
**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 September 30, 2007

or

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

For the transition period from _____ to _____

Commission file number 333-92047-03

EME HOMER CITY GENERATION L.P.

(Exact name of registrant as specified in its charter)

Pennsylvania

(State or other jurisdiction of incorporation
or organization)

33-0826938

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

**1750 Power Plant Road
Homer City, Pennsylvania**

(Address of principal executive offices)

15748

(Zip Code)

Registrant's telephone number, including area code: **(724) 479-9011**

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 ownership interests as of November 2, 2007: Not applicable.

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GLOSSARY

When the following terms and abbreviations appear in the text of this report, they have the meanings indicated below.

Btu	British thermal units
CAIR	Clean Air Interstate Rule
EME	Edison Mission Energy
EME Homer City	EME Homer City Generation L.P.
EMMT	Edison Mission Marketing & Trading, Inc.
ERP	enterprise resource planning
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FIN No. 39-1	Financial Accounting Standards Board Staff Position No. 39-1, "Amendment of FASB Interpretation No. 39"
FIN No. 48	Financial Accounting Standards Interpretation No. 48, "Accounting for Uncertainty in Income Taxes"
Fitch	Fitch Ratings
GWh	gigawatt-hours
ISO	independent system operator
MAAC+APS	Mid-Atlantic Area Council (MAAC) Region and Allegheny Power (APS)
MD&A	Management's Discussion and Analysis of Financial Condition and Results of Operations
MMBtu	million British thermal units
Moody's	Moody's Investors Service, Inc.
MW	megawatts
MWh	megawatt-hours
NAPP	Northern Appalachian
NO _x	nitrogen oxide
NYISO	New York Independent System Operator
NYSEG	New York State Electric & Gas Corporation
PADEP	Pennsylvania Department of Environmental Protection
Penelec	Pennsylvania Electric Company
PJM	PJM Interconnection, LLC
RPM	Reliability Pricing Model
S&P	Standard & Poor's Ratings Services
SCR	selective catalytic reduction
SFAS	Statement of Financial Accounting Standards issued by the FASB

SFAS No. 133	Statement of Financial Accounting Standards No. 133, “Accounting for Derivative Instruments and Hedging Activities”
SFAS No. 155	Statement of Financial Accounting Standards No. 155, “Accounting for Certain Hybrid Financial Instruments”
SFAS No. 157	Statement of Financial Accounting Standards No. 157, “Fair Value Measurements”
SFAS No. 159	Statement of Financial Accounting Standards No. 159, “Fair Value Option for Financial Assets and Liabilities, Including an Amendment of FASB Statement No. 115”
SIP	state implementation plan
SO ₂	sulfur dioxide
US EPA	United States Environmental Protection Agency

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EME HOMER CITY GENERATION L.P.
STATEMENTS OF INCOME
(In thousands, Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Operating Revenues from Marketing Affiliate	\$ 198,837	\$ 198,745	\$ 573,040	\$ 469,477
Operating Expenses				
Fuel	84,486	83,996	224,613	213,472
Gain on sale of emission allowances	—	(540)	—	(1,882)
Plant operations	17,815	22,152	93,042	85,508
Depreciation and amortization	15,999	14,873	46,553	44,503
Loss on disposal of assets	—	—	—	128
Administrative and general	836	1,627	2,653	4,220
Total operating expenses	119,136	122,108	366,861	345,949
Operating income	79,701	76,637	206,179	123,528
Other Income (Expense)				
Interest and other income	3,908	1,678	7,666	17,950
Interest expense	(34,275)	(37,028)	(106,048)	(108,920)
Total other expense	(30,367)	(35,350)	(98,382)	(90,970)
Income before income taxes	49,334	41,287	107,797	32,558
Provision for income taxes	20,719	17,376	44,039	12,472
Net Income	\$ 28,615	\$ 23,911	\$ 63,758	\$ 20,086

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

EME HOMER CITY GENERATION L.P.
STATEMENTS OF COMPREHENSIVE INCOME
(In thousands, Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net Income	\$ 28,615	\$ 23,911	\$ 63,758	\$ 20,086
Other comprehensive income (loss), net of tax:				
Pension and postretirement benefits other than pensions:				
Amortization of prior service credit, net of tax expense of \$22 for the nine months ended September 30, 2007	(26)	—	(56)	—
Amortization of actuarial loss, net of tax benefit of \$23 for the nine months ended September 30, 2007	27	—	58	—
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 \$(591) and \$38,907 for the three months and \$(55,314) and \$128,714 for the nine months ended September 30, 2007 and 2006, respectively	(602)	53,294	(75,448)	176,305
Reclassification adjustments included in net income, net of income tax expense (benefit) of \$(5,216) and \$4,230 for the three months and \$(20,714) and \$8,702 for the nine months ended September 30, 2007 and 2006, respectively	7,057	(5,794)	28,255	(11,919)
Other comprehensive income (loss)	6,456	47,500	(47,191)	164,386
Comprehensive Income	\$ 35,071	\$ 71,411	\$ 16,567	\$ 184,472

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

EME HOMER CITY GENERATION L.P.
BALANCE SHEETS
(In thousands, Unaudited)

	<u>September 30,</u> <u>2007</u>	<u>December 31,</u> <u>2006</u>
Assets		
Current Assets		
Cash and cash equivalents	\$ 156,991	\$ 113,839
Due from affiliates	324	—
Fuel inventory	43,292	47,385
Spare parts inventory	25,945	25,708
Deposits under lease swap agreement	—	45,386
Derivative assets	33,135	89,539
Deferred taxes	15,007	—
Intangible assets	20,948	4,284
Other current assets	18,819	20,439
	314,461	346,580
Property, Plant and Equipment	2,150,906	2,142,813
Less accumulated depreciation and amortization	395,405	348,853
	1,755,501	1,793,960
Deferred taxes	46,821	65,781
Restricted cash	37,119	47,119
Trust deposits	—	325
Long-term derivative assets	13,781	10,797
	\$ 2,167,683	\$ 2,264,562
Liabilities and Partners' Equity		
Current Liabilities		
Accounts payable	\$ 5,466	\$ 3,346
Book overdrafts	192	—
Accrued liabilities	24,545	24,499
Due to affiliates	130,905	117,898
Interest payable	49,298	32,282
Interest payable to affiliates	8,893	39,804
Derivative liabilities	33,771	9,672
Deferred taxes	—	33,062
Current portion of lease financing	52,970	49,788
	306,040	310,351
Long-term debt to affiliate	444,633	512,447
Lease financing, net of current portion	1,206,962	1,259,932
Benefit plans and other	44,953	42,867
Long-term derivative liabilities	11,128	1,565
	2,013,716	2,127,162
Total Liabilities		
Commitments and Contingencies (Note 5)		
Partners' Equity	153,967	137,400
	\$ 2,167,683	\$ 2,264,562

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

EME HOMER CITY GENERATION L.P.
STATEMENTS OF PARTNERS' EQUITY (DEFICIT)
(In thousands, Unaudited)

	<u>Chestnut Ridge Energy Company</u>	<u>Mission Energy Westside Inc.</u>	<u>Total Partners' Equity</u>
Balance at December 31, 2006	\$ 136,443	\$ 957	\$ 137,400
Net income	63,694	64	63,758
Other comprehensive income	<u>(47,144)</u>	<u>(47)</u>	<u>(47,191)</u>
Balance at September 30, 2007	<u>\$ 152,993</u>	<u>\$ 974</u>	<u>\$ 153,967</u>

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

EME HOMER CITY GENERATION L.P.
STATEMENTS OF CASH FLOWS
(In thousands, Unaudited)

	Nine Months Ended September 30,	
	2007	2006
Cash Flows From Operating Activities		
Net income	\$ 63,758	\$ 20,086
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	46,977	44,503
Deferred taxes	5,489	(15,359)
Gain on sale of emission allowances	—	(1,882)
Loss on asset disposal	—	128
Decrease in due to/from affiliates	12,683	54,278
Decrease (increase) in inventory	3,856	(17,625)
Increase in other assets	(15,043)	(11,200)
Increase in accounts payable and other current liabilities	2,358	2,130
Increase (decrease) in interest payable	(13,895)	48,170
Increase in other liabilities	1,665	3,542
Decrease (increase) in derivative assets and liabilities	5,289	(20,657)
Net cash provided by operating activities	113,137	106,114
Cash Flows From Financing Activities		
Refund of deposit under lease swap agreement	45,386	—
Advances under lease swap agreement	—	61,074
Borrowings on long-term obligations from affiliates	—	12,287
Repayments to affiliates	(67,814)	—
Repayments of lease financing	(49,788)	(47,000)
Net cash provided by (used in) financing activities	(72,216)	26,361
Cash Flows From Investing Activities		
Capital expenditures	(8,094)	(9,508)
Proceeds from sale of emission allowances	—	6,173
Trust deposits	325	—
Proceeds from settlement claim	—	3,900
Restricted cash	10,000	—
Net cash provided by investing activities	2,231	565
Net increase in cash and cash equivalents	43,152	133,040
Cash and cash equivalents at beginning of period	113,839	60,248
Cash and cash equivalents at end of period	\$ 156,991	\$ 193,288

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

EME HOMER CITY GENERATION L.P.
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2007
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

EME Homer City's significant accounting policies are described in Note 2 to its financial statements included in its annual report on Form 10-K for the year ended December 31, 2006. EME Homer City follows the same accounting policies for interim reporting purposes, with the exception of the change in accounting for uncertain tax positions (discussed below in "New Accounting Pronouncements"). This quarterly report should be read in connection with such financial statements.

