the disposal of equipment as a result of the pharmacy consolidations.

Amortization expense represents the following costs for the periods (in millions):

	Quarter Ended			
	September 30, 2008		December 31, 2008	
	Amount	% of Revenues	Amount	% of Revenues
Amortization of intangibles:				
Trade names	$ 0.3	0.1%	$ 0.3	0.1%
Non-compete agreements	0.1	NM	0.1	NM
Customer relationships	1.2	0.2	1.3	0.3
Total amortization expense	$ 1.6	0.3%	$ 1.7	0.4%

Impairment of intangible assets

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. Using a discounted cash flow analysis, the Corporation determined that a pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value, resulting in a loss per diluted share impact of $0.30.

Integration, merger related costs and other charges

The following is a summary of integration, merger related costs and other charges incurred by the Corporation (in millions, except per share amounts):

	Quarter Ended	
	September 30, 2008	December 31, 2008
Integration costs and other charges:		
Professional and advisory fees	$ 0.4	$ 0.2
General and administrative	0.5	0.6
Employee costs	2.3	0.9
Severance costs	2.0	1.6
Facility costs	1.9	5.6
Total integration, merger related costs and other charges	$ 7.1	$ 8.9
Negative effect on diluted earnings per share	$ (0.13)	$ (0.20)

The Corporation incurred integration, merger related costs and other charges for the three months ended December 31, 2008 and the three months ended September 30, 2008 related to the consolidation of pharmacies within a similar location and, costs to integrate information systems. As of December 31, 2008, substantially all pharmacy consolidations have been completed. In fiscal year 2009 we will complete our pharmacy consolidations and begin the integration of our pharmacy system platforms.

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Interest Expense

Interest expense represents the following costs for the periods (in millions):

	Quarter Ended	
	September 30, 2008 Amount	December 31, 2008 Amount
Interest expense, net:		
Term Debt	$ 3.5	$ 3.5
Revolving Credit Facility (including commitment fees and letters of credit fees)		
Subtotal	3.5	3.5
Other:		
Interest income	(0.2)	
Amortization of deferred financing fees	0.1	0.1
Total interest expense, net	$ 3.4	$ 3.6
Interest rate (excluding applicable margin):		
Average interest rate on Term Debt	2.66%	2.95%
LIBOR 1 month, at beginning of period	2.46%	3.93%
LIBOR 1 month, at end of period	3.93%	0.44%
LIBOR 3 months, at beginning of period	2.78%	4.05%
LIBOR 3 months, at end of period	4.05%	1.43%

The current applicable margin over the LIBO rate is 1.0%.

Tax Provision (Benefit)

The tax provision (benefit) for the periods presented was as follows (in million):

	Quarter Ended	
	September 30, 2008	December 31, 2008
Tax provision (benefit)	$ 3.4	$ (4.8)
Total provision (benefit) as a percentage of income	42.9%	(46.0)%

The effective tax rate for the three months ended December 31, 2008 was a benefit of 46.0% comprised of the 35.0% federal rate and 11.0% for the state rate and permanent differences. The benefit for the period was favorably impacted by a ruling obtained from the Internal Revenue Service during the period on a specific permanent item. The effective tax rate for the three months ended September 30, 2008 was 42.9%, comprised of 35.0% for the federal rate and 7.9% for the state rate and permanent differences.

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Liquidity and Capital Resources

The following compares the Corporation s Statement of Cash Flows for the three months ended September 30, 2008 and December 31, 2008 (in millions):

	Quarter Ended	
	September 30, 2008	December 31, 2008
Statement of Cash Flows		
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 4.3	$ (5.5)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	5.3	5.2
Amortization	1.6	1.7
Impairment charge		14.8
Integration, merger related costs and other charges	0.6	3.0
Stock-based compensation	1.4	1.4
Amortization of deferred financing fees	0.1	0.1
Deferred income taxes	2.8	(4.1)
Loss (gain) on disposition of equipment	0.2	(0.6)
Other	(0.3)	(0.2)
Change in operating assets and liabilities:		
Accounts receivable	(4.8)	4.3
Inventory and other assets	(1.6)	4.2
Prepaids and other assets	0.1	(1.2)
Accounts payable	8.1	(0.8)
Salaries, wages and other compensation	0.9	(0.7)
Other accrued liabilities	(1.2)	2.4
Net cash provided by operating activities	17.5	24.0
Cash flows provided by (used in) investing activities:		
Purchase of equipment and leasehold improvements	(6.0)	(4.3)
Acquisitions, net of cash acquired	(4.4)	(21.5)
Cash proceeds from sale of assets	0.1	0.3
Net cash used in investing activities	(10.3)	(25.5)
Cash flows provided by financing activities:		
Issuance of common stock	0.5	0.2
Net cash provided by financing activities	0.5	0.2
Change in cash and cash equivalents	7.7	(1.3)
Cash and cash equivalents at beginning of period	34.9	42.6
Cash and cash equivalents at end of period	$ 42.6	$ 41.3
Supplemental information:		
Cash paid for interest	$ 3.6	$ 3.5

Cash paid for taxes	$ 0.5	$ 0.1

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Item 7A. Quantitative and Qualitative Disclosures about Market Risk

On July 31, 2007, the Corporation entered into the Credit Agreement consisting of a $275.0 million term loan facility and a $150.0 million revolving credit facility. The Corporation borrowed $275.0 million under the term loan portion of the Credit Agreement and an additional $20.0 million under the revolving credit portion of the Credit Agreement on July 31, 2007 to refinance the initial financings entered into by PharMerica LTC and KPS to finance their respective cash distributions, to pay fees and expenses incurred in connection with the Pharmacy Transaction and for working capital and other general corporate purposes. Borrowings under the Credit Agreement bear interest at a floating rate equal to, at the Corporation s option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted LIBO rate plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. As of December 31, 2008, borrowing under the Credit Agreement bore interest at a rate of 3.9% per annum based upon the one month and the three month adjusted LIBO rate. As of December 31, 2008, the Corporation s variable rate debt consisted of $40.0 million of indebtedness incurred under the Credit Agreement and the fair value of the Corporation s outstanding variable rate debt approximates its carrying value. We have a two-year interest rate swap agreement in place to mitigate the Corporation s floating interest rate risk on $200.0 million of the outstanding $240.0 million loans under the Credit Agreement.

Based upon the amount of variable rate debt outstanding as of December 31, 2008, a 100 basis point change in interest rates would affect the Corporation s future pre-tax earnings by approximately $2.4 million on an annual basis. The estimated change to the Corporation s interest expense is determined by considering the impact of hypothetical interest rates on the Corporation s borrowing cost and debt balances and before giving effect to the terms of the interest rate swap agreement. These analyses do not consider the effects, if any, of the potential changes in the Corporation s credit ratings or leverage and the overall level of economic activity of the Corporation. Further, in the event of a change of significant magnitude, the Corporation s management would expect to take actions intended to further mitigate its exposure to such change.

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Item 8. Financial Statements

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

PharMerica Corporation:

In our opinion, the accompanying consolidated financial statements listed in the index appearing under Item 8 present fairly, in all material respects, the financial position of PharMerica Corporation at December 31, 2007 and 2008, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Corporation s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Annual Report on Internal Control over Financial Reporting under Item 9A. Our responsibility is to express opinions on these financial statements and on the Corporation s internal control over financial reporting based on our audits, which was an integrated audit in 2008. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed 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 principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Louisville, Kentucky

February 5, 2009

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PHARMERICA CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2006, 2007, and 2008

(In millions, except share and per share amounts)

	2006	2007	2008
Revenues	$ 652.6	$ 1,217.8	$ 1,947.3
Cost of goods sold	557.9	1,044.0	1,662.7
Gross profit	94.7	173.8	284.6
Selling, general and administrative expenses	67.3	141.4	214.1
Amortization expense	3.4	5.0	6.5
Impairment of intangible assets (see Note 4)			14.8
Integration, merger related costs and other charges (See Note 8)	2.9	57.7	26.7
Operating income (loss)	21.1	(30.3)	22.5
Interest (income) expense, net	(0.1)	7.2	14.2
Income (loss) before income taxes	21.2	(37.5)	8.3
Provision (benefit) for income taxes	8.4	(13.4)	3.3
Net income (loss)	$ 12.8	$ (24.1)	$ 5.0
Earnings (loss) per common share:			
Basic	NM	$ (1.13)	$ 0.17
Diluted	NM	$ (1.13)	$ 0.17
Shares used in computing earnings (loss) per common share:			
Basic	NM	21,331,995	30,095,582
Diluted	NM	21,331,995	30,190,893

See accompanying Notes to Consolidated Financial Statements

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PHARMERICA CORPORATION

CONSOLIDATED BALANCE SHEETS

As of December 31, 2007 and 2008

(In millions, except share and per share amounts)

	2007	2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32.0	$ 41.3
Accounts receivable, net	213.0	219.3
Inventory	77.9	73.4
Deferred tax assets	27.1	24.9
Prepaids and other assets	19.5	16.7
	369.5	375.6
Equipment and leasehold improvements	87.4	97.1
Accumulated depreciation	(30.0)	(43.1)
	57.4	54.0
Deferred tax assets, net	58.8	59.4
Goodwill	111.3	113.7
Intangible assets, net	77.5	73.4
Other	5.6	3.1
	$ 680.1	$ 679.2
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 51.5	$ 54.4
Salaries, wages and other compensation	40.5	36.3
Other accrued liabilities	8.9	12.6
	100.9	103.3
Long-term debt	250.0	240.0
Other long term liabilities	15.6	16.1
Commitments and contingencies (See Note 6)		
Minority interest	4.4	
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2007 and December 31, 2008		
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,360,612 shares and 30,477,558 shares issued and outstanding as of December 31, 2007 and 2008, respectively.	0.3	0.3
Capital in excess of par value	332.9	338.7
Accumulated other comprehensive loss	(2.6)	(2.8)
Retained deficit	(21.4)	(16.4)

	309.2	319.8
	$ 680.1	$ 679.2

See accompanying Notes to Consolidated Financial Statements

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PHARMERICA CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2006, 2007, and 2008

(In millions)

	2006	2007	2008
Cash flows provided by (used in) operating activities:			
Net income (loss)	$ 12.8	$ (24.1)	$ 5.0
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation	5.4	15.2	22.0
Amortization	3.4	5.0	6.5
Impairment charge			14.8
Integration, merger related costs and other charges		35.1	4.5
Stock-based compensation	0.9	1.5	4.9
Amortization of deferred financing fees		0.2	0.4
Deferred income taxes	(1.6)	(13.4)	2.8
Loss on disposition of equipment	0.5	0.1	0.2
Other	(3.5)	(0.9)	(0.5)
Change in operating assets and liabilities:			
Accounts receivable, net	(12.6)	(13.9)	(4.4)
Inventory and other assets	(4.0)	1.1	4.2
Prepaids and other assets	(0.3)	(3.3)	3.3
Accounts payable	4.7	23.1	1.1
Salaries, wages and other compensation	3.8	9.3	(2.3)
Other accrued liabilities	0.5	1.3	3.2
Net cash provided by operating activities	10.0	36.3	65.7
Cash flows provided by (used in) investing activities:			
Purchase of equipment and leasehold improvements	(9.9)	(16.7)	(22.1)
Acquisitions, net of cash acquired	(11.0)	(5.6)	(25.9)
Capitalized business combination expenditures	(5.3)		
Cash proceeds from sale of assets	1.5		0.6
Other	(0.3)	0.3	
Net cash used in investing activities	(25.0)	(22.0)	(47.4)
Cash flows provided by (used in) financing activities:			
Net contributions from Former Parent	12.5	14.0	
Proceeds from long-term revolving credit facility		20.0	
Repayments of long-term revolving credit facility		(20.0)	
Proceeds from long-term debt		275.0	
Repayments of long-term debt		(25.0)	(10.0)
Proceeds from Spin-co loans		125.0	
Repayments of Spin-co loans		(250.0)	
Payment of debt issuance costs		(2.0)	
Dividends		(125.0)	
Cash contributions received from minority shareholders	4.8	2.0	0.1
Issuance of common stock			0.9
Net cash provided by (used in) financing activities	17.3	14.0	(9.0)
Change in cash and cash equivalents	2.3	28.3	9.3

Cash and cash equivalents at beginning of period	1.4	3.7	32.0
Cash and cash equivalents at end of period	$ 3.7	$ 32.0	$ 41.3
Supplemental information:			
Transfers of property and equipment from Former Parent	$ 2.6	$ 4.9	$
Cash paid for interest	$	$ 5.4	$ 14.6
Cash paid for taxes	$	$ 1.4	$ 1.5
Supplemental schedule of non-cash activities:			
Fair value of assets acquired	$ 17.0	$ 438.1	$ (1.7)
Fair value of liabilities assumed or incurred	$ 2.5	$ 178.8	$ (1.0)

