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

Form 10-Q

(Mark one)

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

For the Quarterly Period Ended June 30, 2006

or

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

For the transition period from _____ to _____

Commission file number 333-68630

EDISON MISSION ENERGY

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation
or organization)

95-4031807

(I.R.S. Employer Identification No.)

18101 Von Karman Avenue, Suite 1700

Irvine, California

(Address of principal executive offices)

92612

(Zip Code)

Registrant's telephone number, including area code: **(949) 752-5588**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Number of shares outstanding of the registrant's Common Stock as of August 8, 2006: 100 shares (all shares held by an affiliate of the registrant).

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PART I – FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

EDISON MISSION ENERGY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(In millions, Unaudited)

	<u>Three Months Ended</u> <u>June 30,</u>		<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Operating Revenues				
Electric revenues	\$ 427	\$ 398	\$ 914	\$ 898
Net gains from price risk management and energy trading . .	24	17	41	29
Operation and maintenance services	8	7	13	12
Other revenues	4	—	9	—
Total operating revenues	<u>463</u>	<u>422</u>	<u>977</u>	<u>939</u>
Operating Expenses				
Fuel	142	134	291	299
Plant operations	147	146	266	254
Plant operating leases	44	44	88	88
Operation and maintenance services	8	7	13	12
Depreciation and amortization	36	32	71	66
Asset impairment charges	—	7	—	7
Administrative and general	33	34	64	70
Total operating expenses	<u>410</u>	<u>404</u>	<u>793</u>	<u>796</u>
Operating income	<u>53</u>	<u>18</u>	<u>184</u>	<u>143</u>
Other Income (Expense)				
Equity in income from unconsolidated affiliates	46	47	71	83
Interest income	23	15	43	27
Other income (expense), net	11	—	19	(3)
Gain on sale of assets	—	—	4	—
Loss on early extinguishment of debt	(143)	—	(143)	(4)
Interest expense	(73)	(74)	(145)	(151)
Total other income (expense)	<u>(136)</u>	<u>(12)</u>	<u>(151)</u>	<u>(48)</u>
Income (loss) from continuing operations before income taxes	(83)	6	33	95
Provision (benefit) for income taxes	(40)	(13)	1	19
Income (Loss) From Continuing Operations	<u>(43)</u>	<u>19</u>	<u>32</u>	<u>76</u>
Income from operations of discontinued subsidiaries, net of tax (Note 7)	4	21	77	28
Net Income (Loss)	<u>\$ (39)</u>	<u>\$ 40</u>	<u>\$ 109</u>	<u>\$ 104</u>

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

EDISON MISSION ENERGY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In millions, Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net Income (Loss)	\$ (39)	\$ 40	\$ 109	\$ 104
Other comprehensive income (loss), net of tax:				
Minimum pension liability adjustment, net of income tax effect	(2)	—	(2)	—
Unrealized gains (losses) on derivatives qualified as cash flow hedges:				
Other unrealized holding gains (losses) arising during period, net of income tax expense (benefit) of \$45 and \$12 for the three months and \$172 and \$(43) for the six months ended June 30, 2006 and 2005, respectively	67	16	253	(54)
Reclassification adjustments included in net income (loss), net of income tax expense (benefit) of \$(12) and \$2 for the three months and \$8 and \$5 for the six months ended June 30, 2006 and 2005, respectively . .	17	(3)	(12)	(8)
Other comprehensive income (loss)	82	13	239	(62)
Comprehensive Income	\$ 43	\$ 53	\$ 348	\$ 42

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

EDISON MISSION ENERGY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In millions, Unaudited)

	<u>June 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
Assets		
Current Assets		
Cash and cash equivalents	\$ 1,328	\$ 1,155
Short-term investments	260	183
Accounts receivable—trade	191	337
Accounts receivable—affiliates	161	18
Inventory	183	120
Assets under price risk management and energy trading	152	78
Margin and collateral deposits	240	561
Deferred taxes	16	155
Prepaid expenses and other	64	68
Total current assets	<u>2,595</u>	<u>2,675</u>
Investments in Unconsolidated Affiliates	<u>373</u>	<u>405</u>
Property, Plant and Equipment	3,997	3,856
Less accumulated depreciation and amortization	<u>913</u>	<u>844</u>
Net property, plant and equipment	<u>3,084</u>	<u>3,012</u>
Other Assets		
Deferred financing costs	48	43
Long-term assets under price risk management and energy trading	105	90
Restricted cash	121	105
Rent payments in excess of levelized rent expense under plant operating leases	506	395
Long-term margin and collateral deposits	96	137
Other long-term assets	93	161
Total other assets	<u>969</u>	<u>931</u>
Total Assets	<u>\$ 7,021</u>	<u>\$ 7,023</u>

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

EDISON MISSION ENERGY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In millions, Unaudited)

	<u>June 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
Liabilities and Shareholder's Equity		
Current Liabilities		
Accounts payable—affiliates	\$ 17	\$ 32
Accounts payable	56	64
Accrued liabilities	171	207
Liabilities under price risk management and energy trading	119	418
Interest payable	30	51
Current maturities of long-term obligations	<u>130</u>	<u>74</u>
Total current liabilities	<u>523</u>	<u>846</u>
Long-term obligations net of current maturities	3,294	3,330
Deferred taxes and tax credits	304	227
Long-term liabilities under price risk management and energy trading	26	83
Other long-term liabilities	<u>588</u>	<u>598</u>
Total Liabilities	<u>4,735</u>	<u>5,084</u>
Minority Interest	<u>44</u>	<u>29</u>
Commitments and Contingencies (Note 11)		
Shareholder's Equity		
Common stock, par value \$0.01 per share; 10,000 shares authorized; 100 shares issued and outstanding as of June 30, 2006 and December 31, 2005	64	64
Additional paid-in capital	2,212	2,228
Accumulated deficit	(62)	(171)
Accumulated other comprehensive income (loss)	<u>28</u>	<u>(211)</u>
Total Shareholder's Equity	<u>2,242</u>	<u>1,910</u>
Total Liabilities and Shareholder's Equity	<u>\$ 7,021</u>	<u>\$ 7,023</u>

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

EDISON MISSION ENERGY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions, Unaudited)

	Six Months Ended June 30,	
	2006	2005 Revised(1)
Cash Flows From Operating Activities		
Net income	\$ 109	\$ 104
Less: Income from discontinued operations	(77)	(28)
	\$ 32	\$ 76
Income from continuing operations, net		
Adjustments to reconcile income to net cash provided by (used in) operating activities:		
Equity in income from unconsolidated affiliates	(71)	(83)
Distributions from unconsolidated affiliates	88	89
Depreciation and amortization	76	66
Deferred taxes and tax credits	42	16
Gain on sale of assets	(4)	—
Loss on early extinguishment of debt	143	4
Asset impairment charges	—	7
Changes in operating assets and liabilities:		
Decrease (increase) in margin and collateral deposits	363	(142)
Decrease (increase) in accounts receivable	3	(17)
Increase in inventory	(63)	(22)
Decrease in prepaid expenses and other	10	56
Increase in rent payments in excess of levelized rent expense	(112)	(67)
Decrease in accounts payable	(4)	(7)
Decrease in accrued liabilities	(32)	(68)
Decrease in interest payable	(21)	(4)
(Increase) decrease in net assets under risk management	(26)	3
Other operating—assets	(1)	4
Other operating—liabilities	(26)	21
	397	(68)
Operating cash flow from discontinued operations	82	18
Net cash provided by (used in) operating activities	479	(50)
Cash Flows From Financing Activities		
Borrowings on long-term debt	1,315	3
Payments on long-term debt agreements	(1,293)	(511)
Repayment of loan by parent	—	(5)
Cash dividends to parent	(12)	(360)
Payments for price appreciation on stock options exercised	(9)	(7)
Excess tax benefits related to stock option exercises	4	—
Premium paid on extinguishment of debt and financing costs	(153)	(5)
Net cash used in financing activities	(148)	(885)
Cash Flows From Investing Activities		
Capital expenditures	(118)	(35)
Proceeds from return of capital and loan repayments	—	5
Purchase of interest of acquired companies	(18)	—
Proceeds from sale of interest in projects	43	—
Proceeds from sale of discontinued operations	—	124
Purchase of short-term investments	(173)	—
Maturities and sales of short-term investments	97	140
Decrease (increase) in restricted cash	(12)	21
Turbine deposits	(17)	(9)
Proceeds from (investments in) other assets	40	(1)
	(158)	245
Investing cash flow from discontinued operations	—	5
Net cash provided by (used in) investing activities	(158)	250
Effect of consolidation of variable interest entities on cash	—	3
Net increase (decrease) in cash and cash equivalents	173	(682)
Cash and cash equivalents at beginning of period	1,155	2,280
Cash and cash equivalents at end of period	1,328	1,598
Cash and cash equivalents classified as part of discontinued operations	—	(1)
Cash and cash equivalents of continuing operations	\$ 1,328	\$ 1,597

(1) See Note 1—Revisions for further explanation.

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

EDISON MISSION ENERGY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006
(Unaudited)

Note 1. General

In the opinion of management, all adjustments, including recurring accruals, have been made that are necessary to fairly state the consolidated financial position, results of operations and cash flows for the periods covered by this quarterly report on Form 10-Q. The results of operations for the six months ended June 30, 2006 are not necessarily indicative of the operating results for the full year.

Edison Mission Energy's (EME's) significant accounting policies are described in Note 2 to its Consolidated Financial Statements as of December 31, 2005 and 2004, included in EME's annual report on Form 10-K for the year ended December 31, 2005. EME follows the same accounting policies for interim reporting purposes, with the exception of the change in accounting for stock-based compensation (explained below). This quarterly report should be read in connection with such financial statements. Terms used but not defined in this report are defined in EME's annual report on Form 10-K for the year ended December 31, 2005.

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. See Note 6—Acquisitions and Consolidations—Acquisitions, for further discussion. These projects were previously owned by EME's affiliate, Edison Capital. Edison Mission Group is a subsidiary of Edison International and is the holding company for its wholly owned subsidiaries, Mission Energy Holding Company (MEHC) and Edison Capital. MEHC is the holding company of its wholly owned subsidiary EME. 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.

Stock-Based Compensation

EME's stock-based compensation plans primarily include the issuance of Edison International stock options and performance shares. Edison International usually does not issue new common stock for equity awards earned. Rather, a third party is used to facilitate the exercise of stock options and the purchase and delivery of outstanding common stock for settlement of performance shares earned. The amount of cash used to settle stock options exercised was \$6 million and \$13 million for the second quarters of 2006 and 2005, respectively, and \$19 million for both the six months ended June 30, 2006 and 2005. No cash was used to settle performance shares classified as equity awards in the second quarters of 2006 and 2005, and \$10 million and \$4 million was used for the six months ended June 30, 2006 and 2005, respectively. Edison International has approximately 13.7 million shares remaining for future issuance under its stock-based compensation plans, which are described more fully in Note 13—Stock Compensation Plans.

Prior to January 1, 2006, EME accounted for these plans using the intrinsic value method. Upon grant, no stock-based compensation cost for stock options was reflected in net income, as the grant date was the measurement date, and all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Previously, stock-based compensation cost for performance shares was remeasured at each reporting period and related compensation expense was adjusted. As discussed in Note 14—New Accounting Pronouncements,

effective January 1, 2006, EME implemented a new accounting standard that requires companies to use the fair value accounting method for stock-based compensation resulting in the recognition of expense for all stock-based compensation awards. EME recognizes stock-based compensation expense on a straight-line basis over the vesting period. EME recognizes stock-based compensation expense for awards granted to retirement-eligible participants as follows: for stock-based awards granted prior to January 1, 2006, EME recognized stock-based compensation expense over the explicit vesting period and accelerated any remaining unrecognized compensation expense when a participant actually retired; for awards granted or modified after January 1, 2006 to participants who are retirement-eligible or will become retirement-eligible prior to the end of the normal vesting period for the award, stock-based compensation is recognized on a prorated basis over the initial year or over the period between the date of grant and the date the participant first becomes eligible for retirement. If EME recognized stock-based compensation expense for awards granted prior to January 1, 2006, over a period to the date the participant first became eligible for retirement, there would be no significant changes to stock-based compensation expense for the second quarters of 2006 and 2005 and for the six months ended June 30, 2006 and 2005.

Total stock-based compensation expense (reflected in the caption “Administrative and general” on the consolidated statements of income) was \$2 million and \$7 million for the second quarters of 2006 and 2005, respectively, and \$4 million and \$12 million for the six months ended June 30, 2006 and 2005, respectively. The income tax benefit recognized in the income statement was \$1 million and \$3 million for the second quarters of 2006 and 2005, respectively, and \$2 million and \$5 million for the six months ended June 30, 2006 and 2005, respectively.

The following table illustrates the effect on net income if EME had used the fair value accounting method for the second quarter of 2005 and six months ended June 30, 2005.

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
	(in millions)	
Net income, as reported	\$ 40	\$ 104
Add: stock-based compensation expense using the intrinsic value accounting method—net of tax	4	7
Less: stock-based compensation expense using the fair value accounting method—net of tax .	(3)	(6)
Pro forma net income	<u>\$ 41</u>	<u>\$ 105</u>

Reclassifications

Certain prior year reclassifications have been made to conform to the current year financial statement presentation. Except as indicated, amounts reflected in the notes to the consolidated financial statements relate to continuing operations of EME.

Revisions

EME revised its Consolidated Statements of Cash Flows for the six months ended June 30, 2005 to separately disclose the operating and investing portion of the cash flows attributable to its discontinued operations consistent with its Consolidated Statements of Cash Flow for the year ended December 31, 2005 included in EME’s annual report on Form 10-K for the year ended December 31, 2005. EME had previously reported these amounts on a combined basis in its quarterly report on Form 10-Q for the six months ended June 30, 2005.

Note 2. Inventory

Inventory is stated at the lower of weighted average cost or market. Inventory at June 30, 2006 and December 31, 2005 consisted of the following:

	June 30, 2006	December 31, 2005
	(in millions)	
Coal and fuel oil	\$ 139	\$ 77
Spare parts, materials and supplies	44	43
Total	<u>\$ 183</u>	<u>\$ 120</u>

Note 3. Short-term Investments

Held-to-Maturity Securities

At June 30, 2006 and December 31, 2005, EME had marketable debt securities that were classified as held-to-maturity and carried at amortized cost plus accrued interest which approximated their fair value.

Held-to-maturity securities, which all mature within one year, consisted of the following:

	June 30, 2006	December 31, 2005
	(in millions)	
Commercial paper	\$ 197	\$ 99
Certificates of deposit	59	34
Time deposits	—	50
Corporate bonds	4	—
Total	<u>\$ 260</u>	<u>\$ 183</u>

Note 4. Refinancing

Credit Agreement

On June 15, 2006, EME replaced its \$98 million credit agreement with a new credit agreement that provides for a \$500 million senior secured revolving loan and letter of credit facility and matures on June 15, 2012. Loans made under this credit facility bear interest, at EME's election, at either LIBOR (which is based on the interbank Eurodollar market) or the base rate (which is calculated as the higher of Citibank, N.A.'s publicly announced base rate and the federal funds rate in effect from time to time plus 0.50%) plus, in both cases, an applicable margin. The applicable margin depends on EME's debt ratings. As of June 30, 2006, EME had available the full amount of borrowing capacity under this credit facility. The credit facility contains financial covenants which require EME to maintain a minimum interest coverage ratio and a maximum corporate debt to corporate capital ratio. A failure to meet a ratio threshold could trigger other provisions, such as mandatory prepayment provisions or restrictions on dividends.