In the opinion of management, all adjustments, including recurring accruals, have been made that are necessary to fairly state the financial position and results of operations and cash flows in accordance with accounting principles generally accepted in the United States for the periods covered by this quarterly report on Form 10-Q. The results of operations for the nine months ended September 30, 2007 are not necessarily indicative of the operating results for the full year.

Certain prior year reclassifications have been made to conform to the current year financial statement presentation.

Income Taxes

EME Homer City has made an election to be taxed as a corporation for federal and California state tax purposes. EME Homer City is included in the consolidated federal and state income tax returns of Edison International and is party to a tax-allocation agreement with its indirect parent, Edison Mission Holdings Co. As long as Edison International continues to own, directly or indirectly, at least 80% of the voting power of the stock of EME and its existing subsidiaries and at least 80% of the value of such stock, EME Homer City will be included in the consolidated federal and state income tax returns of Edison International. In accordance with the agreement and the tax-allocation procedures in effect since EME Homer City's formation, its current tax liability or benefit is generally determined on a separate return basis, except for calculating consolidated state income taxes, for which EME Homer City uses the long-term state tax apportionment factors of the Edison International group. Also, while EME Homer City is generally subject to separate return limitations for net losses, under the tax-allocation agreement EME Homer City is permitted to transfer to Edison Mission Holdings, or its subsidiaries, net operating loss benefits which would not yet be realized in a separate return in exchange for a reduction in its intercompany account balances (including the subordinated revolving loan). EME Homer City also files a separate state income tax return in Pennsylvania. Because EME Homer City is expected to realize deferred tax assets through future taxable income or by reduction of intercompany loans, no valuation allowance has been recorded.

Amounts included in due to affiliates on the balance sheet associated with this tax-allocation agreement totaled \$59.2 million and \$25.6 million at September 30, 2007 and December 31, 2006, respectively. EME Homer City accounts for deferred income taxes using the asset-and-liability method, wherein deferred tax assets and liabilities are recognized for future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities using enacted income tax rates. Interest expense and penalties associated with income taxes are reflected in the

caption “Provision for income taxes” on the statements of income. For further discussion of income taxes, see Note 4—Income Taxes.

Intangible Assets

Intangible assets consist of emission allowances purchased by EME Homer City. These emission allowances are stated at weighted average cost.

New Accounting Pronouncements

Accounting Principles Adopted

Statement of Financial Accounting Standards Interpretation No. 48—

In July 2006, the FASB issued FIN No. 48, which clarifies the accounting for uncertain tax positions. FIN No. 48 requires an enterprise 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. EME Homer City adopted FIN No. 48 effective January 1, 2007. Adoption of FIN No. 48 did not result in a cumulative-effect adjustment to partner’s equity.

Statement of Financial Accounting Standards No. 155—

In February 2006, the FASB issued SFAS No. 155, which amends SFAS No. 133 and SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.” SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for at fair value at acquisition, at issuance, or when a previously recognized financial instrument is subject to a remeasurement event, on an instrument-by-instrument basis, in cases in which a derivative would otherwise have to be bifurcated. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to remeasurement after January 1, 2007. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of SFAS No. 133 prior to the adoption of this Statement. The adoption of this standard had no effect on EME Homer City’s financial statements for the nine months ended September 30, 2007.

Accounting Principles Not Yet Adopted

FASB Staff Position FIN No. 39-1—

In April 2007, the FASB issued FIN No. 39-1. FIN No. 39-1 amends paragraph 3 of FIN No. 39 to replace the terms conditional contracts and exchange contracts with the term derivative instruments as defined in SFAS No. 133. FIN No. 39-1 also states that under master netting arrangements if collateral is based on fair value, then it must be netted with the fair value of derivative assets/liabilities if an entity qualified and elected the option to net those amounts. EME Homer City will adopt FIN No. 39-1 on January 1, 2008. EME Homer City does not currently have margining agreements and accordingly, adoption of FIN No. 39-1 is not expected to have an impact on its financial statements.

Statement of Financial Accounting Standards No. 157—

In September 2006, the FASB issued SFAS No. 157, which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the disclosures on fair value

measurements. EME Homer City will adopt SFAS No. 157 on January 1, 2008. EME Homer City is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

Statement of Financial Accounting Standards No. 159—

In February 2007, the FASB issued SFAS No. 159, which provides an option to report eligible financial assets and liabilities at fair value, with changes in fair value recognized in earnings. Upon adoption, the first remeasurement to fair value would be reported as a cumulative-effect adjustment to the opening balance of retained earnings. EME Homer City is currently evaluating whether it will opt to report any current or future financial assets and liabilities at fair value and the impact, if adopted, on its financial statements, beginning January 1, 2008.

Note 2. Accumulated Other Comprehensive Income (Loss)

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

	<u>Unrealized Gains (Losses) on Cash Flow Hedges</u>	<u>Unrecognized Losses and Prior Service Costs, Net(1)</u> (in thousands)	<u>Accumulated Other Comprehensive Income (Loss)</u>
Balance at December 31, 2006	\$ 57,907	\$ (1,502)	\$ 56,405
Current period change	<u>(47,193)</u>	<u>2</u>	<u>(47,191)</u>
Balance at September 30, 2007	<u>\$ 10,714</u>	<u>\$ (1,500)</u>	<u>\$ 9,214</u>

(1) For further detail, see Note 3—Compensation and Benefit Plans.

Unrealized gains on cash flow hedges, net of tax, at September 30, 2007, included unrealized gains on commodity hedges related to futures and forward energy sales contracts that qualify for hedge accounting. These gains arise because current forecasts of future electricity prices are lower than EME Homer City’s contract prices. The decrease in unrealized gains during the nine months ended September 30, 2007 resulted from an increase in market prices for power.

As EME Homer City’s hedged positions are realized, \$11.3 million, after tax, of the net unrealized gains on cash flow hedges at September 30, 2007 are expected to be reclassified into earnings during the next 12 months. Management expects that reclassification of net unrealized gains will increase 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, 2010.

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 Homer City recorded net gains (losses) of \$(4.8) million and \$7.6 million during the third quarters of 2007 and 2006, respectively, and \$(14.6) million and \$(8.2) million during the nine months ended September 30, 2007 and 2006, respectively, representing the amount of cash flow hedges’ ineffectiveness, reflected in operating revenues in EME Homer City’s income statements.

Note 3. Employee Benefit Plans

Pension Plans and Postretirement Benefits Other Than Pensions

EME Homer City previously disclosed in its financial statements for the year ended December 31, 2006 that it expected to contribute approximately \$1.7 million to its pension plans in 2007. As of September 30, 2007, \$1.2 million in contributions have been made. EME Homer City continues to expect to contribute approximately \$0.5 million to its pension plans in the last three months of 2007. Expected contribution funding in 2007 could vary from anticipated amounts, depending on the funded status at year-end and the tax-deductible funding limitations.