See accompanying Notes to Consolidated Financial Statements

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PHARMERICA CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Years Ended December 31, 2006, 2007, and 2008

(In millions, except share amounts)

	Common Stock		Capital in Excess of Par Value	Accumulated Other Comprehensive Loss	Retained Deficit	Total
	Shares	Amount				
Balance at December 31, 2006	10	$	$ 133.7	$	$ 64.6	$ 198.3
Comprehensive loss:						
Net loss					(24.1)	(24.1)
Change in fair value of interest rate swap, net				(2.6)		(2.6)
Total comprehensive loss				(2.6)	(24.1)	(26.7)
Net transfers from Former Parent			9.7			9.7
Dividend to Former Parent			(63.1)		(61.9)	(125.0)
Cancellation of common stock	(10)					
Stock issuance spin-off from Former Parent	15,000,000	0.2	(0.2)			
Stock issuance purchase of business	15,000,000	0.1	251.3			251.4
Grant and forfeiture of non-vested restricted stock	360,612					
Stock-based compensation restricted stock			0.4			0.4
Stock-based compensation stock options			1.1			1.1
Balance at December 31, 2007	30,360,612	$ 0.3	$ 332.9	$ (2.6)	$ (21.4)	$ 309.2
Comprehensive income:						
Net income					5.0	5.0
Change in fair value of interest rate swap, net				(0.2)		(0.2)
Total comprehensive income				(0.2)	5.0	4.8
Grant and forfeiture of non-vested restricted stock	49,068		0.1			0.1
Exercise of stock options	67,878		0.8			0.8
Stock-based compensation restricted stock			2.3			2.3
Stock-based compensation stock options			2.6			2.6
Balance at December 31, 2008	30,477,558	$ 0.3	$ 338.7	$ (2.8)	$ (16.4)	$ 319.8

See accompanying Notes to Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended December 31, 2006, 2007, and 2008

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company, which services healthcare facilities and provides management pharmacy services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States. The Corporation operates over 100 institutional pharmacies in 40 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 84 hospitals in the United States.

Pharmacy Transaction

The Corporation, formerly known as Safari Holding Corporation, was formed on October 23, 2006 by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

The shares of common stock of the Corporation were registered with the Securities and Exchange Commission (the Commission) on Form S-4/S-1, which was declared effective by the Commission on July 17, 2007 (the Form S-4/S-1).

On August 1, 2007, the Corporation s common stock began trading on the New York Stock Exchange under the symbol PMC . Under the terms of the Pharmacy Transaction, on the Closing Date, each of KPS and PharMerica LTC borrowed $125.0 million as mutually agreed upon by Kindred and AmerisourceBergen and used such proceeds to fund a one-time, tax-free cash distribution in that amount to their respective parent companies. Following the cash distributions, Kindred spun off to its stockholders all of the outstanding stock of KPS and AmerisourceBergen spun off to its stockholders all of the outstanding stock of PharMerica LTC. Immediately thereafter, separate wholly owned subsidiaries of the Corporation were merged with and into KPS and PharMerica LTC with KPS and PharMerica LTC as the surviving entities of the mergers, and, as a result, KPS and PharMerica LTC became wholly owned subsidiaries of the Corporation. In the mergers, each Kindred stockholder received approximately 0.366 shares of the Corporation s common stock in respect of each share of Kindred common stock held on the record date and each AmerisourceBergen stockholder received approximately 0.083 shares of the Corporation s common stock in respect of each share of AmerisourceBergen common stock held on the record date. Immediately following such spin-offs and mergers, the stockholders of Kindred and AmerisourceBergen each owned 50% of the outstanding common stock of the Corporation. The shares of the Corporation s common stock held by Kindred and AmerisourceBergen prior to the Pharmacy Transaction were cancelled, and neither retained any ownership of the outstanding shares of common stock of the Corporation.

For accounting purposes, the Pharmacy Transaction was treated as an acquisition by KPS of PharMerica LTC with KPS being considered the accounting acquirer based on the application of criteria specified in Statement of Financial Accounting Standards SFAS No. 141 (SFAS 141), *Business Combinations*. As a result, the accompanying financial statements include only certain accounts and results of operations representing the institutional pharmacy business of Kindred on a carve-out basis. Because KPS was determined to be the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

acquirer for accounting purposes, the historical financial statements of KPS became the historical financial statements of the Corporation. Accordingly, the financial statements of the Corporation prior to the Pharmacy Transaction reflect the financial position, results of operations and cash flows of KPS, which during the historical periods presented in the accompanying consolidated financial statements, was a wholly owned subsidiary of Kindred. Following the Pharmacy Transaction, the financial statements reflect the financial position, results of operation and cash flows of the Corporation. The results of operations of PharMerica LTC are included in the results of operations of the Corporation beginning August 1, 2007.

Prior to the closing of the Pharmacy Transaction, the Corporation had no assets or liabilities and conducted no business activity. Prior to the closing of the Pharmacy Transaction, the Corporation s business was operated as two separate businesses within two different public companies, Kindred and AmerisourceBergen.

Principles of Consolidation; Parent Allocations

For all periods prior to the Pharmacy Transaction, the accompanying consolidated financial statements present the historical results of KPS s operations during each respective period. Accordingly, these consolidated financial statements include allocations of certain expenses, as well as assets and liabilities, historically maintained by Kindred and not recorded in the accounts of KPS. Prior to the Pharmacy Transaction, Kindred corporate expenses were allocated based upon either the identification of specific costs or as a percentage of KPS revenues, where applicable. Allocated costs may not necessarily be indicative of the costs that would have been incurred by KPS if it had operated as a separate entity.

For the years ended December 31, 2006 and 2007, the consolidated financial statements include the accounts of the Corporation and its subsidiaries including certain accounts of KPS prior to the Pharmacy Transaction. All intercompany transactions have been eliminated. Investments in affiliates in which the Corporation has a less than 100% interest are accounted for by the equity method. As of December 31, 2008, there were no minority interests.

Use of Estimates

The accompanying consolidated financial statements have been prepared in accordance with U.S. GAAP which require management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosure of contingent liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are involved in revenue recognition, collectibility of accounts receivable, inventory valuation, supplier rebates, stock based compensation, accounting for income taxes and the valuation of long-lived assets and goodwill. Actual amounts may differ from these estimates.

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payors to the Corporation and/or its customers; the overall financial condition of the Corporation s customers; the effect of new government regulations, executive orders and/or legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payors to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental/ regulatory inquiries; other contingent liabilities; changes in international economic and political conditions;

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

changes in interest rates; changes in the valuation of the Corporation s financial instruments, including the swap agreement and other derivative instruments; changes in tax laws and regulations; access to capital and financing; the demand for the Corporation s products and services; pricing and other competitive factors in the industry; changes in insurance claims experience and related assumptions; variations in costs or expenses; and changes in accounting rules and standards.

Minority Interests in Consolidated Entities

The accompanying consolidated financial statements include all assets, liabilities, revenues, and expenses of less-than-100%-owned entities that the Corporation controls. Accordingly, the Corporation recorded minority interests in the earnings and equity of such entities. The Corporation records adjustments to minority interest for the allocable portion of income or loss to which the minority interest holders are entitled based upon their portion of certain subsidiaries that they own. For the years ended December 31, 2006, 2007 and 2008 minority interest was $1.3 million, $1.2 million and $0.5 million, respectively, and recorded in cost of goods sold in our consolidated statements of operations.

On July 9, 2008, the Corporation purchased the 49.0% minority interest held by a third-party in the Corporation s joint ventures.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. The Corporation places its cash in financial institutions that are federally insured. As of December 31, 2008, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets given current economic conditions.

Fair Value of Financial Instruments

The carrying amounts reported in the accompanying consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable, debt and interest rate swap approximate fair value because of the short-term maturity of these instruments.

Derivative Instruments

The Corporation uses derivative instruments to protect against the risk of interest rate movements on future cash flows under the Corporation s credit agreement. In accordance with SFAS No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities* derivative instruments are reported at fair value on the accompanying consolidated balance sheets. For interest rate exposures, derivatives are used primarily to fix the rate on debt based on floating-rate indices and to manage the cost of borrowing obligations. The Corporation currently has an interest rate swap to manage interest rate risk. The Corporation prohibits the use of derivative instruments for trading or speculative purposes. Changes in the fair value of derivatives deemed to be eligible for hedge accounting are reported in accumulated other comprehensive income (loss) exclusive of ineffective amounts which are reported in interest expense. The fair value of the Corporation s interest rate swap agreement is the amount at which it could be settled, based on estimates obtained from the counterparty. The Corporation s interest rate swap is further described in Note 5.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value of Financial Instruments

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157 (SFAS 157), *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value and enhances disclosure about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. On February 2, 2008, the FASB issued FASB Staff Position No. FAS 157-2 which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Where the measurement objective specifically requires the use of fair value , the Corporation has adopted the provisions of SFAS 157 related to financial assets and financial liabilities as of January 1, 2008. The Corporation also adopted the provisions of SFAS 157-2 related to nonfinancial assets and nonfinancial liabilities effective January 1, 2009.

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1: Observable inputs such as quoted prices in active markets;

Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and

Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques noted in SFAS 157:

A. *Market approach:* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

B. *Cost approach:* Amount that would be required to replace the service capacity of an asset (replacement cost).

C. *Income approach:* Techniques to convert future amounts to a single present amount based upon market expectations (including present value techniques, option-pricing and excess earnings models).

Financial assets and liabilities disclosed at fair value at December 31, 2008 are set forth in the table below (in millions):

	Asset/ (Liability)	Level 1	Level 2	Level 3	Valuation Technique
Derivative financial instrument	$ (4.9)	$	$ (4.9)	$	C
Deferred compensation plan	$ (1.4)	$	$ (1.4)	$	A

The Corporation s Level 2 liabilities represent a derivative financial instrument (interest rate swap) and an unfunded obligation associated with a deferred compensation plan offered to eligible employees of the Corporation. The interest rate swap s fair value is derived using a pricing model predicated upon observable

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

market inputs. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and debt approximate fair value because of the nature or short-term maturity of these instruments.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDPs) under Medicare Part D, institutional healthcare providers, the respective state Medicaid programs, third party insurance companies, and private payors. The Corporation s ability to collect outstanding receivables is critical to its results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, the Corporation establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to the extent it is probable that a portion or all of a particular account will not be collected.

The Corporation has an established process to determine the adequacy of the allowance for doubtful accounts that relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement determines the adequacy of the allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Corporation considers a number of factors, which include, but are not limited to, the impact of changes in the regulatory and payor environment as well as, historical trends, financial viability of the payor, contractual reimbursement terms, and other factors which may impact ultimate reimbursement. Accounts receivable are written off after collection efforts have been completed in accordance with the Corporation s policies.

The Corporation s accounts receivable accounts and summarized aging categories as of December 31 are as follows (dollars in millions):

	2007	2008
Institutional healthcare providers	$ 134.7	$ 148.0
Medicare Part D	60.5	59.5
Private payor and other	35.0	35.9
Insured	11.9	10.4
Medicaid	11.5	9.4
Medicare	2.8	2.6
Allowance for doubtful accounts	(43.4)	(46.5)
	$ 213.0	$ 219.3
0 to 60 days	64.8%	64.1%
61 to 120 days	17.4%	18.1%
Over 120 days	17.8%	17.8%
	100.0%	100.0%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following is a summary of activity in the Corporation s allowance for doubtful accounts (dollars in millions):

	Beginning Balance	Acquisitions	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:					
Year Ended December 31, 2006	$ 16.0	$ 0.5	$ 7.3	$ (7.2)	$ 16.6
Year Ended December 31, 2007	$ 16.6	$ 25.7	$ 44.1	$ (43.0)	$ 43.4
Year Ended December 31, 2008	$ 43.4	$ 0.3	$ 24.7	$ (21.9)	$ 46.5

During the year ended December 31, 2007, the Corporation performed a comprehensive assessment of allowance for doubtful accounts estimation methodologies and reserve levels in light of its expectations around the ultimate collection of its accounts receivable balances. As noted above, the Corporation considered recent industry trends, changes in reimbursement sources and procedures, age of receivables and recent collection history. In connection with that comprehensive assessment of allowance for doubtful accounts, included in amounts charged to costs and expenses was a change in accounting estimate to increase the allowance for doubtful accounts by $27.9 million, resulting in a loss per share impact of $0.84.