As security for its obligations under this credit facility, EME pledged its ownership interests in the holding companies through which it owns its interests in the Illinois Plants, the Homer City facilities, the Westside projects and the Sunrise project. EME also granted a security interest in an account into

which all distributions received by it from the Big 4 projects will be deposited. EME will be free to use these proceeds unless an event of default occurs under the credit facility.

Senior Notes Offering

On June 6, 2006, EME completed a private offering of \$500 million aggregate principal amount of its 7.50% senior notes due June 15, 2013 and \$500 million aggregate principal amount of its 7.75% senior notes due June 15, 2016. EME will pay interest on the senior notes on June 15 and December 15 of each year, beginning on December 15, 2006. The senior notes are redeemable by EME at any time at a price equal to 100% of the principal amount of, plus accrued and unpaid interest and liquidated damages, if any, on, the senior notes plus a “make-whole” premium.

The senior notes are EME’s senior unsecured obligations, ranking equal in right of payment to all of EME’s existing and future senior unsecured indebtedness, and will be senior to all of 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 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 \$369 million in aggregate principal amount of its 10% senior notes due August 15, 2008 and \$596 million in aggregate principal amount of its 9.875% senior notes due April 15, 2011. 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 \$143 million loss on early extinguishment of debt during the second quarter of 2006.

Note 5. Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consisted of the following:

	<u>Unrealized Gains (Losses) on Cash Flow Hedges</u>	<u>Minimum Pension Liability Adjustment</u> (in millions)	<u>Accumulated Other Comprehensive Income (Loss)</u>
Balance at December 31, 2005	\$ (210)	\$ (1)	\$ (211)
Current period change	<u>241</u>	<u>(2)</u>	<u>239</u>
Balance at June 30, 2006	<u>\$ 31</u>	<u>\$ (3)</u>	<u>\$ 28</u>

Unrealized gains on cash flow hedges, net of tax, at June 30, 2006, include unrealized gains on commodity hedges primarily related to Midwest Generation, LLC (Midwest Generation) and EME Homer City Generation L.P. (EME Homer City) futures and forward electricity contracts that qualify for hedge accounting. These gains arise because current forecasts of future electricity prices in the relevant markets are lower than the contract prices. The decrease in the unrealized losses during the six months ended June 30, 2006 resulted from a decrease in market prices for power.

As EME’s hedged positions for continuing operations are realized, approximately \$26 million, after tax, of the net unrealized gains on cash flow hedges at June 30, 2006 are expected to be reclassified into earnings during the next 12 months. Management expects that reclassification of net unrealized gains will offset energy revenue recognized at market prices. Actual amounts ultimately reclassified into earnings over the next 12 months could vary materially from this estimated amount as a result of

changes in market conditions. The maximum period over which a cash flow hedge is designated is through December 31, 2008.

Under SFAS No. 133, the portion of a cash flow hedge that does not offset the change in value of the transaction being hedged, which is commonly referred to as the ineffective portion, is immediately recognized in earnings. EME recorded net gains (losses) of approximately \$(6) million and \$1 million during the second quarters of 2006 and 2005, respectively, and \$(17) million and \$(3) million during the six months ended June 30, 2006 and 2005, respectively, representing the amount of cash flow hedges' ineffectiveness for continuing operations, reflected in net gains from price risk management and energy trading in EME's consolidated income statements.

Note 6. Acquisitions and Consolidations

Acquisitions

Transfer of Wind Projects from an Affiliate

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. The acquisition was accounted for as a transaction between entities under common control. As such, the assets and liabilities of the projects acquired were recorded at historical cost on the acquisition date for a net book value of approximately \$76 million. EME's historical financial statements have been adjusted for all periods presented to reflect the acquisition as though EME had always owned the projects. Summarized results of the projects acquired for periods presented prior to the acquisition date of April 1, 2006 are as follows:

	Three Months Ended March 31, <u>2006</u>	Three Months Ended June 30, <u>2005</u> (in millions)	Six Months Ended June 30, <u>2005</u>
Total operating revenues	\$ 4	\$ 5	\$ 11
Loss before income taxes	(1)	—	—
Benefit for income taxes	(3)	(2)	(4)
Income from continuing operations . .	2	2	4

The principal components of the net book value of assets and liabilities at March 31, 2006 are current assets (\$8 million), property, plant and equipment, net (\$156 million), other non-current assets (\$42 million), deferred income (\$56 million) and deferred income taxes (\$59 million).

Wildorado Wind Project

On January 5, 2006, EME completed a transaction with Cielo Wildorado, G.P., LLC and Cielo Capital, L.P. to acquire a 99.9% interest in the Wildorado Wind Project, which owns a 161 MW wind farm located in the panhandle of northern Texas, referred to as the Wildorado wind project. The acquisition included all development rights, title and interest held by Cielo in the Wildorado wind project, except for a small minority stake in the project retained by Cielo. The total purchase price was \$29 million. As of June 30, 2006, a cash payment of \$18 million had been made towards the purchase price. Total project costs of the Wildorado wind project, excluding capitalized interest, are estimated to be approximately \$270 million with commercial operations expected to begin in April 2007. The acquisition was accounted for utilizing the purchase method. The fair value of the Wildorado wind project was equal to the purchase price and as a result, the total purchase price was allocated to property, plant and equipment in EME's consolidated balance sheet.

Consolidations

Variable Interest Entities

In December 2003, the FASB re-issued Statement of Financial Accounting Standards Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46R). FIN 46R defines a variable interest entity as a legal entity whose equity owners do not have sufficient equity at risk or a controlling financial interest in the entity. Under FIN 46R, the primary beneficiary is the variable interest holder that absorbs a majority of expected losses; if no variable interest holder meets this criteria, then it is the variable interest holder that receives a majority of the expected residual returns. The primary beneficiary is required to consolidate the variable interest entity unless specific exceptions or exclusions are met.

EME completed a review of the application of FIN 46R to its subsidiaries and affiliates and concluded that it had significant variable interests in variable interest entities as defined in this Interpretation. As of June 30, 2006, these entities consisted of five equity investments (the Big 4 projects and the Sunrise project) that had interests in natural gas-fired facilities with a total generating capacity of 1,782 MW. An operations and maintenance subsidiary of EME operates the Big 4 projects, but EME does not supply the fuel consumed or purchase the power generated by these facilities. EME determined that it is not the primary beneficiary in these entities; accordingly, EME continues to account for its variable interests on the equity method. EME's maximum exposure to loss in these variable interest entities is generally limited to its investment in these entities, which totaled \$324 million as of June 30, 2006.

Note 7. Divestitures

Dispositions

On March 7, 2006, EME completed the sale of a 25% ownership interest in the San Juan Mesa wind project to Citi Renewable Investments I LLC, a wholly owned subsidiary of Citicorp North America, Inc. Proceeds from the sale were \$43 million. EME recorded a pre-tax gain on the sale of approximately \$4 million during the first quarter of 2006.

Discontinued Operations

Tri Energy Project

On February 3, 2005, EME sold its 25% equity interest in the Tri Energy project pursuant to a Purchase Agreement, dated December 15, 2004, by and between EME and a consortium comprised of International Power plc (70%) and Mitsui & Co., Ltd. (30%), referred to as IPM, for approximately \$20 million. EME recorded an impairment charge of approximately \$5 million during the fourth quarter of 2004 related to the planned disposition of this investment. The sale of this investment had no significant effect on net income in the first quarter of 2005.

CBK Project

On January 10, 2005, EME sold its 50% equity interest in the CBK project pursuant to a Purchase Agreement, dated November 5, 2004, by and between EME and Corporacion IMPSA S.A. Proceeds from the sale were approximately \$104 million. EME recorded a pre-tax gain on the sale of approximately \$9 million during the first quarter of 2005.

Lakeland Project

EME previously owned a 220 MW power plant located in the United Kingdom, referred to as the Lakeland project. An administrative receiver was appointed in 2002 as a result of a default by its counterparty, a subsidiary of TXU Europe Group plc and the project company was subsequently placed in liquidation. In response to its claim against the TXU subsidiary for damages from the termination of the power sales agreement, the Lakeland project received a settlement of £116 million (approximately \$217 million). EME is entitled to receive the amount of the settlement remaining after payment of creditor claims. As creditor claims have been settled, EME has received to date payments of £13 million (approximately \$24 million) in April 2005, £61 million (approximately \$106 million) in the first quarter of 2006, and £9 million (approximately \$16 million) in April 2006. The after-tax income attributable to the Lakeland project was \$10 million and \$24 million for the second quarters of 2006 and 2005, respectively, and \$83 million and \$24 million for the six months ended June 30, 2006 and 2005, respectively. Beginning in 2002, EME reported the Lakeland project among discontinued operations and accounts for its ownership of Lakeland Power on the cost method, with earnings being recognized as cash is distributed from the project.

Summarized Financial Information for Discontinued Operations

In accordance with SFAS No. 144, all the projects discussed above are classified as discontinued operations in the accompanying consolidated statements of income. Summarized results of discontinued operations are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in millions)			
Total operating revenues	\$ —	\$ —	\$ —	\$ —
Income before income taxes and minority interest . . .	7	22	119	22
Provision (benefit) for income taxes	3	1	42	(1)
Minority interest	—	—	—	—
Income from operations of discontinued foreign subsidiaries	4	21	77	23
Gain on sale before income taxes	—	—	—	9
Gain on sale after income taxes	—	—	—	5

Assets of \$1 million and liabilities of \$4 million associated with the discontinued operations are included on the consolidated balance sheet at December 31, 2005 in other long-term assets and other long-term liabilities, respectively.

Note 8. Investments in Unconsolidated Affiliates

The following table presents summarized financial information of the significant subsidiary investments in unconsolidated affiliates accounted for by the equity method. The significant subsidiary investments include the Big 4 projects. The Big 4 projects consist of Kern River Cogeneration

Company, Midway-Sunset Cogeneration Company, Sycamore Cogeneration Company and Watson Cogeneration Company.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in millions)			
Operating revenues	\$263	\$323	\$ 572	\$597
Operating income	70	87	123	137
Net income	67	85	117	132

Note 9. Employee Benefit Plans

Pension Plans

EME previously disclosed in its financial statements for the year ended December 31, 2005 that it expected to contribute \$14 million to its pension plans in 2006. As of June 30, 2006, \$4 million in contributions have been made. EME continues to expect to contribute \$14 million to its pension plans in 2006.

Components of pension expense are:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in millions)			
Service cost	\$ 4	\$ 4	\$ 9	\$ 9
Interest cost	2	2	4	4
Expected return on plan assets	(1)	(2)	(3)	(3)
Net amortization and deferral	—	1	—	1
Total expense	<u>\$ 5</u>	<u>\$ 5</u>	<u>\$ 10</u>	<u>\$ 11</u>

Postretirement Benefits Other Than Pensions

EME previously disclosed in its financial statements for the year ended December 31, 2005 that it expected to contribute \$1 million to its postretirement benefits other than pensions in 2006. As of June 30, 2006, \$0.6 million in contributions have been made. EME continues to expect to contribute \$1 million to its postretirement benefits other than pensions in 2006.

Components of postretirement benefits expense are:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in millions)			
Service cost	\$ —	\$ —	\$ 1	\$ 1
Interest cost	1	1	2	2
Amortization of unrecognized prior service costs	(1)	—	(1)	(1)
Amortization of unrecognized loss	1	—	1	—
Total expense	<u>\$ 1</u>	<u>\$ 1</u>	<u>\$ 3</u>	<u>\$ 2</u>

Note 10. Income Taxes

EME's income tax provision from continuing operations was \$1 million and \$19 million for the six months ended June 30, 2006 and 2005, respectively. Income tax benefits are recognized pursuant to a tax-allocation agreement with Edison International. During the six months ended June 30, 2006 and 2005, EME recognized \$9 million and \$4 million, respectively, of production tax credits related to wind projects and \$3 million and \$5 million, respectively, related to estimated state income tax benefits allocated from EIX. During the second quarter of 2005, EME resolved a dispute regarding additional taxes asserted by the Internal Revenue Service during the audit of the 1994-1996 tax returns. As a result of the resolution of this item, EME reversed \$11.5 million of accrued taxes, recording this amount instead as a reduction of income taxes during the second quarter of 2005.

Note 11. Commitments and Contingencies***Contractual Obligations******Long-term Debt***

EME's long-term debt maturities as of June 30, 2006 are (in millions):

July through December 2006	\$ 25
2007	133
2008	51
2009	613
2010	15

These amounts have been updated primarily to reflect EME's financing activities completed during the second quarter of 2006. See Note 4—Refinancing.

Capital Improvements

At June 30, 2006, EME's subsidiaries had firm commitments to spend approximately \$157 million during the remainder of 2006 and \$33 million in 2007 on capital and construction expenditures. The majority of these expenditures relate to the construction of the Wildorado wind project. Also included are expenditures for boiler header replacement, dust collection and mitigation system and various other projects. These expenditures are planned to be financed by existing subsidiary credit agreements, cash on hand or cash generated from operations.

Commercial Commitments***Introduction***

EME and certain of its subsidiaries have various financial and performance guarantees and indemnifications which are issued in the normal course of business. As discussed below, these contracts include performance guarantees, standby letters of credit, guarantees of debt and indemnifications.

Turbine Commitments

At June 30, 2006, in connection with wind projects in development, EME had entered into agreements with turbine vendors securing 235 turbines with remaining commitments of \$110 million in 2006 and \$244 million in 2007. In addition, EME had options to acquire an additional 50 turbines for

delivery in 2007 that were exercised on July 31, 2006. In July 2006, EME entered into an agreement to purchase 20 turbines from another supplier with options to purchase another 32 turbines for delivery in 2007 subject to certain conditions.

Standby Letters of Credit

At June 30, 2006, standby letters of credit aggregated \$25 million and were scheduled to expire as follows: \$18 million in 2006 and \$7 million in 2007.

Guarantees and Indemnities

Tax Indemnity Agreements—

In connection with the sale-leaseback transactions that EME has entered into related to the Powerton and Joliet Stations in Illinois, the Collins Station in Illinois, and the Homer City facilities in Pennsylvania, EME and several of its subsidiaries entered into tax indemnity agreements. Under these tax indemnity agreements, these entities agreed to indemnify the lessors in the sale-leaseback transactions for specified adverse tax consequences that could result in certain situations set forth in each tax indemnity agreement, including specified defaults under the respective leases. The potential indemnity obligations under these tax indemnity agreements could be significant. Due to the nature of these potential obligations, EME cannot determine a maximum potential liability which would be triggered by a valid claim from the lessors. EME has not recorded a liability related to these indemnities. In connection with the termination of the Collins Station lease in April 2004, Midwest Generation will continue to have obligations under the tax indemnity agreement with the former lease equity investor.

Indemnities Provided as Part of the Acquisition of the Illinois Plants—

In connection with the acquisition of the Illinois Plants, EME agreed to indemnify Commonwealth Edison with respect to specified environmental liabilities before and after December 15, 1999, the date of sale. The indemnification claims are reduced by any insurance proceeds and tax benefits related to such claims and are subject to a requirement that Commonwealth Edison take all reasonable steps to mitigate losses related to any such indemnification claim. Due to the nature of the obligation under this indemnity, a maximum potential liability cannot be determined. This indemnification for environmental liabilities is not limited in term and would be triggered by a valid claim from Commonwealth Edison. Except as discussed below, EME has not recorded a liability related to this indemnity.