Components of pension expense are:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in thousands)			
Service cost	\$ 413	\$ 498	\$ 1,239	\$ 1,493
Interest cost	348	317	1,043	953
Expected return on plan assets	(313)	(243)	(937)	(730)
Amortization of net actuarial (gain) loss	(25)	9	(77)	27
Total expense	<u>\$ 423</u>	<u>\$ 581</u>	<u>\$ 1,268</u>	<u>\$ 1,743</u>

Postretirement Benefits Other Than Pensions

EME Homer City previously disclosed in its financial statements for the year ended December 31, 2006, that it expected to contribute \$271,000 to its postretirement benefits other than pensions in 2007. As of September 30, 2007, \$204,000 in contributions have been made. EME Homer City continues to expect to contribute \$67,000 to its postretirement benefits other than pensions in the last three months of 2007. Expected contribution funding in 2007 could vary from anticipated amounts, depending on the funded status at year-end and the tax-deductible funding limitations.

Components of postretirement benefits expense are:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in thousands)			
Service cost	\$ 212	\$ 208	\$ 636	\$ 624
Interest cost	330	287	992	860
Amortization of prior service costs	(26)	(26)	(78)	(78)
Amortization of net actuarial loss	53	67	158	201
Total expense	<u>\$ 569</u>	<u>\$ 536</u>	<u>\$ 1,708</u>	<u>\$ 1,607</u>

Note 4. Income Taxes

EME Homer City had effective income tax provision rates during the first nine months of 2007 and 2006 of 40.9% and 38.3%, respectively. EME Homer City's effective income tax provision rate varies from the federal statutory rate of 35% primarily due to state income taxes and estimated benefits

from a federal deduction related to qualified domestic production activities under Section 199 of the Internal Revenue Code.

The total amount of unrecognized tax benefits (excluding the effect of federal income taxes on unrecognized state tax benefits) as of the date of adoption of FIN No. 48 was \$3.9 million. The total amount of unrecognized tax benefits as of the date of adoption that, if recognized, would affect the effective tax rate was \$3.9 million. The total amount of accrued interest and penalties was \$1.5 million as of the date of adoption.

EME Homer City remains subject to examination by the Internal Revenue Service, the California Franchise Tax Board, and other state tax authorities from 1994 to present. EME Homer City continues its efforts to resolve open tax issues with the Internal Revenue Service and state authorities. The timing for resolving these open tax positions is subject to uncertainty, but it is reasonably possible that some portion of these open tax positions could be resolved in the next twelve months.

Note 5. Commitments and Contingencies

Termination of Lease Swap Agreement

In connection with the sale-leaseback transaction, EME Homer City had entered into a swap agreement with a bank in order to more effectively match its cash flow, which generally is higher during the summer months when energy prices are higher, with its lease payments. At December 31, 2006, EME Homer City had a net deposit balance due from the bank of \$45.4 million. On March 30, 2007, EME Homer City terminated the lease swap agreement and received a refund of the net deposit and the accrued interest totaling \$45.9 million.

Other Commitments

Capital Improvements

At September 30, 2007, EME Homer City had firm commitments to spend approximately \$3.9 million on capital expenditures during the remainder of 2007 primarily related to non-environmental improvements such as upgrades to boiler and turbine controls, and replacement of feedwater heater and superheater tubes. These capital expenditures are planned to be financed by cash generated from operations.

Fuel Supply Contracts

EME Homer City has entered into additional fuel purchase commitments with various third-party suppliers for purchase of coal during the first nine months of 2007. These additional commitments are currently estimated to be \$109.3 million in 2008, \$129.6 million in 2009, and \$9.5 million in 2010.

Other Contractual Obligations

EME Homer City has entered into additional contractual agreements for the purchase of limestone and anhydrous ammonia during the first nine months of 2007. The additional commitments are currently estimated to be \$3.6 million in 2008, \$5.1 million in 2009, \$7.0 million in 2010, and \$7.2 million in 2011.

Interconnection Agreement

EME Homer City's general partner, Mission Energy Westside, is a party to an interconnection agreement with NYSEG and Penelec to provide interconnection services necessary to interconnect the Homer City facilities with NYSEG's and Penelec's transmission systems. Unless terminated earlier in accordance with specified terms, the interconnection agreement will terminate on a date mutually agreed to by Mission Energy Westside, NYSEG and Penelec. This date will not exceed the retirement date of the Homer City units. NYSEG and Penelec have agreed to extend the interconnection services (but not the expiration of the agreement) to modifications, additions or upgrades to, or repowering of the Homer City units. Mission Energy Westside is required to compensate NYSEG and Penelec for all reasonable costs associated with any modifications, additions or replacements made to NYSEG's or Penelec's interconnection facilities or transmission systems in connection with any modification, addition or upgrade to, or repowering of the Homer City units.

Guarantees and Indemnities

Tax Indemnity Agreements

In connection with the sale-leaseback transaction related to the Homer City facilities, EME Homer City and its indirect parent, EME, entered into tax indemnity agreements. Under these tax indemnity agreements, EME Homer City and EME agreed to indemnify the equity investors in the sale-leaseback transaction for specified adverse tax consequences that could result in certain situations set forth in the tax indemnity agreements, including specified defaults under the respective leases. The potential indemnity obligation under these tax indemnity agreements could be significant. Due to the nature of the obligations under these tax indemnity agreements, EME Homer City cannot determine a maximum potential liability. The indemnities would be triggered by a valid claim from the lessors. EME Homer City has not recorded a liability related to these indemnities.

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. Payments would be triggered under this indemnity by a claim from the sellers. 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. EME Homer City has not recorded a liability related to this indemnity.

Contingencies

Ash Disposal Site

EME Homer City's ash disposal site is a permitted Class I Residual Waste Landfill, the most stringently regulated of the three categories of residual waste landfills authorized by the regulations of the PADEP. EME Homer City's permit allows it to dispose of coal combustion by-products, including fly ash, bottom ash and pyrites, and miscellaneous plant wastes at the landfill. The wastes are deposited in compacted layers within lifts, or sections. Each lift where coal ash is disposed must be capped and covered when it reaches final grade. EME Homer City must also monitor groundwater quality at and adjacent to the ash disposal site through a network of monitoring wells and report the results to the PADEP on a periodic basis. In the event that a disposal facility's groundwater monitoring identifies degradation in any of its wells, the PADEP's regulations require the facility to first confirm the existence and nature of the degradation by conducting a groundwater assessment. If the assessment

confirms groundwater degradation in excess of the applicable regulatory standards, the facility is then required to prepare and implement an abatement plan that could include measures such as installing a liner in a previously unlined area. To date, no degradation has been found in the groundwater monitoring system at EME Homer City that would require the development of an assessment or abatement plan. EME Homer City also provides financial assurance in the form of a surety bond to guarantee its closure and post-closure obligations at the landfill. The estimated closure date is 2018. Based on the remaining capacity of the landfill and the estimated material requiring future disposal, EME Homer City has begun permitting additional areas for expansion of the landfill. Management does not believe that the costs of maintaining and closing the ash disposal site will have a material impact on EME Homer City's financial statements.

Insurance

EME Homer City maintains insurance policies that are comparable to those carried by other electric generating facilities of a similar size. The insurance program includes all-risk real and personal property insurance, including coverage for losses from boiler and machinery breakdowns, and the perils of earthquake and flood, subject to certain sublimits. The property insurance program currently covers losses up to \$1.1 billion. Under the terms of the participation agreements entered into as part of EME Homer City's sale-leaseback transaction, EME Homer City is required to maintain specified minimum insurance coverages if and to the extent that such insurance is available on a commercially reasonable basis. Although the insurance covering the Homer City facilities is comparable to insurance coverages normally carried by companies engaged in similar businesses, and owning similar properties, the insurance coverages that are in place do not meet the minimum insurance coverages required under the participation agreements. Due to the current market environment, the minimum insurance coverage is not commercially available at reasonable prices. EME Homer City has obtained a waiver under the participation agreements which permits it to maintain its current insurance coverage through June 1, 2008.

EME Homer City also carries general liability insurance covering liabilities to third parties for bodily injury or property damage resulting from operations, automobile liability insurance and excess liability insurance. Limits and deductibles in respect of these insurance policies are consistent with the requirements of the participation agreements.

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 resulted in claims under EME Homer City's property and business interruption insurance policies. At September 30, 2007, EME Homer City had a \$15.8 million receivable recorded related to these claims, of which \$2.8 million was recorded during the third quarter of 2007 related to business interruption insurance coverage and has been reflected in interest and other income on EME Homer City's income statement.