Deferred Financing Fees

The Corporation capitalizes deferred financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs and filing fees. The Corporation amortizes these deferred financing fees over the life of the respective debt instrument using the straight-line method.

Inventory

Inventory is located at the Corporation s institutional pharmacy locations. Inventory consists solely of finished product (primarily prescription drugs), and is valued at the lower of first-in, first-out (FIFO) cost or market. Physical inventories are performed on a monthly basis at all pharmacy sites. Costs of goods sold is recorded based on actual results of the physical inventory counts.

Equipment and leasehold improvements

Equipment and leasehold improvements are recorded at cost at the acquisition date and are depreciated using the straight-line method over their estimated useful lives as follows (in years):

	Estimated Useful Lives
Leasehold improvements	1-5

Equipment and software	3-10
Leased equipment	1-5

Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred and included in selling, general and administrative expenses. Major rebuilds and improvements are capitalized. For the years ended December 31, 2006, 2007 and 2008, maintenance and repairs were approximately $2.4 million, $5.2 million, and $7.3 million, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In accordance with SFAS No. 144 (SFAS 144), *Accounting for the Impairment or Disposal of Long-lived Assets*, long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future undiscounted net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements for the years ended December 31, 2006, 2007 or 2008.

The Corporation s equipment and leasehold improvements are further described in Note 3.

Capitalization of Internal Software Costs

Preliminary costs incurred by the Corporation are expensed and, thereafter, costs incurred in the developing or obtaining of internal software are capitalized. Certain costs, such as maintenance and training, are expensed as incurred. Capitalized costs are amortized over a period of not more than seven years and are subject to impairment evaluations in accordance with SFAS 144. Amounts capitalized for internal software costs were $3.4 million and $1.6 million during the years ended December 31, 2007 and 2008, respectively.

Goodwill and Other Intangibles

The Corporation accounts for its acquisitions in accordance with SFAS No. 141 using the purchase method of accounting. Goodwill represents the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets with indefinite lives are reviewed by the Corporation at least annually for impairment. The Corporation s business is comprised of two reporting units for impairment test purposes, institutional pharmacy and hospital management. The Corporation performed its annual impairment tests for goodwill recorded as of December 31, 2008, and did not incur an impairment charge.

The Corporation s finite lived intangible assets are comprised primarily of trade names, customer relationship assets and non-compete agreements originating from business acquisitions. Finite lived intangible assets are amortized on a straight-line basis over the terms of the agreements ranging from 5 to 18 years. The Corporation s goodwill and intangible assets are further described in Note 4.

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million, related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to intangible assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. In addition, these asset groups were assessed for recoverability under SFAS No. 144 and management determined the finite lived customer relationship assets to be impaired, but no other assets within the asset groups were deemed to be impaired. Using a discounted cash flow analysis, the Corporation determined that a pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value resulting in a loss per diluted share impact of $0.30. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

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Self-Insured Employee Health Benefits

The Corporation is self-insured for employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based on historical claims data and inputs from third-party administrators. As of December 31, 2007 and 2008, the Corporation had approximately $8.8 million and $2.6, respectively, recorded as a liability for self-insured employee health benefits.

In September 2008, the Corporation recorded a benefit of a $2.1 million refund as a result of over charges on the self-insured employee health benefits of which approximately $1.2 million related to charges from August 2007 through December 2007.

Supplier Rebates

The Corporation receives rebates on purchases from its various vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendor and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory, in accordance with Emerging Issues Task Force Issue No. 02-16, Accounting by a Customer for Certain Consideration Received from a Vendor. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory. For the years ended December 31, 2006, 2007, and 2008 rebates were $13.9 million, $31.7 million, and $50.6 million, respectively, and recorded as a reduction of cost of goods sold in the accompanying consolidated statements of operations. Rebates for the year ended December 31, 2007 included $3.1 million related to the change in estimate more fully described below. The Corporation had approximately $0.7 million, $2.9 million and $2.8 million of rebates capitalized in inventory as of December 31, 2006, 2007, and 2008, respectively.

Upon completion of the Pharmacy Transaction, the Corporation refined the methods of estimating rebates received from its vendors and suppliers. The change in estimate is driven primarily by management s experience in the industry and known facts and assumptions from the Pharmacy Transaction. The effect of the change in accounting estimate on the Corporation s operating results was income of $3.1 million or $0.09 per diluted share for the year ended December 31, 2007.

Delivery expenses

The Corporation incurred expenses totaling approximately $22.6 million, $40.2 million and $61.9 million for the years ended December 31, 2006, 2007, and 2008, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying consolidated statements of operations.

Comprehensive Income (Loss)

The Corporation entered into an interest rate swap agreement, which the Corporation has designated as a cash flow hedge in accordance with SFAS No. 133. The Corporation recognizes all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

meets the hedge criteria as defined by SFAS 133, depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of assets and liabilities through earnings or recognized in accumulated other comprehensive income (loss) until the hedged item is recognized into earnings. The ineffective portion of a derivative s change in fair value, if any, is immediately recognized into earnings.

The changes in the fair value of the interest rate swap for the years ended December 31, 2007 and 2008 resulted in comprehensive loss of $2.6 million and $0.2 million, net of income taxes, respectively. As of December 31, 2007 and 2008, the Corporation recorded a deferred tax asset of $0.9 million and $2.1 million, respectively, for the interest rate swap. Accumulated other comprehensive loss at December 31, 2008 was $2.8 million. The interest rate swap is described more fully in Note 5.

Stock Based Compensation

The Corporation accounts for its stock-based awards in accordance with the provisions of SFAS No. 123(R) (SFAS 123(R)), *Share-Based Payment*. Under SFAS 123(R), the Corporation recognizes compensation expense based on the grant date fair value estimated in accordance with the standard.

The following table summarizes stock compensation of the Corporation for the periods presented (dollars in millions, except per share amounts):

	Years Ended December 31,		
	2006	**2007**	**2008**
Nonvested stock and stock option expense	$ 0.9	$ 1.5	$ 4.9
Income tax benefit	$ 0.3	$ 0.5	$ 1.9
Effect of stock based compensation expense per share	NM	$ 0.05	$ 0.10

Stock based compensation is more fully described in Note 9.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Corporation accrues for probable tax obligations as required by facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 10.

Impact of Recent Accounting Pronouncements

On March 19, 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an Amendment of FASB Statement No. 133. Statement No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and (c) derivative

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Years Ended December 31, 2006, 2007 and 2008

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. Specifically, Statement No. 161 requires:

- Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation;
- Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format;
- Disclosure of information about credit-risk-related contingent features; and
- Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

Statement No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged, however, at the current time the Corporation does not plan to adopt the standard early. The adoption of SFAS No. 161 is not expected to have a material impact on the Corporation s financial position, results of operations or liquidity.

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations.* This statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: 1) the formation of a joint venture; 2) the acquisition of an asset or a group of assets that does not constitute a business; 3) a combination between entities or businesses under common control; 4) a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The adoption of SFAS No. 141(R), prospectively, will have a material effect on the Corporation s results of operations and financial position, to the extent the Corporation has acquisitions, as costs that have historically been capitalized as part of the purchase price will now be expensed, such as accounting, legal and other professional fees.

In December 2007, the FASB issued SFAS No. 160. *Non-controlling Interests in Consolidated Financial Statements, an Amendment to ARB No. 51*. This statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The effective date of this statement is the same as that of the related Statement No. 141(R). The adoption of SFAS No. 160 will not have a material effect on the Corporation s results of operations, cash flows or financial position.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The intent of FSP FAS 142-3 is to improve the consistency

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NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles. FSP FAS 142-3 requires an entity to disclose information for a recognized intangible asset that enables users of the financial statements to assess the extent to which the expected future cash flows associated with the asset are affected by the entity s intent and/or ability to renew or extend the arrangement. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The requirements for determining the useful life of intangible assets apply to intangible assets acquired after January 1, 2009. The disclosure requirements will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The adoption of FSP FAS 142-3 will have a material effect on the Corporation s results of operations and financial position, to the extent the Corporation has acquisitions.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications have no impact on the Corporation s total assets, liabilities, stockholders equity, net income (loss) or cash flows.

NOTE 2 ACQUISITIONS

2008 Acquisitions

On November 1, 2008, the Corporation acquired certain assets and assumed certain liabilities of an institutional pharmacy business providing medications, pharmacy and medical supplies and services to residents of skilled nursing homes for $21.5 million in cash. The transaction was accounted for as a purchase, in which the preliminary purchase price was allocated based upon the fair value of the assets acquired and liabilities assumed with the difference recorded as goodwill. As a result of the acquisition the Corporation recorded $17.2 million as a finite lived intangible customer relationship and $1.5 million as goodwill.

On July 9, 2008, the Corporation purchased the 49.0% minority interest held by a third-party in the Corporation s joint ventures. The Corporation paid approximately $4.4 million in cash for the minority interest share of the joint ventures. The amount paid for the minority interest share of the joint ventures approximates fair value and resulted in the recognition of $0.2 million in goodwill as a result of the transaction, of which approximately $0.1 million included professional fees capitalized as part of the purchase price.

2007 Acquisitions

On the Closing Date, the Corporation completed the Pharmacy Transaction. As discussed in Note 1, the Pharmacy Transaction was accounted for as an acquisition by KPS of PharMerica LTC. In the Pharmacy Transaction, the Corporation issued 30.0 million shares of common stock, of which Kindred and AmerisourceBergen stockholders each received 15.0 million shares. The aggregate purchase price was $436.4 million, comprised primarily of the 15.0 million shares of common stock of the Corporation issued to AmerisourceBergen stockholders, with a fair value of $251.4 million, and the assumption of long-term debt related to the dividend payment to AmerisourceBergen of $125.0 million before the Pharmacy Transaction. The fair value of the common stock issued by the Corporation was calculated using the opening stock price on August 1, 2007. The total purchase price of PharMerica LTC was allocated to the net tangible and identifiable

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 2 ACQUISITIONS (Continued)

intangible assets based upon their estimated fair values as of the Closing Date. The excess of the purchase price over the estimated fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the assets acquired were recorded by the Corporation under the provisions of the Internal Revenue Code at the respective assets carryover basis. The results of operations of PharMerica LTC were included in the results of operations of the Corporation beginning August 1, 2007.

The following are the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition (dollars in millions):

Fair value of 15.0 million shares at $16.76 per share issued to PharMerica LTC	$ 251.4
Fair value of the liabilities assumed:	
Current liabilities	32.6
Capital lease obligations	0.1
Deferred tax liabilities	12.3
Long-term liabilities	7.1
PharMerica LTC debt borrowing to fund cash distribution to parent in connection with the Pharmacy Transaction	125.0
Total fair value of liabilities assumed	177.1
Total fair value of liabilities assumed and shares issued	428.5
Legal, advisory and other acquisition costs incurred by KPS	7.9
Total purchase price	$ 436.4
The allocation of the purchase price was as follows:	
Current assets	$ 242.3
Property and equipment	32.8
Identifiable intangible assets	44.5
Other assets	52.3
Goodwill	64.5
	$ 436.4

The following are the fair values of the property and equipment of PharMerica LTC acquired at the date of acquisition (dollars in millions):

	Fair Value	Weighted Average Useful Lives
Leasehold improvements	$ 4.1	0.8

Equipment and software	28.0	3.7
Leased equipment	0.7	1.3
Total property and equipment acquired	$ 32.8	2.5

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Years Ended December 31, 2006, 2007 and 2008

NOTE 2 ACQUISITIONS (Continued)

The following are the fair values of the identifiable intangible assets of PharMerica LTC acquired at the date of acquisition (dollars in millions):

	Fair Value	Weighted Average Useful Lives
Trade name PharMerica	$ 27.6	20.0
Trade name MedMate	0.3	20.0
Non-competition agreement	0.2	5.0
Customer relationships	16.4	15.0
Total identifiable intangible assets acquired	$ 44.5	17.6

2006 Acquisitions

During 2006, KPS acquired three institutional pharmacies for an aggregate cost of $14.9 million. The acquired pharmacies were PharmaSTAT, LLC in Louisville, Kentucky (the PS Transaction); EconoMed of Iowa, Inc. in Des Moines, Iowa (the EM Transaction); and ValuScript, in Coralville, Iowa (the VS Transaction). Goodwill recorded in connection with these acquisitions aggregated $3.7 million. The purchase price also included acquired identifiable intangible assets totaling $7.1 million that are being amortized over approximately ten years. The following are the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition (in millions):

	PS Transaction	EM Transaction	VS Transaction
Fair values of the assets acquired, including goodwill and other intangible assets	$ 10.0	$ 4.5	$ 2.5
Fair values of the liabilities assumed	(1.5)	(0.5)	(0.5)
Net cash paid through December 31, 2006	8.5	4.0	2.0
Contingent consideration released from escrow	0.5	0.4	0.3
Total cash paid through December 31, 2007	9.0	4.4	2.3
Contingent consideration released from escrow	1.0		
Total cash paid through December 31, 2008	$ 10.0	$ 4.4	$ 2.3

Other

The total amount of goodwill expected to be deductible for tax purposes from the 2006, 2007 and 2008 acquisitions of the Corporation is $118.7 million as of December 31, 2008. Deferred tax assets and liabilities are further described in Note 10.