Midwest Generation entered into a supplemental agreement with Commonwealth Edison and Exelon Generation Company on February 20, 2003 to resolve a dispute regarding interpretation of its reimbursement obligation for asbestos claims under the environmental indemnities set forth in the Asset Sale Agreement. Under this supplemental agreement, Midwest Generation agreed to reimburse Commonwealth Edison and Exelon Generation for 50% of specific existing asbestos claims and 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 the agreement. As a general matter, Commonwealth Edison and Midwest Generation apportion responsibility for future asbestos-related claims based upon the number of exposure sites that are Commonwealth Edison locations or Midwest Generation locations. The obligations under this agreement are not subject to a maximum liability. The supplemental agreement has a five-year term with an automatic renewal provision (subject to the right of either party to terminate). Payments are made under this indemnity upon tender by Commonwealth Edison of appropriate proof of liability for an asbestos-related settlement, judgment, verdict, or expense. There were approximately 175 cases for which Midwest Generation was potentially

liable and that had not been settled and dismissed at June 30, 2006. Midwest Generation had recorded a \$66 million liability at June 30, 2006 related to this matter.

The amounts recorded by Midwest Generation for the asbestos-related liability are based upon a number of assumptions. Future events, such as the number of new claims to be filed each year, the average cost of disposing of claims, as well as the numerous uncertainties surrounding asbestos litigation in the United States, could cause the actual costs to be higher or lower than projected.

Indemnity Provided as Part of the Acquisition of the Homer City Facilities—

In connection with the acquisition of the Homer City facilities, EME Homer City agreed to indemnify the sellers with respect to specific environmental liabilities before and after the date of sale. EME guaranteed the obligations of EME Homer City. Due to the nature of the obligation under this indemnity provision, it is not subject to a maximum potential liability and does not have an expiration date. Payments would be triggered under this indemnity by a claim from the sellers. EME has not recorded a liability related to this indemnity.

Indemnities Provided under Asset Sale Agreements—

The asset sale agreements for the sale of EME's international assets contain indemnities from EME to the purchasers, including indemnification for taxes imposed with respect to operations of the assets prior to the sale and for pre-closing environmental liabilities. During the second quarter of 2006, EME paid \$34 million related to an indemnity to IPM for matters arising out of the exercise by one of its project partners of a purported right of first refusal. Not all indemnities under the asset sale agreements have specific expiration dates. Payments would be triggered under these indemnities by valid claims from the sellers or purchasers, as the case may be. At June 30, 2006, EME had recorded a liability of \$94 million related to these matters.

In connection with the sale of various domestic assets, EME has from time to time provided indemnities to the purchasers for taxes imposed with respect to operations of the asset prior to the sale. EME has also provided indemnities to purchasers for items specified in each agreement (for example, specific pre-existing litigation matters and/or environmental conditions). Due to the nature of the obligations under these indemnity agreements, a maximum potential liability cannot be determined. Not all indemnities under the asset sale agreements have specific expiration dates. Payments would be triggered under these indemnities by valid claims from the sellers or purchasers, as the case may be. EME has not recorded a liability related to these indemnities.

Guarantee of Brooklyn Navy Yard Contractor Settlement Payments—

On March 31, 2004, EME completed the sale of 100% of the stock of Mission Energy New York, Inc., which held a 50% partnership interest in Brooklyn Navy Yard Cogeneration Partners, L.P. (referred to as Brooklyn Navy Yard), to BNY Power Partners LLC. Brooklyn Navy Yard owns a 286 MW gas-fired cogeneration power plant in Brooklyn, New York. In February 1997, the construction contractor asserted general monetary claims under the turnkey agreement against Brooklyn Navy Yard. A settlement agreement was executed on January 17, 2003, and all litigation has been dismissed. EME agreed to indemnify Brooklyn Navy Yard and, in connection with the sale of EME's interest in Brooklyn Navy Yard, BNY Power Partners for any payments due under this settlement agreement, which are scheduled through January 2007. At June 30, 2006, EME had recorded a liability of \$4 million related to this indemnity.

Capacity Indemnification Agreements—

EME has guaranteed, jointly and severally with Texaco Inc., the obligations of March Point Cogeneration Company under its project power sales agreements to repay capacity payments to the project's power purchaser in the event that the power sales agreements terminate, March Point Cogeneration Company abandons the project, or the project fails to return to normal operations within a reasonable time after a complete or partial shutdown, during the term of the power sales agreements. In addition, a subsidiary of EME has guaranteed the obligations of Sycamore Cogeneration Company under its project power sales agreement to repay capacity payments to the project's power purchaser in the event that the project unilaterally terminates its performance or reduces its electric power producing capability during the term of the power sales agreement. The obligations under the indemnification agreements as of June 30, 2006, if payment were required, would be \$114 million. EME has not recorded a liability related to these indemnities.

Subsidiary Guarantee for Performance of Unconsolidated Affiliate—

A subsidiary of EME has guaranteed the obligations of an unconsolidated affiliate to make payments to a third party for power delivered under a fixed-price power sales agreement. This agreement runs through 2007. EME believes there is sufficient cash flow to pay the power suppliers, assuming timely payment by the power purchasers. Due to the nature of this indemnity, a maximum potential liability cannot be determined. To the extent EME's subsidiary would be required to make payments under the guarantee, EME's subsidiary and EME are indemnified by Peabody Energy Corporation pursuant to the 2000 Purchase and Sale Agreement for Citizens Power LLC. EME's subsidiary has not recorded a liability related to this indemnity.

Contingencies

MISO Revenue Sufficiency Guarantee Charges

On April 25, 2006, the FERC issued an order regarding the MISO's "Revenue Sufficiency Guarantee" charges (RSG charges). The MISO's business practice manuals and other instructions to market participants have stated, since the implementation of market operations on April 1, 2005, that RSG charges will not be imposed on offers to supply power not supported by actual generation (also known as virtual supply offers). However, some market participants raised questions about the language of the MISO's tariff concerning that issue and, in October 2005, the MISO submitted to the FERC proposed tariff revisions clarifying its tariff to reflect its business practices with respect to RSG charges and filed corrected tariff sheets exempting virtual supply from RSG charges. In its April 25 decision, the FERC interpreted the MISO's tariff to require that virtual supply offers must be included in the calculation of the RSG charges and that, to the extent that the MISO did not charge virtual supply offers for RSG charges, it violated the terms of its tariff. The FERC order then proceeded to require the MISO to recalculate the RSG charges back to April 1, 2005, and to make refunds to customers, with interest, reflecting the recalculated charges. In order to make such refunds, it is likely that the MISO will attempt to impose retroactively RSG charges on those who submitted virtual supply offers during the recalculation period. Edison Mission Marketing & Trading (EMMT) made virtual supply offers in the MISO during this period on which no RSG charges were imposed, and thus may be subject to a claim for refunds from the MISO (which claim will be contested by EMMT). Because calculation of any claimed liability for refunds depends on information not currently available to it, EMMT cannot reasonably estimate a range of loss related to this matter. In addition, the FERC's April 25 order has been challenged by the MISO and other parties, including EMMT, and as the FERC has issued an extension of time to comply with the requirements of the order until after the date of issuance of an order on rehearing, the eventual outcome of these proceedings is unclear.

Tax Matters

EME is, and may in the future be, under examination by tax authorities in varying tax jurisdictions with respect to positions it takes in connection with the filing of its tax returns. Matters raised upon audit may involve substantial amounts, which, if resolved unfavorably, an event not currently anticipated, could possibly be material. However, in EME's opinion, it is unlikely that the resolution of any such matters will have a material adverse effect upon EME's financial condition or results of operations.

Litigation

EME experiences other routine litigation in the normal course of its business. None of such pending routine litigation is expected to have a material adverse effect on EME's consolidated financial position or results of operations.

Insurance

On January 29, 2006, the main power transformer on Unit 3 of the Homer City facilities failed, resulting in a suspension of operations at this unit. EME Homer City secured a replacement transformer and Unit 3 returned to service on May 5, 2006. The main transformer failure will result in claims under EME Homer City's property and business interruption insurance policies. At June 30, 2006, EME Homer City recorded a \$17 million receivable, of which \$11 million relates to business interruption insurance coverage and has been reflected in other income (expense), net in EME's consolidated income statements.

Environmental Matters and Regulations

The construction and operation of power plants are subject to environmental regulation by federal, state and local authorities. EME believes that it is in substantial compliance with environmental regulatory requirements and that maintaining compliance with current requirements will not materially affect its financial position or results of operation. However, possible future developments, such as the promulgation of more stringent environmental laws and regulations, future proceedings that may be initiated by environmental authorities, and settlements agreed to by other companies could affect the costs and the manner in which EME conducts its business, and may also cause it to make substantial additional capital expenditures. There is no assurance that EME would be able to recover these increased costs from its customers or that EME's financial position and results of operations would not be materially adversely affected as a result.

Typically, environmental laws and regulations 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. Failure to comply with applicable environmental laws may subject a project's owner or operator to injunctive relief or penalties and fines imposed by regulatory authorities.

With respect to potential liabilities arising under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, commonly referred to as CERCLA, or similar laws for the investigation and remediation of contaminated property, EME accrues a liability to the extent that the costs are probable and can be reasonably estimated. Midwest Generation has accrued approximately \$4 million at June 30, 2006 for estimated environmental investigation and remediation costs for the

Illinois Plants. This estimate is based upon the number of sites, the scope of work and the estimated costs for environmental activity where such expenditures could be reasonably estimated. Future estimated costs may vary based on changes in regulations or requirements of federal, state or local governmental agencies, changes in technology, and actual costs of disposal. In addition, future remediation costs will be affected by the nature and extent of contamination discovered at the sites that requires remediation. Given the prior history of the operations at its facilities, EME cannot be certain that the existence or extent of all contamination at its sites has been fully identified. However, based on available information, management believes that future costs in excess of the amounts disclosed on all known and quantifiable environmental contingencies will not be material to EME's financial position. See "Note 16. Commitments and Contingencies—Environmental Matters and Regulations" in EME's financial statements included in its annual report on Form 10-K for the year ended December 31, 2005 for a more complete discussion of EME's environmental contingencies.

Note 12. Supplemental Statements of Cash Flows Information

	Six Months Ended June 30,	
	2006	2005
	(in millions)	
Cash paid (received)		
Interest (net of amount capitalized)	\$ 163	\$ 149
Income taxes	168	2
Cash payments under plant operating leases	199	154
Details of assets acquired		
Fair value of assets acquired	\$ 29	\$ —
Liabilities assumed	—	—

During the first six months of 2006, EME accrued \$11 million in connection with the purchase price of the Wildorado wind project due upon completion of construction. In addition, EME received a capital contribution of \$76 million in the form of ownership interests in a portfolio of wind projects and a small biomass project.

Note 13. Stock Compensation Plans

Stock Options

Under various plans, EME may grant stock options at exercise prices equal to the average of high and low price at the grant date and other awards related to or with a value derived from Edison International common stock to directors and certain employees. Options generally expire 10 years after the grant date and vest over a period of four years of continuous service, with expense recognized evenly over the vesting period, except for awards granted to retirement-eligible participants, as discussed in Note 1—General—Stock-Based Compensation. Stock-based compensation expense associated with stock options was \$2 million and \$4 million for the second quarter of 2006 and six months ended June 30, 2006, respectively. Under prior accounting rules, there was no comparable expense recognized for the same periods in 2005. See Note 1—General—Stock-Based Compensation, for further discussion.

Beginning with awards made in 2003, stock options accrue dividend equivalents for the first five years of the option term. Unless transferred to non-qualified deferral plan accounts, dividend equivalents accumulate without interest. Dividend equivalents are paid only on options that vest, including options that are unexercised. Dividend equivalents are paid in cash after the vesting date.

Edison International has discretion to pay certain dividend equivalents in shares of Edison International common stock. Additionally, Edison International will substitute cash awards to the extent necessary to pay tax withholding or any government levies.

The fair value for each option granted was determined as of the grant date using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model requires various assumptions noted in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Expected terms (in years)	9 to 10	9 to 10	9 to 10	9 to 10
Risk-free interest rate	4.3%-4.5%	4.2%-4.3%	4.3%-4.5%	4.2%-4.3%
Expected dividend yield	2.6%-2.8%	2.5%-2.8%	2.4%-2.8%	2.5%-3.1%
Weighted-average expected dividend yield	2.7%	2.7%	2.4%	3.1%
Expected volatility	16.8%-17.5%	18.7%-19.2%	16.2%-17.5%	18.7%-19.6%
Weighted-average volatility	17.2%	18.9%	16.3%	19.6%

The expected term of options granted is based on the actual remaining contractual term of the options. The risk-free interest rate for periods within the contractual life of the option is based on a 52-week historical average of the 10-year semi-annual coupon U.S. Treasury note. In 2006, expected volatility is based on the historical volatility of Edison International's common stock for the recent 36 months. Prior to January 1, 2006, expected volatility was based on the median of the most recent 36 months historical volatility of peer companies because Edison International's historical volatility was impacted by the California energy crisis.

A summary of the status of Edison International's stock options granted to EME employees is as follows:

	Stock Options	Weighted Average		Aggregate Intrinsic Value
		Exercise Price	Remaining Contractual Term (Years)	
Outstanding at December 31, 2005	3,626,365	\$ 22.06		
Granted	407,848	44.11		
Transferred to affiliates	(298,647)	21.83		
Forfeited	(27,949)	28.35		
Exercised	(379,482)	18.73		
Outstanding at June 30, 2006	<u>3,328,135</u>	\$ 25.10		
Vested and expected to vest at June 30, 2006 . .	<u>3,195,872</u>	\$ 24.86	7.00	\$ 48,249,676
Exercisable at June 30, 2006	<u>1,690,208</u>	\$ 20.30	5.89	\$ 33,225,264

The weighted-average fair value of options granted during the quarters ended June 30, 2006 and 2005 was \$13.47 and \$13.31, respectively. The weighted-average fair value of options granted for the six months ended June 30, 2006 and 2005 was \$14.42 and \$11.72, respectively. The total intrinsic value of options exercised during the quarters ended June 30, 2006 and 2005 was \$3 million and \$7 million, respectively. The total intrinsic value of options exercised for the six months ended June 30, 2006 and 2005 was \$11 million and \$10 million, respectively. At June 30, 2006, there was \$12 million of total unrecognized compensation cost related to stock options net of expected forfeitures. That cost is expected to be recognized over a weighted-average period of approximately 2 years. The fair value of

options vested during the quarters and six-month periods ended June 30, 2006 and 2005, was \$1 million and \$2 million, respectively.

Cash received from options exercised for the quarters ended June 30, 2006 and 2005 was \$3 million and \$6 million, respectively, and for the six months ended June 30, 2006 and 2005 was \$8 million and \$9 million, respectively. The estimated tax benefit from options exercised was \$4 million for both the six months ended June 30, 2006 and 2005.

Performance Shares

A target number of contingent performance shares were awarded to executives in January 2004, January 2005 and March 2006, and vest at the end of December 2006, 2007 and 2008, respectively. Dividend equivalents associated with these performance shares accumulate without interest and will be payable in cash following the end of the performance period when the performance shares are paid, although Edison International has discretion to pay certain dividend equivalents in Edison International common stock. The vesting of Edison International's performance shares is dependent upon a market condition and three years of continuous service subject to a prorated adjustment for employees who are terminated under certain circumstances or retire, but payment cannot be accelerated. The market condition is based on Edison International's common stock performance relative to the performance of a specified group of companies at the end of a three-calendar-year period. The number of performance shares earned is determined based on Edison International's ranking among these companies. Dividend equivalents will be adjusted to correlate to the actual number of performance shares paid. Performance shares earned are settled half in cash and half in common stock; however, Edison International has discretion under certain of the awards to pay the half subject to cash settlement in common stock. Additionally, cash awards are substituted to the extent necessary to pay tax withholding or any government levies. The portion of performance shares settled in cash is classified as a share-based liability award. The fair value of these shares is remeasured at each reporting period and the related compensation expense is adjusted. The portion of performance shares payable in common stock is classified as a share-based equity award. Compensation expense related to these shares is based on the grant-date fair value. Performance shares expense is recognized ratably over the vesting period based on the fair values determined, except for awards granted to retirement-eligible participants, as discussed in "Stock-Based Compensation" in Note 1—General—Stock-Based Compensation. Stock-based compensation expense associated with performance shares was \$0.1 million and \$5.0 million for the quarters ended June 30, 2006 and 2005, respectively, and \$0.5 million and \$9.0 million for the six months ended June 30, 2006 and 2005, respectively.