FERC Notice Regarding Investigatory Proceeding against EMMT

In October 2006, EMMT was advised by the enforcement staff at the FERC that it is prepared to recommend that the FERC initiate a formal investigatory proceeding and seek monetary sanctions against EMMT for alleged violation of the Energy Policy Act of 2005 and the FERC's rules regarding market behavior, all with respect to certain bidding practices previously employed by EMMT. EMMT is engaged in discussions with the staff to explore the possibility of resolution of this matter. Discussions to date have been constructive and may lead to a settlement agreement acceptable to both parties. Should these discussions not result in a settlement and a formal proceeding commenced, EMMT will

be entitled to contest any alleged violations before the FERC and an appropriate court. EMMT has advised EME Homer City that EMMT believes that it has complied with all applicable laws and regulations and intends to contest vigorously any allegation of violation.

Environmental Matters and Regulations

The construction and operation of power plants are subject to environmental regulation by federal, state and local authorities. EME Homer City believes that it is in substantial compliance with existing environmental regulatory requirements. 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. If EME Homer City fails to comply with applicable environmental laws, it may be subject to injunctive relief or penalties and fines imposed by regulatory authorities.

Note 6. Supplemental Statements of Cash Flows Information

	Nine Months Ended September 30,	
	2007	2006
	(in thousands)	
Cash paid		
Interest	\$ 119,519	\$ 60,365
Income taxes	2,398	2,010
Non-cash investing and financing activities		
Non-cash settlement of intercompany tax liabilities through an increase in the subordinated revolving loan agreement	—	60,154

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This MD&A contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements reflect EME Homer City's current expectations and projections about future events based on EME Homer City'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 Homer City 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 Homer City, 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 Homer City's generating units have access;*
- the cost and availability of fuel and fuel transportation services;*
- market volatility and other market conditions that could increase EME Homer City's obligations to post collateral beyond the amounts currently expected, and the potential effect of such conditions on the ability of EME Homer City to provide sufficient collateral in support of its 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 Homer City or the electricity industry generally, including market structure rules;*
- environmental regulations that could require additional expenditures or otherwise affect EME Homer City's cost and manner of doing business;*
- the ability of EME Homer City to borrow funds and access capital markets on favorable terms;*
- 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 Homer City's generating facilities and/or increased access by competitors to EME Homer City's markets as a result of transmission upgrades;*
- the difficulty of predicting wholesale prices, transmission congestion, energy demand, and other aspects in the complex and volatile markets in which EME Homer City participates;*
- operating risks, including equipment failure, availability, heat rate, output and availability and cost of spare parts and repairs;*

- 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; and
- weather conditions, natural disasters and other unforeseen events.

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 Homer City’s Annual Report on Form 10-K for the year ended December 31, 2006. 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 Homer City’s business. Forward-looking statements speak only as of the date they are made, and EME Homer City is not obligated to publicly update or revise forward-looking statements. Readers should review future reports filed by EME Homer City with the Securities and Exchange Commission.

This MD&A discusses material changes in the results of operations, financial condition and other developments of EME Homer City since December 31, 2006, and as compared to the third quarter of 2006 and nine months ended September 30, 2006. This discussion presumes that the reader has read or has access to the MD&A included in Item 7 of EME Homer City’s annual report on Form 10-K for the year ended December 31, 2006.

This MD&A is presented in four sections:

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Management’s Overview; Critical Accounting Policies	15
Results of Operations	17
Liquidity and Capital Resources	20
Market Risk Exposures	26

MANAGEMENT’S OVERVIEW; CRITICAL ACCOUNTING POLICIES

Management’s Overview

Introduction

EME Homer City is a Pennsylvania limited partnership formed for the purpose of acquiring, owning and operating three coal-fired electric generating units and related facilities located near Pittsburgh, Pennsylvania with an aggregate capacity of 1,884 MW. EME Homer City does not have any plans to purchase or develop new power plants at this time. In December 2001, EME Homer City completed a sale-leaseback transaction of the Homer City facilities to third-party lessors. The sale-leaseback transaction is accounted for as a lease financing for financial reporting purposes.

The Homer City facilities are located in the control area managed by PJM. The energy and capacity from the Homer City facilities are sold under terms, including price and quantity, arranged by EMMT, on behalf of EME Homer City, to customers through a combination of bilateral agreements, forward energy sales and spot market sales. See “Market Risk Exposures” for further discussion of forward market prices.

Overview of EME Homer City's Operating Performance

EME Homer City had net income of \$28.6 million for the third quarter of 2007, compared to \$23.9 million for the third quarter of 2006, and net income of \$63.8 million for the first nine months of 2007, compared to \$20.1 million for the first nine months of 2006. The increases in earnings were primarily attributable to an increase in energy revenues from higher generation and average realized energy prices, and an increase in capacity revenues resulting from the PJM RPM auction. Earnings for 2007 were adversely affected due to the timing of unrealized gains and losses related to hedge contracts as described further in "Results of Operations—Operating Revenues." Partially offsetting the year-to-date increases were higher maintenance costs in 2007 related to the planned outage at Unit 2 and an estimated insurance recovery related to the Unit 3 outage of \$10.8 million recorded during the second quarter of 2006, compared to \$2.5 million recorded during the third quarter of 2007. The Unit 3 outage reduced the amount of generation during the nine months ended September 30, 2006.

PJM Reliability Pricing Model

During 2007, PJM completed capacity auctions under the PJM RPM for periods through May 31, 2010. EMMT participated in each auction which sold forward significant capacity at prices from \$40.80 per MW-day to \$191.32 per MW-day. The increase in capacity prices determined through the PJM RPM reflected the auction design to encourage increased capacity resources to meet projected demand. As a result of these auctions, capacity revenues are expected to increase significantly through May 31, 2010 as compared to the amounts realized previously. For further discussion regarding the PJM and recent auctions, see "Market Risk Exposures—Commodity Price Risk—Capacity Price Risk."

Critical Accounting Policies

For a discussion of EME Homer City's critical accounting policies, refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Estimates" of EME Homer City's annual report on Form 10-K for the year ended December 31, 2006.

RESULTS OF OPERATIONS

Summary

The table below summarizes revenues and key performance measures related to coal-fired generation, which represents the majority of EME Homer City's operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in millions)			
Operating Revenues	\$ 198.8	\$ 198.7	\$ 573.0	\$ 469.4
Statistics				
Generation (in GWh)	3,759	3,664	10,211	9,052
Aggregate plant performance				
Equivalent availability(1)	96.5%	91.9%	89.0%	79.4%
Capacity factor(2)	90.2%	87.9%	82.6%	73.2%
Load factor(3)	93.4%	95.6%	92.8%	92.1%
Forced outage rate(4)	3.5%	5.8%	3.7%	16.9%
Average realized energy price/MWh(5) .	\$ 51.48	\$ 48.04	\$ 54.42	\$ 48.26
Capacity revenue only (in millions) . . .	\$ 9	\$ 4	\$ 22	\$ 10
Average fuel costs/MWh	\$ 22.48	\$ 22.92	\$ 22.00	\$ 23.58

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

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

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

(4) Homer City refers to unplanned maintenance as a forced outage.

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

Operating Revenues

Operating revenues increased \$0.1 million and \$103.6 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. Energy revenues increased during the third quarter and nine months ended September 30, 2007 attributable to higher generation and average realized energy prices, and an increase in capacity revenues resulting from the PJM RPM auction, as compared to the corresponding periods of 2006. These increases were adversely affected by the timing of unrealized gains and losses from hedging activities, as described below. During the nine months ended September 30, 2006, an unplanned outage at Unit 3 contributed to lower generation and availability.

Included in operating revenues were unrealized gains (losses) from hedging activities of \$(3.2) million and \$17.3 million for the third quarters of 2007 and 2006, respectively, and \$(5.3) million and \$20.6 million for the nine months ended September 30, 2007 and 2006, respectively. Unrealized gains (losses) were primarily attributable to the ineffective portion of forward and futures contracts which are derivatives that qualify as cash flow hedges under SFAS No. 133. The ineffective portion of hedge

contracts was primarily attributable to changes in the difference between energy prices at PJM West Hub and the energy prices at the Homer City busbar. At September 30, 2007, unrealized losses of \$16.4 million were recognized primarily from the ineffective portion of cash flow hedges related to subsequent periods. See “Market Risk Exposures—Commodity Price Risk” for more information regarding forward market prices.

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. EME Homer City secured a replacement transformer and Unit 3 returned to service on May 5, 2006. The main transformer failure resulted in claims under EME Homer City’s property and business interruption insurance policies. At September 30, 2007, EME Homer City had a \$15.8 million receivable recorded related to these claims.