The following pro forma consolidated financial information is not intended to represent or be indicative of the consolidated results of operations or financial condition of the Corporation that would have been reported had the 2007 and 2008 acquisitions been completed as of the date or for the periods presented, and should not be taken as representative of the future consolidated results of operations or financial condition of the Corporation. The following proforma financial information includes the $14.8 million impairment charge as the charge was not related to the acquisitions in 2007 and 2008.

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NOTE 2 ACQUISITIONS (Continued)

The pro forma effect of the acquisitions assuming the transactions occurred on January 1, 2007 and 2008 excluding integration, merger related costs and other charges and the change in estimate for rebates, would be as follows for the years ended December 31, (dollars in millions, except per share amounts):

	2007	2008
Revenues	$ 1,965.2	$ 1,969.9
Net income	$ 9.5	$ 22.6
Earnings per common share:		
Basic	$ 0.31	$ 0.75
Diluted	$ 0.31	$ 0.75

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consist of the following as of December 31, (dollars in millions):

	2007	2008
Leasehold improvements	$ 9.0	$ 8.9
Equipment and software	76.5	83.2
Leased equipment	0.7	0.7
Construction in progress	1.2	4.3
	87.4	97.1
Accumulated depreciation	(30.0)	(43.1)
	$ 57.4	$ 54.0

	Balance at December 31, 2006	Additions	Disposals	Assets Acquired in Pharmacy Transaction	Transfers	Balance at December 31, 2007	Additions	Disposals	Assets Acquired in 2008 Transaction	Balance at December 31, 2008
Equipment and leasehold improvements:										
Leasehold improvements	$ 3.9	$ 0.9	$ (0.5)	$ 4.3	$ 0.4	$ 9.0	$ 2.1	$ (2.2)	$	$ 8.9
Equipment and software	32.0	15.7	(2.3)	27.8	3.3	76.5	17.8	(11.2)	0.1	83.2
Leased equipment				0.7		0.7				0.7
Construction in progress	2.8	1.5	(0.8)		(2.3)	1.2	3.2	(0.1)		4.3

Sub Total	38.7	18.1	(3.6)	32.8	1.4	87.4	23.1	(13.5)	0.1	97.1
Accumulated depreciation	(14.3)	(15.6)	1.5		(1.6)	(30.0)	(22.0)	8.9		(43.1)
Total	$ 24.4	$ 2.5	$ (2.1)	$ 32.8	$ (0.2)	$ 57.4	$ 1.1	$ (4.6)	$ 0.1	$ 54.0

Depreciation expense totaled approximately $5.4 million, $15.6 million, and $22.0 million for the years ended December 31, 2006, 2007, and 2008, respectively. Transfers represent amounts transferred from construction in progress into operations during the period as well as transfers from the Corporation s Former Parent at the Closing Date of the Pharmacy Transaction.

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For the Years Ended December 31, 2006, 2007 and 2008

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS (Continued)

Total estimated depreciation expense for the Corporation s equipment and leasehold improvements for the next five years and thereafter are as follows (dollars in millions):

Year Ending December 31,	
2009	$ 15.8
2010	12.6
2011	8.1
2012	5.6
2013	2.8
Thereafter	9.1
Total	$ 54.0

NOTE 4 GOODWILL AND INTANGIBLES

The following table presents the changes in the carrying amount of goodwill for the two years ended December 31, 2008 (dollars in millions):

Balance at December 31, 2006	$ 45.2
Purchase adjustments to Goodwill from 2006 and prior acquisitions	1.2
Goodwill acquired in Pharmacy Transaction	64.9
Balance at December 31, 2007	111.3
Purchase adjustments to Goodwill recorded from acquisitions	0.7
Goodwill acquired from 2008 acquisitions	1.7
Balance at December 31, 2008	$ 113.7

The changes in goodwill relate to prior acquisitions and the acquisitions of the current year. The Corporation recorded approximately $1.7 million of goodwill related to the buy-out of joint ventures and the purchase of the institutional pharmacy in the fourth quarter of 2008.

The following table presents the components of the Corporation s intangible assets at December 31 (dollars in millions):

Finite Lived Intangible Assets	**Balance at December 31, 2007**	**Additions**	**Impairment**	**Balance at December 31, 2008**

Customer relationships	$ 57.4	$ 17.2	$ (21.5)	$ 53.1
Trade name	27.9			27.9
Non-compete agreement	2.4			2.4
Sub Total	87.7	17.2	(21.5)	83.4
Accumulated amortization	(10.2)	(6.5)	6.7	(10.0)
Net intangible	$ 77.5	$ 10.7	$ (14.8)	$ 73.4

Amortization expense relating to finite lived intangible assets was approximately $3.4 million, $5.0 million and $6.5 million for the years ended December 31, 2006, 2007, and 2008, respectively.

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million, related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Years Ended December 31, 2006, 2007 and 2008

NOTE 4 GOODWILL AND INTANGIBLES (Continued)

segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to intangible assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. These asset groups were assessed for recoverability under SFAS No. 144 and management determined the finite lived customer relationship assets to be impaired, but no other assets within the asset groups were deemed to be impaired. Using a discounted cash flow analysis, the Corporation determined the pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value, resulting in a loss per diluted share impact of $0.30. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Total estimated amortization expense for the Corporation s finite lived intangible assets for the next five years and thereafter are as follows (dollars in millions):

Year Ending December 31,	
2009	$ 6.5
2010	6.1
2011	5.0
2012	4.9
2013	4.9
Thereafter	46.0
	$ 73.4

NOTE 5 CREDIT AGREEMENT

On the Closing Date, the Corporation entered into a credit agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent (the Credit Agreement). The Credit Agreement consists of a $275.0 million term loan facility and a $150.0 million revolving credit facility. The Corporation borrowed $275.0 million under the term loan portion of the Credit Agreement and an additional $20.0 million under the revolving credit portion of the Credit Agreement on the Closing Date to refinance the initial financings entered into by KPS and PharMerica LTC, to finance their respective cash distributions, to pay fees and expenses incurred in connection with the Pharmacy Transaction and for working capital and other general corporate purposes. Indebtedness under the Credit Agreement matures on July 31, 2012, at which time the commitment of the Lenders to make revolving loans also shall expire. There is no scheduled amortization under the term loan facility but the term loans are subject to certain prepayment obligations relating to asset sales, casualty losses and the incurrence by the Corporation of certain indebtedness.

Prior to the Pharmacy Transaction, KPS and PharMerica LTC each entered into a financing arrangement for daylight loans (Spin-Co Loans). The Spin-Co Loans were provided by a syndicate of lenders arranged by J.P. Morgan Securities Inc. (JPMorgan) pursuant to a commitment letter that KPS, PharMerica LTC, and the Corporation entered into with JPMorgan and JPMorgan Chase Bank, N.A. on May 31, 2007. KPS and PharMerica LTC each obtained a $125.0 million loan under the Spin-Co Loans, for a total of $250.0 million, subject to certain adjustments for changes in working capital. The initial financings were funded immediately prior to closing of the Pharmacy Transaction.

The proceeds of the initial financings were used by KPS and PharMerica LTC to make the Kindred cash distribution and AmerisourceBergen cash distribution, respectively, prior to consummation of the Pharmacy Transaction. The amounts of the distributions to Kindred and AmerisourceBergen were in the amounts of the

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For the Years Ended December 31, 2006, 2007 and 2008

NOTE 5 CREDIT AGREEMENT (Continued)

indebtedness incurred by KPS and PharMerica LTC, respectively. The Spin-Co Loans were paid by the Corporation on July 31, 2007 with proceeds from the Credit Agreement.

The table below summarizes the term debt and revolving credit facility of the Corporation (dollars in millions):

	December 31, 2007	December 31, 2008
2007 Credit Agreement:		
Term Debt payable to lenders at LIBOR plus applicable margin (3.9% as of December 31, 2008), matures July 31, 2012	$ 250.0	$ 240.0
Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin, matures July 31, 2012		
Long-term debt	$ 250.0	$ 240.0

Maturities of the Corporation s long-term debt are as follows for the years indicated (dollars in millions):

Year Ending December 31,	
2009	$
2010	
2011	
2012	240.0
Total	$ 240.0

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of December 31, 2008 was $2.7 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $147.3 million as of December 31, 2008. The Corporation has been informed by one of its lenders that they will not fund any of their commitments under the revolving credit facility up to the amount of $8.3 million thus decreasing the availability under the revolving credit facility to $139.0 million. The Corporation is actively pursuing a replacement lender to fulfill the commitment.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted LIBOR rate plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625% and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving

credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation.

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation s wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and

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For the Years Ended December 31, 2006, 2007 and 2008

NOTE 5 CREDIT AGREEMENT (Continued)

non-financial affirmative and negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

Covenants

The Credit Agreement requires the Corporation to satisfy a minimum fixed charge coverage ratio and a maximum leverage ratio. The fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than 2.00:1.00 during the period from the Closing Date through December 31, 2008; 2.25:1.00 during the period January 1, 2009 through December 31, 2009; and 2.50:1.00 thereafter. The maximum leverage ratio, which also is tested quarterly, cannot exceed 4.50:1.00 during the period July 1, 2008 through December 31, 2008; 3.50:1.00 during the period January 1, 2009 through December 31, 2009; and 3.00:1.00 thereafter. The leverage ratio is not tested when at any time it is less than 2.00:1.00 or both S&P and Moody s shall have in effect corporate credit ratings for the Corporation that are investment grade. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues, subject to certain carry over rights in regards to unused portions commencing with the fiscal year ended December 31, 2008.

The financial covenant requirements as defined by the Corporation s Credit Agreement are as follows:

	Minimum Fixed Charge Coverage Ratio	Maximum Total Leverage Coverage Ratio	Capital Expenditure
Requirement	> = 2.00 to 1.00	< = 4.50 to 1.00	< = 3.00%
December 31, 2007	2.57	2.99	1.40%
December 31, 2008	3.67	1.99	1.13%

In addition, the Credit Agreement contains customary affirmative and negative covenants, which among other things, limit the Corporation s ability to incur additional debt, create liens, pay dividends, effect transactions with the Corporation s affiliates, sell assets, pay subordinated debt, merge, consolidate, enter into acquisitions, and effect sale leaseback transactions.

Interest Rate Swap

On the Closing Date, the Corporation entered into an interest rate swap agreement with JPMorgan as the counterparty. The interest rate swap agreement was effective as of the Closing Date and has a maturity date of July 31, 2009. The Corporation entered into the interest rate swap agreement to mitigate the floating interest rate risk on $200.0 million of its outstanding variable rate borrowings. The interest rate swap agreement requires the Corporation to make quarterly fixed rate payments to JPMorgan calculated on a notional amount set at an annual fixed rate of 5.123%, plus applicable margin (1.0%). JPMorgan will be obligated to make quarterly floating payments to the Corporation based on the three-month LIBOR, plus applicable margin (1.0%) on the same referenced notional amount.

Notwithstanding the terms of the interest rate swap transaction, the Corporation is ultimately obligated for all amounts due and payable under the Credit Agreement. The notional value of the swap is $200.0 million as of December 31, 2007 and 2008.

The Corporation assesses the effectiveness of its cash flow hedge instrument on a quarterly basis. The Corporation completed an assessment of the cash flow hedge instrument at December 31, 2008, and determined

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 5 CREDIT AGREEMENT (Continued)

the hedge to be highly effective in accordance with SFAS No. 133. The interest rate swap agreement exposes the Corporation to credit risk in the event of non-performance by JPMorgan and other participating financial institutions, however, the Corporation does not anticipate non-performance by the parties to the agreement. The Corporation does not hold or issue derivative financial instruments for trading purposes.

The fair value of the interest rate swap agreement is the amount at which it could be settled, based on estimates. The Corporation has designated the interest rate swap as a cash flow hedge instrument, which is recorded in the Corporation s accompanying consolidated balance sheet at its fair value. The fair value of the Corporation s interest rate swap at December 31, 2008, reflected as a liability of approximately $4.9 million, is included in other accrued liabilities in the Corporation s accompanying consolidated balance sheets.