The performance shares' fair value is determined using a Monte Carlo simulation valuation model. The Monte Carlo simulation valuation model requires a risk-free interest rate and an expected volatility rate assumption. The risk-free interest rate is based on a 52-week historical average of the three-year U.S. Treasury note and is used as proxy for the expected return for the specified group of companies. Volatility is based on the historical volatility of Edison International's common stock for the recent 36 months. Historical volatility for each company in the specified group is obtained from a financial data services provider.

Edison International's risk-free interest rate and expected volatility used to determine the grant date fair values for the 2006 and 2005 performance shares classified as share-based equity awards was 4.1% and 16.2%, respectively, and 2.7% and 27.7%, respectively. The portion of performance shares classified as share-based liability awards are revalued at each reporting period. The risk-free interest rate and expected volatility rate used to determine the fair value as of June 30, 2006 was 4.5% and 17.2%, respectively.

The total intrinsic value of performance shares settled during each of the quarters ended June 30, 2006 and 2005 was zero. The total intrinsic value of performance shares settled during the six months ended June 30, 2006 and 2005 was \$19 million and \$8 million, respectively, which included cash paid to settle the performance shares classified as liability awards of \$8 million and \$4 million for the six months ended June 30, 2006 and 2005, respectively. At June 30, 2006, there was \$2 million (based on the June 30, 2006 fair value of performance shares classified as liability awards) of total unrecognized compensation cost related to performance shares. That cost is expected to be recognized over a weighted-average period of less than two years. The fair values of performance shares vested during the quarters and six-month periods ended June 30, 2006 and 2005, was zero.

A summary of the status of Edison International nonvested performance shares granted to EME employees and classified as equity awards is as follows:

	<u>Performance Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested at December 31, 2005	67,530	\$ 38.63
Granted	16,377	52.55
Forfeited	<u>(1,266)</u>	39.36
Nonvested at June 30, 2006	<u>82,641</u>	\$ 41.38

The weighted-average grant-date fair value of performance shares classified as equity awards granted during the quarter ended June 30, 2005 was \$46.09.

A summary of the status of Edison International nonvested performance shares granted to EME employees and classified as liability awards (the current portion is reflected in the caption “Accrued liabilities” and the long-term portion is reflected in “Other long-term liabilities” on the consolidated balance sheets) is as follows:

	<u>Performance Shares</u>	<u>Weighted-Average Fair Value</u>
Nonvested at December 31, 2005	67,547	
Granted	16,396	
Forfeited	<u>(1,267)</u>	
Nonvested at June 30, 2006	<u>82,676</u>	\$ 80.84

Note 14. New Accounting Pronouncements

Statement of Financial Accounting Standards No. 151

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs.” SFAS No. 151 requires that abnormal amounts of idle facility expense, freight, handling costs and spoilage be recognized as current-period charges. Further, SFAS No. 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. Unallocated overheads must be recognized as an expense in the period in which they are incurred. SFAS No. 151 is effective for inventory costs incurred beginning in the first quarter of 2006. The adoption of this standard had no impact on EME’s consolidated financial statements.

Statement of Financial Accounting Standards No. 123(R)

A new accounting standard requires companies to use the fair value accounting method for stock-based compensation. EME implemented the new standard in the first quarter of 2006 and applied the modified prospective transition method. Under the modified prospective method, the new accounting standard was applied effective January 1, 2006 to the unvested portion of awards previously granted and will be applied to all prospective awards. Prior financial statements were not restated under this method. The new accounting standard resulted in the recognition of expense for all stock-based compensation awards. Prior to January 1, 2006, EME used the intrinsic value method of accounting, which resulted in no recognition of expense for Edison International stock options.

Prior to adoption of the new accounting standard, EME presented all tax benefits of deductions resulting from the exercise of stock options as a component of operating cash flows under the caption “Other operating—liabilities” in the consolidated statements of cash flows. The new accounting standard requires the cash flows resulting from the tax benefits that occur from estimated tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$4 million excess tax benefit is classified as a financing cash inflow in 2006.

Due to the adoption of this new accounting standard, EME recorded a cumulative effect adjustment that increased net income by approximately \$0.4 million, net of tax, in the first quarter of 2006, mainly to reflect the change in the valuation method for performance shares classified as liability awards and the use of forfeiture estimates.

FASB Staff Position FIN 46(R)-6

In April 2006, the FASB issued Staff Position FIN 46(R)-6, “Determining Variability to be Considered in Applying FIN 46(R).” FIN 46(R)-6 states that the variability to be considered in applying FIN 46(R) shall be based on an analysis of the design of the entity following a two-step process. The first step is to analyze the nature of the risks in the entity. The second step would be to determine the purpose(s) for which the entity was created and determine the variability (created by the risks identified in Step 1) the entity is designed to create and pass along to its interest holders. The guidance in this FASB Staff Position is effective prospectively beginning July 1, 2006, although companies have until December 31, 2006 to elect retrospective applications. EME has not yet selected a transition method.

Statement of Financial Accounting Standards Interpretation No. 48

In July 2006, the FASB issued Statement of Financial Accounting Standards Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” that clarifies the accounting for uncertain tax positions. An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position by determining if the weight of the available evidence indicates it is more likely than not, based solely on the technical merits, that the position will be sustained on audit. The effective date applicable to EME is January 1, 2007. EME is currently assessing the potential impact of the interpretation on its financial condition.

ITEM 2. 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 (MD&A) contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements reflect EME's current expectations and projections about future events based on EME's knowledge of present facts and circumstances and assumptions about future events and include any statement that does not directly relate to a historical or current fact. Other information distributed by EME that is incorporated in this report, or that refers to or incorporates this report, may also contain forward-looking statements. In this quarterly report on Form 10-Q, 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 EME, 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 EME's 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 EME's obligations to post collateral beyond the amounts currently expected, and the potential effect of such conditions on the ability of EME and its 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 EME or the electricity industry generally, including the market structure rules applicable to each market and environmental regulations that could require additional expenditures or otherwise affect EME's cost and manner of doing business;*
- 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 EME's generating facilities and/or increased access by competitors to EME's markets as a result of transmission upgrades;*
- the difficulty of predicting wholesale prices, transmission congestion, energy demand, and other activities in the complex and volatile markets in which EME and its subsidiaries participate;*
- operating risks, including equipment failure, availability, heat rate and output;*
- 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*
- the continued participation by EME and its subsidiaries in tax-allocation and payment agreements with their affiliates.*

Additional information about risks and uncertainties, including more detail about the factors described above, is contained throughout this MD&A and in the “Risk Factors” section included in Part I, Item 1A of EME’s Annual Report on Form 10-K for the year ended December 31, 2005. Readers are urged to read this entire quarterly report on Form 10-Q and carefully consider the risks, uncertainties and other factors that affect EME’s business. Forward-looking statements speak only as of the date they are made, and EME is not obligated to publicly update or revise forward-looking statements. Readers should review future reports filed by EME with the Securities and Exchange Commission.

This MD&A discusses material changes in the results of operations, financial condition and other developments of EME since December 31, 2005, and as compared to the second quarter of 2005 and six months ended June 30, 2005. This discussion presumes that the reader has read or has access to the MD&A included in Item 7 of EME’s annual report on Form 10-K for the year ended December 31, 2005.

This MD&A is presented in four sections:

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Liquidity and Capital Resources	37
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MANAGEMENT’S OVERVIEW; CRITICAL ACCOUNTING ESTIMATES

Management’s Overview

Results of Operations

Net income (loss) is comprised of the following components:

	<u>Three Months Ended</u> <u>June 30,</u>		<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(in millions)			
Income (loss) from continuing operations	(43)	19	32	76
Income from discontinued operations	4	21	77	28
Net Income (Loss)	<u>\$ (39)</u>	<u>\$ 40</u>	<u>\$ 109</u>	<u>\$104</u>

EME’s decrease in income from continuing operations in the second quarter of 2006 was primarily attributable to an \$88 million, after tax, loss on early extinguishment of debt recorded during the second quarter of 2006. Partially offsetting this decrease were higher earnings at the Illinois Plants and the Homer City facilities, driven by higher wholesale energy prices. The year-to-date decrease in income from continuing operations was primarily due to loss on early extinguishment of debt and lower earnings at the Homer City facilities due to a transformer failure related to Unit 3. Partially offsetting these decreases were higher earnings at the Illinois Plants and higher energy trading income from Edison Mission Marketing & Trading (EMMT).

EME’s income from discontinued operations during the second quarters of 2006 and 2005 and six months ended June 30, 2006 and 2005 was primarily related to distributions authorized by the liquidators of the Lakeland power project. Together with \$16 million received in April 2006, EME has

received a total of \$122 million of distributions in 2006 from the settlement of a 2001 claim for termination of a power contract by a subsidiary of TXU Europe Group plc. The activities of the Lakeland liquidator are near completion and substantially all the distributions from the Lakeland project have been made.

Business Development

Wind Projects

EME has undertaken a number of activities with respect to new wind projects, including:

- Completion of the purchase of development rights for the Wildorado wind project for \$29 million. This project started construction on April 24, 2006. Project completion is scheduled for April 2007, with total construction costs estimated to be \$270 million. Upon completion, power from the project will be sold under a twenty-year power purchase agreement to Southwestern Public Service.
- Securing a supply of 285 turbines for 538 MW of new wind projects which are expected to be developed and constructed by the end of 2007.
- Advancing development of a number of wind projects, including four projects totaling 181 MW that have been approved for investment, subject to completion of specific contractual or permitting arrangements.

In addition, EME received, as a capital contribution, ownership interests in a 192 MW portfolio of wind projects (EME's share is 176 MW) located in Iowa and Minnesota. 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.

Thermal Projects

EME has continued to develop two 500 MW natural gas-fired peaker projects in Southern California. Southern California Edison Company has announced a request for offers from new generation resources. EME intends to respond to the request for offers.

In June 2006, subsidiaries of EME and BP America Inc. formed Carson Hydrogen Power LLC for the development of a power project to be located in Carson, California. Carson Hydrogen is conducting engineering studies for this industrial gasification project that will integrate proven gasification, power generation and enhanced oil recovery technologies. In June 2006, the project submitted an application to the United States Department of Energy (DOE) to qualify for gasification tax credits under the Energy Policy Act of 2005. Funding of tax credits is limited and, accordingly, there is no assurance that the project will be allocated tax credits. A decision is not expected until the end of 2006.

Financing Activities

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. In connection with the repayment, EME recorded a \$143 million loss on early extinguishment of debt in the second quarter of 2006.

On June 15, 2006, EME entered into a new credit agreement providing for \$500 million in revolving loan and letter of credit capacity to be used to repay existing debt and/or to provide liquidity and credit support for the hedging and trading activities of EME and its subsidiaries. The new credit agreement replaces EME's \$98 million credit agreement.

ERP Initiative

EME has commenced a new initiative as part of an Edison International enterprise-wide project to implement an integrated 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 objective of this initiative is to improve the efficiency and effectiveness of EME's operational systems and enhance the transparency of information throughout the company.

Critical Accounting Estimates

For a discussion of EME's critical accounting estimates, refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Estimates" of EME's annual report on Form 10-K for the year ended December 31, 2005.

RESULTS OF OPERATIONS

Introduction

This section discusses operating results for the second quarters of 2006 and 2005 and six months ended June 30, 2006 and 2005, and is organized under the following headings:

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Results of Continuing Operations	28
Results of Discontinued Operations	36
New Accounting Pronouncements	36

Results of Continuing Operations

Overview

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. 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.

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

The following section provides a summary of the operating results for the second quarters of 2006 and 2005 and six months ended June 30, 2006 and 2005 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,	
	2006	2005	2006	2005
	(in millions)			
Project Earnings (Losses)(1)				
<i>Consolidated operations</i>				
Illinois Plants	\$ 25	\$ 18	\$ 152	\$ 110
Homer City	35	8	33	50
Energy Trading(2)	26	19	55	41
San Juan Mesa	1	—	5	—
Storm Lake	3	2	3	2
Other	(1)	—	—	—
<i>Unconsolidated affiliates</i>				
Big 4 projects	32	40	55	61
Sunrise	5	5	3	2
March Point	—	(4)	—	4
Doga	5	1	4	5
Other	2	1	3	5
	133	90	313	280
Corporate interest income	20	13	37	24
Corporate interest expense	(64)	(68)	(130)	(136)
Corporate administrative and general	(25)	(26)	(49)	(59)
Gain on sale of assets	—	—	4	—
Loss on early extinguishment of debt	(143)	—	(143)	(4)
Other income (expense), net	—	—	10	(6)
	<u>\$ (79)</u>	<u>\$ 9</u>	<u>\$ 42</u>	<u>\$ 99</u>

(1) Project earnings are equal to income from continuing operations before income taxes, except for production tax credits. Accordingly, project earnings for the wind projects include \$4 million and \$3 million of production tax credits for the second quarters of 2006 and 2005, respectively, and \$9 million and \$4 million for the six months ended June 30, 2006 and 2005, 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 financial measure. 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	
	2006	2005	2006	2005
	(in millions)			
Project earnings (losses)	\$ (79)	\$ 9	\$ 42	\$ 99
Less: Production tax credits	(4)	(3)	(9)	(4)
Income (loss) from continuing operations before income taxes	<u>\$ (83)</u>	<u>\$ 6</u>	<u>\$ 33</u>	<u>\$ 95</u>

(2) Income from energy trading represents the gains recognized from price volatility associated with the purchase and sale of contracts for electricity, fuels and transmission. The indirect 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,	
	2006	2005	2006	2005
	(in millions)			
Operating Revenues				
Energy revenues	\$ 261	\$ 244	\$ 599	\$ 571
Capacity revenues	7	8	13	14
Other revenues	2	2	4	4
Net losses from price risk management	(4)	(1)	(4)	(11)
Total operating revenues	<u>266</u>	<u>253</u>	<u>612</u>	<u>578</u>
Operating Expenses				
Fuel	72	72	166	171
Gain on sale of emission allowances(1)	—	—	(6)	—
Plant operations	115	107	196	191
Plant operating leases	18	19	37	37
Depreciation and amortization	25	25	50	50
Asset impairment charges	—	7	—	7
Administrative and general	7	5	12	10
Total operating expenses	<u>237</u>	<u>235</u>	<u>455</u>	<u>466</u>
Operating Income	<u>29</u>	<u>18</u>	<u>157</u>	<u>112</u>
Other Income (Expense)				
Interest income on note receivable from EME	28	29	56	57
Interest expense and other	(32)	(29)	(61)	(59)
Total other income (expense)	<u>(4)</u>	<u>—</u>	<u>(5)</u>	<u>(2)</u>
Income Before Taxes	<u>\$ 25</u>	<u>\$ 18</u>	<u>\$ 152</u>	<u>\$ 110</u>
Statistics				
Coal-Fired Generation(2)				
Generation (in GWh)	5,493	5,834	12,738	14,229
Equivalent availability(3)	66.0%	62.1%	76.4%	71.1%
Capacity factor(4)	44.8%	47.6%	52.3%	58.4%
Load factor(5)	67.9%	76.7%	68.4%	82.1%
Forced outage rate(6)	7.7%	9.6%	5.0%	8.7%
Average energy price/MWh	\$ 47.63	\$ 41.83	\$ 47.09	\$ 40.12
Average fuel costs/MWh	\$ 13.42	\$ 12.51	\$ 13.14	\$ 12.12

(1) EME recorded \$6 million of intercompany profit during the first quarter of 2006 on emission allowances sold by the Illinois Plants to the Homer City facilities in the fourth quarter of 2005 but not used by the Homer City facilities until the first quarter of 2006.