Seasonal Disclosure

Due to higher electric demand resulting from warmer weather during the summer months and cold weather during the winter months, electric revenues from the Homer City facilities vary substantially on a seasonal basis. In addition, maintenance outages generally are scheduled during periods of lower projected electric demand (spring and fall) further reducing generation and increasing major maintenance costs which are recorded as an expense when incurred. Accordingly, earnings from the Homer City facilities are seasonal and have significant variability from quarter to quarter. Seasonal fluctuations may also be affected by changes in market prices. See “Market Risk Exposures—Commodity Price Risk—Energy Price Risk” for further discussion regarding market prices.

Operating Expenses

Operating expenses decreased \$3.0 million and increased \$20.9 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. Operating expenses consisted of expenses for fuel, gain on sale of emission allowances, plant operations, depreciation and amortization, loss on disposal of assets, and administrative and general expenses. The change in the components of operating expenses is discussed below.

Fuel expenses increased \$0.5 million and \$11.1 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. The increases were primarily due to higher coal consumption as a result of higher generation, partially offset by lower coal prices. The cost of SO₂ allowances increased to \$10.9 million during the third quarter of 2007 from \$9.0 million during the third quarter of 2006, and decreased to \$22.6 million during the nine months ended September 30, 2007 from \$29.9 million during the nine months ended September 30, 2006. During 2007, EME Homer City purchased more SO₂ emission allowances at lower market prices, as compared to 2006. See “Market Risk Exposures—Commodity Price Risk—Emission Allowances Price Risk” for more information regarding the price of SO₂ emission allowances.

Gain on the sale of emission allowances was \$1.9 million during the nine months ended September 30, 2006. EME Homer City sold excess NO_x emission allowances to an affiliate during the first and third quarters of 2006. EME Homer City had no comparable results in the nine months ended September 30, 2007.

Plant operations decreased \$4.3 million and increased \$7.5 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. The third quarter decrease was primarily attributable to lower maintenance costs as compared to 2006,

as the EME Homer City units had very high equivalent availability factors in the third quarter of 2007. The year-to-date increase was primarily attributable to higher maintenance costs related to the planned outage at Unit 2 during the second quarter of 2007.

Other Income (Expense)

Interest and other income increased \$2.2 million and decreased \$10.3 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. The third quarter increase was primarily attributable to an additional \$2.5 million recorded related to the estimated insurance recovery from the Unit 3 outage in 2006. The year-to-date decrease was primarily attributable to the estimated insurance recovery of \$10.8 million related to the Unit 3 outage recorded during the second quarter of 2006.

Interest expense decreased \$2.8 million and \$2.9 million in the third quarter of 2007 and nine months ended September 30, 2007, respectively, compared to the corresponding periods of 2006. Interest expense primarily relates to the lease financing of the Homer City facilities that originated in December 2001. Interest expense also included interest of \$9.1 million and \$10.4 million in the third quarters of 2007 and 2006, respectively, and \$29.5 million and \$29.5 million in the nine months ended September 30, 2007 and 2006, respectively, on EME Homer City's subordinated revolving loan agreement with Edison Mission Finance.

Provision for Income Taxes

EME Homer City had effective income tax provision rates during the first nine months of 2007 and 2006 of 40.9% and 38.3%, respectively. EME Homer City's effective income tax provision rate varies from the federal statutory rate of 35% primarily due to state income taxes and estimated benefits from a federal deduction related to qualified domestic production activities under Section 199 of the Internal Revenue Code.

New Accounting Pronouncements

For a discussion of new accounting pronouncements affecting EME Homer City, see "EME Homer City Generation L.P. Notes to Financial Statements—Note 1. Summary of Significant Accounting Policies—New Accounting Pronouncements."

LIQUIDITY AND CAPITAL RESOURCES

Introduction

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

	<u>Page</u>
Cash Flow	20
Capital Expenditures and Lease Covenants	21
Distributions to EME	22
Credit Ratings	22
Contractual Obligations and Contingencies	23
Environmental Matters and Regulations	24

For a complete discussion of these issues, read this quarterly report on Form 10-Q in conjunction with EME Homer City's annual report on Form 10-K for the year ended December 31, 2006.

Cash Flow

At September 30, 2007, EME Homer City had cash and cash equivalents of \$157.0 million, compared to \$113.8 million at December 31, 2006. Net working capital at September 30, 2007 was \$8.4 million, compared to \$36.2 million at December 31, 2006. Net working capital decreased \$27.8 million primarily attributable to the refund of deposits under the lease swap agreement that terminated in 2007, a net increase in derivative liabilities, and an increase in interest payable. Partially offsetting the decrease was an increase in cash and cash equivalents, an increase in current deferred tax assets, an increase in inventory of SO₂ emission allowance credit, and a net decrease in interest and other payable to affiliate.

Net cash provided by operating activities increased \$7.0 million in the first nine months of 2007, compared to the corresponding period of 2006. The 2007 increase was primarily due to higher net income in 2007 and the timing of cash receipts and disbursement related to working capital items.

Net cash used in financing activities increased \$98.6 million in the first nine months of 2007, compared to the corresponding period of 2006. The 2007 increase was primarily attributable to total repayments of \$67.8 million in 2007, versus total borrowings of \$12.3 million in 2006, under the subordinated revolving loan agreement with Edison Mission Finance. In addition, EME Homer City received a payment of \$45.4 million from the termination of the lease swap agreement in 2007, compared to advances of \$61.1 million received under the lease swap agreement in 2006.

Net cash provided by investing activities increased \$1.7 million in the first nine months of 2007, compared to the corresponding period of 2006. The increase was primarily due to a release of funds from EME Homer City's restricted cash accounts in 2007 as compared to the 2006 proceeds received from the sale of emission allowances and from a settlement in connection with the 2002 outage of Unit 3.

The use of EME Homer City's cash generated from operations is restricted by the sale-leaseback agreements. EME Homer City believes that it will have adequate liquidity to meet its obligations as they become due in the next 12 months.

Capital Expenditures and Lease Covenants

At September 30, 2007, the estimated capital expenditures by EME Homer City for October through December 2007 and for 2008 and 2009 were as follows:

	October through December 2007	2008	2009
	(in millions)		
Plant capital expenditures	\$ 4.0	\$ 25.7	\$ 20.0
Environmental expenditures	1.3	9.5	14.7
Total	<u>\$ 5.3</u>	<u>\$ 35.2</u>	<u>\$ 34.7</u>

Plant capital expenditures relate to non-environmental projects such as upgrades to boiler and turbine controls, replacement of feedwater heater and superheater tubes, and an expansion of a coal cleaning plant refuse site. Environmental expenditures relate to projects such as low NO_x burners, mercury emission monitoring and control, selenium removal system, and SCR performance improvements. EME Homer City plans to finance these expenditures with cash on hand or cash generated from operations. See further discussion regarding possible additional capital expenditures, including environmental control equipment, under “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Environmental Matters and Regulations—Air Quality Regulation” of EME Homer City’s annual report on Form 10-K for the year ended December 31, 2006.

Under the participation agreements entered into as part of the sale-leaseback transaction, EME Homer City’s ability to enter into specified transactions and to engage in specified business activities, including financing and investment activities, is subject to significant restrictions. These restrictions could affect, and in some cases significantly limit or prohibit, its ability to, among other things, merge, consolidate or sell its assets, create liens on its properties or assets, enter into non-permitted trading activities, enter into transactions with its affiliates, incur indebtedness, create, incur, assume or suffer to exist guarantees or contingent obligations, make restricted payments to its partners, make capital expenditures, own subsidiaries, liquidate or dissolve, engage in non-permitted business activities, sublease its leasehold interests in the facilities or make improvements to the facilities. Accordingly, EME Homer City’s liquidity is substantially based on its ability to generate cash flow from operations. If EME Homer City is unable to generate cash flow from operations necessary to meet its obligations, EME Homer City will have limited ability to obtain additional capital on attractive terms and conditions, unless its partners provide additional funding, which they are under no legal obligation to do.