Deferred Financing Fees

The Corporation capitalized a total of $2.0 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying consolidated balance sheet. The Corporation amortizes the financing fees under the straight-line method over the term of the Credit Agreement. As of December 31, 2008, the Corporation had $1.4 million of unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

The Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. None of such legal proceedings are, in the opinion of management, expected to have a material adverse effect on the consolidated financial position, results of operations or liquidity of the Corporation.

Effective October 1, 2007, CMS promulgated new rules under the Deficit Reduction Act of 2005 DRA (DRA) changing the federal upper payment limit for Medicaid reimbursement from 150% of the lowest published price for a drug (which is usually the average wholesale price) to 250% of the lowest average manufacturer price or AMP. Although the use of an AMP benchmark would have reduced Medicaid reimbursement rates for certain generic pharmaceuticals, it did not take effect due to a December 19, 2007 federal district court injunction against CMS prohibiting the agency from implementing the rule. The outcome of the AMP litigation is uncertain, and there can be no assurance that changes in reimbursement formula under the DRA or future legislation or regulation will not have an adverse impact on our business and results of operations.

Average wholesale price or AWP, is a pricing benchmark published by First DataBank, Inc., which provides drug databases, content integration software and drug reference products. AWP is widely used to calculate a portion of the Medicaid and Medicare Part D drug reimbursements payable to pharmacy providers. In 2005, several pension funds brought an action against First DataBank and another healthcare provider alleging collusion to set AWPs for branded drugs.

In June 2008, First DataBank, Inc. reported that it filed amendments with the Courts to a previously proposed settlement. If the terms of the amended settlement are approved by the court, First DataBank will (1) adjust its reporting of Blue Book AWP for those prescription drugs identified in the plaintiffs previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the WAC or Direct Price for those prescription drugs that are on a mark-up basis; (2) establish a centralized data repository to facilitate reasonable access to discoverable material from First

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NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

DataBank concerning its drug price reporting practices, (3) make a $1.0 million contribution into a court- supervised fund for the benefit of the settlement class members, and (4) pay certain settlement-related notice and other expenses and fees. The Court granted preliminary approval of the amended settlement on July 14, 2008. Further the court conducted a final fairness hearing on December 17, 2008 to consider among other things the fairness, reasonableness, and adequacy of the settlement. The court did not rule on the fairness hearing considerations and asked that the parties provide the court with certain additional information. It is expected that the Court will make a final decision in early February, 2009.

Independent of the settlement and on the same schedule as the Blue Book AWP adjustment noted above, First DataBank intends to apply the same 1.20 markup factor to all other NDCs whose Blue Book AWP is set based upon a markup to WAC or Direct Price in excess of 1.20. First DataBank will also independently discontinue publishing the Blue Book AWP data field for all drugs no later than two years following the date that the Blue Book AWP adjustments noted above are implemented.

Currently, we are unable to fully evaluate the potential impact until a final action is ultimately determined. There can be no assurance that changes in the calculation of AWP will not have an adverse impact on our business and results of operations.

Acquisitions

The Corporation has historically acquired the assets of businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, medical and general professional liabilities, workers compensation liabilities, previous tax liabilities and unacceptable business practices. Although the Corporation institutes policies designed to conform practices to its standards following completion of acquisitions, there can be no assurance the Corporation will not become liable for past activities that may later be asserted to be improper by private plaintiffs or government agencies.

Although the Corporation generally seeks to obtain indemnification from prospective sellers covering such matters, there can be no assurance that any such matter will be covered by indemnification, or if covered, that such indemnification will be adequate to cover potential losses and fines. In the ordinary course of business, the Corporation enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as business acquisitions and disposals of an operating facility. These indemnifications may cover claims against employment-related matters, governmental regulations, environmental issues, tax matters, as well as customer, third party payor, supplier and contractual relationships. Obligations under these indemnities generally would be initiated by a breach of the terms of the contract or by a third party claim or event.

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen, the Corporation s former 50% stockholder and former parent of PharMerica LTC. Pursuant to this agreement, the Corporation has agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years following the Closing Date. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. Since July 31, 2007, the Corporation has purchased approximately $1.8 billion under the AmerisourceBergen Prime Vendor Agreement.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred, the Corporation s former 50% stockholder (the IT Services Agreement). Pursuant to this agreement, KHOI will be the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years following the Closing Date. The services provided by KHOI will include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services will include, among other matters, functions for financial management, systems and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support and general business systems.

Except for certain services which will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement shall automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination of the agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred $7.3 million and $17.3 million for the years ended December 31, 2007 and 2008, respectively, under the IT Services Agreement.

Transition Services Agreements

At the consummation of the Pharmacy Transaction, the Corporation entered into a Transition Services Agreement with Kindred (the Kindred TSA). Pursuant to this agreement, Kindred provided the Corporation with certain corporate administrative services, such as payroll and employee benefit administration, human resources, risk management, treasury, tax, accounting and financial reporting services, for a period of fifteen months following the Closing Date. Kindred provided such services at its cost, which were actual costs and expenses incurred by Kindred in providing these services, including overhead costs and per hour costs of the Kindred employees providing the services. The Kindred TSA expired on October 31, 2008. The Corporation has incurred $0.8 million and $0.5 million for the years ended December 31, 2007 and 2008, respectively, under the Kindred TSA.

At the consummation of the Pharmacy Transaction, the Corporation entered into a Transition Services Agreement with AmerisourceBergen (the AmerisourceBergen TSA). Pursuant to this agreement,

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NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

AmerisourceBergen provided the Corporation with certain transition services, such as payroll and employee benefit administration services for a period of twelve months following the Closing Date. AmerisourceBergen provided such services at its cost, which were the actual costs and expenses incurred by AmerisourceBergen in providing these services, including overhead costs and per hour costs of the AmerisourceBergen employees providing the services. The AmerisourceBergen TSA expired on July 31, 2008. The Corporation has incurred $0.2 million and less than $0.1 million for the years ended December 31, 2007 and 2008, respectively, under the AmerisourceBergen TSA.

Employment Agreements

The Corporation has entered into employment agreements with certain of its executive officers. During the employment period, each of the executive officers will be eligible to (i) participate in any short-term and long-term incentive programs established or maintained by the Corporation, (ii) participate in all incentive, savings and retirement plans and programs of the Corporation, (iii) participate, along with their dependents, in all welfare benefit plans and programs provided by the Corporation and (iv) receive four weeks of paid vacation per calendar year.

The type of compensation due to each of the executive officers in the event of the termination of their employment period varies depending on the nature of the termination. The employment agreements do not entitle the executive officers to any additional payment or benefits solely upon the occurrence of a change in control.

Leases

The Corporation leases real estate properties, buildings, vehicles and equipment under cancelable and non-cancelable leases. The leases expire at various times and have various renewal options. Certain leases that meet the lease capitalization criteria in accordance with SFAS No. 13, *Accounting for Leases*, as amended, have been recorded as an asset and liability at the net present value of the minimum lease payments at the inception of the lease. Interest rates used in computing the net present value of the lease payments are based on the Corporation s incremental borrowing rate at the inception of the lease. The Corporation recorded the following lease expense for the years ended December 31 (in millions):

	2006	2007	2008
Pharmacy locations and administrative offices lease expense	$ 4.8	$ 10.7	$ 16.4
Office equipment lease expense	0.8	3.3	5.7
Total lease expense	$ 5.6	$ 14.0	$ 22.1

Future minimum lease payments for those leases having an initial or remaining non-cancelable lease term in excess of one year are as follows for the years indicated (dollars in millions):

Year Ending December 31,		**Operating Leases**
2009	$	16.4
2010		14.2
2011		10.1
2012		6.5
2013		4.4
Thereafter		10.2
Total	$	61.8

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 7 REVENUES

The Corporation recognizes revenues at the time services are provided or products are delivered. A significant portion of these revenues are billed to PDPs under Medicare Part D, the state Medicaid programs, long-term care institutions, third party insurance companies, and private payors. Some claims are electronically adjudicated through online processing at the point the prescription is dispensed such that the Corporation s operating system is automatically updated with the actual amount to be reimbursed. As a result, revenues and the associated receivables are based upon the actual reimbursement to be received by the Corporation. For claims that are adjudicated on-line and are rejected or otherwise denied upon submission, the Corporation provides contractual allowances based upon historical trends, contractual reimbursement terms and other factors which may impact ultimate reimbursement. Amounts are adjusted to actual reimbursed amounts upon cash receipt.

Under the new Part D benefit, payment is determined in accordance with the agreements the Corporation has negotiated with the Part D Plans. The remainder of the Corporation s billings are paid or reimbursed by individual residents, long-term care facilities (including revenues for residents funded under Medicare Part A) and other third party payors, including Medicaid and private insurers.

The Medicaid and Medicare programs are highly regulated. The failure, even if inadvertent, of the Corporation and/or client facilities to comply with applicable reimbursement regulations could adversely affect the Corporation s reimbursement under these programs and the Corporation s ability to continue to participate in these programs. In addition, failure to comply with these regulations could subject the Corporation to other penalties.

As noted, the Corporation obtains reimbursement for drugs it provides to enrollees of a given Part D Plan in accordance with the terms of the agreement negotiated between it and that Part D Plan. The Corporation has entered into such agreements with nearly all Part D Plan sponsors under which it will provide drugs and associated services to their enrollees. The Corporation continues to have ongoing discussions with Part D Plans in the ordinary course and may, as appropriate, renegotiate agreements.

The Corporation s hospital pharmacy management revenues represent contractually defined management fees and the reimbursement of costs associated with the direct operations of hospital pharmacies, which are primarily comprised of personnel costs.

A summary of revenues by payor type follows (dollars in millions):

	2006		2007		2008	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 252.0	38.6%	$ 550.2	45.2%	$ 885.8	45.5%
Institutional healthcare providers	241.6	37.1	369.3	30.3	577.2	29.7
Medicaid	56.4	8.6	108.8	8.9	181.1	9.3
Private and other	23.3	3.6	77.7	6.4	133.2	6.8
Insured	20.8	3.2	46.8	3.8	101.4	5.2
Medicare	8.1	1.2	10.2	0.9	10.1	0.5
Hospital management fees	50.4	7.7	54.8	4.5	58.5	3.0
Total	$ 652.6	100.0%	$ 1,217.8	100.0%	$ 1,947.3	100.0%

Co-payments for the Corporation s services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payors and are typically not collected at the time products are delivered or

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NOTE 7 REVENUES (Continued)

services are provided. Co-payments under the Medicaid programs and third party plans are generally billed to the responsible party as part of the Corporation s normal billing procedures and are subject to the Corporation s normal collection procedures.

Under Medicare Part D, co-payments related to institutional residents who are both Medicare and Medicaid eligible (dual eligible) are due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility, subsequent to which the PDPs are responsible for reimbursement.

Under certain circumstances, including state-mandated return policies under various Medicaid programs, the Corporation accepts returns of medications and issues a credit memorandum to the applicable payor. Product returns are processed in the period in which the return is accepted by the Corporation. A reserve has been established for such returns based on historical information.

NOTE 8 INTEGRATION, MERGER RELATED COSTS AND OTHER CHARGES

The following is a summary of integration, merger related costs and other charges incurred by the Corporation (dollars in millions):

	Years Ended December 31,		
	2006	**2007**	**2008**
Integration costs and other charges:			
Allowance for doubtful accounts	$	$ 27.9	$
Professional and advisory fees		1.1	1.7
General and administrative		0.6	3.2
Employee costs		0.6	7.2
Severance costs		1.1	5.3
Facility costs		2.6	9.3
		33.9	26.7
Merger related costs:			
Professional and advisory fees	2.9	8.0	
General and administrative		5.4	
Employee costs		7.6	
Severance costs		2.0	
Facility costs		0.7	
Other costs		0.1	
	2.9	23.8	
Total integration, merger related costs and other charges	$ 2.9	$ 57.7	$ 26.7

Negative effect on diluted earnings per share	NM	$ (1.74)	$ (0.53)

The Corporation incurred integration, merger related costs and other charges through December 31, 2008 related to the consolidation of pharmacies within a similar location and costs to convert data and integrate systems. As of December 31, 2008, substantially all pharmacy consolidations have been completed. In fiscal year 2009 we will complete our pharmacy consolidations and begin the integration of our pharmacy system platforms.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 8 INTEGRATION, MERGER RELATED COSTS AND OTHER CHARGES (Continued)

During the year ended December 31, 2007, the Corporation performed a comprehensive assessment of allowance for doubtful accounts estimation methodologies and reserve levels in light of its expectations around the ultimate collection of its accounts receivable balances. The Corporation considered recent industry trends, changes in reimbursement sources and procedures, age of receivables and recent collection history. In connection with that comprehensive assessment of allowance for doubtful accounts, included in amounts charged to costs and expenses is a change in accounting estimate to increase the allowance for doubtful accounts by $27.9 million resulting in loss per dilutive share impact of $0.84.