(2) This table summarizes key performance measures related to coal-fired generation, which represents the majority of the operations of the Illinois Plants.

(3) The equivalent availability factor is defined as the number of megawatt-hours the coal plants are available to generate electricity divided by the product of the capacity of the coal plants (in megawatts) 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 plants are not available during periods of planned and unplanned maintenance.

- (4) Capacity factor is defined as the actual number of megawatt-hours generated by the coal plants divided by the product of the capacity of the coal plants (in megawatts) 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.

Earnings from the Illinois Plants were \$25 million and \$152 million during the second quarter of 2006 and six months ended June 30, 2006, respectively, compared to \$18 million and \$110 million for the comparable periods in the prior year. The increase in the second quarter earnings of \$7 million was primarily due to higher energy margin (energy revenues less fuel expenses) and an asset impairment charge recorded during the second quarter of 2005 primarily associated with a redefined capital program related to coal dust mitigation partially offset by higher planned maintenance costs. Although generation in the second quarter of 2006 was lower than the second quarter of 2005, energy margin increased primarily due to a 14% increase in average energy prices.

Earnings for the six months ended June 30, 2006 increased \$42 million primarily due to higher energy margin driven by higher average energy prices, recognition of income in 2006 from the sale of emission allowances to the Homer City facilities, and the 2005 asset impairment charge described above.

Losses from price risk management activities are due to price changes on power contracts that did not qualify for hedge accounting under SFAS No. 133. At June 30, 2006, cumulative unrealized losses of \$12 million (pre-tax) have been recognized on hedge contracts that pertain to the remainder of 2006, 2007 and 2008. 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 and \$29 million for the second quarters of 2006 and 2005, respectively, and \$56 million and \$57 million for the six months ended June 30, 2006 and 2005, respectively, 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,	
	2006	2005	2006	2005
	(in millions)			
Operating Revenues				
Energy revenues	\$ 143	\$ 133	\$ 277	\$ 288
Capacity revenues	4	5	6	9
Other revenues	3	—	4	—
Net gains (losses) from price risk management	1	(2)	(13)	(4)
Total operating revenues	<u>151</u>	<u>136</u>	<u>274</u>	<u>293</u>
Operating Expenses				
Fuel(1)	68	60	129	124
Gain on sale of emission allowances(2)	—	—	—	—
Plant operations	28	37	63	59
Plant operating leases	26	26	51	51
Depreciation and amortization	4	4	8	8
Administrative and general	1	2	2	4
Total operating expenses	<u>127</u>	<u>129</u>	<u>253</u>	<u>246</u>
Operating Income	<u>24</u>	<u>7</u>	<u>21</u>	<u>47</u>
Other Income (Expense)				
Interest and other income	12	2	13	4
Interest expense	(1)	(1)	(1)	(1)
Total other income (expense)	<u>11</u>	<u>1</u>	<u>12</u>	<u>3</u>
Income Before Taxes	<u>\$ 35</u>	<u>\$ 8</u>	<u>\$ 33</u>	<u>\$ 50</u>
Statistics				
Generation (in GWh)	2,866	3,102	5,387	6,636
Equivalent availability(3)	74.3%	77.1%	73.1%	82.6%
Capacity factor(4)	69.5%	75.2%	65.7%	80.8%
Load factor(5)	93.6%	97.6%	89.9%	97.9%
Forced outage rate(6)	19.9%	3.6%	22.8%	5.6%
Average energy price/MWh	\$ 50.02	\$ 42.93	\$ 51.43	\$ 43.38
Average fuel costs/MWh	\$ 24.13	\$ 19.36	\$ 24.03	\$ 18.65

- (1) Included in fuel costs were \$9 million and \$14 million during the second quarters of 2006 and 2005, respectively, and \$21 million and \$29 million during the six months ended June 30, 2006 and 2005, respectively, related to the net cost of SO2 emission allowances. See “Market Risk Exposures—Commodity Price Risk—Emission Allowances Price Risk” for more information regarding the price of SO2 allowances.
- (2) The Homer City facilities sold excess NOx emission allowances to the Illinois Plants at fair market value. Sales to the Illinois Plants were \$6 million in the first quarter of 2006. EME eliminated the intercompany transaction for emission allowances sold but not yet used by the Illinois Plants at June 30, 2006.
- (3) The equivalent availability factor is defined as the number of megawatt-hours the coal plants are available to generate electricity divided by the product of the capacity of the coal plants (in megawatts) 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 plants are not available during periods of planned and unplanned maintenance.
- (4) The capacity factor is defined as the actual number of megawatt-hours generated by the coal plants divided by the product of the capacity of the coal plants (in megawatts) and the number of hours in the period.
- (5) The load factor is determined by dividing capacity factor by the equivalent availability factor.
- (6) Homer City refers to unplanned maintenance as a forced outage.

Earnings from Homer City increased \$27 million and decreased \$17 million for the second quarter of 2006 and six months ended June 30, 2006, respectively, compared to the corresponding periods of 2005. The second quarter increase is primarily attributable to higher energy margin, lower planned maintenance costs and estimated insurance recovery related to the Unit 3 outage. Although generation in the second quarter of 2006 was lower than the second quarter of 2005, due to the unplanned outage at Unit 3, there was a 17% increase in average energy prices. The 2006 year-to-date decrease is primarily attributable to lower energy margin and higher plant operating costs in 2006 due to an unplanned outage at Unit 3, partially offset by estimated insurance recovery. Homer City is generally classified as a baseload plant, which means the amount of generation is largely based on the availability of the plant. Accordingly, the Unit 3 outage reduced the amount of generation during the first six months of 2006.

Homer City Unit 3 Outage—

On January 29, 2006, the main power transformer on Unit 3 of the Homer City facilities failed resulting in a suspension of operations at this unit. Homer City secured a replacement transformer and Unit 3 returned to service on May 5, 2006. Homer City has adjusted its previously planned outage schedules for Unit 3 and the other Homer City units in order to minimize to the extent practicable overall outage activities for all units through the first half of 2007. Taking into consideration the impact of the outage, generation for the year is currently expected to be approximately 13 TWh. The actual financial impact and generation levels in 2006 will depend on the effect of market conditions upon the dispatch of the plant and on prevailing power prices during the balance of the year.

The main transformer failure will result in claims under Homer City's property and business interruption insurance policies. At June 30, 2006, Homer City recorded a \$17 million receivable related to these claims. Resolution of the claims is subject to a number of uncertainties, including computations of the lost profit during the outage period.

Price Risk Management—

Homer City recorded gains (losses) of approximately \$(5) million and \$1 million during the second quarters of 2006 and 2005, respectively, and \$(16) million and \$(3) million during the six months ended June 30, 2006 and 2005, respectively, representing the amount of cash flow hedges' ineffectiveness. Losses related to the ineffective portion of hedge contracts were primarily due to changes in the difference between energy prices at PJM West Hub (the settlement point under forward contracts) and the energy prices at the Homer City busbar (the delivery point where power generated by the Homer City facilities is delivered into the transmission system). Also included in net gains (losses) from price risk management activities are economic hedges that did not qualify for hedge accounting under SFAS No. 133 of \$6 million and \$(3) million in the second quarters of 2006 and 2005, respectively, and \$3 million and \$(1) million during the six months ended June 30, 2006 and 2005, respectively. At June 30, 2006, cumulative unrealized losses of \$42 million (pre-tax) have been recognized on hedge contracts that pertain to the remainder of 2006, 2007 and 2008. See "Market Risk Exposures—Commodity Price Risk" for more information regarding forward market prices.

Energy Trading

EME seeks to generate profit by utilizing the commercial platform of its subsidiary, EMMT, to engage in trading activities in those markets in which it is active as a result of its management of the merchant power plants of Midwest Generation and Homer City. EMMT trades power, fuel and transmission primarily in the eastern power grid using products available over the counter, through exchanges and from independent system operators. Earnings from energy trading activities increased \$7 million and \$14 million for the second quarter of 2006 and six months ended June 30, 2006,

respectively, compared to the corresponding periods of 2005. The increase in earnings from energy trading activities was primarily due to increased congestion at specific delivery points in the eastern power grid in which EMMT purchased financial transmission rights. See “Market Risk Exposures—Regulatory Matters—MISO Revenue Sufficiency Guarantee Charges” for information regarding potential refund exposure related to virtual supply offers made by EMMT in MISO after April 1, 2005.

San Juan Mesa

EME’s earnings from the San Juan Mesa wind project were \$1 million and \$5 million for the second quarter of 2006 and six months ended June 30, 2006, with no earnings recorded in 2005 due to the acquisition of the San Juan Mesa wind project on December 27, 2005.

During the first quarter of 2006, EME completed the sale of 25% of its ownership interest in the San Juan Mesa wind project to Citi Renewable Investments I LLC, a wholly owned subsidiary of Citicorp North America, Inc. Proceeds from the sale were \$43 million. EME recorded a pre-tax gain on the sale of approximately \$4 million during the first quarter of 2006.

Earnings from Unconsolidated Affiliates

Big 4 Projects

Earnings from the Big 4 projects decreased \$8 million and \$6 million for the second quarter of 2006 and six months ended June 30, 2006, respectively, compared to the corresponding periods of 2005. The decreases in earnings were primarily due to lower earnings from the Kern River project during the first six months of 2006, compared to the first six months of 2005, resulting from the expiration of the project’s long-term power purchase and steam supply agreements in August 2005. Effective June 1, 2006, the project commenced selling electricity under a five-year bilateral agreement with Southern California Edison Company. The decrease in year-to-date earnings was partially offset by generally higher steam and energy prices in 2006 over 2005.

The earnings from the Big 4 projects included interest expense from Edison Mission Energy Funding of \$1 million and \$2 million for the second quarters of 2006 and 2005, respectively, and \$3 million and \$5 million for the six months ended June 30, 2006 and 2005, respectively.

March Point

EME’s share of earnings from its ownership interest in March Point was \$(4) million for the second quarter of 2005 and \$4 million for the six months ended June 30, 2005, respectively, resulting, in part, from mark-to-market gains (losses) related to gas purchase contracts. During the third quarter of 2005, EME recorded an impairment charge related to its March Point investment which resulted in suspension of equity accounting. Accordingly, no earnings were recorded during the first six months of 2006.

Doga

Earnings from the Doga project increased \$4 million in the second quarter of 2006 compared to the second quarter of 2005 and were about the same for the respective six-month periods. The second quarter increase in earnings was primarily due to higher energy margin, lower maintenance expenses and lower taxes.

In June 2006, the corporate tax rate in Turkey was reduced from 30% to 20%. Although this will reduce future income tax payments, Doga will report a loss from a reduction in deferred tax assets

(related to levelization of income under the power purchase agreement for financial reporting purposes). EME records its share of earnings from Doga on a lag, which means that the impact of the reduction in deferred tax assets will be recorded in the third quarter of 2006. EME's share of the loss related to reduction in deferred tax assets is estimated to be approximately \$11 million.

Seasonal Disclosure

EME's third quarter equity in income from its energy projects is materially higher than equity in income related to other quarters of the year due to warmer weather during the summer months and because a number of EME's energy projects located on the West Coast have power sales contracts that provide for higher payments during the summer months.

Corporate Interest Income

EME corporate interest income increased \$7 million and \$13 million for the second quarter of 2006 and six months ended June 30, 2006, respectively, compared to the corresponding periods of 2005. The increase was primarily attributable to higher interest rates in 2006 compared to 2005.

Corporate Interest Expense

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(in millions)			
Interest expense to third parties	\$ 36	\$ 39	\$ 74	\$ 79
Interest expense to Midwest Generation	<u>28</u>	<u>29</u>	<u>56</u>	<u>57</u>
Total corporate interest expense	<u>\$ 64</u>	<u>\$ 68</u>	<u>\$ 130</u>	<u>\$ 136</u>

Corporate Administrative and General Expenses

Administrative and general expenses decreased \$10 million for the six months ended June 30, 2006, compared to the corresponding period of 2005. The decrease was primarily due to \$10 million of costs incurred during the six months ended June 30, 2005 for severance and related costs in connection with EME restructuring activities.

Loss on Early Extinguishment of Debt

Loss on early extinguishment of debt was \$143 million for the second quarter of 2006 and six months ended June 30, 2006 related to the early repayment of EME's 10% senior notes due August 15, 2008 and 9.875% senior notes due April 15, 2011.

Loss on early extinguishment of debt was \$4 million in the first six months of 2005 consisting of a \$4 million loss related to the early repayment of junior subordinated debentures recorded during the first quarter of 2005.

Other Income (Expense), Net

Other income (expense), net increased \$16 million for the six months ended June 30, 2006, compared to the corresponding period of 2005. The 2006 increase was partially attributable to an \$8 million gain related to receipt of shares from Mirant Corporation from settlement of a claim recorded during the first quarter of 2006.

Income Taxes

EME's income tax provision from continuing operations was \$1 million and \$19 million for the six months ended June 30, 2006 and 2005, respectively. Income tax benefits are recognized pursuant to a tax-allocation agreement with Edison International. See "Liquidity and Capital Resources—EME's Liquidity as a Holding Company—Intercompany Tax-Allocation Agreement." During the six months ended June 30, 2006 and 2005, EME recognized \$9 million and \$4 million, respectively, of production tax credits related to wind projects and \$3 million and \$5 million, respectively, related to estimated state income tax benefits allocated from EIX. During the second quarter of 2005, EME resolved a dispute regarding additional taxes asserted by the Internal Revenue Service during the audit of the 1994-1996 tax returns. As a result of the resolution of this item, EME reversed \$11.5 million of accrued taxes, recording this amount instead as a reduction of income taxes during the second quarter of 2005.

Results of Discontinued Operations

Income from discontinued operations, net of tax, was \$4 million and \$21 million for the second quarters of 2006 and 2005, respectively, and \$77 million and \$28 million during the first six months of 2006 and 2005, respectively. The 2006 increase is largely attributable to distributions received from the Lakeland project, discussed below. During the first six months of 2005, EME completed the following sales:

- On January 10, 2005, EME sold its 50% equity interest in the CBK hydroelectric power project to CBK Projects B.V. Proceeds from the sale were approximately \$104 million.
- On February 3, 2005, EME sold its 25% equity interest in the Tri Energy project to IPM. Proceeds from the sale were approximately \$20 million.

The aggregate after-tax gain on the sale of the aforementioned projects was \$5 million.

Lakeland Project

EME previously owned a 220 MW power plant located in the United Kingdom, referred to as the Lakeland project. An administrative receiver was appointed in 2002 as a result of default by its counterparty, a subsidiary of TXU Europe Group plc and the project company was subsequently placed in liquidation. In response to its claim against the TXU subsidiary for damages resulting from the termination of the power sales agreement, the Lakeland project received a settlement of £116 million (approximately \$217 million). EME is entitled to receive the amount of the settlement remaining after payment of creditor claims. As creditor claims have been settled, EME has received to date payments of £13 million (approximately \$24 million) in April 2005, £61 million (approximately \$106 million) in the first quarter of 2006, and £9 million (approximately \$16 million) in April 2006. The after-tax income attributable to the Lakeland project was \$10 million and \$24 million for the second quarters of 2006 and 2005, respectively, and \$83 million and \$24 million for the six months ended June 30, 2006 and 2005, respectively. Beginning in 2002, EME reported the Lakeland project among discontinued operations and accounts for its ownership of Lakeland Power on the cost method, with earnings being recognized as cash is distributed from the project.