The rent payments that EME Homer City owes under the sale-leaseback agreements are comprised of two components, a senior rent portion and an equity rent portion. The senior rent is used exclusively for debt service to the holders of the senior secured bonds issued in connection with the sale-leaseback transaction, while the equity rent is paid to the owner-lessors. In order to pay the equity portion of the rent, EME Homer City is required to meet historical and projected senior rent service coverage ratios of 1.7 to 1 subject to reduction to 1.3 to 1 under circumstances specified in the participation agreements. During the 12 months ended September 30, 2007, the senior rent service coverage ratio was 2.81 to 1. The senior rent service coverage ratio is determined by dividing net cash flow as defined in the participation agreements by the senior rent due in that period. In addition, if EME Homer City does not meet specified debt service coverage ratios while the lease debt is outstanding, it will not pay the equity portion of the rent to the owner-lessors. Accordingly, the sale-leaseback documentation does not permit the lessor to terminate the lease in the event of non-payment of the equity portion of the rent while the lease debt is outstanding.

EME Homer City's use of cash in its bank accounts is limited to specific operating and capital expenditures as set forth in the security deposit agreement executed as part of the sale-leaseback transaction. The amount in certain reserve accounts will be available for payments due on the equity portion of lease rent during specified periods, and in accordance with the sale-leaseback documents, unless there is a default in the payment of the senior portion of lease rent, in which case the amount will be available to pay such senior portion of the lease rent. The release of funds from these restricted cash accounts is permitted, provided EME Homer City maintains specified reserve balances in accordance with the sale-leaseback documents, no event of default shall have occurred or be continuing and no two failed rent payments shall have occurred. EME Homer City had \$30 million included in restricted cash at September 30, 2007 related to these reserve accounts.

Distributions to EME

The following table summarizes the payments by EME Homer City under its subordinated revolving loan that constitute permitted distributions pursuant to the terms of the sale-leaseback transaction:

	Nine Months Ended September 30,	
	2007	2006(1)
	(in millions)	
Payment of interest	\$ 60.4	\$ —
Payment of principal	67.8	—
Total payments	<u>\$ 128.2</u>	<u>\$ —</u>

(1) In March 2006, EME made an equity contribution of \$8.8 million for working capital purposes. Subsequently, EME Homer City made a permitted distribution to EME of \$8.8 million through a payment of interest on the subordinated revolving loan.

Credit Ratings

EME Homer City is not currently rated. EME Homer City has entered into a contract with EMMT for the sale of energy and capacity from its facilities, which enables this marketing affiliate to engage in forward sales and hedging. The credit ratings for EME and EMMT, at September 30, 2007, were as follows:

	<u>Moody's Rating</u>	<u>S&P Rating</u>	<u>Fitch Rating</u>
EME	B1	BB-	BB-
EMMT	Not Rated	BB-	Not Rated

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

EME Homer City's 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 its facilities if EMMT does not have an investment grade credit rating from S&P 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 Homer City, which is not rated, currently sells all the output from its facilities through EMMT, which has a

below investment grade credit rating. Therefore, in order for EME Homer City to continue to sell forward the output of its facilities, either: (1) EME Homer City must obtain consent from the sale-leaseback owner participant to permit it 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 Homer City has obtained a consent from the sale-leaseback owner participant that will allow it to enter into such sales, under specified conditions, through December 31, 2008. EME Homer City continues to be in compliance with the terms of the consent. EME Homer City is permitted to sell the output of its facilities into the spot market at any time. See “Market Risk Exposures—Commodity Price Risk.”

Contractual Obligations and Contingencies

Capital Improvements

At September 30, 2007, EME Homer City had firm commitments to spend approximately \$3.9 million on capital expenditures during the remainder of 2007 primarily related to non-environmental improvements such as upgrades to boiler and turbine controls, and replacement of feedwater heater and superheater tubes. These capital expenditures are planned to be financed by cash generated from operations.

Fuel Supply Contracts

EME Homer City has entered into additional fuel purchase commitments with various third-party suppliers for purchase of coal during the first nine months of 2007. These additional commitments are currently estimated to be \$109.3 million in 2008, \$129.6 million in 2009, and \$9.5 million in 2010.

Other Contractual Obligations

EME Homer City has entered into additional contractual agreements for the purchase of limestone and anhydrous ammonia during the first nine months of 2007. The additional commitments are currently estimated to be \$3.6 million in 2008, \$5.1 million in 2009, \$7.0 million in 2010, and \$7.2 million in 2011.

Termination of Lease Swap Agreement

In connection with the sale-leaseback transaction, EME Homer City had entered into a swap agreement with a bank in order to more effectively match its cash flow, which generally is higher during the summer months when energy prices are higher, with its lease payments. At December 31, 2006, EME Homer City had a net deposit balance due from the bank of \$45.4 million. On March 30, 2007, EME Homer City terminated the lease swap agreement and received a refund of the net deposit and the accrued interest totaling \$45.9 million.

Contingencies

FERC Notice Regarding Investigatory Proceeding against EMMT

In October 2006, EMMT was advised by the enforcement staff at the FERC that it is prepared to recommend that the FERC initiate a formal investigatory proceeding and seek monetary sanctions against EMMT for alleged violation of the Energy Policy Act of 2005 and the FERC’s rules regarding market behavior, all with respect to certain bidding practices previously employed by EMMT. EMMT is engaged in discussions with the staff to explore the possibility of resolution of this matter. Discussions

to date have been constructive and may lead to a settlement agreement acceptable to both parties. Should these discussions not result in a settlement and a formal proceeding commenced, EMMT will be entitled to contest any alleged violations before the FERC and an appropriate court. EMMT has advised EME Homer City that EMMT believes that it has complied with all applicable laws and regulations and intends to contest vigorously any allegation of violation.

Environmental Matters and Regulations

For a discussion of EME Homer City'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 Homer City's annual report on Form 10-K for the year ended December 31, 2006 and the notes to the Financial Statements set forth therein. There have been no other significant developments with respect to environmental matters specifically affecting EME Homer City since the filing of its annual report, except as follows:

Air Quality Regulation

Clean Air Act

The Pennsylvania SIP for the Clean Air Mercury Rule is pending approval by the US EPA. It was published in the Federal Register on September 18, 2007 and the comment period ended on October 15, 2007. The SIP is expected to become effective in 2010. EME Homer City intends to comply with the rule using its existing scrubber at one of its units, supplemented by a combination of carbon injection and coal washing at the other two units.

The proposed Pennsylvania CAIR is expected to be approved by the Pennsylvania Environmental Quality Board in late 2007 and subsequently submitted to the US EPA for approval. EME Homer City will be subject to the Federal CAIR rule during 2009 and expects to be able to comply with the NO_x requirement using its existing SCR system. The Pennsylvania CAIR, including both NO_x and SO₂ limits, is expected to become effective in 2010, at which time EME Homer City expects to purchase SO₂ allowances.

Water Quality Regulation

Clean Water Act—Cooling Water Intake Structures

On July 9, 2007, the US EPA published in the Federal Register a notice immediately suspending the requirements for cooling water intake structures, pending further rulemaking. The US EPA is expected to begin another rulemaking process by the end of 2008. Although the rule to be generated in the new rulemaking process could have a material impact on EME Homer City's operations, its compliance criteria have not yet been finalized, and EME Homer City cannot reasonably determine the financial impact at this time.

Pennsylvania

EME Homer City and the PADEP have entered into a consent order and agreement related to selenium discharge, which was filed in Pennsylvania state court on July 17, 2007. Under the consent order and agreement, EME Homer City agreed to pay a civil penalty of \$200,000 and to install modifications to its wastewater system to achieve consistent compliance with discharge limits. Until the pilot programs have been completed and the treatment system design has been finalized, EME Homer City will be unable to estimate the costs for ongoing treatment.

Climate Change

On April 2, 2007, the United States Supreme Court issued an opinion in *Massachusetts et. al. v. Environmental Protection Agency, et. al.*, ruling that the US EPA has the authority to regulate greenhouse gas emissions of new motor vehicles under the Clean Air Act and that it has a duty to (i) determine whether greenhouse gas emissions of new motor vehicles contribute to climate change or (ii) offer a reasoned explanation for its failure to make such a determination when presented with a request for a rulemaking on the issue by the state claimants. The Court ruled that the US EPA's failure to make the necessary determination or offer a reasonable explanation for its refusal to do so was impermissible. While this case hinged on a provision of the Clean Air Act related to emissions of motor vehicles, a parallel provision of the Clean Air Act applies to stationary sources such as electric generators. The US EPA has recently announced that it plans to propose regulations to address carbon dioxide emissions as part of the Clean Air Act's New Source Review program. Even in the absence of federal regulation, states may begin to take into account carbon dioxide emissions when considering permits to construct or modify significant sources of such emissions. EME Homer City also believes that the Court's *Massachusetts* decision may spur additional congressional action to require reductions of greenhouse gas emissions by all material sources, including electric generators.