As the Corporation continues to integrate the businesses of PharMerica LTC and KPS additional costs will be incurred. In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities,* costs will be recognized as an expense to the Corporation as incurred. During the year ended December 31, 2008, there were twenty-one pharmacy locations impacted by consolidation.

NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS

Common Stock

Holders of the Corporation s common stock are entitled to one vote for each share held of record on all matters on which stockholders may vote. There are no preemptive, conversion, redemption or sinking fund provisions applicable to our common stock. In the event of liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in the assets available for distribution, subject to any prior rights of any holders of preferred stock then outstanding. Delaware law prohibits the Corporation from paying any dividends unless it has capital surplus or net profits available for this purpose. In addition, the Corporation s Credit Agreement imposes restrictions on its ability to pay dividends.

As a part of the Pharmacy Transaction, the Corporation issued 30 million shares of common stock. In the Pharmacy Transaction, each Kindred stockholder received approximately 0.366 shares of the Corporation s common stock in respect of each share of Kindred common stock held on the record date and each AmerisourceBergen stockholder received approximately 0.083 shares of the Corporation s common stock in respect of each share of AmerisourceBergen common stock held on the record date. Immediately following the Pharmacy Transaction, the stockholders of Kindred and AmerisourceBergen each owned 50% of the outstanding common stock of the Corporation. The shares of the Corporation s common stock held by Kindred and AmerisourceBergen prior to the Pharmacy Transaction were cancelled, and neither retained any ownership of the outstanding shares of common stock of the Corporation.

The historical common stock of the Corporation was cancelled on the Closing Date of the Pharmacy Transaction and reclassified as capital in excess of par value.

Preferred Stock

The certificate of incorporation authorizes the issuance of an aggregate of 1.0 million shares of preferred stock. As of December 31, 2008, there were no shares of preferred stock outstanding.

Our board of directors may, from time to time, direct the issue of shares of preferred stock in series and may, at the time of issuance, determine the designation, powers, rights, preferences and limitations of each series.

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NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)

Satisfaction of any dividend preferences of outstanding preferred stock would reduce the amount of funds available for the payment of dividends on our shares of common stock. Holders of preferred stock may be entitled to receive a preference payment in the event of any liquidation, dissolution or winding-up of our company before any payment is made to the holders of our common stock. Under certain circumstances, the issuance of preferred stock may render more difficult or tend to discourage a merger, tender offer or proxy contest, the assumption of control by a holder of a large block of our company s securities or the removal of incumbent management. The board of directors may issue shares of preferred stock with voting and conversion rights that could adversely affect the holders of shares of our common stock. Specifically, our certificate of incorporation authorizes our board to adopt a rights plan without stockholder approval. This could delay or prevent a change in control of us or the removal of existing management.

2007 Omnibus Incentive Plan

On July 12, 2007, the Corporation adopted the PharMerica Corporation 2007 Omnibus Incentive Plan, as amended on May 30, 2008, (Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors and consultants. The Corporation has reserved 3,800,000 shares of its common stock for awards to be granted under the Omnibus Plan plus 534,642 shares reserved for substitute equity awards for employees of KPS and PharMerica LTC whose awards were cancelled or forfeited upon the consummation of the Pharmacy Transaction. The Corporation s Compensation Committee administers the Omnibus Plan and has the authority to determine the recipient of the awards, the types of awards, the number of shares covered and the terms and conditions of the awards. The Omnibus Plan allows for grants of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock and restricted stock units, deferred shares, performance awards, including cash bonus awards, and other stock-based awards. On July 24, 2008, the Corporation s stockholders approved an amendment to the Omnibus Plan to provide the Compensation Committee with increased flexibility to use non-GAAP measures to measure performance, including the ability to exclude from the performance measures certain items or charges related to an event or occurrence which the Compensation Committee determines should be excluded, in accordance with the performance criteria of performance awards granted pursuant to the Omnibus Plan.

The stock options granted under the Omnibus Plan to replace options granted by Kindred or AmerisourceBergen that were cancelled or forfeited upon the consummation of the Pharmacy Transaction have the same basic terms, conditions and vesting schedule of the awards granted to them by Kindred and AmerisourceBergen. In addition, unvested restricted shares of Kindred and AmerisourceBergen common stock held by our named executive officers who were formerly KPS or PharMerica LTC employees were replaced with restricted shares of the Corporation s common stock, which have the same basic terms, conditions and vesting schedule as applied to the forfeited Kindred or AmerisourceBergen restricted shares.

2008 Stock-based Awards

The Compensation Committee establishes long-term and short-term incentive programs under the Omnibus Plan. On March 10, 2008 the Compensation Committee granted stock based compensation awards with respect to 247,869 options for common stock under the Omnibus Plan with a grant price of $15.10 per share. The Compensation Committee also granted performance share units with a performance target of 67,328 shares.

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For the Years Ended December 31, 2006, 2007 and 2008

NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)

Additionally, subsequent to March 10, 2008 the Compensation Committee granted stock based compensation awards with respect to 76,638 options for common stock under the Omnibus Plan with a grant price of $16.16 to $23.79 per share, 72,548 shares of restricted stock to members of the board of directors and new employees of the Corporation and performance share units with a performance target of 947 shares. The terms and conditions of these awards have similar terms to other awards granted by the Compensation Committee.

Based upon the achievement of the performance criteria at the end of the performance cycle for the performance share units issued to date, the Corporation may issue no shares or a maximum of 149,975.

Stock based compensation granted under the Omnibus Plan in 2008 vests in four equal annual installments and has a term of seven years. The restricted stock granted under the Omnibus Plan in 2008 to new employees vest in full, upon the three-year anniversary of the date of grant. The restricted stock grant to members of the board of directors vests ratable each year from the date of grant. The performance share units granted under the Omnibus Plan in 2008 vest based upon the Corporation s earnings before interest, income taxes, depreciation and amortization, or Adjusted EBITDA performance, which reinforces the importance of achieving the Corporation s profitability objectives. The performance is measured over a three-year period.

As of December 31, 2008, total shares available for grants of stock based awards pursuant to the Omnibus Plan were 2,252,406.

2007 Stock-based Awards

On August 7, 2007 the Compensation Committee granted stock based compensation awards with respect to 1,072,695 options for common stock under the Omnibus Plan with a grant price of $16.31 per share and 356,938 shares of restricted stock and performance share units with a target of 8,950 shares.

With regards to the stock options granted under the Omnibus Plan in 2007 (other than the substitute options granted to replace cancelled Kindred and AmerisourceBergen options), each option vests in four equal annual installments and has a term of seven years. The restricted stock granted under the Omnibus Plan in 2007 (other than the substitute restricted stock granted to replace cancelled Kindred and AmerisourceBergen restricted stock) generally vests in full, upon the three-year anniversary of the date of grant, thus stressing the retentive aspect of these awards. In addition, with respect to the performance share units granted under the Omnibus Plan in 2007, vesting is based upon the Corporation s earnings before interest, income taxes, depreciation and amortization, or Adjusted EBITDA performance, which reinforces the importance of achieving the Corporation s profitability objectives. The performance share units granted August 7, 2007 have a performance period measured on a three-year period.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)

Stock-Based Compensation Expense

The following is a summary of stock-based compensation incurred by the Corporation (in millions):

	Years Ended December 31,	
	2007	2008
Stock option compensation expense	$ 1.1	$ 2.6
Nonvested stock compensation expense	0.4	2.3
Total Stock Compensation Expense	$ 1.5	$ 4.9

As of December 31, 2008, there was $8.4 million of total unrecognized compensation cost related to the Corporation s stock compensation arrangements. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Corporation expects to recognize that cost over weighted average periods ranging from 1.0 2.38 years depending on the type of award granted.

Total estimated compensation expense for the Corporation s stock options and restricted stock awards for the next five years and thereafter are as follows (dollars in millions):

Year Ending December 31,	
2009	$ 3.8
2010	3.4
2011	1.1
2012	0.1
2013	
Thereafter	
Total	$ 8.4

The following weighted average assumptions were used to estimate the fair value of options granted using the Black-Scholes Merton option-pricing model:

	2007	2008
Expected volatility	33.3-45.0%	33.3-41.7%
Risk free interest rate (range)	4.55-4.98%	1.53-2.45%

Expected dividends		
Average expected term (years)	0.3 - 5.0	2.0 - 5.0
Fair value per share of stock options granted based on the Black-Sholes-Merton model	$ 5.82	$ 4.67

Expected Volatility

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. Historical volatility is an appropriate starting point for setting this assumption under SFAS No. 123(R). According to SFAS No. 123(R), companies should also consider how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility

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NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)

and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of ten companies in the same or similar industries as the Corporation. SFAS No. 123(R) and Staff Accounting Bulletin No. 107 acknowledge that there is likely to be a range of reasonable estimates for volatility. In addition, SFAS No. 123(R) requires that if a best estimate cannot be made, management should use the mid-point in the range of reasonable estimates for volatility. The Corporation estimates the volatility of its common stock in conjunction with the Corporation s annual grant and volatility is calculated utilizing the historical volatility of the Corporation s and its peer-group, which is consistent with SFAS No. 123(R) and SAB 107. To the extent material grants are made subsequent to the Corporation s annual grant the volatility calculation is updated through the most recent grant date of the awards.

Risk-Free Interest Rate

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option.

Expected Dividends

The Corporation has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, it uses an expected dividend yield of zero.

Expected Term

The Corporation calculated an expected term using management s estimate of option exercises. The majority of the Corporation s stock options are on a graded-vesting schedule. SFAS No. 123(R) permits companies to estimate the value of awards with graded vesting by treating each vesting tranche as a separate award. Alternatively, the award may be valued as a single award. Management has determined to value each tranche of the awards separately utilizing a multiple fair value method.

Stock Option Activity

During 2008, the Compensation Committee granted 324,507 stock options under the Omnibus Plan. The weighted average fair value based on the Black-Scholes option pricing model for stock options granted December 31, 2007 and 2008, was $5.82 and $4.67 per share, respectively. The fair value of stock options exercised for the year ended December 31, 2008 was $0.4 million. No options were exercised in 2007. The total fair value of shares vested was $0.1 million and $2.3 million for the years ended December 31, 2007 and 2008, respectively. Cash received from stock option exercises for the year ended December 31, 2008 was $0.8 million.

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NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)

The following table summarizes option activity for the periods presented:

	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Term	Aggregate Instrinsic Value (in millions)
Outstanding at December 31, 2006	127,787	$ 21.56	6.0 years	
Cancellation of nonvested stock options under former Parent s Omnibus Plan	(127,787)	21.56		
Effect of Pharmacy Transaction on options	479,302	12.73		
Granted	1,072,695	16.31		
Exercised				
Canceled	(281,614)	15.09		
Outstanding at December 31, 2007	1,270,383	$ 15.23	6.8 years	
Granted	324,507	15.65		
Exercised	(67,878)	13.28		
Canceled	(194,363)	14.88		
Outstanding at December 31, 2008	1,332,649	$ 15.47	5.7 years	$ 0.9
Exercisable at December 31, 2008	393,023	$ 15.23	5.3 years	$ 0.4

Nonvested Shares

During 2008, the Compensation Committee granted 72,548 shares of restricted stock and 68,275 performance share units under the Omnibus Plan. The total fair value of shares vested for the years ended December 31, 2007 and 2008 was $0.1 million and $2.0 million.

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2006	28,961	$ 26.04
Cancellation of nonvested shares under former Parent s Omnibus Plan	(28,961)	26.04
Effect of Pharmacy Transaction on nonvested shares and units	55,340	6.66
Granted	365,888	16.31
Forfeited	(51,666)	12.71

Vested	(8,658)		14.18
Outstanding shares at December 31, 2007	360,904	$	15.13
Granted	140,823		16.83
Forfeited	(33,578)		12.84
Vested	(125,558)		16.23
Outstanding at December 31, 2008	342,591	$	15.93

Other Plans

The Corporation sponsors defined contribution retirement plans for all eligible employees, as defined in the plan documents. These plans are qualified under Section 401(k) of the Internal Revenue Code. Contributions to the plans are based upon employee contributions and the Corporation s matching contributions. The Corporation s matching contributions to the plans were $0.9 million, $2.3 million, and $5.9 million for the years ended December 31, 2006, 2007, and 2008, respectively. For the year ended December 31, 2006, all contributions to the defined contribution retirement plans were paid by Kindred.