New Accounting Pronouncements

For a discussion of new accounting pronouncements affecting EME, see "Edison Mission Energy and Subsidiaries Notes to Consolidated Financial Statements—Note 14. New Accounting Pronouncements."

LIQUIDITY AND CAPITAL RESOURCES

Introduction

The following discussion of liquidity and capital resources is organized in the following sections:

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EME's Historical Consolidated Cash Flow	38
Credit Ratings	39
Margin, Collateral Deposits and Other Credit Support for Energy Contracts . .	40
EME's Liquidity as a Holding Company	40
Dividend Restrictions in Major Financings	42
Off-Balance Sheet Transactions	42
Environmental Matters and Regulations	42

For a complete discussion of these issues, read this quarterly report on Form 10-Q in conjunction with EME's annual report on Form 10-K for the year ended December 31, 2005.

EME's Liquidity

At June 30, 2006, EME and its subsidiaries had cash and cash equivalents and short-term investments of \$1.6 billion and EME had available the full amount of borrowing capacity under its new \$500 million corporate credit facility. EME's consolidated debt at June 30, 2006 was \$3.4 billion. In addition, EME's subsidiaries had \$4.4 billion of long-term lease obligations related to the sale-leaseback transactions that are due over periods ranging up to 29 years.

EME Financing Developments

During June 2006, EME replaced its \$98 million credit agreement with a new credit agreement that provides for a \$500 million senior secured revolving loan and letter of credit facility and matures on June 15, 2012 and completed a private offering of \$500 million aggregate principal amount of its 7.50% senior notes due June 15, 2013 and \$500 million aggregate principal amount of its 7.75% senior notes due June 15, 2016. EME will pay interest on the senior notes on June 15 and December 15 of each year, beginning on December 15, 2006. The senior notes are redeemable by EME at any time at a price equal to 100% of the principal amount of, plus accrued and unpaid interest and liquidated damages, if any, on, the senior notes plus a "make-whole" premium.

As security for its obligations under this credit facility, EME pledged its ownership interests in the holding companies through which it owns its interests in the Illinois Plants, the Homer City facilities, the Westside projects and the Sunrise project. EME also granted a security interest in an account into which all distributions received by it from the Big 4 projects will be deposited. EME will be free to use these proceeds unless an event of default occurs under the credit facility.

EME used the net proceeds of the offering of the senior notes, together with cash on hand, to purchase \$369 million in aggregate principal amount of its 10% senior notes due August 15, 2008 and \$596 million in aggregate principal amount of its 9.875% senior notes due April 15, 2011, that were validly tendered pursuant to EME's previously announced cash tender offer and consent solicitation. 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 \$143 million loss on early extinguishment of debt during the second quarter of 2006.

Capital Expenditures

The estimated capital and construction expenditures of EME's subsidiaries are \$280 million in the remaining two quarters of 2006 and \$493 million, \$28 million and \$25 million for 2007, 2008 and 2009, respectively. The non-environmental portion of these expenditures relates to the construction of the Wildorado wind project, purchases of turbines, upgrades to dust collection/mitigation systems and the coal handling system, ash removal improvements and various other projects. EME plans to finance these expenditures with existing subsidiary credit agreements, cash on hand or cash generated from operations. Included in the estimated expenditures are environmental expenditures of \$4 million for the remaining two quarters of 2006, \$12 million for 2007, \$6 million for 2008, and \$25 million for 2009. The environmental expenditures relate to environmental projects such as selective catalytic reduction system improvements at the Homer City facilities and projects at the Illinois Plants.

EME's Historical Consolidated Cash Flow

Consolidated Cash Flows from Operating Activities

Cash provided by operating activities from continuing operations increased \$465 million in the first six months of 2006, compared to the first six months of 2005. The 2006 increase was primarily attributable to a decrease of \$363 million in required margin and collateral deposits in 2006 for EME's price risk management and trading activities, compared to an increase of \$33 million in 2005. This change resulted from a decrease in forward market prices at June 30, 2006 as compared to December 31, 2005.

Cash provided by operating activities from discontinued operations increased \$64 million in the first six months of 2006, compared to the first six months of 2005. The 2006 increase reflects higher distributions received in 2006 compared to 2005 from the Lakeland power project. See "Results of Operations—Results of Discontinued Operations—Lakeland Project" for more information regarding these distributions.

Consolidated Cash Flows from Financing Activities

Cash used in financing activities from continuing operations decreased \$737 million in the first six months of 2006, compared to the first six months of 2005. The 2006 decrease was primarily attributable to net proceeds of \$1 billion received from EME's issuance of senior notes in June 2006, which were mostly used to repay \$965 million of EME's outstanding senior notes and \$136 million paid for tender premiums and related fees.

In addition, Midwest Generation also had borrowings of \$315 million under its credit facility, mostly offset by repayments of \$285 million in 2006. In addition, dividend payments were made to MEHC of \$360 million in 2005 compared to a \$12 million dividend payment to MEHC in 2006. In 2005, EME repaid its junior subordinated debentures for \$150 million and Midwest Generation repaid \$302 million related to its existing term loan.

Consolidated Cash Flows from Investing Activities

Cash used in investing activities from continuing operations increased \$403 million in the first six months of 2006, compared to the first six months of 2005. The 2006 increase was primarily due to net

purchases of marketable securities of \$76 million in the first six months of 2006, compared to net sales of marketable securities of \$140 million in the first six months of 2005. In addition, EME paid \$18 million towards the purchase price of the Wildorado wind project during the first quarter of 2006, incurred higher capital expenditures in 2006 and received lower proceeds from sales of projects. In 2005, EME received proceeds of \$124 million from the sale of its 25% investment in the Tri Energy project and its 50% investment in the CBK project compared to proceeds of \$43 million in 2006 from the sale of 25% of its ownership interest in the San Juan Mesa wind project.

Credit Ratings

Overview

Credit ratings for EME and its subsidiaries, Midwest Generation and EMMT, are as follows:

	<u>Moody's Rating</u>	<u>S&P Rating</u>
EME	B1	B+
Midwest Generation:		
First priority senior secured rating	Ba2	BB-
Second priority senior secured rating	Ba3	B
EMMT	Not Rated	B+

EME cannot provide assurance that its current credit ratings or the credit ratings of its subsidiaries will remain in effect for any given period of time or that one or more of these ratings will not be lowered. EME notes that these credit ratings are not recommendations to buy, sell or hold its securities and may be revised at any time by a rating agency.

EME does not have any “rating triggers” contained in subsidiary financings that would result in it or EME being required to make equity contributions or provide additional financial support to its subsidiaries.

Credit Rating of EMMT

The Homer City sale-leaseback documents restrict EME Homer City’s ability to enter into trading activities, as defined in the documents, with EMMT to sell forward the output of the Homer City facilities if EMMT does not have an investment grade credit rating from Standard & Poor’s or Moody’s or, in the absence of those ratings, if it is not rated as investment grade pursuant to EME’s internal credit scoring procedures. These documents include a requirement that the counterparty to such transactions, and EME Homer City, if acting as seller to an unaffiliated third party, be investment grade. EME currently sells all the output from the Homer City facilities through EMMT, which has a below investment grade credit rating, and EME Homer City is not rated. Therefore, in order for EME to continue to sell forward the output of the Homer City facilities, either: (1) EME must obtain consent from the sale-leaseback owner participant to permit EME Homer City to sell directly into the market or through EMMT; or (2) EMMT must provide assurances of performance consistent with the requirements of the sale-leaseback documents. EME has obtained a consent from the sale-leaseback owner participant that will allow EME Homer City to enter into such sales, under specified conditions, through December 31, 2006. EME Homer City continues to be in compliance with the terms of the consent; however, the consent is revocable by the sale-leaseback owner participant at any time. The sale-leaseback owner participant has not indicated that it intends to revoke the consent; however, there can be no assurance that it will not do so in the future. Revocation of the consent would not affect trades between EMMT and EME Homer City that had been entered into while the consent was still in effect. EME is permitted to sell the output of the Homer City facilities into the spot market at any

time. See “Market Risk Exposures—Commodity Price Risk—Energy Price Risk Affecting Sales from the Homer City Facilities.”

Margin, Collateral Deposits and Other Credit Support for Energy Contracts

In connection with entering into contracts in support of EME’s price risk management and energy trading activities (including forward contracts, transmission contracts and futures contracts), EME’s subsidiary, EMMT, has entered into agreements to mitigate the risk of nonperformance. Because the credit ratings of EMMT and EME are below investment grade, EME has historically provided collateral in the form of cash and letters of credit for the benefit of counterparties related to accounts payable and unrealized losses in connection with these price risk management and trading activities. At June 30, 2006, EMMT had deposited \$289 million in cash with brokers in margin accounts in support of futures contracts and had deposited \$46 million with counterparties in support of forward energy and transmission contracts. In addition, EME had issued letters of credit of \$7 million in support of commodity contracts at June 30, 2006.

Future cash collateral requirements may be higher than the margin and collateral requirements at June 30, 2006, if wholesale energy prices increase further or the amount hedged increases. EME estimates that margin and collateral requirements for energy contracts outstanding as of June 30, 2006 could increase by no more than approximately \$310 million over the remaining life of the contracts using a 95% confidence level.

Midwest Generation has cash on hand and a \$500 million working capital facility to support margin requirements specifically related to contracts entered into by EMMT related to the Illinois Plants. At June 30, 2006, Midwest Generation had borrowed \$200 million under this credit facility which was partially used to finance margin advances to EMMT of \$142 million. In addition, EME has cash on hand and a \$500 million working capital facility to provide credit support to subsidiaries. See “—EME Financing Developments” and “—EME’s Liquidity as a Holding Company” for further discussion.

EME’s Liquidity as a Holding Company

Overview

At June 30, 2006, EME had corporate cash and cash equivalents and short-term investments of \$1.3 billion to meet liquidity needs. See “—EME’s Liquidity.” Cash distributions from EME’s subsidiaries and partnership investments and unused capacity under its corporate credit facility represent EME’s major sources of liquidity to meet its cash requirements. The timing and amount of distributions from EME’s subsidiaries may be affected by many factors beyond its control. See “—Dividend Restrictions in Major Financings.”

EME Homer City Interim Funding Arrangements

During March 2006, EME, through its subsidiary, Edison Mission Finance, advanced funds in the amount of \$9 million to EME Homer City under the subordinated revolving loan agreement in place between Edison Mission Finance and EME Homer City. The funds were used to assist EME Homer City with a cash shortfall resulting from reduced revenues and higher maintenance expenses caused by the Unit 3 outage. For similar reasons, at the end of March 2006 and April 2006, EMMT made advance payments to EME Homer City in the amounts of \$43.5 million and \$20 million, respectively, against future deliveries of power to it under its trading arrangements with EME Homer City. The proceeds of the subordinated loans were deposited in EME Homer City’s operating account and the

prepayment by EMMT was deposited in EME Homer City's revenue account. It is currently anticipated that a substantial portion of the advance payments will be applied against amounts invoiced to EMMT within the next 12 months.

Historical Distributions Received By EME

The following table is presented as an aid in understanding the cash flow of EME's continuing operations and its various subsidiary holding companies which depend on distributions from subsidiaries and affiliates to fund general and administrative costs and debt service costs of recourse debt.

	Six Months Ended June 30,	
	2006	2005
	(in millions)	
Distributions from Consolidated Operating Projects:		
Edison Mission Midwest Holdings (Illinois Plants)	\$ 380	\$ 171
EME Homer City Generation L.P. (Homer City facilities)	—	41
Holding companies of other consolidated operating projects	3	—
Distributions from Unconsolidated Operating Projects:		
Edison Mission Energy Funding Corp. (Big 4 Projects)(1)	41	29
Sunrise Power Company	7	5
Holding company for Doga project	—	17
Holding companies for Westside projects	6	6
Holding companies of other unconsolidated operating projects	1	4
Total Distributions	<u>\$ 438</u>	<u>\$ 273</u>

(1) The Big 4 projects consist of investments in the Kern River project, Midway-Sunset project, Sycamore project and Watson project. Distributions reflect the amount received by EME after debt service payments by Edison Mission Energy Funding Corp.

Intercompany Tax-Allocation Agreement

EME is included in the consolidated federal and combined state income tax returns of Edison International and is eligible to participate in tax-allocation payments with other subsidiaries of Edison International in circumstances where domestic tax losses are incurred. The right of EME to receive and the amount of and timing of tax-allocation payments are dependent on the inclusion of EME in the consolidated income tax returns of Edison International and its subsidiaries and other factors, including the consolidated taxable income of Edison International and its subsidiaries, the amount of net operating losses and other tax items of EME, its subsidiaries, and other subsidiaries of Edison International and specific procedures regarding allocation of state taxes. EME receives tax-allocation payments for tax losses when and to the extent that the consolidated Edison International group generates sufficient taxable income in order to be able to utilize EME's consolidated tax losses in the consolidated income tax returns for Edison International and its subsidiaries. Based on the application of the factors cited above, EME is obligated during periods it generates taxable income to make payments under the tax-allocation agreements. EME made tax-allocation payments to Edison International of \$162 million during the first six months of 2006. EME received tax-allocation payments from Edison International of \$3 million during the first six months of 2005.

Dividend Restrictions in Major Financings

General

Each of EME's direct or indirect subsidiaries is organized as a legal entity separate and apart from EME and its other subsidiaries. Assets of EME's subsidiaries are not available to satisfy EME's obligations or the obligations of any of its other subsidiaries. However, unrestricted cash or other assets that are available for distribution may, subject to applicable law and the terms of financing arrangements of the parties, be advanced, loaned, paid as dividends or otherwise distributed or contributed to EME or to its subsidiary holding companies.

Key Ratios of EME's Principal Subsidiaries Affecting Dividends

Set forth below are key ratios of EME's principal subsidiaries required by financing arrangements for the twelve months ended June 30, 2006:

<u>Subsidiary</u>	<u>Financial Ratio</u>	<u>Covenant</u>	<u>Actual</u>
Midwest Generation, LLC (Illinois Plants)	Interest Coverage Ratio	Greater than or equal to 1.40 to 1	6.45 to 1
Midwest Generation, LLC (Illinois Plants)	Secured Leverage Ratio	Less than or equal to 7.25 to 1	2.00 to 1
EME Homer City Generation L.P. (Homer City facilities)	Senior Rent Service Coverage Ratio	Greater than 1.7 to 1	2.26 to 1(1)

- (1) The senior rent service coverage ratio is determined by dividing net operating cash flow by senior rent. Net operating cash flow represents revenues less operating expenses as defined in the sale-leaseback documents. Revenue during the twelve months ended June 30, 2006 includes \$43.5 million and \$20 million from an advance payment from EMMT on March 31, 2006 and April 30, 2006, respectively, against future deliveries of power to it under its trading arrangements with EME Homer City.

For a more detailed description of the covenants binding EME's principal subsidiaries that may restrict the ability of those entities to make distributions to EME directly or indirectly through the other holding companies owned by EME, refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Dividend Restrictions in Major Financings" of EME's annual report on Form 10-K for the year ended December 31, 2005.