MARKET RISK EXPOSURES

Introduction

EME Homer City's primary market risk exposures arise from fluctuations in electricity, capacity and fuel prices, emission allowances and transmission rights. EME Homer City 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:

	<u>Page</u>
Commodity Price Risk	26
Accounting for Energy Contracts	32
Derivative Financial Instruments	32
Credit Risk	33
Interest Rate Risk	34
Regulatory Matters	34

For a complete discussion of these issues, read this quarterly report on Form 10-Q in conjunction with EME Homer City's annual report on Form 10-K for the year ended December 31, 2006.

Commodity Price Risk

Overview

EME Homer City's revenues and results of operations 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 PJM and in NYISO. Among the factors that influence future market prices for energy, capacity and ancillary services in PJM and NYISO are:

- prevailing market prices for coal, natural gas and fuel oil, and associated transportation;
- the cost and availability of emission credits or allowances;
- 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 the Homer City facilities and/or increased access by competitors to EME Homer City'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, and regulatory developments affecting, PJM and NYISO, including any price limitations and other mechanisms adopted to address volatility or illiquidity in these markets or the physical stability of the system;
- 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.

Introduction

EME Homer City sells all its energy and capacity into wholesale power markets through EMMT. EMMT enters into forward contracts for EME Homer City's electric output in order to provide more predictable earnings and cash flow. When appropriate, EMMT manages the spread between electric prices and fuel prices through the use of forward contracts, swaps, futures, or options contracts. There is no assurance that contracts to hedge changes in market prices will be effective.

EME Homer City's 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 Homer City's risk management policies through EMMT. 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 a 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 Homer City'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.

EMMT uses "value at risk" to identify, measure, monitor and control EME Homer City's overall market risk exposure. 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, EMMT 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 Homer City hedges a portion of its merchant portfolio risk through EMMT. To the extent that EME Homer City 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,
- forward sales transactions entered into on a bilateral basis with third parties, including electric utilities and power marketing companies, and
- participation in capacity auctions.

The extent to which EME Homer City hedges its market price risk depends on several factors. First, EME Homer City evaluates over-the-counter market prices to determine whether the types of

hedge transactions set forth above at forward market prices are sufficiently attractive compared to assuming the risk associated with fluctuating spot market sales. Second, EME Homer City's ability to enter into hedging transactions depends upon EMMT's credit capacity and upon the forward sales markets having sufficient liquidity to enable EME Homer City to identify appropriate counterparties for hedging transactions.

Energy Price Risk

All the energy and capacity from the Homer City facilities is sold under terms, including price and quantity, arranged by EMMT with customers through a combination of bilateral agreements (resulting from negotiations or from auctions), forward energy sales and spot market sales. 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 (EME Homer City's primary trading hub) during the first nine months of 2007 and 2006:

	Historical Energy Prices(1)			
	24-Hour PJM			
	Homer City		West Hub	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
January	\$ 40.30	\$ 48.67	\$ 44.63	\$ 54.57
February	64.27	49.54	73.93	56.39
March	55.00	53.26	61.02	58.30
April	52.42	48.50	58.74	49.92
May	48.12	44.71	53.89	48.55
June	45.88	38.78	60.19	45.78
July	48.23	53.68	58.89	63.47
August	55.44	58.60	71.00	76.57
September	48.90	33.26	60.14	34.40
Nine-Month Average	<u>\$ 50.95</u>	<u>\$ 47.67</u>	<u>\$ 60.27</u>	<u>\$ 54.22</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-ISO 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 September 30, 2007:

	24-Hour PJM West Hub Forward Energy Prices(1)
2007	
October	\$ 46.39
November	45.74
December	51.31
2008 Calendar “strip”(2)	\$ 61.71
2009 Calendar “strip”(2)	\$ 64.53

(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 EME Homer City’s hedge position at September 30, 2007:

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
MWh	1,912,375	7,232,000	3,889,600	1,022,400
Average price/MWh(1)	\$ 64.29	\$ 60.87	\$ 74.88	\$ 77.80

(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 September 30, 2007 is not directly comparable to the 24-hour PJM West Hub prices set forth above.

The average price/MWh for EME 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.

Capacity Price Risk

On June 1, 2007, PJM implemented the RPM for capacity. The purpose of the RPM is to provide a long-term pricing signal for capacity resources. The RPM allows PJM to satisfy the region’s need for generation capacity, which is then allocated among the load-serving entities through a locational reliability charge.

The first RPM auction took place in April 2007 and resulted in a fixed price for EME Homer City’s capacity sold into the auction (included in PJM as “rest of market” location) of \$40.80/MW per day for the period from June 1, 2007 through May 31, 2008. The second auction took place in July 2007 and resulted in a fixed price for EME Homer City’s capacity sold into the auction of \$111.92/MW per day for the period from June 1, 2008 through May 31, 2009. In October 2007, the third auction took place for the period from June 1, 2009 through May 31, 2010 and resulted in a fixed price for EME Homer City’s net capacity sold of 1,670 MW into the auction of \$191.32/MW per day. In the October 2007 auction, EME Homer City was segregated out of the “rest of market” location in PJM into MAAC+APS. A subsequent auction will be conducted in January 2008 to auction capacity for the period from June 1, 2010 through May 31, 2011.

Prior to the RPM auctions for the relevant delivery periods, EME Homer City sold a portion of its capacity to an unrelated third party for the delivery periods from June 1, 2007 through May 31, 2008 and June 1, 2008 through May 31, 2009. EME Homer City is not receiving the RPM auction clearing

price for this previously sold capacity. The price EME Homer City is receiving for these capacity sales is a function of NYISO capacity clearing prices resulting from separate NYISO capacity auctions.

The following table summarizes the status of capacity sales for EME Homer City at September 30, 2007:

	<u>October 1, 2007 to May 31, 2008</u>	<u>June 1, 2008 to May 31, 2009</u>
Fixed Price Capacity Sales		
MW	786	820
Price per MW-day	\$ 40.80	\$ 111.92
Variable Capacity Sales		
MW	885	891
Expected price per MW-day(1)	\$ 66.72	\$ 72.11

(1) Actual contract price is a function of NYISO capacity auction clearing prices. Expected price per MW-day is based on forward over-the-counter NYISO capacity prices on September 28, 2007.

Revenues from the sale of capacity from EME Homer City beyond the periods set forth above will depend upon the amount of capacity available and future market prices either in PJM or nearby markets if EME Homer City has an opportunity to capture a higher value associated with those markets. Under PJM’s RPM system, the market price for capacity is generally determined by aggregate market-based supply conditions and an administratively set aggregate demand curve. Among the factors influencing the supply of capacity in any particular market are plant forced outage rates, plant closings, plant delistings (due to plants being removed as capacity resources and/or to export capacity to other markets), capacity imports from other markets, and new entry.

Basis Risk

Sales made from the Homer City facilities in the real-time or day-ahead market receive the actual spot prices or day-ahead prices, as the case may be, at the Homer City busbar. In order to mitigate price risk from changes in spot prices at the Homer City busbar, EME Homer City 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 Homer City busbar does not exist. A liquid market does exist at the PJM West Hub. EME Homer City’s hedging activities use this settlement point to enter into hedging contracts. EME Homer City’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 Homer City busbar, plus,
- sales to third parties at the price under such hedging contracts at designated settlement points (generally the PJM West Hub) 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. Effective June 1, 2007, PJM implemented marginal losses which adjusts the algorithm that calculates locational marginal prices to include a component for marginal transmission losses in addition to the component included for congestion. 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 nine months ended September 30, 2007, transmission congestion in PJM has resulted in prices at the Homer City busbar being lower than those at the PJM West Hub by an average of 15%, compared to 12% during the nine months ended September 30, 2006. The monthly average difference during the twelve months ended September 30, 2007 ranged from 6% to 24%.

By entering into cash settled futures contracts and forward contracts using the PJM West Hub as the settlement point, EME Homer City is exposed to basis risk as described above. In order to mitigate basis risk, EME Homer City may purchase financial transmission rights and basis swaps in PJM for EME Homer City. 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 Homer City’s hedging activities include using financial transmission rights alone or in combination with forward contracts and basis swap contracts to manage basis risk.

Coal Price Risk

The Homer City facilities purchase coal primarily obtained from mines located near the facilities in Pennsylvania. Coal purchases are made under a variety of supply agreements extending through 2010. The following table summarizes the amount of coal under contract at September 30, 2007 for the remainder of 2007 and the following three years.