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NOTE 10 INCOME TAXES

The components of the provision (benefit) for income taxes are as follows for the years ended December 31, (dollars in millions):

	2006	2007	2008
Current provision:			
Federal	$ 8.6	$	$
State	1.4		0.5
Total	10.0		0.5
Deferred provision (benefit):			
Federal	(1.5)	(11.7)	2.6
State	(0.1)	(1.7)	0.2
Total	(1.6)	(13.4)	2.8
Total provision (benefit) for income taxes	$ 8.4	$ (13.4)	$ 3.3

A reconciliation of the Corporation s effective tax rate and the U.S. statutory rate is as follows for the years ended December 31,:

	2006	2007	2008
U.S. statutory rate applied to pretax income (loss)	35.0%	(35.0)%	35.0%
Differential arising from:			
State taxes	3.5	(3.6)	5.6
Other	1.1	2.9	(0.9)
Effective tax rate	39.6%	(35.7)%	39.7%

A tax benefit of $13.1 million for a federal net operating loss for the year ended December 31, 2008 is included in the total provision for the year. Also included is a benefit of $2.2 million, net of valuation allowances, for state net operating losses for the year ended December 31, 2008.

The provision (benefit) for periods prior to July 31, 2007 was the responsibility of Kindred. The benefit from the net operating losses originating prior to that date are included in the deferred provision (benefit) as it is a carryforward tax asset available for use in future years. The Corporation is precluded from carrying back losses to periods prior to the Pharmacy Transaction under the terms of the Tax Matters Agreement.

The income tax provision includes federal and state income taxes currently payable and those deferred or prepaid because of temporary differences between financial statement and tax basis of assets and liabilities. The Corporation records income taxes under the liability method.

Under this method, deferred income taxes are recognized for the estimated future tax effects of differences between the tax basis of assets and liabilities and their financial reporting amounts based on enacted tax laws.

At December 31, 2008, the Corporation has tax benefits from federal net operating loss carryforwards of $19.5 million. The Corporation s deferred tax assets also include tax benefits for state net operating loss carryforwards of $17.4 million. The net operating losses have carryforward periods ranging from 1 to 20 years depending on the taxing jurisdiction. A valuation allowance of $10.3 million is provided for the state net operating loss carryforwards as it is more likely than not that some portion or all of the associated net deferred

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For the Years Ended December 31, 2006, 2007 and 2008

NOTE 10 INCOME TAXES (Continued)

tax assets will not be realized based on cumulative historic losses and other relevant considerations such as the expiration of carryforward periods.

The Corporation s valuation allowance of $10.3 million, which is provided for state net operating loss carryforwards, includes an increase of $4.3 million for the year ended December 31, 2008 over the prior year amount of $6.0 million. The increase is primarily related to the recognition or generation of additional state net operating loss carryforwards which required full valuation allowances. Of the $4.3 million increase, $1.8 million related to additional net operating losses recognized by the Corporation based on returns filed by Kindred prior to the Pharmacy Transaction, $0.8 million related to additional valuation allowances on state net operating loss carryforwards arising from the Corporation s tax year ended December 31, 2007 and $1.7 million related to state net operating losses and associated net deferred tax assets generated for the period ended December 31, 2008.

Current deferred income taxes consisted of (dollars in millions):

	December 31, 2007		December 31, 2008	
	Assets	Liabilities	Assets	Liabilities
Accrued expenses	$ 8.1	$	$ 3.5	$
Accrued rebates	2.0		1.4	
Allowance for doubtful accounts	21.3		20.7	
Other	(2.8)		2.3	
Valuation allowance	(1.5)		(3.0)	
Total current deferred taxes	$ 27.1	$	$ 24.9	$

Noncurrent deferred income taxes consisted of (dollars in millions):

	December 31, 2007		December 31, 2008	
	Assets	Liabilities	Assets	Liabilities
Accelerated depreciation	$ 1.4	$	$	$ 1.9
Stock-based compensation	0.6		2.6	
Goodwill and intangibles	44.5	17.8	24.7	
Net operating losses	17.1		36.9	
Other	18.5	1.0	4.4	
Valuation allowances	(4.5)		(7.3)	
Total noncurrent deferred taxes	$ 77.6	$ 18.8	$ 61.3	$ 1.9
Noncurrent deferred taxes, net	$ 58.8		$ 59.4	

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. The interpretation clarifies the accounting for uncertain income tax issues recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Corporation adopted the provisions of FIN 48 on January 1, 2007. As of the date of adoption, the Corporation did not have any unrecognized tax benefits.

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NOTE 10 INCOME TAXES (Continued)

To the extent the Corporation has unrecognized tax benefits for uncertain income tax issues, accrued interest will be recorded as income tax expense in the accompanying consolidated statements of operations. As of December 31, 2008, the Corporation had no accrued interest related to uncertain tax positions as it is indemnified for pre-merger liabilities associated with its FIN 48 additions for tax positions of prior years under the terms of the Tax Matters Agreement and no accrual is required at present for additions related to the current year.

As of December 31, 2008, the Corporation had a $2.4 million liability recorded for unrecognized tax benefits for U.S. Federal and State tax jurisdictions. It is reasonably possible that the Corporation s existing liabilities for unrecognized tax benefits may decrease up to $0.4 million within the next twelve months primarily due to the progression of audits or the expiration of statutes of limitation. The total amount of unrecognized tax benefits at December 31, 2008 that, if recognized, would affect the effective tax rate is $2.4 million.

Prior to the Pharmacy Transaction, KPS was included in the consolidated federal and state income tax returns filed by Kindred. Kindred allocated the consolidated federal and state income tax liabilities among the members of the consolidated return group as if KPS was a separate taxpayer, and the results of the corresponding tax liability were settled with Kindred through stockholders equity. The federal statute of limitations remains open for tax years 2006 through 2007. Kindred has reached a settlement with the Internal Revenue Service (the IRS) related to all disputed federal tax issues for tax years 2005 and prior. As a result of the consummation of the Pharmacy Transaction, subsequent to the spin-off, KPS is no longer included in Kindred income tax filings.

State jurisdictions generally have statutes of limitations ranging from three to five years. The state income tax impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification of IRS settlement to the states.

Under the terms of the Master Agreement, the Corporation entered into a tax matters agreement with Kindred and AmerisourceBergen (the Tax Matters Agreement). The Tax Matters Agreement governs the Corporation s, AmerisourceBergen s and Kindred s rights and obligations following consummation of the Pharmacy Transaction with respect to taxes, for both pre-merger and post-merger periods. Generally, Kindred and AmerisourceBergen are responsible for the taxes of KPS (and its subsidiaries) and PharMerica LTC (and its subsidiaries), respectively, that relate to pre-merger periods and the Corporation is responsible for all taxes that relate to post-merger periods.

To preserve the tax-free treatment of the spin-offs, the Corporation has agreed to certain tax-related restrictions and indemnities in the Tax Matters Agreement. These restrictions cover the two-year period following the Closing Date of the Pharmacy Transaction and generally require the Corporation to continue its current business and limit the Corporation s ability to engage in certain transactions with respect to its common shares. Each of Kindred and AmerisourceBergen is required to indemnify the Corporation for any taxes for which it is responsible under the Tax Matters Agreement, any taxes that are imposed upon the Corporation because PharMerica LTC or KPS, as the case may be, was part of the consolidated tax return of Kindred and AmerisourceBergen, respectively, or any taxes resulting from a breach of certain representations or covenants made by Kindred and AmerisourceBergen, respectively.

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NOTE 11 EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings (loss) per share for the years ended December 31, (in millions, except share and per share amounts):

	2006	2007	2008
Numerator:			
Numerator for basic and diluted earnings per share net income (loss)	$ 12.8	$ (24.1)	$ 5.0
Denominator:			
Denominator for basic earnings per share weighted average shares	NM	21,331,995	30,095,582
Effective of dilutive securities:			
Employee stock options		2,789	45,285
Employee restricted shares		9,186	50,026
Denominator for diluted earnings per share adjusted weighted average shares	NM	21,343,970	30,190,893
Basic earnings (loss) per share	NM	$ (1.13)	$ 0.17
Diluted earnings (loss) per share	NM	$ (1.13)	$ 0.17

In accordance with SFAS No. 128 (SFAS 128), *Earnings per Share*, stock options and restricted stock shares granted by the Corporation are required to be treated as potential common shares outstanding in computing diluted earnings per share.

The diluted earnings (loss) per share shown above for the year ended December 31, 2007 does not include the effects of potential common shares because their inclusion would be anti-dilutive due to the net loss for the period.

NOTE 12 BUSINESS SEGMENT DATA

The Corporation operates two business segments: institutional pharmacies and hospital pharmacy management. Institutional pharmacies provide pharmacy services to nursing centers and other healthcare providers and the hospital pharmacy management business provides management services to substantially all of Kindred s hospitals. For business segment reporting purposes, the Corporation defines segment operating income as earnings before interest, income taxes, depreciation, amortization and rent. Segment operating income reported for each of the Corporation s business segments excludes the allocation of corporate overhead.

The Corporation identifies its segments in accordance with the aggregation provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. This information is consistent with information used by the Corporation in managing its businesses.

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PHARMERICA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Years Ended December 31, 2006, 2007 and 2008

NOTE 12 BUSINESS SEGMENT DATA (Continued)

The following table sets forth certain data by business segment (dollars in millions):

	Year Ended December 31,		
	2006	2007	2008
Revenues:			
Institutional pharmacies	$ 602.2	$ 1,163.0	$ 1,888.8
Hospital pharmacy management	50.4	54.8	58.5
	$ 652.6	$ 1,217.8	$ 1,947.3
Net income (loss):			
Segment operating income:			
Institutional pharmacies	$ 41.9	$ 61.6	$ 105.6
Hospital pharmacy management	8.4	8.4	9.0
Segment operating income	50.3	70.0	114.6
Allocated Kindred corporate services	(11.9)	(8.4)	
Rent	(5.6)	(14.0)	(22.1)
Depreciation and amortization	(8.8)	(20.2)	(28.5)
Impairment of intangible assets			(14.8)
Integration, merger related costs and other charges	(2.9)	(57.7)	(26.7)
Interest income (expense), net	0.1	(7.2)	(14.2)
Income (loss) before income taxes	21.2	(37.5)	8.3
Provision (benefit) for income taxes	8.4	(13.4)	3.3
Net income (loss):	$ 12.8	$ (24.1)	$ 5.0
Rent:			
Institutional pharmacies	$ 5.6	$ 14.0	$ 22.0
Hospital pharmacy management			0.1
	$ 5.6	$ 14.0	$ 22.1
Depreciation and amortization:			
Institutional pharmacies	$ 8.8	$ 20.6	$ 28.4
Hospital pharmacy management			0.1

	$ 8.8	$ 20.6	$ 28.5
Capital expenditures, excluding acquisitions:			
Institutional pharmacies	$ 9.9	$ 16.7	$ 22.1
Hospital pharmacy management			
	$ 9.9	$ 16.7	$ 22.1

	December 31, 2007	December 31, 2008
Assets:		
Institutional pharmacies	$ 672.3	$ 671.4
Hospital pharmacy management	7.8	7.8
	$ 680.1	$ 679.2
Goodwill:		
Institutional pharmacies	$ 111.3	$ 113.7
Hospital pharmacy management		
	$ 111.3	$ 113.7

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PHARMERICA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Years Ended December 31, 2006, 2007 and 2008

NOTE 13 UNAUDITED QUARTERLY FINANCIAL INFORMATION

The quarterly interim financial information shown below has been prepared by the Corporation s management and is unaudited. It should be read in conjunction with the audited consolidated financial statements appearing herein (in millions, except per share amounts).