Off-Balance Sheet Transactions

For a discussion of EME's off-balance sheet transactions, refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Off-Balance Sheet Transactions" of EME's annual report on Form 10-K for the year ended December 31, 2005. There have been no significant developments with respect to EME's off-balance sheet transactions that affect disclosures presented in EME's annual report.

Environmental Matters and Regulations

For a discussion of EME's environmental matters, refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Environmental Matters and Regulations" of EME's annual report on Form 10-K for the year ended

December 31, 2005 and the notes to the Consolidated Financial Statements set forth therein. There have been no significant developments with respect to environmental matters specifically affecting EME since the filing of EME's annual report, except as follows:

Federal—United States of America

Clean Air Act

Mercury Regulation—

As part of its evaluation of environmental control technologies for the Homer City facilities, EME has obtained cost estimates from an engineering and construction company that are substantially higher than the approximately \$350 million to \$400 million previously estimated for the 2006-2010 timeframe. The estimated costs have increased for a number of reasons, including increased material costs and greater demand for environmental control equipment scheduled for installation during the same period. In light of higher estimated capital costs, the impact of the recent decline in emissions costs and the continued uncertainty over the final provisions of relevant environmental regulations, EME has deferred making commitments for the installation of further environmental controls at the Homer City facilities at this time. EME plans to study alternative environmental technologies while continuing to review and refine the scope of the project, estimated costs for control equipment and to monitor developments related to mercury and other environmental regulations.

State—Illinois

Air Quality

On March 14, 2006, the Illinois Environmental Protection Agency submitted a proposed rule to the Illinois Pollution Control Board (PCB) for adoption. The proposed rule requires a 90% reduction of mercury emissions from coal-fired power plants averaged across company-owned Illinois stations and a minimum reduction of 75% for individual generating units by July 1, 2009. A 90% reduction at each station would be required by 2013. The first hearing on the rule was held in June 2006 and a second hearing is set for August 2006.

MARKET RISK EXPOSURES

Introduction

EME's primary market risk exposures are associated with the sale of electricity and capacity from and the procurement of fuel for its merchant power plants. These market risks arise from fluctuations in electricity, capacity and fuel prices, emission allowances, and transmission rights. Additionally, EME's financial results can be affected by fluctuations in interest rates. EME manages these risks in part by using derivative financial instruments in accordance with established policies and procedures.

This section discusses these market risk exposures under the following headings:

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Commodity Price Risk	44
Credit Risk	51
Interest Rate Risk	52
Fair Value of Financial Instruments	53
Regulatory Matters	54

For a complete discussion of these issues, read this quarterly report on Form 10-Q in conjunction with EME's annual report on Form 10-K for the year ended December 31, 2005.

Commodity Price Risk

General Overview

EME's revenues and results of operations of its merchant power plants will depend upon prevailing market prices for capacity, energy, ancillary services, emission allowances or credits, coal, natural gas and fuel oil, and associated transportation costs in the market areas where EME's merchant plants are located. Among the factors that influence the price of energy, capacity and ancillary services in these markets are:

- 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 and/or technologies that may be able to produce electricity at a lower cost than EME's generating facilities and/or increased access by competitors to EME's 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.

A discussion of commodity price risk for the Illinois Plants and the Homer City facilities is set forth below.

Introduction

EME's merchant operations expose it to commodity price risk, which represents the potential loss that can be caused by a change in the market value of a particular commodity. Commodity price risks are actively monitored by a risk management committee to ensure compliance with EME's risk management policies. Policies are in place which define risk management processes, and procedures exist which allow for monitoring of all commitments and positions with regular reviews by EME's risk management committee. Despite this, there can be no assurance that all risks have been accurately identified, measured and/or mitigated.

In addition to prevailing market prices, EME's ability to derive profits from the sale of electricity will be affected by the cost of production, including costs incurred to comply with environmental regulations. The costs of production of the units vary and, accordingly, depending on market conditions, the amount of generation that will be sold from the units is expected to vary from unit to unit.

EME uses "value at risk" to identify, measure, monitor and control its overall market risk exposure in respect of its Illinois Plants, its Homer City facilities, and its trading positions. The use of value at risk allows management to aggregate overall commodity risk, compare risk on a consistent basis and identify the risk factors. Value at risk measures the possible loss over a given time interval, under normal market conditions, at a given confidence level. Given the inherent limitations of value at risk and relying on a single risk measurement tool, EME supplements this approach with the use of stress testing and worst-case scenario analysis for key risk factors, as well as stop loss limits and counterparty credit exposure limits.

Hedging Strategy

To reduce its exposure to market risk, EME hedges a portion of its merchant portfolio risk through EMMT, an EME subsidiary engaged in the power marketing and trading business. To the extent that EME does not hedge its merchant portfolio, the unhedged portion will be subject to the risks and benefits of spot market price movements. Hedge transactions are primarily implemented through the use of contracts cleared on the Intercontinental Trading Exchange and the New York Mercantile Exchange. Hedge transactions are also entered into as forward sales to utilities and power marketing companies.

The extent to which EME hedges its market price risk depends on several factors. First, EME evaluates over-the-counter market prices to determine whether sales at forward market prices are sufficiently attractive compared to assuming the risk associated with fluctuating spot market sales. Second, EME's ability to enter into hedging transactions depends upon its and Midwest Generation's credit capacity and upon the forward sales markets having sufficient liquidity to enable EME to identify appropriate counterparties for hedging transactions.

In the case of hedging transactions related to the generation and capacity of the Illinois Plants, Midwest Generation is permitted to use its working capital facility and cash on hand to provide credit support for these hedging transactions entered into by EMMT under an energy services agreement

between Midwest Generation and EMMT. Utilization of this credit facility in support of hedging transactions provides additional liquidity support for implementation of EME’s contracting strategy for the Illinois Plants. In the case of hedging transactions related to the generation and capacity of the Homer City facilities, credit support is provided by EME pursuant to intercompany arrangements between it and EMMT. See “—Credit Risk,” below.

Energy Price Risk Affecting Sales from the Illinois Plants

All the energy and capacity from the Illinois Plants is sold under terms, including price and quantity, negotiated by EMMT with customers through a combination of bilateral agreements, forward energy sales and spot market sales. As discussed further below, power generated at the Illinois Plants is generally sold into the PJM market.

Midwest Generation sells its power into PJM at spot prices based upon locational marginal pricing. Hedging transactions related to the generation of the Illinois Plants are generally entered into at the Northern Illinois Hub in PJM, and may also be entered into at other trading hubs, including the AEP/Dayton Hub in PJM and the Cinergy Hub in the MISO. These trading hubs have been the most liquid locations for hedging purposes. However, hedging transactions which settle at points other than the Northern Illinois Hub are subject to the possibility of basis risk. See “—Basis Risk” below for further discussion.

PJM has a short-term market, which establishes an hourly clearing price. The Illinois Plants are situated in the PJM control area and are physically connected to high-voltage transmission lines serving this market.

The following table depicts the average historical market prices for energy per megawatt-hour during the first six months of 2006 and 2005.

	24-Hour Northern Illinois Hub Historical Energy Prices(1)	
	2006	2005
January	\$ 42.27	\$ 38.36
February	42.66	34.92
March	42.50	45.75
April	43.16	38.98
May	39.96	33.60
June	34.80	42.45
Six-Month Average	<u>\$ 40.89</u>	<u>\$ 39.01</u>

(1) Energy prices were calculated at the Northern Illinois Hub delivery point using hourly real-time prices as published by PJM.

Forward market prices at the Northern Illinois Hub fluctuate as a result of a number of factors, including natural gas prices, transmission congestion, changes in market rules, electricity demand (which in turn is affected by weather, economic growth, and other factors), plant outages in the region, and the amount of existing and planned power plant capacity. The actual spot prices for electricity delivered by the Illinois Plants into these markets may vary materially from the forward market prices set forth in the table below.

The following table sets forth the forward market prices for energy per megawatt-hour as quoted for sales into the Northern Illinois Hub at June 30, 2006:

	<u>24-Hour Northern Illinois Hub Forward Energy Prices(1)</u>
2006	
July	\$ 43.77
August	47.64
September	36.86
October	33.17
November	38.21
December	50.37
2007 Calendar "strip"(2)	\$ 45.49
2008 Calendar "strip"(2)	\$ 45.10

(1) Energy prices were determined by obtaining broker quotes and information from other public sources relating to the Northern Illinois Hub delivery point.

(2) Market price for energy purchases for the entire calendar year, as quoted for sales into the Northern Illinois Hub.

The following table summarizes Midwest Generation's hedge position (primarily based on prices at the Northern Illinois Hub) at June 30, 2006:

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Megawatt hours	10,039,760	16,237,200	3,072,000
Average price/MWh(1)	\$ 47.61	\$ 48.25	\$ 66.13

(1) The above hedge positions include forward contracts for the sale of power during different periods of the year and the day. Market prices tend to be higher during on-peak periods and during summer months, although there is significant variability of power prices during different periods of time. Accordingly, the above hedge position at June 30, 2006 is not directly comparable to the 24-hour Northern Illinois Hub prices set forth above.

Subsequent to June 30, 2006, EMMT entered into an agreement with a third party to hedge the price risk for 500 MW of on-peak power from the Illinois Plants for 2007, 2008 and 2009 (using the Northern Illinois Hub as a reference point). Under the terms of the agreement, EME has guaranteed the obligation of EMMT, but neither EME nor EMMT is required to post margin, provide liens on property or provide other collateral to support the obligations under the agreement.

Energy Price Risk Affecting Sales from the Homer City Facilities

Electric power generated at the Homer City facilities is generally sold into the PJM market. PJM has a short-term market, which establishes an hourly clearing price. The Homer City facilities are situated in the PJM control area and are physically connected to high-voltage transmission lines serving both the PJM and NYISO markets.

The following table depicts the average historical market prices for energy per megawatt-hour at the Homer City busbar and in PJM West Hub during the first six months of 2006 and 2005:

	Historical Energy Prices(1)			
	24-Hour PJM			
	Homer City		West Hub	
	2006	2005	2006	2005
January	\$ 48.67	\$ 45.82	\$ 54.57	\$ 49.53
February	49.54	39.40	56.39	42.05
March	53.26	47.42	58.30	49.97
April	48.50	44.27	49.92	44.55
May	44.71	43.67	48.55	43.64
June	38.78	46.63	45.78	53.72
Six-Month Average	<u>\$ 47.24</u>	<u>\$ 44.54</u>	<u>\$ 52.25</u>	<u>\$ 47.24</u>

(1) Energy prices were calculated at the Homer City busbar (delivery point) and PJM West Hub using historical hourly real-time prices provided on the PJM web-site.

Forward market prices at the PJM West Hub fluctuate as a result of a number of factors, including natural gas prices, transmission congestion, changes in market rules, electricity demand (which in turn is affected by weather, economic growth and other factors), plant outages in the region, and the amount of existing and planned power plant capacity. The actual spot prices for electricity delivered by the Homer City facilities into these markets may vary materially from the forward market prices set forth in the table below.

The following table sets forth the forward market prices for energy per megawatt-hour as quoted for sales into the PJM West Hub at June 30, 2006:

	24-Hour PJM West Hub Forward Energy Prices(1)
2006	
July	\$ 59.69
August	63.18
September	49.56
October	48.23
November	53.15
December	65.25
2007 Calendar “strip”(2)	\$ 63.80
2008 Calendar “strip”(2)	\$ 62.58

(1) Energy prices were determined by obtaining broker quotes and information from other public sources relating to the PJM West Hub delivery point. Forward prices at PJM West Hub are generally higher than the prices at the Homer City busbar.

(2) Market price for energy purchases for the entire calendar year, as quoted for sales into the PJM West Hub.

The following table summarizes Homer City's hedge position at June 30, 2006:

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Megawatt hours	4,415,900	7,590,000	2,371,200
Average price/MWh(1)	\$ 54.07	\$ 64.35	\$ 66.01

(1) The above hedge positions include forward contracts for the sale of power during different periods of the year and the day. Market prices tend to be higher during on-peak periods and during summer months, although there is significant variability of power prices during different periods of time. Accordingly, the above hedge position at June 30, 2006 is not directly comparable to the 24-hour PJM West Hub prices set forth above.

The average price/MWh for Homer City's hedge position is based on PJM West Hub. Energy prices at the Homer City busbar have been lower than energy prices at the PJM West Hub. See "—Basis Risk" below for a discussion of the difference.

Basis Risk

Sales made from the Illinois Plants and the Homer City facilities in the real-time or day-ahead market receive the actual spot prices at the busbars (delivery points) of the individual plants. In order to mitigate price risk from changes in spot prices at the individual plant busbars, EME may enter into cash settled futures contracts as well as forward contracts with counterparties for energy to be delivered in future periods. Currently, a liquid market for entering into these contracts at the individual plant busbars does not exist. A liquid market does exist for a settlement point at the PJM West Hub in the case of the Homer City facilities and for a settlement point at the Northern Illinois Hub in the case of the Illinois Plants. EME's price risk management activities use these settlement points (and, to a lesser extent, other similar trading hubs) to enter into hedging contracts. EME's revenues with respect to such forward contracts include:

- sales of actual generation in the amounts covered by the forward contracts with reference to PJM spot prices at the busbar of the plant involved, plus,
- sales to third parties at the price under such hedging contracts at designated settlement points (generally the PJM West Hub for the Homer City facilities and the Northern Illinois Hub for the Illinois Plants) less the cost of power at spot prices at the same designated settlement points.

Under PJM's market design, locational marginal pricing, which establishes market prices at specific locations throughout PJM by considering factors including generator bids, load requirements, transmission congestion and losses, can cause the price of a specific delivery point to be higher or lower relative to other locations depending on how the point is affected by transmission constraints. To the extent that, on the settlement date of a hedge contract, spot prices at the relevant busbar are lower than spot prices at the settlement point, the proceeds actually realized from the related hedge contract are effectively reduced by the difference. This is referred to as "basis risk." During the six months ended June 30, 2006, transmission congestion in PJM has resulted in prices at the Homer City busbar being lower than those at the PJM West Hub (EME Homer City's primary trading hub) by an average of 10%, compared to 6% during the six months ended June 30, 2005. The monthly average difference during the twelve months ended June 30, 2006 ranged from 3% to 20%, which occurred in August 2005. In contrast to the Homer City facilities, during the past 12 months, the prices at the Northern Illinois Hub were substantially the same as those at the individual busbars of the Illinois Plants.

By entering into cash settled futures contracts and forward contracts using the PJM West Hub and the Northern Illinois Hub (or other similar trading hubs) as settlement points, EME is exposed to basis risk as described above. In order to mitigate basis risk, EME has purchased 7.8 TWh of financial

transmission rights and basis swaps in PJM for Homer City during the period July 1, 2006 through May 31, 2007, and may continue to purchase financial transmission rights and basis swaps in the future. A financial transmission right is a financial instrument that entitles the holder to receive the difference of actual spot prices for two delivery points in exchange for a fixed amount. Accordingly, EME's price risk management activities include using financial transmission rights alone or in combination with forward contracts and basis swap contracts to manage basis risk.

Coal Price and Transportation Risk

The Illinois Plants use approximately 18 million to 20 million tons of coal annually, primarily obtained from the Southern Powder River Basin of Wyoming. In addition, the Homer City facilities use approximately 5 million to 6 million tons of coal annually, obtained primarily from mines located near the facilities in Pennsylvania. Coal purchases are made under a variety of supply agreements with terms ranging from one year to eight years. The following table summarizes the percent of expected coal requirements for the next five years that were under contract at June 30, 2006.