	<u>October through December 2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Amount of coal under contract in millions of tons(1)	1.4	4.4	3.5	0.2

(1) The amount of coal under contract in tons is calculated based on contracted tons and applying a 13,000 Btu equivalent.

EME Homer City is subject to price risk for purchases of coal that are not under contract. Prices of NAPP coal, which are related to the price of coal purchased for the Homer City facilities, increased during the first nine months of 2007 from 2006 year-end prices. The price of NAPP coal (with 13,000 Btu per pound heat content and <3.0 pounds of SO₂ per MMBtu sulfur content) increased to \$46.25 per ton at September 28, 2007 from \$43.00 per ton at December 15, 2006, as reported by the Energy Information Administration. The 2007 increase in the NAPP coal price was in line with normal market price volatility.

Emission Allowances Price Risk

The federal Acid Rain Program requires electric generating stations to hold SO₂ allowances, and Pennsylvania regulations implemented the federal NO_x SIP Call requirement. As part of the acquisition of the Homer City facilities, EME Homer City obtained the rights to the emission allowances that have been or are allocated to these facilities. EME Homer City 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. The average price of purchased SO₂ allowances decreased to \$521 per ton during the first nine months of 2007 from \$664 per ton during 2006. The price of SO₂ allowances, determined by obtaining broker quotes and information from other public sources, was \$558 per ton as of October 31, 2007.

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 Homer City’s annual report on Form 10-K for the year ended December 31, 2006.

Accounting for Energy Contracts

EME Homer City uses a number of energy contracts to manage exposure from changes in the price of electricity, including forward sales and purchases of physical power and forward price swaps which settle only on a financial basis (including futures contracts). EME Homer City follows SFAS No. 133, and under this Standard these energy contracts are generally defined as derivative financial instruments. Importantly, SFAS No. 133 requires changes in the fair value of each derivative financial instrument to be recognized in earnings at the end of each accounting period unless the instrument qualifies for hedge accounting under the terms of SFAS No. 133. For derivatives that do qualify for cash flow hedge accounting, changes in their fair value are recognized in other comprehensive income until the hedged item settles and is recognized in earnings. However, the ineffective portion of a derivative that qualifies for cash flow hedge accounting is recognized currently in earnings. For further discussion of derivative financial instruments, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Management’s Overview; Critical Accounting Estimates—Critical Accounting Estimates—Derivative Financial Instruments and Hedging Activities” of EME Homer City’s annual report on Form 10-K for the year ended December 31, 2006.

SFAS No. 133 affects the timing of income recognition, but has no effect on cash flow. To the extent that income varies under SFAS No. 133 from accrual accounting (i.e., revenue recognition based on settlement of transactions), EME Homer City records unrealized gains or losses. EME Homer City classifies unrealized gains and losses from energy contracts as part of operating revenues. The results of derivative activities are recorded as part of cash flow from operating activities in the statements of cash flows. The following table summarizes unrealized gains (losses) for the third quarters of 2007 and 2006 and nine months ended September 30, 2007 and 2006:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in millions)			
Non-qualifying hedges	\$ (1.3)	\$ (1.5)	\$ (0.1)	\$ 0.2
Ineffective portion of cash flow hedges	(1.9)	18.8	(5.2)	20.4
Total unrealized gains (losses)	<u>\$ (3.2)</u>	<u>\$ 17.3</u>	<u>\$ (5.3)</u>	<u>\$ 20.6</u>

Derivative Financial Instruments

The following table summarizes the fair values for outstanding financial instruments used for hedging activities. The decrease in fair value of electricity contracts at September 30, 2007 as compared to December 31, 2006 is attributable to an increase in the average market prices for power as compared to contracted prices at September 30, 2007, which is the valuation date.

	September 30, 2007	December 31, 2006
	(in thousands)	
Commodity price:		
Electricity contracts	<u>\$ 2,017</u>	<u>\$ 89,099</u>

In assessing the fair value of EME Homer City's derivative financial instruments, EMMT 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 Homer City's commodity derivative assets and liabilities as of September 30, 2007 (in thousands):

	<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>\$ 2,017</u>	<u>\$ (636)</u>	<u>\$ 2,653</u>	<u>\$ —</u>	<u>\$ —</u>

Credit Risk

In conducting EME Homer City's hedging activities, EMMT 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 Homer City 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 Homer City. Further, EME Homer City 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, EMMT 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. EMMT 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. EMMT also takes other appropriate steps to limit or lower credit exposure. Processes have also been established to determine and monitor the creditworthiness of counterparties. EMMT 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 EMMT'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.

In addition, coal for the Homer City facilities is purchased from suppliers under contracts which may be for multiple years. A number of the coal suppliers to the Homer City facilities do not currently have an investment grade credit rating and, accordingly, EME Homer City may have limited recourse to collect damages in the event of default by a supplier. EME Homer City 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 Homer City derives a significant source of its operating revenues from electric power sold into the PJM market by EMMT. Sales into PJM accounted for approximately 75% of EME Homer City's operating revenues for the nine months ended September 30, 2007. Moody's rates PJM's senior unsecured debt Aa3. PJM, an ISO 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. For the

nine months ended September 30, 2007, a second customer accounted for 11% of EME Homer City's operating revenues.

Interest Rate Risk

EME Homer City has mitigated the risk of interest rate fluctuations by obtaining fixed rate financing on its subordinated revolving loan with Edison Mission Finance. EME Homer City does not believe that interest rate fluctuations will have a material adverse effect on its financial position or results of operations.

Regulatory Matters

For a discussion of EME Homer City's regulatory matters, refer to "Item 1. Business—Regulatory Matters" of EME Homer City's annual report on Form 10-K for the year ended December 31, 2006. There have been no significant developments with respect to regulatory matters specifically affecting EME Homer City since the filing of EME Homer City's annual report on Form 10-K for the year ended December 31, 2006, except as follows:

On December 22, 2006, the FERC issued an order conditionally approving the RPM settlement subject to PJM making certain compliance filings. The compliance filings were made by PJM on January 22, 2007 and February 20, 2007, and accepted by the FERC on June 25, 2007 and July 11, 2007, respectively. On June 1, 2007, PJM implemented marginal losses for transmission for its competitive wholesale electric market. For further discussion regarding the RPM and recent auctions, see "—Commodity Price Risk—Capacity Price Risk." EME Homer City is still evaluating the impact that marginal loss pricing in PJM will have on its results of operations, but continues to believe that it may reduce locational marginal prices for the Homer City facilities relative to the locational marginal prices for the benchmark location of Western Hub.

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 Homer City's annual report on Form 10-K for the year ended December 31, 2006. 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 Homer City's management, under the supervision and with the participation of the partnership's principal executive officer and principal financial officer, has evaluated the effectiveness of EME Homer City'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 principal executive officer and principal financial officer have concluded that, as of the end of the period, EME Homer City's disclosure controls and procedures are effective.

Changes in Internal Control Over Financial Reporting

There were changes as described below in EME Homer City's internal control over financial reporting (as that 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 Homer City's internal control over financial reporting.

During the third quarter of 2007, EME Homer City implemented a series of SAP ERP modules, including a new general ledger and chart of accounts and new consolidation, reporting, and accounts payable. In addition, procurement and materials management systems were implemented for the Homer City facilities. EME Homer City's human resources module will be implemented in 2008 as part of Edison International's ERP implementation. The introduction of these ERP modules and the related workflow capabilities resulted in changes to EME Homer City's financial reporting controls and procedures, with such changes identified during the implementation of the ERP modules. Therefore, as appropriate, EME Homer City is modifying the design and documentation of internal control process and procedures relating to the new system to supplement and complement existing internal controls over financial reporting. The system changes were undertaken to integrate systems and consolidate information, and were not undertaken in response to any actual or perceived deficiencies in EME Homer City's internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

No material legal proceedings are presently pending against EME Homer City.

ITEM 1A. RISK FACTORS

For a discussion of the risks, uncertainties, and other important factors which could materially affect EME Homer City's business, financial condition, or future results, refer to "Item 1A. Risk Factors" of EME Homer City's annual report on Form 10-K for the year ended December 31, 2006. The risks described in EME Homer City's annual report on Form 10-K are not the only risks facing EME Homer City. Additional risks and uncertainties that are not currently known, or that are currently deemed to be immaterial, also may materially adversely affect EME Homer City'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.