	2007 Quarters				2008 Quarters			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Net revenues:								
Institutional pharmacy revenues	$ 161.2	$ 159.7	$ 364.0	$ 478.0	$ 480.2	$ 471.3	$ 471.6	$ 465.7
Hospital management revenues	13.5	13.7	13.5	14.2	14.9	15.0	14.6	14.0
Total revenues	$ 174.7	$ 173.4	$ 377.5	$ 492.2	$ 495.1	$ 486.3	$ 486.2	$ 479.7
Income (loss) before income taxes	$ 0.9	$ (0.7)	$ (41.7)	$ 4.0	$ 5.8	$ 5.1	$ 7.7	$ (10.3)
Net income (loss)	$ 0.5	$ (0.4)	$ (27.0)	$ 2.8	$ 3.3	$ 2.9	$ 4.3	$ (5.5)
Earnings (loss) per common share:								
Basic	NM	NM	$ (1.07)	$ 0.09	$ 0.11	$ 0.10	$ 0.14	$ (0.18)
Diluted	NM	NM	$ (1.07)	$ 0.09	$ 0.11	$ 0.10	$ 0.14	$ (0.18)
Shares used in computing earnings (loss) per common share:								
Basic	NM	NM	25.1	30.0	30.1	30.1	30.1	30.1
Diluted	NM	NM	25.1	30.0	30.1	30.2	30.4	30.1

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Corporation has carried out an evaluation under the supervision and with the participation of management, including the Corporation s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Corporation s disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of the end of the period covered by this report. The Corporation s disclosure controls and procedures are designed so that information required to be disclosed in the Corporation s reports filed under the Exchange Act, such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms. The Corporation s disclosure controls and procedures are also intended to ensure that such information is accumulated and communicated to the Corporation s management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives, and management necessarily is required to use its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2008, the Corporation s disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Corporation files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

Changes in Internal Control Over Financial Reporting

There have been no changes in the Corporation s internal control over financial reporting during the quarter ended December 31, 2008, that has materially affected, or is reasonably likely to materially affect, the Corporation s internal control over financial reporting.

Management s Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process designed 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 principles. Our internal control over financial reporting includes those policies and procedures that:

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Corporation;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Corporation are being made only in accordance with authorizations of management and directors of the Corporation; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Corporation s assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of the Corporation s internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework.*

Based upon our assessment and those criteria, management has concluded that the Corporation maintained effective internal control over financial reporting as of December 31, 2008.

The effectiveness of the Corporation s internal control over financial reporting as of December 31, 2008 has been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm, who also audited our consolidated financial statements included in this Annual Report on Form 10-K, as stated in their report which appears with our accompanying consolidated financial statements.

Item 9B. Other Information

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item is incorporated herein by reference from the Corporation s definitive proxy statement to be filed no later than 120 days after December 31, 2008. We refer to this proxy statement as the 2009 Proxy Statement.

Item 11. Executive Compensation

Incorporated herein by reference from the Corporation s 2009 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Incorporated herein by reference from the Corporation s 2009 Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Incorporated herein by reference from the Corporation s 2009 Proxy Statement.

Item 14. Principal Accountant Fees and Services.

Incorporated herein by reference from the Corporation s 2009 Proxy Statement.

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PART IV

Item 15. Exhibits

(a)

(1) All Financial Statements

Consolidated financial statements filed as part of this report are listed under Part II, Item 8 of this Form 10-K.

(2) Financial Statement Schedules

No schedules are required because either the required information is not present or is not present in amounts sufficient to require submission of the schedule, or because the information required is included in the accompanying consolidated financial statements or the notes thereto.

(3) Exhibits

Exhibit No.	Description
2.1	Master Transaction Agreement, dated as of October 25, 2006, by and among AmerisourceBergen Corporation, PharMerica, Inc., Kindred Healthcare, Inc., Kindred Pharmacy Services, Inc., Kindred Healthcare Operating, Inc., Safari Holding Corporation, Hippo Merger Corporation and Rhino Merger Corporation (1)
2.2	Amendment No. 1 to Master Transaction Agreement, dated as of June 4, 2007, by and among AmerisourceBergen Corporation, PharMerica, Inc., Kindred Healthcare, Inc., Kindred Pharmacy Services, Inc., Kindred Healthcare Operating, Inc., Safari Holding Corporation, Hippo Merger Corporation and Rhino Merger Corporation (2)
3.1	Certificate of Incorporation of the Registrant, as amended (3)
3.2	Amended and Restated By-Laws of the Registrant (3)
4.1	Specimen Common Stock Certificate of the Registrant (2)
10.1	Transition Services Agreement Kindred Healthcare, Inc. (5)
10.2	Transition Services Agreement AmerisourceBergen Corp. (5)
10.3	Tax Matters Agreement, dated as of October 25, 2006, by and among AmerisourceBergen Corporation, PharMerica, Inc., Kindred Healthcare, Inc., Kindred Pharmacy Services, Inc. and Safari Holding Corporation (1)
10.4#	Prime Vendor Agreement (5)
10.5	Pharmacy Services Agreement dated as of July 1, 2006 between PharMerica, Inc. and Ceres Strategies, Inc. (6)
10.6	Master Pharmacy Provider Agreement dated as of July 1, 2004 by and among Kindred Healthcare Operating, Inc., Kindred Hospitals East L.L.C., Kindred Hospitals West, L.L.C., Kindred Hospitals Limited Partnership, THC Seattle, Inc., THC Chicago, Inc., and Kindred Pharmacy Services, Inc. (6)
10.7	Corporate Integrity Agreement dated as of March 29, 2005 between PharMerica, Inc., PharMerica Drug Systems, Inc., their subsidiaries and the Office of Inspector General of the United States Department of Health and Human Services (2)
10.8	Employment Agreement dated January 14, 2007 between Gregory S. Weishar, AmerisourceBergen Corporation, Kindred Healthcare, Inc. and Safari Holding Corporation (1)

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Exhibit No.	Description
10.9	Safari Holding Corporation Omnibus Incentive Plan (2)
10.10	Corporate Integrity Agreement Modifications dated as of June 26, 2007 between PharMerica, Inc., PharMerica Drug Systems, Inc., their subsidiaries and the Office of Inspector General of the United States Department of Health and Human Services (6)
10.11	Commitment Letter dated as of May 31, 2007 among JPMorgan Chase Bank, N.A., J.P. Morgan Securities Inc., PharMerica, Inc., Kindred Pharmacy Services, Inc. and Safari Holding Corporation (6)
10.12	Employment Agreement dated July 11, 2007 between Michael Culotta and Safari Holding Corporation (6)
10.13	Employment Agreement dated July 11, 2007 between Mark McCullough and Safari Holding Corporation (6)
10.14	Employment Agreement dated July 11, 2007 between Richard Toole and Safari Holding Corporation (6)
10.15	Employment Agreement dated July 11, 2007 between Anthony Hernandez and Safari Holding Corporation (6)
10.16	Form CEO Restricted Share Award Agreement (7)
10.17	Form CEO Stock Option Award Agreement (7)
10.18	Form Founder s Grant Agreement (7)
10.19	Form McKay Founder s Grant Award Agreement (7)
10.20	Form Non-Qualified Stock Option Award Agreement (7)
10.21	Employment Agreement dated July 31, 2007 between Robert McKay and PharMerica Corporation (3)
10.22	Credit Agreement dated July 31, 2007 between PharMerica Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A., as Administrative Agent (3)
10.23	Guarantee and Collateral Agreement dated July 31, 2007 between PharMerica Corporation, Its Subsidiaries Party thereto, and JPMorgan Chase Bank, N.A., as Collateral Agent (3)
10.24	Patent and Trademark Security Agreement dated July 31, 2007 between PharMerica Corporation, the Subsidiaries party hereto, and JPMorgan Chase Bank, N.A., as Collateral Agent (3)
10.25	Employment Agreement dated August 7, 2007 between Thomas Caneris and PharMerica Corporation (3)
10.26	Form Performance Share Award Agreement (3)
10.27	Form Long-Term Cash Award Agreement (3)
10.28	Form Director Restricted Share Award Agreement (3)
10.29	Form Director Non-Qualified Stock Option Award Agreement (3)
10.30	Form of Substitution NQSO Agreement for AmerisourceBergen 2001 Grants (3)
10.31	Form of Substitution NQSO Agreement for AmerisourceBergen 2002 Grants (3)
10.32	Form of Substitution NQSO Agreement for Kindred Grants (3)
10.33	Form of Substitution ISO Agreement for Kindred Grants (3)

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Exhibit No.	Description
10.34	Form of Transferring Employee (Kindred) Restricted Share Award Agreement (3)
10.35	IT Services Agreement (5)
10.36	Trademark License Agreement (5)
10.37	Separation of Employment Agreement and General Release, dated September 21, 2007 (5)
10.38	Summary of 2007 Short Term Incentive Program (5)
10.39	Summary of Director Compensation Program (5)
10.40	Amendment No. 1 to Letter Agreement with Gregory S. Weishar, dated November 13, 2007 (13)
10.41	Employment Agreement dated August 1, 2007 between Janice D. Rutkowski and the Corporation (8)
10.42	Summary of 2008 Long Term Incentive Program (9)
10.43	Summary of 2008 Short Term Incentive Program (9)
10.44	Form of Non-Qualified Stock Option Award Agreement (9)
10.45	Separation of Employment Agreement and General Release dated June 27, 2008 (10)
10.46	Separation of Employment Agreement and General Release dated July 25, 2008 (11)
10.47	Employment Agreement dated March 31, 2008 between John Kernaghan and PharMerica Corporation (12)
10.48	First Amendment to the PharMerica Corporation 2007 Omnibus Incentive Plan (12)
21.1	Subsidiaries of the Registrant
23.1	Consent of PricewaterhouseCoopers LLP
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Filed with Amendment No. 1 to the Corporation s Registration Statement on Form S-4/S-1 (Reg. No. 333-142940) filed with the Securities and Exchange Commission on May 24, 2007, and incorporated herein by reference.

(2) Filed with Amendment No. 2 to the Corporation s Registration Statement on Form S-4/S-1 (Reg. No. 333-142940) filed with the Securities and Exchange Commission on June 27, 2007, and incorporated herein by reference.

(3) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 31, 2007, and incorporated herein by reference.

(4) Filed with the Corporation s Current Report on Form 8-K filed with the Securities and Exchange Commission on July 26, 2007, and incorporated herein by reference.

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(5) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 9, 2007, and incorporated herein by reference.

(6) Filed with Amendment No. 3 to the Corporation s Registration Statement on Form S-4/S-1 (Reg. No. 333-142940) filed with the Securities and Exchange Commission on July 13, 2007, and incorporated herein by reference.

(7) Filed with the Corporation s Current Report on Form 8-K filed with the Securities and Exchange Commission on August 13, 2007, and incorporated herein by reference.

(8) Filed with Amendment No. 1 to the Corporation s Annual Report on Form 10-K/A filed with the Securities and Exchange Commission on April 29, 2008, and incorporated herein by reference.

(9) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 8, 2008, and incorporated herein by reference.

(10) Filed with the Corporation s current report on Form 8-K filed with the Securities and Exchange Commission on July 1, 2008.

(11) Filed with the Corporation s current report on Form 8-K filed with the Securities and Exchange Commission on July 25, 2008.

(12) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on October 30, 2008, and incorporated herein by reference.

(13) Filed with the Corporation s Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 19, 2008, and incorporated herein by reference.

Application has been made to the Securities and Exchange Commission to seek confidential treatment of certain provisions. Omitted material for which confidential treatment has been requested has been filed separately with the Securities and Exchange Commission.

Management contract or compensatory plan or arrangement.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

PHARMERICA CORPORATION

Date: February 5, 2009

By: /s/ GREGORY S. WEISHAR
Gregory S. Weishar

Chief Executive Officer and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ GREGORY S. WEISHAR **(Gregory S. Weishar)**	Chief Executive Officer and Director	February 5, 2009
/s/ MICHAEL J. CULOTTA **(Michael J. Culotta)**	Senior Vice President and Chief Financial Officer	February 5, 2009
/s/ BERARD E. TOMASSETTI **(Berard E. Tomassetti)**	Senior Vice President and Chief Accounting Officer	February 5, 2009
/s/ FRANK E. COLLINS **(Frank E. Collins)**	Director	February 5, 2009
/s/ W. ROBERT DAHL JR. **(W. Robert Dahl Jr.)**	Director	February 5, 2009
/s/ DR. THOMAS P. GERRITY **(Dr. Thomas P. Gerrity)**	Director	February 5, 2009
/s/ THOMAS P. MAC MAHON* **(Thomas P. Mac Mahon)**	Director	February 5, 2009
/s/ DANIEL N. MENDELSON **(Daniel N. Mendelson)**	Director	February 5, 2009

/s/ DR. ROBERT A. OAKLEY	Director	February 5, 2009
(Dr. Robert A. Oakley)		
/s/ MARJORIE W. DORR	Director	February 5, 2009
(Marjorie W. Dorr)		

* Power of Attorney given by Thomas P. Mac Mahon as a Director of PharMerica Corporation to Thomas A. Caneris authorizing such person to sign this 2008 Annual Report on Form 10-K.

By: /s/ THOMAS A. CANERIS
Thomas A. Caneris
Attorney-in-Fact

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EXHIBIT INDEX

Exhibit No.	Description
21.1	Subsidiaries of the Registrant
23.1	Consent of PricewaterhouseCoopers LLP
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002