	Percent of Coal Requirements Under Contract				
	2006(1)	2007	2008	2009	2010
Illinois Plants	108%	95%	33%	33%	33%
Homer City facilities	99%	97%	39%	15%	0%

(1) The percentage in 2006 is calculated based on coal supply and expected generation requirements for a full year.

EME is subject to price risk for purchases of coal that are not under contract. Prices of Northern Appalachian (NAPP) coal, which is related to the price of coal purchased for the Homer City facilities, increased considerably during 2005. The price of NAPP coal (with 13,000 British Thermal units (Btu) per pound heat content and <3.0 pounds of SO2 per MMBtu sulfur content) fluctuated between \$44 per ton and \$57 per ton during 2005, with a price of \$45 per ton at December 30, 2005, as reported by the Energy Information Administration. The 2005 overall increase in the NAPP coal price was largely attributed to greater demand from domestic power producers and increased international shipments of coal to Asia. During the first six months of 2006, the price of NAPP coal decreased to \$37.50 per ton at June 23, 2006, as reported by the Energy Information Administration, due to the combined effects of a mild winter, easing natural gas prices and improving eastern stockpiles. Prices of Powder River Basin (PRB) coal (with 8,800 Btu per pound heat content and 0.8 pounds of SO2 per MMBtu sulfur content), which is purchased for the Illinois Plants, significantly increased in 2005 due to the curtailment of coal shipments during 2005 due to increased PRB coal demand from other regions (east), rail constraints (discussed below), higher oil and natural gas prices and higher prices for SO2 allowances. On June 23, 2006, the Energy Information Administration reported the price of PRB coal to be \$12.25 per ton, which compares to 2005 prices that ranged from \$6.20 per ton to \$18.48 per ton. The price of PRB coal decreased during the first six months of 2006 from 2005 year-end prices due to easing natural gas prices, lower prices for SO2 allowances and mild weather during the first six months of 2006.

After two derailments in May 2005, the railroads that bring coal from the PRB mines to the Illinois Plants discovered significant problems with the joint-rail line that serves the PRB mines. Repairs to the joint-rail line are expected to continue through most of 2006. Even though some restrictions in coal shipments have occurred while repairs are being completed, EME expects to continue receiving a sufficient amount of coal to generate power based on communications with the railroad companies.

Emission Allowances Price Risk

The federal Acid Rain Program requires electric generating stations to hold SO₂ allowances, and Illinois and Pennsylvania regulations implemented the federal NO_x SIP Call requirement. Under these programs, EME purchases (or sells) emission allowances based on the amounts required for actual generation in excess of (or less than) the amounts allocated under these programs. As part of the acquisition of the Illinois Plants and the Homer City facilities, EME obtained the rights to the emission allowances that have been or are allocated to these plants.

The price of emission allowances, particularly SO₂ allowances issued through the federal Acid Rain Program, decreased during the first half of 2006 from 2005 year-end prices. The average price of purchased SO₂ allowances decreased to \$899 per ton during the six months ended June 30, 2006 from \$1,219 per ton during 2005. The decrease in the price of SO₂ allowances during the six months ended June 30, 2006 from 2005 year-end prices has been attributed to lower loads in January 2006 and a decline in natural gas prices. The price of SO₂ allowances, determined by obtaining broker quotes and information from other public sources, was \$750 per ton as of July 31, 2006.

For a discussion of environmental regulations related to emissions, refer to “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Environmental Matters and Regulations” of EME’s annual report on Form 10-K for the year ended December 31, 2005.

Credit Risk

In conducting EME’s price risk management and trading activities, EME contracts with a number of utilities, energy companies, financial institutions, and other companies, collectively referred to as counterparties. In the event a counterparty were to default on its trade obligation, EME would be exposed to the risk of possible loss associated with re-contracting the product at a price different from the original contracted price if the non-performing counterparty were unable to pay the resulting liquidated damages owed to EME. Further, EME would be exposed to the risk of non-payment of accounts receivable accrued for products delivered prior to the time a counterparty defaulted.

To manage credit risk, EME looks at the risk of a potential default by counterparties. Credit risk is measured by the loss that would be incurred if counterparties failed to perform pursuant to the terms of their contractual obligations. EME measures, monitors and mitigates credit risk to the extent possible. To mitigate credit risk from counterparties, master netting agreements are used whenever possible and counterparties may be required to pledge collateral when deemed necessary. EME also takes other appropriate steps to limit or lower credit exposure. Processes have also been established to determine and monitor the creditworthiness of counterparties. EME manages the credit risk on the portfolio based on credit ratings using published ratings of counterparties and other publicly disclosed information, such as financial statements, regulatory filings, and press releases, to guide it in the process of setting credit levels, risk limits and contractual arrangements, including master netting agreements. A risk management committee regularly reviews the credit quality of EME’s counterparties. Despite this, there can be no assurance that these efforts will be wholly successful in mitigating credit risk or that collateral pledged will be adequate.

EME measures credit risk exposure from counterparties of its merchant energy activities as either: (i) the sum of 60 days of accounts receivable, current fair value of open positions, and a credit value at risk, or (ii) the sum of delivered and unpaid accounts receivable and the current fair value of open positions. EME’s subsidiaries enter into master agreements and other arrangements in conducting price risk management and trading activities which typically provide for a right of setoff in the event of

bankruptcy or default by the counterparty. Accordingly, EME's credit risk exposure from counterparties is based on net exposure under these agreements. At June 30, 2006, the amount of exposure, broken down by the credit ratings of EME's counterparties, was as follows:

<u>S&P Credit Rating</u>	<u>June 30, 2006</u> <u>(in millions)</u>
A or higher	\$ 88
A-	18
BBB+	52
BBB	65
BBB-	—
Below investment grade	<u>2</u>
Total	<u>\$ 225</u>

EME's plants owned by unconsolidated affiliates in which EME owns an interest sell power under power purchase agreements. Generally, each plant sells its output to one counterparty. Accordingly, a default by a counterparty under a power purchase agreement, including a default as a result of a bankruptcy, would likely have a material adverse effect on the operations of such power plant.

In addition, coal for the Illinois Plants and the Homer City facilities is purchased from suppliers under contracts which may be for multiple years. A number of the coal suppliers to the Illinois Plants and the Homer City facilities do not currently have an investment grade credit rating and, accordingly, EME may have limited recourse to collect damages in the event of default by a supplier. EME seeks to mitigate this risk through diversification of its coal suppliers and through guarantees and other collateral arrangements when available. Despite this, there can be no assurance that these efforts will be successful in mitigating credit risk from coal suppliers.

EME's merchant plants sell electric power generally into the PJM market by participating in PJM's capacity and energy markets or transact capacity and energy on a bilateral basis. Sales into PJM accounted for approximately 69% of EME's consolidated operating revenues for the six months ended June 30, 2006. Moody's Investors Service rates PJM's senior unsecured debt Aa3. PJM, an independent system operator with over 300 member companies, maintains its own credit risk policies and does not extend unsecured credit to non-investment grade companies. Any losses due to a PJM member default are shared by all other members based upon a predetermined formula. At June 30, 2006, EME's account receivable due from PJM was \$70 million.

Interest Rate Risk

Interest rate changes can affect earnings and the cost of capital for capital improvements or new investments in power projects. EME mitigates the risk of interest rate fluctuations by arranging for fixed rate financing or variable rate financing with interest rate swaps, interest rate options or other hedging mechanisms for a number of its project financings. The fair market values of long-term fixed interest rate obligations are subject to interest rate risk. The fair market value of EME's consolidated long-term obligations (including current portion) was \$3.5 billion at June 30, 2006, compared to the carrying value of \$3.4 billion.

Fair Value of Financial Instruments

Non-Trading Derivative Financial Instruments

The following table summarizes the fair values for outstanding derivative financial instruments used in EME's continuing operations for purposes other than trading, by risk category (in millions):

	<u>June 30, 2006</u>	<u>December 31, 2005</u>
Commodity price:		
Electricity	\$ (3)	\$ (434)

In assessing the fair value of EME's non-trading derivative financial instruments, EME uses a variety of methods and assumptions based on the market conditions and associated risks existing at each balance sheet date. The fair value of commodity price contracts takes into account quoted market prices, time value of money, volatility of the underlying commodities and other factors. The following table summarizes the maturities and the related fair value, based on actively traded prices, of EME's commodity price risk management assets and liabilities as of June 30, 2006 (in millions):

	<u>Total Fair Value</u>	<u>Maturity <1 year</u>	<u>Maturity 1 to 3 years</u>	<u>Maturity 4 to 5 years</u>	<u>Maturity >5 years</u>
Prices actively quoted	<u>\$ (3)</u>	<u>\$ 5</u>	<u>\$ (8)</u>	<u>\$ —</u>	<u>\$ —</u>

Energy Trading Derivative Financial Instruments

The fair value of the commodity financial instruments related to energy trading activities as of June 30, 2006 and December 31, 2005, are set forth below (in millions):

	<u>June 30, 2006</u>		<u>December 31, 2005</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
Electricity	\$ 120	\$ 4	\$ 127	\$ 27
Other	1	2	1	—
Total	<u>\$ 121</u>	<u>\$ 6</u>	<u>\$ 128</u>	<u>\$ 27</u>

The change in the fair value of trading contracts for the six months ended June 30, 2006, was as follows (in millions):

Fair value of trading contracts at January 1, 2006	\$ 101
Net gains from energy trading activities	59
Amount realized from energy trading activities	(52)
Other changes in fair value	7
Fair value of trading contracts at June 30, 2006	<u>\$ 115</u>

Quoted market prices are used to determine the fair value of the financial instruments related to energy trading activities, except for the power sales agreement with an unaffiliated electric utility that EME's subsidiary purchased and restructured and a long-term power supply agreement with another unaffiliated party. EME's subsidiary recorded these agreements at fair value based upon a discounting of future electricity prices derived from a proprietary model using a discount rate equal to the cost of

borrowing the non-recourse debt incurred to finance the purchase of the power supply agreement. The following table summarizes the maturities, the valuation method and the related fair value of energy trading assets and liabilities (as of June 30, 2006) (in millions):

	<u>Total Fair Value</u>	<u>Maturity <1 year</u>	<u>Maturity 1 to 3 years</u>	<u>Maturity 4 to 5 years</u>	<u>Maturity >5 years</u>
Prices actively quoted	\$ 29	\$ 26	\$ 3	\$ —	\$ —
Prices based on models and other valuation methods	86	1	11	17	57
Total	<u>\$ 115</u>	<u>\$ 27</u>	<u>\$ 14</u>	<u>\$ 17</u>	<u>\$ 57</u>

Regulatory Matters

For a discussion of EME’s regulatory matters, refer to “Item 1. Business—Regulatory Matters” of EME’s annual report on Form 10-K for the year ended December 31, 2005. There have been no significant developments with respect to regulatory matters specifically affecting EME since the filing of EME’s annual report on Form 10-K for the year ended December 31, 2005, except as follows:

PJM Reliability Pricing Model

On August 31, 2005, PJM filed under sections 205 and 206 of the Federal Power Act a proposal for a reliability pricing model (RPM) to replace its existing capacity construct. The proposal offers RPM as a new capacity construct to address the deficiencies in PJM’s current structure in a comprehensive and integrated manner. On April 20, 2006, the FERC issued an Initial Order on RPM, finding that as a result of a combination of factors, PJM’s existing capacity construct is unjust and unreasonable as a long-term capacity solution, because it fails to set prices adequate to ensure energy resources to meet its reliability responsibilities. Although the FERC did not find that the RPM proposal, as filed by PJM, is the just and reasonable replacement for the current capacity construct because some elements of the proposal need further development and elaboration, it did find that certain elements of the RPM proposal, with some adjustment and clarification, may form the basis for a just and reasonable capacity market. Accordingly, in the order the FERC provided guidance on PJM’s RPM proposal, as well as other features that need to be included in a just and reasonable capacity market, and established further proceedings to resolve these issues.

MISO Revenue Sufficiency Guarantee Charges

On April 25, 2006, the FERC issued an order regarding the MISO’s “Revenue Sufficiency Guarantee” charges (RSG charges). The MISO’s business practice manuals and other instructions to market participants have stated, since the implementation of market operations on April 1, 2005, that RSG charges will not be imposed on offers to supply power not supported by actual generation (also known as virtual supply offers). However, some market participants raised questions about the language of the MISO’s tariff concerning that issue and, in October 2005, the MISO submitted to the FERC proposed tariff revisions clarifying its tariff to reflect its business practices with respect to RSG charges and filed corrected tariff sheets exempting virtual supply from RSG charges. In its April 25 decision, the FERC interpreted the MISO’s tariff to require that virtual supply offers must be included in the calculation of the RSG charges and that, to the extent that the MISO did not charge virtual supply offers for RSG charges, it violated the terms of its tariff. The FERC order then proceeded to require the MISO to recalculate the RSG charges back to April 1, 2005, and to make refunds to customers, with interest, reflecting the recalculated charges. In order to make such refunds, it is likely that the MISO will attempt to impose retroactively RSG charges on those who submitted virtual supply offers

during the recalculation period. EMMT made virtual supply offers in the MISO during this period on which no RSG charges were imposed, and thus may be subject to a claim for refunds from the MISO (which claim will be contested by EMMT). Because calculation of any claimed liability for refunds depends on information not currently available to it, EMMT cannot reasonably estimate a range of loss related to this matter. In addition, the FERC's April 25 order has been challenged by the MISO and other parties, including EMMT, and as the FERC has issued an extension of time to comply with the requirements of the order until after the date of issuance of an order on rehearing, the eventual outcome of these proceedings is unclear. The FERC order also requires the MISO to modify its tariff on a prospective basis to impose RSG charges on virtual supply offers. At this time, it is not possible to predict how the prospective effect of the order will affect the nature and operation of the MISO markets.

FERC Order Regarding PJM Marginal Losses

On May 1, 2006, the FERC issued an order in response to a complaint filed by Pepco Holdings, Inc. against PJM regarding marginal losses for transmission. The FERC concluded that PJM had violated its tariff by not implementing marginal losses and further directed PJM to implement marginal losses by October 2, 2006. Implementation of marginal losses will adjust the algorithm that calculates locational marginal prices to include a marginal loss component in addition to the already included congestion component. This may have an adverse impact on sellers in the Western PJM and Northern Illinois regions. On June 19, 2006, the FERC issued an order delaying implementation of marginal losses in PJM until June 1, 2007, and at this time it is not possible to predict how the prospective effect of the order will affect the prices at which EME Homer City and Midwest Generation will be able to sell their power.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For a discussion of market risk sensitive instruments, refer to “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Market Risk Exposures” of EME’s annual report on Form 10-K for the year ended December 31, 2005. Refer to “Market Risk Exposures” in Item 2 of this quarterly report on Form 10-Q for an update to that disclosure.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

EME’s management, with the participation of the company’s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of EME’s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) or 15d-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. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period, EME’s disclosure controls and procedures are effective.

Internal Control Over Financial Reporting

There were no changes in EME’s internal control over financial reporting (as such term is defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, EME’s internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

No material legal proceedings are presently pending against EME.

ITEM 1A. RISK FACTORS

For a discussion of the risks, uncertainties, and other important factors which could materially affect EME's business, financial condition, or future results, refer to "Item 1A. Risk Factors" of EME's annual report on Form 10-K for the year ended December 31, 2005. The risks described in EME's annual report on Form 10-K are not the only risks facing EME. Additional risks and uncertainties that are not currently known, or that are currently deemed to be immaterial, also may materially adversely affect EME's business, financial condition or future results.

ITEM 6. EXHIBITS

<u>Exhibit No.</u>	<u>Description</u>
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act.
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act.
32	Statement Pursuant to 18 U.S.C. Section 1350.

